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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.*

*Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**IFRIC meeting: May 2006, London**

**Project: Upfront revenue recognition by a Fund Manager  
(Agenda Paper 10(ii))**

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### **INTRODUCTION**

1. Over the past three months, the IFRIC has received three requests for an interpretation of how IAS 18 should be applied to the recognition of revenue arising upon the initial sale of mutual fund units by a Fund Manager.
2. Divergent views exist as to whether IAS 18 requires this revenue to be recognised immediately upon receipt or to be deferred in the balance sheet and amortised over the investment period.

### **RELEVANT GUIDANCE**

3. The staff believe that there are two potential models which would allow recognition of revenue upfront :
  - a. Under paragraph 13 of IAS 18, “in certain circumstances it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.” Therefore, if there is a separately identifiable service which is provided at the inception of the investment, it is correct to recognise revenue upfront in respect of this service.

- b. If there are no separately identifiable components, then revenue (encompassing both the upfront fee and the monthly management charge) should be recognised by reference to the stage of completion of the transaction. In this case, assuming that the conditions in paragraph 20 of IAS 18 are met, revenue should be recognised to the extent services have been performed upfront.
4. The common feature of both of these models is that revenue is recognised in the accounting periods in which the services are rendered. Therefore, for revenue to be recognised upfront, it is first necessary to demonstrate that a service has been provided upfront.
5. Whilst IAS 18 paragraph 24 does allow the use of costs to estimate the stage of completion of a transaction, this is only used where it “reliably measures the services performed”. The only costs that are used in this computation are costs reflecting “services performed or to be performed”. Costs incurred for reasons other than the provision of services (for example upfront advertising costs) are not included in this calculation and do not give rise to the recognition of revenue.
6. The fact that costs are incurred upfront is not necessarily evidence that services have been performed upfront and does not in itself trigger the recognition of revenue.

#### **IDENTIFICATION OF AN UPFRONT SERVICE**

7. Supporters of the upfront recognition of revenue argue that the fund manager does perform services upfront and that the upfront payment represents a payment at fair value for these services. They argue that these upfront services are different to the ongoing management services and include :
  - Creating the units for investors to invest in (units are created in a fund in response to investor demand);
  - preparing and providing general information on the fund and analysis of its performance;
  - providing specific information and advice relating to the client’s investment and an operation guide (e.g. how to subscribe, withdraw, receive distributions);

- performing control and regulatory checks, such as client identification and the source of funds, to comply with anti-money laundering regulations;
- performing the administrative work for the sale transaction and updating the accounting records;
- informing the client about the risks of the product;
- registering individuals and their details on the unit holder register; and
- where the investor has invested through a third party distribution agent, paying the commission to the agent.

9. Opponents of the upfront recognition of revenue argue that the contractually agreed service provided by the fund manager to the investor is a management service. It does not include upfront ‘advisory and/or brokerage services’ for the following reasons:

- The ‘services’ above are in the main not provided for the investor. For example, the fact sheets and operation guide are prepared to meet regulatory requirements and for marketing efforts. The control and regulatory checks on the investor are also requirements imposed on the fund manager and not services provided to the investor.
- Many of the services are available to all potential investors, who may or may not invest in the fund and who may or may not pay an upfront fee. It is not necessary for a potential investor to invest in the fund to receive advice on the product. This advice therefore takes the form of advertising, marketing, and raising product awareness rather than being a service which is provided to the investor.
- A broker acts as an intermediary between investors and a fund. The initial commission charged by a broker is not for a continuing involvement with either party after the transaction has taken place. A Fund Manager, on the other hand, sets up and sells its own managed funds with the purpose of generating future revenue from the provision of investment management services. The Fund

Manager will have continuing involvement with the fund and, through the fund, with the investors. The service that is provided by the Fund Manager is an ongoing, through life service as opposed to the upfront service provided by a broker.

- Only a third party intermediary can act as a broker. By selling fund units, a broker is acting as a salesman and is providing the Fund Manager with the service of selling the Fund Manager's product. Introducing clients to itself or marketing its own services is not a service to the clients and is not a revenue generating activity.

#### **STAFF ANALYSIS**

10. As discussed above, in order for the fund manager to recognise revenue upfront, it is first necessary to demonstrate that it provides services to its customer upfront. These services may take the form of separately identifiable services or be part of a single through life "investment management service" which can be shown to have been provided upfront.
11. Whilst there is no doubt that the fund manager incurs costs at inception, this is not a sufficient trigger to recognise revenue unless those costs relate to services provided to the customer.
12. Many of the activities described above as being carried out at inception by the fund manager (for example preparing and providing general information) are available to all potential investors to inform them about the products, their key features and potential risks. As such, many of these items take a form similar to advertising and marketing and are not services provided to the customer.
13. [Paragraph not reproduced for the Observer Notes]
14. [Paragraph not reproduced for the Observer Notes]
15. However, the staff does consider that certain of the upfront activities of the fund manager may be regarded as services which are provided to the customer. For example, the staff considers that, in certain instances, some

of the services provided at inception may take the form of providing investment advice to the customer as a service to them. Similarly, creating the initial investment and registering the investor with the fund may be regarded as a 'brokerage' service to the customer.

### ***Conclusion***

16. The staff concludes that whilst there is evidence that there are, in certain instances, services provided up front by the fund manager, not all activities carried out by the fund manager at inception are in relation to services provided to the customer. [Sentence not reproduced for the Observer Notes]

17. [Paragraph not reproduced for the Observer Notes]

### ***Example 1***

18. [Paragraph not reproduced for the Observer Notes]

19. [Paragraph not reproduced for the Observer Notes]

20. [Paragraph not reproduced for the Observer Notes]

21. [Paragraph not reproduced for the Observer Notes]

### ***Other considerations***

22. An example could be envisaged where the fund manager received no upfront fee, but did provide an upfront service. In this situation, recognition of revenue in line with the provision of services may result in the recognition of revenue before the fees are paid or become payable. The staff do not believe that this would be appropriate since the investor can cancel the investment at any time and so the receipt of the fees in respect of this service cannot be regarded as probable (in accordance with paragraph 20a of IAS 18).

23. If the proportion of the services which are provided upfront cannot be reliably measured, then the staff believe that the recognition of the fee on a straight line basis over the expected period of the investment would be appropriate (in line with IAS 18 paragraph 25).

#### **OTHER GUIDANCE**

24. The staff considered whether further guidance exists in respect of how upfront fees should be accounted for. In particular, the staff considered the specific examples given in the appendix to IAS 18 relating to the rendering of services (including but not limited to the examples quoted in the original submissions to the IFRIC).

#### *Paragraph 14b (iii) Investment management fees*

25. Paragraph 14b of the appendix discusses fees earned as services are provided. Example (iii) discusses investment management fees and states that “fees charged for managing investments are recognised as revenue as the services are provided”.

26. The example discusses the treatment of costs associated with investment management. In respect of upfront costs, it states that “the provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services” and “incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered.”

27. As discussed above, incurring costs is not in itself a sufficient trigger for the recognition of revenue. However, in making a distinction between “transaction costs relating to the origination of the financial instrument” and “costs of securing an investment management contract” the example could be taken to imply that the upfront activities of the fund manager can be split between transaction costs incurred providing services to the customer and costs of securing a contract incurred in advertising and marketing the fund for the fund manager. Furthermore, if revenue is

recognised on the same basis as the costs in the example, then capitalising certain of the upfront costs and amortising them in line with the recognition of revenue could be taken to imply that not all of the upfront fee should be recognised as revenue upfront.

28. The staff notes however that the example is not clear in making the distinction between upfront services to the customer and upfront costs of securing the contract. It is also focussed on the treatment of differing costs rather than on identifying services which will trigger the recognition of revenue.
29. The staff concludes that, whilst paragraph 14b (iii) of the appendix is clear in requiring revenue to be recognised as services are provided, it does not give clear guidance as to the type of upfront activities which constitute services provided as opposed to other fund manager activities. The example does not therefore give clear guidance on how IAS 18 should be interpreted in relation to upfront mutual fund fees.

*Paragraph 17 Initiation, entrance and membership fees*

30. Paragraph 17 of the appendix refers to initiation, entrance and membership fees. The example states that “revenue recognition depends on the nature of the services provided. If the fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognised as revenue when no significant uncertainty as to its collectibility exists.”
31. The example of initial membership fees which are recognised upfront shares a number of common features with upfront management fees. Both are paid up front, neither is refundable, and in both cases, the ‘member’ subsequently pays an ongoing monthly charge.
32. Whilst paragraph 17 states that revenue recognition depends on the nature of services provided, it also states that if there is a separate annual subscription, the revenue from initial membership fees is recognised when

there is no longer uncertainty as to collectibility. The example therefore implies that the existence of a monthly management charge is sufficient to trigger the recognition of the upfront fee as revenue.

33. This treatment would be inconsistent with the spirit of paragraph 14 b (iii), which implies that not all of the upfront fee would be recognised as revenue upfront. Furthermore, it could be argued that in the case of upfront investment management fees, this approach does not match the recognition of revenue with the performance of services as is required by IAS 18.

34. The staff notes that upfront fund management fees more closely resemble the “investment management fees” discussed in paragraph 14b (iii) of the appendix than the “initiation, entrance and membership fees” discussed in paragraph 17. The staff believes that, the guidance in paragraph 14b should therefore take precedence.

*Paragraph 13 Insurance agency commissions*

35. Paragraph 13 of the appendix considers insurance agency commissions receivable and states that where an insurance agent is “required to render further services during the life of the policy, the commission, or part thereof, is deferred and recognised over the period during which the policy is in force.” The staff believes that this example is consistent with the above analysis, in requiring the deferral of some or all of the upfront fee where it relates to future services. However, this does not provide guidance as to which activities that occur upfront should be treated as services or how the revenue in respect of those items should be measured.

*Paragraph 14 ( c ) Fees that are earned on the execution of a significant act*

36. Example 14 (c) of the appendix refers to fees that are received on completion of a significant act. In each of the three examples under this heading, the ‘significant act’ represents the culmination of the service activity provided by the entity. They therefore differ fundamentally from

the example of mutual funds since in the case of shares there is no ongoing involvement by the seller subsequent to the initial allotment.

***Conclusion***

37. Paragraph omitted.

**CONSIDERATION OF WHETHER THE ISSUE SHOULD BE TAKEN ONTO THE IFRIC AGENDA**

***Significantly divergent interpretations***

38. Certain investment management companies have interpreted IAS 18 as requiring them to recognise upfront fees on a straight line basis over the average holding period of its investments. This is consistent with guidance issued by at least one large accountancy firm.
39. In contrast, the requests received by IFRIC include examples where initial fees are being recognised as received or as receivable (for example in Germany). They also state that the industry is united in its view that initial fees receivable should be recognised upfront.
40. The staff believe that the above examples demonstrate that significantly divergent interpretations currently exist in practice.

***Widespread and practical relevance***

41. Based on the analysis presented, the issue is applicable to funds established across Europe, the USA and the rest of the world, with a total value in the region of €14 trillion.
42. The staff believe that the applicability of the issue to a significant global industry means that the issue has widespread relevance. Furthermore, any guidance that is issued by the IFRIC which clarifies the upfront activities which can be treated as services and for which revenue may be recognised is likely to be of immediate practical relevance to these companies in preparing their financial statements.

***Relationship with an existing Board project***

43. Whilst the Board revenue project is re-visiting the accounting for revenue, it is unlikely to be completed in the near future.

***Likelihood of resulting in a consensus view of the IFRIC on a timely basis***

44. Although divergent interpretations exist, there is no reason why the IFRIC should not be able to reach a consensus on the issue.
45. Without the issuance of further guidance on the subject, it is likely that divergent interpretations will continue to exist at least until the Board revenue project is completed. The timely intervention of IFRIC will therefore increase comparability of accounts in the immediate term.

***Conclusion and recommendation***

46. As discussed above, the issue does have widespread and practical relevance, involves significantly divergent interpretations, and is unrelated to a Board project that is likely to be completed in the near future. The staff believes the IFRIC should be able to reach a consensus on the issue in the near future. The issue therefore meets the criteria for acceptance onto the IFRIC agenda.
47. Paragraph omitted.
48. Therefore the staff recommends that the issue be accepted onto the IFRIC agenda.
49. In contemplating this issue, the staff considered the guidance in paragraph 17 of the Appendix to IAS 18, “initiation, entrance, and membership fees”. [Sentence not reproduced for the Observer Notes] The staff asks the IFRIC to consider whether an Interpretation should only address the relatively self-contained industry issue discussed in this paper, or whether it should also address the more general question of when ‘upfront’ non-refundable fees should be recognised as revenue.