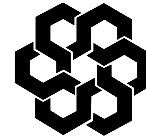

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **2 November 2006, London**

Project: **Recognition of revenue in respect of upfront fees (Agenda Paper 4)**

INTRODUCTION

1. At its September meeting, the IFRIC considered how revenue in respect of initial fees received by a fund manager should be accounted for.

2. At that meeting, the IFRIC agreed that:

   - upfront investment advice constitutes a valuable service to a customer and triggers the recognition of revenue in situations where the investment advice has to be paid for regardless of whether the investor acts upon that advice;
   - upfront investment advice which is provided under an arrangement whereby the investor only pays for the advice if the advice is acted upon is not a service which triggers the recognition of revenue; and
   - brokerage and other start up and set up activities are services to the investor, but the benefits of these services are received by the customer over the life of the investment. These services trigger the recognition of revenue under

IAS 18, however, from a customer perspective the benefits of those services are received over the life of the investment. Revenue arising from the provision of these services should therefore be recognised over the life of the investment.

3. This paper serves three main purposes. Firstly it considers the decisions made at the September IFRIC meeting and attempts to develop general guidance based on those decisions. Secondly it builds upon the discussions taken at the September meeting and considers the remaining decisions which need to be made in order to develop a model for the recognition of revenue in respect of upfront fees. Thirdly it considers a number of related issues which need to be concluded on to develop an Interpretation (for example the scope and transitional arrangements).

4. The decisions requested by the staff in this paper can be summarised as follows:

   i. Does the IFRIC agree that the draft guidance which the staff has developed in respect of upfront investment advice correctly reflects the decisions reached by the IFRIC at its September meeting?

   ii. A credit balance arises in the balance sheet as a result of the deferred recognition of revenue. What does the IFRIC believe that this credit balance represents?

   iii. In September, the IFRIC decided that upfront brokerage and setup services do not trigger the upfront recognition of revenue. How can this principle be developed into interpretive guidance?

   iv. How should deferred revenue in respect of upfront fees be apportioned to different accounting periods?

   v. Does the IFRIC agree with the staffs proposed scope for the Interpretation?

   vi. Does the IFRIC consider that any specific transitional arrangements should be developed for the Interpretation?

   vii. A fund manager receives its upfront fee from an investor and its ongoing fee from a fund. Under what circumstances should transactions with different counterparties be considered together for the purpose of applying IAS 18?

viii. Does the IFRIC consider that the examples in IAS 18 should be amended to reflect the proposed Interpretation?

TREATMENT OF UPFRONT INVESTMENT ADVICE

5. At its September meeting, the IFRIC agreed that upfront investment advice given by a fund manager is a service to the customer (and gives rise to the recognition of revenue) if the advice has to be paid for even if it is not acted upon. The IFRIC also agreed that, in situations where payment for investment advice is only required if the advice is acted upon, the investment advice is not a service which gives rise to the recognition of revenue.

6. The staff has produced a draft wording for an Interpretation which attempts to codify the principles behind the IFRIC's decision. This draft wording is set out below :

"*If an entity undertakes activities on behalf of a customer either:*

(a) before a binding arrangement exists requiring the customer to pay for those activities; or

(b) under a binding arrangement which provides that the customer does not have to pay for those activities unless the customer commits to receive additional goods and services,

those activities do not trigger the recognition of revenue even when the commitment to buy additional goods or services is entered into by the customer.

If an entity provides a customer with services under an arrangement whereby:

- *the entity will receive a payment for the services provided regardless of future events; and*
- *the entity will receive an additional payment if the customer commits to receive additional goods or services;*

the services provided trigger the recognition of revenue but only to the extent of the guaranteed payment. The customer's commitment to purchase the

additional goods or services does not trigger the recognition of the contingent payment as revenue."

7. The first paragraph of this draft guidance details the staffs understanding of the principles underlying the IFRIC's decision that upfront investment advice is not a service giving rise to the recognition of revenue unless the investor has to pay regardless of whether it acts on the advice or not. The staff notes the following features of this paragraph:

    i. The paragraph refers to a binding arrangement to pay. The staff considered whether a formal written contract was required in a selling arrangement but rejected this since, in many situations, a verbal contract, or implied contract gives rise to the same rights and obligations as a written contract.

    ii. The staff considered that two different types of contingent arrangements may exist. In the first, the payment of the contingent fee is dependent either on the future performance of the seller (for example, a consulting firm may be paid a bonus if its recommendations result in savings in excess of $1m) or on some external indicator (for example, an additional $1m is payable if oil prices average above $80 per barrel over a 12 month period). In the second, the contingent fee is only payable if a contract for further services between the two entities is entered into. The staff understands that it is only the second example that the IFRIC believes is not a valuable service and does not trigger the recognition of revenue.

8. In the second paragraph the staff has included guidance in respect of fee arrangements which are partly fixed and partly contingent on the purchasing entity entering into a commitment to acquire further goods or services.

DEFERRED REVENUE CREDIT

9. The staff notes that, the deferral of an upfront fee will result in entities recognising a credit balance in their balance sheet.

10. Supporters of the view that the initial fee received by fund managers should be recognised as revenue upfront note that, after the receipt of this upfront fee, fund managers have no further obligation to provide services related to this fee

and will never be required to repay this amount (even if the investor leaves the fund immediately).

11. The staff has reviewed publicly available documents in respect of one fund which support this view. In the case of the fund reviewed, the fund manager discloses charges related to one of its actively managed funds on its website. The initial fee for the fund is 5% but it is discounted to 2.5% if an investor buys online. Ongoing fees are 1.5% with 0.08% additional charges for other expenses (including auditors, trustees, custodian and regulator fees). The fund manager states that :

    Due to a restructure within our investment management operation we are, on a temporary basis, changing the way the actively managed fund is managed. The fund will continue to meet its objective but will invest in a greater number of shares, with less active fund management, in line with our Tracker Fund. The annual management charge for this fund will be reduced from 1.50% to 0.75% from 1 October 2006 to 31 March 2007.[1]

12. The index-tracking fund has no upfront fee, a 0.75% ongoing fee and a 0.08% additional charge for other expenses (including include auditors, trustees, custodian and regulator fees).

13. In this example, the reduction in the ongoing services provided to the fund has not resulted in a refund of the upfront fee. Instead the reduction in services results in a reduction in the ongoing fee.

14. Given that the fund manager will never have an obligation to repay the upfront fee, and that it is not required to provide any future services in respect of that fee, it could be argued that the credit on the balance sheet does not meet the definition of a liability.

15. Paragraph 95 of the Framework states that "the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities." Supporters of the upfront recognition of revenue would argue that paragraph 95 of the Framework therefore precludes the recognition of deferred revenue in the

[1] The wording for this extract is derived from a fund manager's website but has been edited to preserve the fund manager's anonymity. Other than changes to preserve anonymity, the extract is a direct quote from publicly available documents.

balance sheet in situations where the resulting credit does not meet the definition of a liability.

16. Supporters of the deferred recognition of upfront fees note that, under IAS 18, revenue is recognised in line with the provision of services. This may result in deferred balances arising on the balance sheet representing amounts received in advance of the recognition of revenue.

17. In the case of a fund manager, if it is agreed that the upfront fee does not all relate to upfront services, then some must relate to ongoing services. If this is the case, then the credit in the balance sheet represents fees received in respect of services which have not yet been provided. The credit in the balance sheet could therefore be regarded as relating to a constructive 'obligation' to provide services which have been paid for but not provided.

18. The staff considers that, if the IFRIC concludes that some or all of the upfront fee should be deferred, then the justification for the credit which arises on the balance sheet should be based on the above.

THE CUSTOMER PERSPECTIVE

19. At its September 2006 meeting, the IFRIC agreed that, where a fund manager undertakes brokerage and other upfront activities after a binding contract has been entered into, these qualify as services to the customer but, since the customer only receives the benefit of these services over the life of the investment, revenue should be recognised in respect of these services over the life of the investment.

20. The IFRIC concluded that the recognition of revenue should be based on the customer's perspective of when the benefit of the services is received not the supplier's perspective of when the services are delivered.

21. The staff has set out below draft guidance which could be developed reflecting this approach to revenue recognition.

> *Services provided by an entity upfront trigger the recognition of revenue at the point at which the benefit of the service is received by the customer. For example, in the case of a fund manager, the benefits of setting up the investment, brokerage, and set up activities are only received by the*

investor over the life of the investment. In this situation, a fund manager should recognise revenue in respect of these services over the period in which the benefits of the services are received by the customer, not at the point at which the services are provided.

22. The staff has further considered this approach and has identified a number of potential issues which may arise if it is adopted.

23. The staff considered the example of an entity offering painting, decorating, and office maintenance services. The entity contracts with a customer to refurbish and redecorate a customer's office for which it receives a fee of CU100,000. The entity also enters into a contract to provide maintenance services related to the refurbishment. Under this contract, the entity agrees to undertake certain minor repairs as required (in accordance with a schedule of permitted minor repairs) for which it receives a fee of CU20,000 per annum. The customer may terminate this ongoing maintenance contract at any time.

24. The staff considers that, in this situation, the entity receives a one-off, non-refundable upfront fee followed by regular ongoing fees. This situation is therefore likely to fall within the scope of the draft Interpretation.

25. If revenue is recognised in respect of the upfront fee in the periods in which the customer receives the benefits of the upfront service then the staff believes that, revenue should be deferred in respect of the initial refurbishment and recognised over the period in which the customer receives the benefit of those services. Revenue in respect of the initial refurbishment will therefore be recognised over the useful life of the refurbishment.

26. In this example, significant services are clearly provided upfront although the customer will only benefit from them over a period of time.

27. The staff therefore believes that basing an Interpretation on 'the customers perspective' or 'when the customer receives the benefit of services' may have implications for the recognition of revenue in a wide range of situations where a service is provided which has enduring benefit to a customer.

28. Furthermore, the staff considers that IAS 18 does not require the use of the 'customer perspective'. IAS18.21 states that "revenue is recognised in the

accounting periods in which the services are rendered" not "the accounting periods in which the customer receives the benefit of the services."

29. The staff concludes that an Interpretation based on a 'customer perspective model' is likely to result in significant changes to the recognition of revenue in a wide range of situations which are not necessarily required by IAS 18.

30. To avoid these issues, the staff considers that the IFRIC could pursue an Interpretation which considers whether the services are interlinked in such a way that it would not be possible for the entity to divide them and consider them separately. Alternatively, the IFRIC may conclude that revenue should be recognised at the point at which the selling entity undertakes the services.

31. If the IFRIC considers that the Upfront service is so intertwined with the ongoing service that it cannot be considered separately, then the IFRIC may wish to consider :

    - whether the customer could enter into the ongoing service contract without first entering into the upfront service agreement;
    - whether the customer would enter into the upfront service arrangement if there was no ongoing service arrangement.

32. In the decorating and maintenance example discussed above, the staff considers that the customer could enter into a building maintenance contract without entering into an initial contract to refurbish the offices.

33. Similarly, an entity may enter into a contract to refurbish and redecorate its offices without entering into a contract to maintain them.

34. In the example of a fund manager, an investor can not receive the ongoing services without first receiving the upfront set-up and brokerage services. Similarly, a rational investor would not invest in a fund unless the ongoing fund management service existed. The IFRIC may therefore be able to conclude that the two services are so intertwined that the entity should recognise the revenue associated with both services over the period across which the services as a whole are delivered.

35. Guidance developed in this way might read :

If an entity enters into an arrangement to provide an upfront service followed by an ongoing service and :

- *The customer could not receive the ongoing service if it did not first receive the upfront service; and*
- *A rational customer would not acquire the upfront service if the benefit of the ongoing service did not exist*

the entity shall recognise the revenue associated with the upfront service over the period in which the customer benefits from the ongoing services.

36. The staff considers that the potential pitfall with this approach is that it may result in many of the contracts which are considered together under IAS18.13 having revenue spread over the life of the combined contracts.

37. Additionally this approach ignores the fact that, in a lot of long term service contracts, the service is not provided evenly over the course of the contract.

38. The staff therefore considers that, where identifiable upfront services exist, revenue should be recognised upfront in respect of those services. The staff's proposed methodology for measuring this revenue is discussed in the following section.

HOW SHOULD REVENUE IN RESPECT OF UPFRONT FEES BE RECOGNISED?

39. The staff considers that there are a number of models which could be used to defer recognition of some or all revenue in respect of upfront fees. These include :

    - Deferral and recognition on a straight line basis over the contract period.
    - Deferral and recognition based on the costs of services provided in the period as a proportion of total contract costs.
    - Deferral and recognition in a manner which gives a constant rate of return for the seller.
    - Deferral and recognition based upon the fair value of goods and services provided.

40. The staff notes that the above models may involve varying degrees of complexity and may or may not be possible in differing situations. Deferral and recognition on a straight line basis over the contract period represents the simplest model to apply, but does not take into account the timing of the delivery of services which may not arise evenly over the course of the contract. In contrast, recognition based on the fair value of the services provided will take into account the timing of the delivery of the services, but may not be measurable in all situations.

41. IAS18.9 states that "revenue shall be measured at the fair value of the consideration received or receivable."

42. IAS 18.20 states that "When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date."

43. IAS 18.24 states that "The stage of completion of a transaction may be determined by a variety of methods….Depending on the nature of the transaction, the methods may include:

    (a) surveys of work performed;

    (b) services performed to date as a percentage of total services to be performed; or

    (c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction."

44. IAS 18.25 states that "For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion."

45. The staff considers that a hierarchy for the measurement of revenue in relation to upfront fees can be developed from the above guidance as follows :

- To the extent that an entity performs upfront services which can be separately measured at fair value, revenue should first be measured at fair value in respect of those items.
- To the extent that an entity is able to measure progress in providing its services, revenue should next be measured with reference to the stage of completion of the services.
- To the extent that an entity can estimate its progress in providing its services based upon the costs of providing those services, the entity should next apportion revenue based upon the cost of delivering services.
- To the extent that an entity cannot reliably measure its progress in delivering its services, revenue should be recognised on a straight line basis over the period of the services' delivery.

46. The staff considers that the suggestion raised in the previous IFRIC meeting that, in the case of fund managers, the upfront fee should be deferred and recognised in a way that gives rise to an annual fee which is a constant percentage of fund growth is one example of recognising revenue in line with the performance of services[2].

47. The staff has set out below an example of how the above hierarchy may be applied to a fund management agreement.

48. Suppose that an investor invests CU1,000 in a fund at t_0. The investor pays an upfront fee of CU50 to the fund manager. The fund manager subsequently receives a fee from the fund of 1% of fund assets per annum. The fund manager expects that the investor will invest for a period of 10 years and forecasts incurring the following costs :

    - CU30 at t_0 to pay the IFA who introduced the business;
    - CU7 at t_0 relating to brokerage services;
    - CU5 at t_0 for initial fund management set-up services;

[2] The staff has rejected this method. To spread the fee in this way would require an entity to use an estimated rate of return at the outset in order to allocate the upfront fee to different periods. This estimated rate of return is unlikely to bear any resemblance to actual movements in the fund (which are, by their nature, unpredictable). Applying this method on an ongoing basis would not only result in some anomalous results (for example negative revenue if the fund shrinks in a period) but would also be extremely complex to apply for an investment which does not have a constant rate of return.

- A fixed cost of CU4 per annum a for ongoing fund management services; and
- A variable cost of 0.2% of fund assets per annum for ongoing fund management services.

49. The fund manager is able to estimate a fair value for the brokerage service of CU10 based upon the open market value of brokerage services sold separately from fund management.

50. Appendix 1 to this document shows how the fund manager would allocate revenue to different periods in this example. This shows that, in accordance with the hierarchy set out above, the fund manager would recognise revenue as follows :

    - Revenue equal to the fair value of the brokerage service of CU10 is recognised at t_0
    - The remaining revenues of CU180 (comprising the estimated total ongoing fees plus the upfront fee less the amount allocated to brokerage) is allocated to periods based upon the cost of providing the service in those periods.
    - The cost of the IFA does not represent a service and so does not trigger the recognition of revenue.

51. The staff notes that if it is not possible to allocate the revenue based upon the costs of providing the services, then the fund manager should allocate the revenue on a straight line basis over the course of the investment[3]. The staff also notes that, as the customer can cancel the arrangement at any time, the fund manager should never recognise revenue in advance of the receipt of cash.

52. One of the consequences of the deferred recognition of upfront fees as revenue is that more revenue will be recognised in situations where the duration of the investment is reduced. Appendix 2 to this document includes an extract from the paper presented to the IFRIC in September which discusses this consequence of deferring revenue and recognising it over the investment period.

[3] In the case of fund managers, because the ongoing fees and the ongoing costs are dependent on fund growth which is inherently uncertain, the staff considers that recognition of the upfront fee (adjusted for separately identifiable amounts measured at fair value) on a straight line basis over the life of the investment may be justifiable.

53. The staff notes that fund managers who perform poorly and so expect investors to remain in the fund for a reduced period will recognise revenue faster than fund managers who perform well and expect investors to remain with the fund for a longer period. This outcome may appear counter-intuitive.

54. The staff considers that this consequence is a necessary outcome of a deferral model. Supporters of the deferral of revenue may argue that it reflects the fact that an entity with a reduced investment period is earning the same fee for undertaking less work over a shorter period.

SCOPE

55. In keeping with the IFRIC's decision when it took the issue onto its agenda, the staff have attempted to develop a scope which applies to all similar arrangements with an upfront fee followed by a regular ongoing fee. In doing so, the staff considered the following key features of the arrangements being discussed by the IFRIC, the absence of which may result in differing accounting treatments:

    - The selling entity must receive a one-off upfront fee followed by regular payments for ongoing services.
    - The up-front fee must be non-refundable even if the selling entity or the customer terminates the ongoing service arrangement.

56. The staff considers that the above may also capture the situation where a customer purchases goods (for example double glazing) and then enters into an ongoing service arrangement (for example an annual warranty arrangement). In this situation, there would be a one-off non-refundable upfront fee along with an ongoing fee.

57. The staff considers that, whilst the guidance created is unlikely to alter the accounting for such arrangements, the IFRIC has not considered situations involving the sale of goods. The staff therefore proposes that the scope includes a specific exclusion stating that the Interpretation does not apply to the sale of goods followed by the sale of services.

58. The Staff has set out below draft scope paragraphs for the proposed Interpretation on upfront fees:

> "*This [draft] Interpretation applies to all situations where a selling entity receives a one off upfront non-refundable fee followed by a regular fee in respect of services provided.*
>
> *The [draft] Interpretation does not apply to situations where an entity receives an upfront payment for the supply of goods followed by an ongoing fee for the supply of services (for example the sale of electrical goods followed by the sale of a warranty service).*"

TRANSITIONAL ARRANGEMENTS

59. The staff notes that preparers that have previously recognised revenue in respect of upfront fees as they are received are likely to be required to adopt a different accounting treatment on the issuance of this Interpretation.

60. Under IAS 8, such changes would normally be applied retrospectively.

61. The staff notes that a fund manager that manages funds with an average investment period of 10 years and prepares a five year summary may be required to estimate the effect of fees from 15 years before its year end date in order to reflect this change. This change is likely to require the re-creation of accounting records from that time as the entity is unlikely to have retained a split between upfront and ongoing fees if it has historically recognised all fees as revenue as they are received.

62. The staff considers that the IFRIC may conclude that this requirement is onerous and that the transitional arrangements should include a relief for preparers that find this requirement too difficult to apply retrospectively.

63. If the IFRIC concludes that this requirement is overly onerous, and proposes a relief from retrospective application, entities which have historically deferred income in respect of upfront fees will report results on a different basis from those which have previously reported revenue as received. In the example where the average life of the investment is 10 years, this inconsistency will continue for a further 10 years.

64. On the other hand, the IFRIC may consider that entities will be able to make a reasonable estimate of the deferred liability brought forwards and conclude it is not appropriate to offer a relief from retrospective restatement.

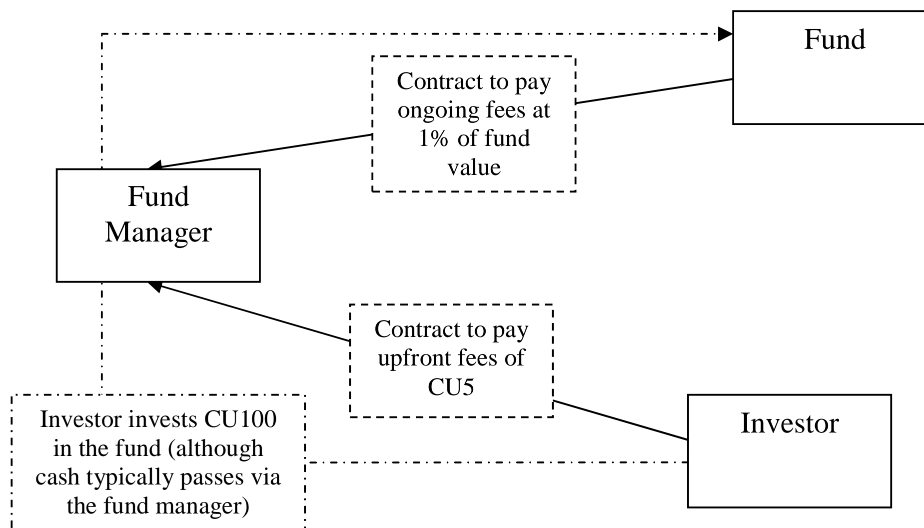
65. In considering this issue, the staff notes that the further back an entity is required to look, the smaller the proportion of revenue that is attributable to any one year, and the smaller that the deferred revenue brought forward should be. An entity may be able to use some degree of estimation in arriving at the brought forward deferred revenue relating to fees received in earlier years.

66. Given that offering relief from fully retrospective application would reduce the comparability of accounts, and that entities may be able to apply a degree of estimation, the staff considers that no relief from retrospective application should be offered.

CONSIDERATION OF THE LEGAL ARRANGEMENTS FOR FUND MANAGERS

67. Fund managers note that they receive their upfront fees as a result of a contract with the investor whereas ongoing fees are received as a result of a contract with the fund.

68. Fund managers may summarise the structure in these arrangements as follows:



69. Fund managers note that the upfront fee and the ongoing fee have two different counter-parties. Given that there are two different counter-parties, fund managers argue that the two transactions should be considered separately for the purposes of applying IAS 18.

70. Supporters of this view point to IAS 18.13 which states that "the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole." They note that if two transactions have different counter-parties, then the commercial effect of those transactions can be understood without reference to each other. The two should not therefore be considered together.

71. The staff considers that concluding that the two transactions should be considered together is a fundamental step in the argument that a fund manager should defer the recognition of revenue in respect of upfront fees. The rationale for this conclusion is therefore a matter that will need to be explained in the basis for conclusions.

72. The staff has considered four potential rationales as to why these arrangements should be considered together:

i. Since the body of investors as a whole "own" the fund, the fund and the investors can be considered as being one and the same. As such the upfront and ongoing transactions must be considered together.

ii. The investors suffer the ultimate cost of the investment management charges as a reduction in the value of their units. Since the investors suffer the ultimate cost, they can be considered as being a party to the ongoing fee arrangement. If the investor is considered as a party to the ongoing transaction as well as the upfront transaction then it may be argued that the commercial effect of the two cannot be separately understood (from the perspective of the investor). The upfront and ongoing transactions should therefore be considered together.

iii. The contract between the investor and the fund manager provides for the payment of the upfront fee. By signing that contract, the investor also agrees that an ongoing fee will be deducted from their investment. The contract for the ongoing services and ongoing fee can only exist because the contract with the investor provides for them. The contract for the ongoing services can therefore be considered as part of the contract for the upfront fee. In effect, there is therefore only one contract and one transaction. The upfront fee and ongoing fee should therefore be considered together.

iv. If an investor purchases a £1,000 unit in a fund, then the fund manager will receive an annual fee of 1% of that unit's market value as long as the investor remains invested. As soon as the investor terminates its investment, the unit will be cancelled and the fund manager will cease receiving fees in respect of that unit. Since the investor has sufficient control to stop the fund manager receiving ongoing fees in respect of that unit, the upfront and ongoing fees in respect of that unit should be considered together.

73. The staff notes IAS27.13 which states that "control also exists when…there is power to govern the financial and operating policies of the entity under a statute or an agreement." A fund manager could be argued to have control over the fund as it is able to dictate the operating and financial decisions of that fund as a result of its contract with the fund.

74. Since the fund manager is remunerated in line with the performance of the fund (the fund manager is paid based on fund net assets) and, in many cases, also has

an investment in the fund, the fund manager is exposed to all of the risks and rewards associated with the fund.

75. Given that the fund manager can be argued to have control over the fund and an interest in all of its risks and rewards, it may be argued that the fund manager should consolidate the fund[4]. If there is an argument that the fund manager should consolidate the fund then the staff does not believe that the fund and the investor can be considered to be the same. The staff has therefore rejected this rationale as a justification for considering the two transactions together.

76. The staff also notes that, for any entity, the owners ultimately bear the cost of any contract that the entity enters into. For example, if a listed company enters into a contract for management consultancy, then the entity's shareholders will ultimately bear the cost (in terms of a reduced share price) of the consultancy. The shareholders will also receive any benefits that arise (in terms of an increased share price).

77. The staff do not therefore believe that the fact that the investors in a fund bear the ultimate cost of the fund managers fees provides sufficient justification on its own to conclude that transactions with the investors and with the fund should be considered together.

78. Any prospectus for an investment will include information about the investment's operations. Supporters of the view that the upfront and ongoing contracts should be considered separately argue that the fund is an investment and that the ongoing fee is a feature of the fund's operations. When the investor enters into the contract for the upfront fee, it acknowledges the existence of the ongoing service arrangement in the same way that an investor entering into any investment acknowledges the existence of that investment's ongoing operations. Acknowledging the existence of the ongoing fee arrangement does not mean that the investor becomes party to that arrangement. Supporters of this view do not therefore believe that the two contracts are one arrangement and so they do not believe that they should necessarily be considered together.

79. The staff considers that the fact that the owners of a unit have sufficient control over a unit to be able to end the fund manager's fees in respect of that unit (by

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[4] This issue is currently being considered by the Consolidations team.

withdrawing from the fund) may be able to provide a rationale for considering the two transactions together.

80. The staff considers that a justification drawn up along these lines might read :

In some situations, a selling entity will enter into a contractual arrangement whereby it receives an upfront non-refundable fee from one entity followed by an ongoing fee from another entity (for example a fund manager will receive an upfront fee from an investor followed by an ongoing fee from a fund). The IFRIC considered that in these situations, the two transactions can be considered together for the purposes of applying the revenue recognition criteria of IAS 18 because :

- *the entity paying the upfront fee has sufficient control over some or all of the ongoing fee to be able to unilaterally terminate some or all of the ongoing fee arrangement; and*
- *the entity paying the upfront fee would not enter into the arrangement without receiving the benefits of the ongoing service; and*
- *the ongoing service is not available unless the buyer first receives an upfront service.*

Since the entity paying the upfront fee only has sufficient control to terminate a portion of the ongoing fee relating to its units, only that part of the fee related to those units is considered together with the upfront fee.

AMENDMENTS TO THE EXAMPLES IN IAS 18

81. The appendix to IAS18 includes a number of examples as to how the provisions of IAS18 should be applied.

82. Example 14 (b) (iii) discusses Investment Management Fees and states:

> "Fees charged for managing investments are recognised as revenue as the services are provided.
>
> 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. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the

> related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.
>
> Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. 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."

83. Example 17 refers to Initiation, entrance and membership fees and states:

> "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. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or services at prices lower than those charged to non-members, it is recognised on a basis that reflects the timing, nature and value of the benefits provided."

84. The staff notes that, example 14 (b) (iii) relates specifically to Investment Management Fees. However, this example provides very little guidance on the recognition of revenue other than to state that revenue is recognised as the services are provided. The staff considers that, if the IFRIC issues an Interpretation discussing the accounting for upfront fees, then the IFRIC should also propose that this example is amended.

85. Furthermore, the staff notes that there is no conceptual reason why "initiation, entrance, and membership fees" should not apply the same principles for the recognition of revenue as any other situation where an upfront fee is followed by a regular ongoing fee.

86. The staff therefore considers that the IFRIC should also seek to amend example 17 in the appendix to IAS 18 to require the deferral of revenue in line with the IFRIC's proposed Interpretation on Upfront fees.

Appendix 1 : Illustration of the application of the revenue recognition hierarchy to a fund manager

	T0	T1	T2	T3	T4	T5	T6	T7	T8	T9	T10	Total
Fund value (allowing 6% growth pa)	1,000	1,060	1,124	1,191	1,262	1,338	1,418	1,503	1,593	1,689	1,790	
Cash receipts												
Upfront fee (5% of investment)	50	0	0	0	0	0	0	0	0	0	0	50
Ongoing fee (1% of fund value)	0	11	11	12	13	13	14	15	16	17	18	140
Costs												
IFA	-30	0	0	0	0	0	0	0	0	0	0	-30
Brokerage	-7	0	0	0	0	0	0	0	0	0	0	-7
Fund management set-up	-5	0	0	0	0	0	0	0	0	0	0	-5
Fund management fixed costs	0	-4	-4	-4	-4	-4	-4	-4	-4	-4	-4	-40
Fund management variable costs (0.2% of fund assets)	0	-2	-2	-2	-3	-3	-3	-3	-3	-3	-4	-28
Revenue recognition												
Relating to the IFA	0	0	0	0	0	0	0	0	0	0	0	0
Brokerage at FV	10	0	0	0	0	0	0	0	0	0	0	10
Fund management revenue (*)	12	15	15	15	17	17	17	17	17	17	20	180
Total revenue recognised	**22**	**15**	**15**	**15**	**17**	**17**	**17**	**17**	**17**	**17**	**20**	**190**

Note : Total fund management revenue is computed as total revenue (CU190) less revenue allocated to brokerage (CU10). Fund management revenue is apportioned to periods based upon the total fund management costs in a period as a portion of the total expected fund management costs (set-up costs of CU5 plus total ongoing fixed costs of CU40 plus ongoing variable costs of CU28)

Appendix 2:

Extract from IFRIC Agenda Paper on Revenue recognition in respect of initial fees received by a fund manager (presented to the IFRIC in September 2006)

A) SMOOTHING OF INCOME

91. The deferral of revenue and its recognition over the expected average life of the investment will result in revenue being recognised a number of years after the initial fees have been received by an entity. At its simplest level, this deferral will result in the smoothing of revenue, and may conceal ongoing fluctuations in the fund's performance.

92. Supporters of the upfront recognition of initial fees also point to the following example:

    - Suppose fund A has deferred revenue of $500m on its balance sheet which it is recognising on a straight line basis over the expected average investment period of 10 years.
    - Fund A is therefore recognising $50m of revenue pa.
    - Suppose that the fund manager leaves, and the fund is unable to attract a fund manager of a similar quality. Following this adverse change in the fund manager, the average investment period is assessed to have reduced to 4 years.
    - The fund will now amortise its deferred revenue over a 4 year period and so will recognise $125m pa.

93. Supporters of the upfront recognition of initial fees consider that in this type of example, adverse developments in the fund, and a deteriorating performance in the fund will lead to an increase in revenue recognised in the short term. This does not reflect the commercial substance of what has happened within the fund.

94. Supporters note that this type of example means that not only will the deferred recognition of revenue result in the smoothing of revenue over a period of time, but it will also result in credits being deferred in the balance sheet when the fund is performing well, and being released to profit when the fund is performing poorly.

95. This deferral and amortisation will be influenced by the fund manager's expectations of customer behaviour, which in turn will be driven by the manager's optimism about the market, the fund performance, customer behaviour, etc. Similar funds may therefore have very different expected lives based upon their level of optimism about future performance.

96. Supporters of the upfront recognition of revenue believe that the deferral of revenue may result in the recognition of revenue in inverse proportion to the performance of the fund, which will result in fund managers publishing results that do not reflect their current performance.

97. For this reason, the staff understands that analysts prefer the upfront recognition of initial fees to the deferred recognition of initial fees