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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

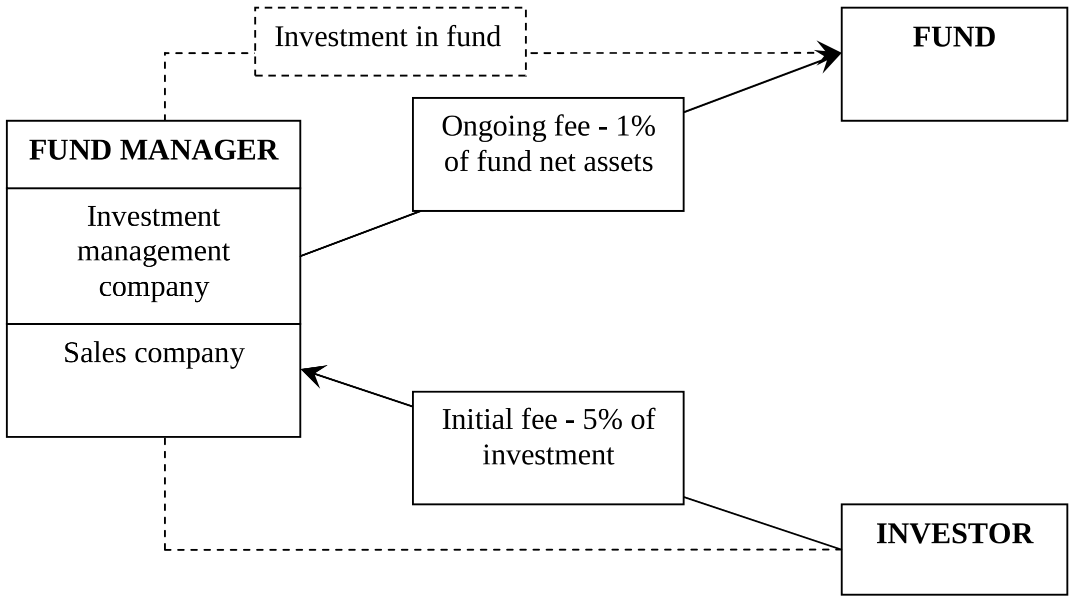
Project: **Linkage of transactions for fund managers (Agenda Paper 4 (ii))**

INTRODUCTION

1. At its November meeting the IFRIC discussed the linkage of transactions for fund managers. The discussion arose because, in the case of fund managers, an upfront fee is paid by the investor to the fund manager's sales division. An ongoing service is then provided by the fund manager's investment division to the fund. The upfront and ongoing fees therefore have two separate counter-parties.

2. For fund managers to be included within the scope of an Interpretation on how upfront fees should be accounted for in the situation where the upfront fee is received and then an ongoing service is provided, it will first be necessary to establish why the upfront and ongoing transactions should be considered together for the purposes of recognising revenue.

3. The transactions can be summarised as follows:



4. At its November meeting, the IFRIC asked the staff to develop a rationale as to why the upfront and the ongoing fees should be considered together in the case of fund managers.

5. This paper considers two questions:

   1) In what circumstances should a transaction with an investor be considered together with a transaction with a fund for the purposes of recognising revenue?

   2) In situations in which fund manager's sales and investment management activities are conducted by different entities, how should the two interact:

      i. when the investment management company and sales company are both within the same group?

      ii. when the investment management company and sales company are within different groups?

1) RATIONALE FOR LINKING TRANSACTIONS WITH A FUND WITH THOSE WITH AN INVESTOR

6. A number of potential rationales for linking the upfront and ongoing transactions have been identified in previous papers presented to the IFRIC. For example, some have suggested that the investor and the fund are one and the

same because the fund exists purely to benefit its investors. Some have suggested that the contract between the fund and the fund manager only exists, and is only allowed to exist, because of the contract between the fund and the investor. In other words, the contract between the investor and the fund manager includes a clause stating that the fund manager may also charge the fund a set percentage of the funds net assets per annum.

7. Others believe that the contracts are linked because the investor may terminate part of the ongoing service contract by terminating their investment.

8. Others point to IAS18.13, 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. Supporters of this view believe that, from the investor's perspective, it is impossible to understand the commercial effect of the upfront transaction without understanding the series of transactions as a whole. Supporters of this view note that the investor is primarily concerned with the value of the investment at the end of the investment period and not the split between investment growth, the upfront fee and ongoing fees.

9. In considering why the upfront and ongoing transactions should be considered together, the staff have focused on the following potential rationales:

   1) that the fund and the investor are effectively one and the same;

   2) that the contract for the ongoing fee only exists, and can only exist because of the upfront contract, i.e. the ongoing contract is subsidiary to the upfront contract;

   3) that the investor has effective control over the ongoing contract because the investor can terminate part of it by withdrawing from the investment; and

   4) that the two should be considered together for revenue recognition purposes because the investor cannot understand the commercial effect of the upfront transaction without reference to the ongoing transaction.

The fund and the investor are one and the same

10. Supporters of the view that the fund and the investor are one and the same note that the fund only exists to benefit the investor. The assets of the fund are

directly linked to the value of the investor's investment, and any gains or losses made by the fund are passed directly on to the investor.

11. Supporters of this view consider that when an investor makes an initial investment into the fund, a contract is entered into with the fund manager to manage that individual investment. The fund manager adds the investment to a portfolio of other individual investments to create a collection of individual investments. In other words the fund is a collection of individual investors' units added together.

12. Opponents of this view believe that this is the case in all corporate structures. For example, a listed entity will have a number of shareholders and exists for the benefit of those shareholders. Any gains or losses made by the entity will be split amongst the shareholders by adjustment to share prices. The assets of the entity could be seen as being held on behalf of the entity's shareholders.

13. The staff considers that it would be extremely difficult to write guidance which states that the fund and the investor are one in the same without also implying that the shareholders and the entity are one and the same in any corporate entity.

14. The staff does not therefore consider that a rationale based on the fund and the investor being the same is likely to resolve the issue.

The contract for the ongoing fee only exists because of the upfront fee

15. Supporters of this view believe that the contract between the fund manager and the investor provides not only for the payment of the upfront fee but also for the payment of the ongoing fee. Without the agreement of the investor upfront, the ongoing fee could not exist.

16. Since the ongoing fee is allowed for in the contract for the upfront fee and the ongoing fee could not exist without that provision, supporters of this view believe that the ongoing and upfront fees arise as part of the same contract. The two should therefore be considered together.

17. Opponents of this view point out that a shareholder investing in a company has to authorise (explicitly in some cases) certain contracts and payments made by the company. For example a shareholder resolution will be required to authorise auditor's remuneration in some countries, and may be required to authorise directors' remuneration.

18. Furthermore, many prospectuses for investments include details of significant contracts, arrangements, and other types of obligations associated with the entity in which the readers of the prospectus are being asked to invest. This does not make those contracts subsidiary to the contract to acquire the shares in the equity instruments.

19. The staff considers that developing a rationale based upon the contract for the ongoing investment management being subsidiary to the contract for the upfront payment, may have implications for many other types of investment sold using a prospectus.

20. This staff does not therefore propose pursuing a rationale based upon the contract for the ongoing services being subsidiary to the contract for the upfront fee.

Investor can terminate the ongoing arrangement

21. In the arrangement described above the investor can terminate the payment of part of the ongoing fee by terminating the investment at any time.

22. This can be carried out unilaterally without any involvement of the fund manager.

23. Some consider that, since the ongoing fee can be terminated at any time by the investor, the investor has effective control over the contract to provide the ongoing service. The investor also has access to the risks and rewards associated with that contract. Since the investor has control over the contract, it is appropriate to consider that contract as an arrangement with the investor.

24. Supporters of this view note that this is a different relationship to that between a company and its shareholders. In the case of the ongoing fee, the portion of the contract which relates to an investor can be terminated by that investor individually. In the case of an audit contract, for example, the service can only be terminated by agreement between a number of investors. Similarly, when investors have the ability to block executive remuneration packages in an entity, the agreement of a majority of investors will be required in order to block a package.

25. Opponents of this view note that the ongoing contract is one contract to provide investment management services to the fund as a whole and is based upon the

net assets of the fund. The notion of being able to terminate part of a contract may not be easy to apply to other situations.

26. The staff considers that a model developed based upon the investor's ability to influence the ongoing contract may be able to be used to develop indicators that two contracts should be considered together.

Investor's understanding of the upfront fee

27. IAS 18.13 states "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."

28. Some consider that, from an investor's perspective, it is not possible to understand the upfront fee without reference to the ongoing fee. Supporters of this view note that an investor is primarily interested in the net return on investment which includes the effects of both the upfront and ongoing fees.

29. Whilst an investor may be interested in the split between the upfront and ongoing fee from the perspective of risk management and as a result of the length of time which they wish to invest, their primary concern will be the net of the fund growth and the total fee.

30. An investor would not pay the upfront fee if they did not secure access to the ongoing service. From an investor's perspective, it is therefore impossible to understand the upfront fee without reference to the ongoing fee; so it is necessary to consider the series of transactions together for the purpose of measuring revenue in accordance with IAS 18.

31. Opponents of this view believe that an investor and fund manager are able to understand the upfront fee separately from the ongoing fee. They note that, from the fund manager perspective, the upfront fee is paid to the sales team and the ongoing fee is paid to the investment management team. The two fees are managed differently and so the fund manager is capable of understanding both separately.

32. Similarly, in many cases, the agreements between the fund manager and the investor will make reference to the fact that the upfront fee is paid for services provided upfront whereas the ongoing fee is paid for ongoing services.

33. Once the upfront fee has been paid it is non-refundable. As soon as it is paid the investor will only consider fund growth net of the ongoing fee in making assessments of return on capital.

34. Supporters of the view that the two can be understood separately believe that an investor understands that the upfront fee is for a different purpose from the ongoing fee. The investor can therefore understand the upfront fee separately from the ongoing fee and the two should be considered separately for revenue recognition purposes.

35. The staff considers that, whether the upfront fee can be understood separately goes to the heart of the question as to whether the upfront fee should be recognised upfront or should be deferred. Since the IFRIC has tentatively concluded that the upfront fee often relates (at least in part) to the ongoing service, it follows that the investor can only understand the two together. The staff considers that useful indicators could be developed based upon identifying situations in which the investor can and cannot understand the commercial effect of the upfront and ongoing transactions separately.

STAFF RECOMMENDATION AND CONCLUSION

36. The staff do not consider that adopting a rationale based on the fund and the investor being one and the same is appropriate as it is likely to have implications which are widespread and may affect a wide range of corporate structures. Similarly, a rationale based upon the upfront contract and the ongoing contract being one and the same is unlikely to succeed as this may impact a wide range of contracts including many prospectuses.

37. On the other hand, the staff considers that it may be possible to develop guidance which states that the two contracts should be considered together when one party has sufficient control over both contracts as well as access to the risks and rewards associated with both contracts.

38. The staff notes that paragraph IAS 18.13 deals specifically with when transactions should be considered together. The staff believes that any guidance developed should remain as close to this paragraph as possible. In order to achieve this, the staff proposes that guidance be developed incorporating a range of indicators which can be used in assessing whether the two transactions can be understood separately, including indicators considering control of the ongoing

transaction and access to the risks and rewards associated with the ongoing transaction.

39. ~~A section drafted along these lines might read as follows:~~ [Paragraph omitted from the observer note]

~~**Identifying of an ongoing service**~~

~~For the purpose of applying IAS 18 an entity considers an ongoing service together with an initial fee when the two are linked in such a way that the commercial effect of the initial fee cannot be understood without reference to the ongoing service.~~

~~A series of transactions may involve a range of counterparties. For example, an entity may receive an initial fee from a customer and provide an ongoing service to another entity in which the initial customer has an interest. In such situations, the entity shall consider whether the commercial effect of the initial fee can be understood without reference to the series of transactions as a whole. This assessment shall be made both from the perspective of the customer and from the perspective of the selling entity. Indicators that the two transactions cannot be understood separately include (but are not limited to):~~

~~(a)the entity receiving the ongoing service exists primarily as a vehicle to deliver the benefits and costs of the ongoing service to a customer or group of customers;~~

~~(b)the customer receives some or all of the benefit and cost of the ongoing service in proportion to the level of its participation in the entity receiving the ongoing service;~~

~~(c)the customer is informed of the ongoing fee for the ongoing service at the time at which the initial fee is paid;~~

~~(d)the customer is able to terminate unilaterally some or all of the ongoing service (for example by withdrawing from the arrangement); and~~

~~(e)the customer would not pay the initial fee without access to some or all of the benefits of the ongoing service.~~

~~Indicators that the two transactions can be understood separately include (but are not limited to):~~

~~(a)the customer receives goods or services in return for the initial fee and those goods or services can be, and are, sold separately to customers;~~

~~(b)the entity receiving the ongoing service is a trading entity and the ongoing service relates to the trade of that entity; and~~

~~(c)the customer cannot curtail, terminate, or reduce the level of the ongoing service even by exiting the arrangement.~~

~~Basis for conclusions~~

~~BC10The IFRIC noted that, in many situations, entities enter into arrangements whereby a customer pays an initial fee to the entity, and the entity then provides an ongoing service to another entity in such a way that the customer receives a portion of the benefits and bears a portion of the costs of the ongoing service.~~

~~BC11IAS 18 paragraph 13 states 'recognition criteria are applied to two or more transactions together when they linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.'~~

~~BC12The IFRIC took the view that, in many situations where a customer pays an initial fee and receives the benefit of an ongoing service, even if the service is not provided to the customer direct, it is appropriate to consider the initial fee and ongoing service together for the purposes of recognising revenue.~~

~~BC13The IFRIC decided that, although the development of detailed guidance on the linkage of transactions was outside the scope of this project, it could instead develop indicators to help entities to assess whether an initial fee should be considered together with an ongoing service for the purpose of recognising revenue in accordance with IAS 18.~~

~~BC14In producing this guidance, the IFRIC noted that it had considered only the situation of initial fees and ongoing services, and that other indicators might be applicable for assessing whether other sales transactions should be~~

~~considered together for the purpose of applying the revenue recognition criteria in IAS 18.~~

~~Does the IFRIC support including wording to this effect in the draft Interpretation?~~

2) LINKAGE OF THE SELLING COMPANY AND INVESTMENT MANAGEMENT COMPANY

40. In most cases, fund managers will operate selling divisions (which receive upfront fees) separate from fund management divisions (which receive ongoing fees and provide ongoing services).

41. Fund managers also frequently introduce investors to funds managed by other fund managers. In this case, the introducing fund manager will receive the initial fee, but not provide the ongoing service.

42. At its November meeting, the IFRIC asked the staff to consider :

- the rationale for linking the upfront fee and the ongoing service when they are provided by two different legal entities within a group; and
- the rationale for not linking the upfront fee and the ongoing service when they are provided by two different fund managers.

Rationale for linking transactions when the sales and fund management divisions are separate entities in the same group

43. The staff considered a group of companies which prepares consolidated financial statements in which both the selling entity and the fund management entity are included.

44. IAS27.4 defines consolidated financial statements as being “the financial statements of a group presented as those of a single economic entity.”

45. The staff considers that, as the consolidated group presents its financial statements as if it were a single economic entity, the location of activities within the group should not have any effect on the accounting for those activities.

46. In the consolidated financial statements of the group the upfront fee should therefore be accounted for as if it had been received by the same entity that provides the ongoing service.

Initial fee paid to one group, with ongoing fee paid to another

47. The staff considered the example of a fund managed by entity A. The upfront fee is 5% of the initial investment and the ongoing fee is 5% of the funds net assets. Assuming that entity A sells the units then it recognises 1.5% of the upfront fee as revenue immediately and spreads the remaining 3.5% over the expected average investment period of 10 years.

48. If another fund manager (fund manager B) provides the initial introduction, then that fund manager will retain the 5% initial fee and entity A will only receive the ongoing fee in respect of its ongoing services.

49. Since entity B does not provide any ongoing services, it must recognise the initial fee upfront.

50. This leads to the apparent contradiction that, if entity A receives the initial fee, it defers 3.5% but if entity B receives the initial fee then it recognises the whole amount immediately, despite performing exactly the same activities.

51. Furthermore, if entity B also manages an identical fund, then it will recognise 5% revenue upfront if it sells units in entity A's fund, but will only recognise 1.5% of the initial fee as revenue upfront if it sells units in its own fund.

52. The staff considers that the reason for this apparent inconsistency might be explained as follows. If entity B sells units in entity A's fund, then it also provides an introduction and sales service to entity A. Entity B receives 1.5% of the initial investment as revenue in respect of the upfront services which would normally be provided by entity A. It receives the remaining 3.5% as a sales commission in respect of the introduction service provided to entity A.

53. If the transactions are accounted for in this way, then entity B will recognise revenue of 5% on initial receipt (being 1.5% in respect of initial services to the customer and 3.5% as sales commission from entity A). Entity A will recognise income of 3.5% (being the receipt from the customer of 5% less 1.5% paid by the customer to A for services performed by B). B will also recognise costs of 3.5% being the sales commission paid to A.

54. Since A undertakes no activities upfront, it does not provide a service to the customer upfront and so the 3.5% received is deferred and recognised over 10 years.

55. If the upfront fee is accounted for in this way then, regardless of whether A or B performs the upfront service, A will defer revenue of 3.5%. Either A or B will recognise revenue of 1.5% in respect of services provided to the customer upfront depending on which entity performed the related services. If B has also provided a selling service to A, then B will also recognise 3.5% revenue in respect of that service and A will also recognise costs of 3.5% for that service.

56. The staff considers that how transactions between the introducing selling agent and the ongoing fund manager should be accounted for is likely to be resolved as part of the IFRIC's project on agency relationships. Furthermore, since the precise arrangements between the introducing entity and the provider of the ongoing service may vary greatly in different industries, it will be very hard to provide detailed guidance as to how these transactions should be accounted for within the initial fees project.

57. The staff therefore recommends that no guidance in this area is included within the draft Interpretation.

~~Does the IFRIC agree with the staff's recommendation?~~