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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2008, London**

Project: **Accounting for Trailing Commission (Agenda Paper 6B)**

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1. The IFRIC has received a request to add an item to its agenda to provide guidance on how an entity should account for on-going commission arrangements, referred to as trailing commissions.

Submission

2. The submission describes an example of the type of arrangement in question as follows. A financial advisor directs its client's funds to an investment manager's product. The advisor receives an initial commission for the placement of the business with the investment manager and a further on-going (trailing) commission provided that the client's funds remain invested in the product for a specified time.

3. The issue focuses on the accounting treatment when the contractual obligation for the payment/receipt of the commission is not linked to the performance of any future service by the financial advisor to its client.

4. The submission identifies two views currently being taken in practice:

    a) The contracts meet the definition of a financial instrument in IAS 32 and should be accounted for in accordance with IAS 39

    b) The commission should be recorded as a receivable and payable when due, that is, when the client has remained invested in the investment manager's product for the requisite period.

5. The rationale for the two views is set out in detail in the submission which is attached as Appendix A to this agenda paper.

Staff Analysis

6. The staff notes that in the fact pattern described a contractual arrangement exists that entitles the financial advisor to receive a payment if certain conditions are fulfilled. In the staff's view, such a contract meets the definition of a financial instrument in IAS 32. IAS 32 does not require the payment to be certain or to be fixed in amount for a financial instrument to exist. If this were the case, most derivatives would not meet the definition.

7. Consequently, the staff believes that the contract should be accounted for in accordance with IAS 39, that is View A in the submission.

8. However, the staff also believes that a similar accounting conclusion could be reached based on other IFRSs. For example, IAS 18 requires revenue to be measured at the fair value of the consideration received or receivable. In this case, the financial advisor performs a single service and in exchange receives consideration in two components – an immediate cash payment and a contractual receivable. In accordance with IAS 18, the revenue recognised should be the fair value of both components.

9. The issue can also be considered from the perspective of the investment manager. The investment manager has a contractual obligation to make a payment to the financial advisor if specified conditions are met. In its Exposure Draft to amend IAS 37, the Board clarified that an unconditional obligation was a liability not a contingent liability. Any uncertainty regarding the eventual outcome of any condition should be reflected in the measurement of the liability. The Board reached a similar conclusion regarding the recognition of contingent consideration in a business combination in IFRS 3, revised in 2008.

Staff recommendation

10. The staff recommends that the IFRIC not add this issue to its agenda. In the staff's view the application of a variety of standards to the accounting for both parties to the contract lead to consistent conclusions. Consequently, the staff does not expect diversity in practice.

11. The staff has set out wording for the tentative agenda decision in Appendix B.

Question for the IFRIC

12. Does the IFRIC agree with the staff recommendation?

APPENDIX A

IFRIC AGENDA ITEM REQUEST
Accounting for Trailing Commission

The issue:

Many financial service products distributed by third parties (such as mortgage brokers, agents or financial advisors) have on-going commission arrangements in place; referred to as trailing commissions.

An example of this type of arrangement is where a financial advisor directs their client's funds to an investment manager's product. The advisor receives an initial "up-front" commission for the placement of the business with the investment manager's product, and a further "trailing" commission provided that the client remains invested in the product for a pre-requisite time.

Trailing commission arrangements are generally of two types:

- those which involve the financial advisor (or other service provider) continuing to provide services to their client and thus where it can be evident that the commission is linked to future service; and
- those where the commission is paid without further services being provided to the client.

This issue focuses on the accounting treatment of the latter type of arrangement where the contractual obligation for the payment / receipt of the commission is not linked to the performance of any future service. In the example noted above, this would be an arrangement where the investment manager has a contractual obligation to pay commission to the financial advisor over the period the financial advisor's client remains invested in the underlying fund without the financial advisor providing any further service to the client.

Debate within the industry is currently occurring over the treatment for such commission arrangements for those paying, and receiving, the future trailing commissions.

Current practice:

There are currently two views being taken in the market:

View A – The contracts meet the definition of a financial instrument as defined by IAS 32 and should be accounted for in accordance with IAS 39

The commission arrangements between the financial advisor and investment manager meet the definition of a financial instrument under paragraph 11 of IAS 32 as defined below:

“A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. “

“A financial asset is any asset that is:
(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
(i) to receive cash or another financial asset from another entity…..”

“A financial liability is any liability that is:
(a) a contractual obligation:
(i) to deliver cash or another financial asset to another entity…..”

Contractual agreements for trailing commission are enforceable by law. Accordingly the financial advisor is regarded as having a financial asset which is “a contractual right to receive cash …from another entity”. Because the investment manager is contractually obliged to pay the financial advisor the trailing commission, they are regarded as having a financial liability “to deliver cash....to another entity”...

The financial asset and financial liability would be recognised from the date on which the financial advisor and investment manager become a party to the contractual relationship and the client’s funds are invested. Both would be recognised initially at fair value in accordance with paragraph 43 of IAS 39. In determining fair value, an estimate would need to be made of the length of time the client’s funds are expected to remain invested in the underlying fund. Uncertainty over the period does not preclude recognition of a financial asset and a financial liability.

For the type of arrangement covered in this issue proposal, the financial advisor would recognise revenue at the date of the initial recognition of the financial asset, reflecting that they have provided all of the service required by them to earn the commission. There is no additional service to be provided by them.

Subsequently, the asset and liability would be recognised at amortised cost in accordance with paragraphs 46 and 47 of IAS 39. This will include an adjustment each period to reflect actual and revised estimated cash flows in accordance with paragraph AG 8 of IAS 39. While this exercise is not identical to subsequent measurement at fair value, since expected cash flows are discounted at the original effective interest rate, it could result in significant volatility in the carrying value where estimates of cash flows do not match actual outturn.

View B – The commission is recorded as a receivable and payable when due

The future trail commission arrangements do not meet the definition of a financial instrument when they are entered into as they do not meet the definition of an asset or the definition of a liability.

As mentioned above, paragraph 11 of IAS 32 defines a financial instrument as:

"…. any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. "

*"A financial asset is **any asset** that is:*
(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
(i) to receive cash or another financial asset from another entity….."

*"A financial liability is **any liability** that is:*
(a) a contractual obligation:
(i) to deliver cash or another financial asset to another entity….."

Proponents of this view argue that for a financial instrument to exist, it must first meet the definition of an asset or a liability.

The definitions of asset and liability relied on are those set out in paragraph 8 of IAS 38 *Intangible Assets* ("IAS 38") for the definition of an asset and paragraph 10 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* ("IAS 37") for the definition of liability, as well as the corresponding definitions in paragraph 49 of the *Framework for the Preparation and Presentation of Financial Statements* (which are referred to in paragraph 13 of IAS 1 *Presentation of Financial Statements*). These are set out below:

"An asset is a resource:
(a) controlled by an entity as a result of past events; and
(b) from which future economic benefits are expected to flow to the entity."

"A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."

Proponents of View B argue that the financial advisor does not have an asset because it does not control any resources as a result of a past event. The cash flow it is entitled to receive under the contractual arrangement is outside its control as it is entirely dependent upon the investor's decision to remain invested in the fund. The financial advisor's contractual right to receive the trailing commission does not arise until the client's funds have remained invested in the fund for the requisite period.

Although there is a contract in place between the investment manager and the financial advisor, the past event that triggers the investment manager's obligation to pay the commission is the client remaining invested in the relevant fund for the requisite period of time.

Even if it were considered that trail commission arrangements give rise to assets and liabilities for future trail commissions, proponents of View B argue that the arrangements to not give rise to a financial asset or financial liability at reporting date. Proponents of View B argue that a contractual right to receive cash or another financial asset from another entity or a contractual obligation to deliver cash or another financial asset to another entity does not exist until the client monies have remained invested in the relevant fund for the requisite period of time.

Accordingly, the contractual arrangements for trailing commission do not meet the definitions of financial instrument in IAS 32 and future trail commissions are not accounted for in accordance with IAS 39 at the time of entering into the arrangements or subsequently.

At any period end there would be an amount of commission due to be received under the contractual arrangement by the financial advisor/paid by the investment manager relating to funds that have remained invested for the requisite period. These amounts would meet the definition of asset and liability and thus would be recognised.

Reasons for the IFRIC to address the issue:

The issue has widespread and practical relevance within the global financial services industry. With the current differing views, the lack of clarity effectively offers scope for a policy choice; which can significantly impact the reported financial position of the entity and therefore reduce comparability of financial statements by users.

We also note that the issue is unrelated to a Board project that is expected to be completed in the long term.