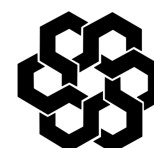

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**International**
**Accounting Standards**
**Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*
*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

**INFORMATION FOR OBSERVERS**

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|---|---|
| **Board Meeting:** | **January 2009, London** |
| **Project:** | **Fair Value Measurement** |
| **Subject:** | **Day One Gains – Service Contracts (Agenda paper 3E)** |

## Purpose of this paper

1 The Board has consistently taken the view that the transaction price is generally the best evidence of the fair value of an asset or liability at initial recognition (with some exceptions, such as related party transactions, distressed transactions, different markets or different units of account).

2 This paper considers how that presumption applies for contracts to provide services.

## Summary of recommendations

3 This paper recommends that the Board confirm the following for a contract to provide services:

a the only true exit market for the provider is the secondary (wholesale) market with other providers, not the primary (retail) market with customers.

b the exit price for the provider reflects the perspective of the provider, not the perspective of the customer.

c at initial recognition, the exit price for the provider is likely to differ from the transaction price because the provider will typically price the transaction to recover its direct and indirect origination costs and to provide a reasonable return on the origination activity. In contrast, a transferee would not require payment for the origination activity performed by the original provider.

4 This paper deals with the following subjects:

a Previous Board decisions (paragraph 5)

b An example (paragraphs 6-12)

c Unit of account (paragraphs 13-16)

d Different markets (paragraphs 17-29)

e Recommendations and question for the Board (paragraphs 30-32)

f Other points not addressed in this paper (paragraph 33)

## Previous Board decisions

5 The Board has made the following tentative decisions:

a the transaction price is the best evidence of the fair value of an asset or liability at initial recognition unless:

i the transaction is between related parties;

ii the transaction is made under duress or the seller is forced to accept the price in the transaction;

iii the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value;

iv the market in which the transaction is made is different from the market in which the reporting entity would sell the asset or transfer the liability.

b. if there is evidence that the transaction price does not represent fair value at initial recognition, an entity recognises a day 1 gain or loss, even when the initial fair value measurement is derived using unobservable inputs.

### An example

6. Consider a contract in which an investment fund manager manages a mutual fund for retail investors. The fund manager charges the investor an annual fee of, say, 1.5% of the fund value. For simplicity, let's assume for the moment that:

   a. the fund manager charges no other front-end, recurring or back-end fees.

   b. the annual fee is payable monthly in arrears.

   c. the fund manager incurs no costs to originate the contract (origination costs).

7. For convenience, this paper uses the following terms:

   a. **originator**: the fund manager in this example (ie the entity that enters into the contract with the retail investor)

   b. **transferee**: another fund manager to which the originator might transfer the contract (ie the originator's rights and obligations arising under the contract)

   c. **transaction price presumption**: the presumption that the transaction price is generally the best evidence of fair value at initial recognition

   d. **initial fair value** of the contract: the fair value of the contract at initial recognition (immediately after the fund manager and retail investor have entered into the contract, before the investor has paid the first fee and before the manager has provided any services under the contract)

8. The initial fair value of the contract equals (a) the fair value of the consideration receivable from the retail investor over the life of the contract, less (b) the fair value of the fund manager's obligation to provide the investment management services. If the transaction price presumption holds, (a) and (b) are equal and the initial fair value of the contract is then zero.

9 What price would the fund manager (originator) receive if it transferred the contract (ie all the rights and obligations under the contract) to another fund manager (transferee) immediately after initial recognition of the contract? The prices for such transactions are commonly described as a percentage of funds under management (say 0.5% to 2% of funds under management). Such transactions do not occur at a price of zero. Thus, it appears that the transaction price presumption would not hold in this example.

10 As noted above, the Board identified four factors that might rebut the transaction price presumption:

a the transaction is between related parties;

b the transaction is made under duress or the seller is forced to accept the price;

c different unit of accounts;

d different markets.

11 In this example, the first two of these factors (related parties, duress) do not apply but the third and fourth factors (different unit of account, different market) might apply:

a In practice, a transfer to another fund manager would involve an entire fund (a portfolio of contracts) rather than a single contract with a single retail investor.

b The market for the original transaction between the retail investor and the original fund manager is one market. The market between the original fund manager (the originator) and the new fund manager (the transferee) is a different market.

12 Paragraphs 13-29 consider whether the unit of account or the existence of different markets could explain the difference between (a) the transaction price the retail investor pays and (b) the price that two fund managers would agree for a transaction between them.

## Unit of account

13 A transaction between two fund managers would typically involve a transfer of the whole fund, not just a transfer of the contract with a single retail investor. However, this does not necessarily mean that the proportionate price for a transfer of the whole portfolio would differ systematically from the price for a single contract. There is no plausible reason why the original fund manager would transfer a single contract but retain all the other contracts relating to the same fund. Furthermore, it would not generally be economic to incur transaction costs negotiating the transfer of a single contract. These facts explain why observed transfers are typically for the whole fund. That does not mean that a single contract would change hands for a different price.

14 Paragraph AG 71 of IAS 39 refers to "the price at which a transaction would occur at the end of the reporting period in that instrument (ie **without modifying or repackaging the instrument**) in the most advantageous active market to which the entity has **immediate access**". Similarly, paragraph AG76 refers to "prices from any observable current market transactions in the same instrument (ie **without modification or repackaging**)" [emphasis added]. It follows that any change in fair value attributable to modifying or repackaging is not recognised until the modification or repackaging occurs.

15 As noted above, observable transactions between fund managers will typically be for a transfer of all the contracts, not a single contract. However, that fact does not mean that the contracts have been modified, transformed, or repackaged in any way before the transfer. All the rights and obligations arising under the contracts with the investors still exist immediately before the transfer. The transfer merely changes one of the parties to those contracts by substituting the transferee for the originator.

16 The discussion in paragraphs 13-15 suggests that the difference between the transaction price and the exit price does not arise from differences in the unit of account. Put differently, the initial fair value would be the same regardless of whether the contracts are measured individually or as a portfolio.

## Different markets

17 Retail investors do not have access to the wholesale market that exists between fund managers. At first sight, therefore, the existence of different markets might explain

the difference between the transaction price paid by the retail investor and the wholesale price that applies between fund managers. However, the transferee is contractually required to provide exactly the same services to each retail investor as the originator was required to provide. Therefore, it seems logical that these contracts would have the same fair value in the hands of the originator and the transferee.

18 In contrast, if the initial transaction price presumption held, the contracts would have one fair value (zero) at inception in the hands of the originator and a different fair value in the hands of the transferee (the price paid by the transferee). This seems odd, given that the performance obligation is identical before and after the transfer.

19 So why would different prices apply in the two markets we are considering (primary, retail market with retail investors and secondary, wholesale market between fund managers)? There is an important difference between the original fund manager and the transferee. The originator must attract and sign up retail investors. Starting with the most obvious point, the originator might incur incremental costs as a direct result of originating a contract: for example if it pays a commission of, say, 0.3% to an intermediary when a retail investor introduced by that intermediary enters into a contract with the originator.

20 In contrast, the transferee does not need to recover the commission, and so it would willingly negotiate a price that leaves 0.3% with the originator. Furthermore, in negotiating a price with the transferee, the originator would seek to retain the 0.3%.

21 In practice, a rational originator would price the contract on a basis that aims to recover not only direct costs (such as the commission in the above example), but also:

a indirect costs incurred in the period when the retail investor and originator enter into the contract. These costs might include sales force salaries.

b recovery of selling and distribution costs incurred by the originator in earlier periods, such as advertising, developing and maintaining the brand and building a distribution network.

c a reasonable return on those costs incurred in earlier periods.

22 In contrast, the transferee does not need to recover any of those costs of attracting and signing up retail investors. Therefore, it will willingly accept a price that leaves the recovery of those costs with the originator. Thus, if the originator recognises the contract initially at exit price, it will recognise a day one gain. (It is worth remembering that the gross day one gain [initial exit price less transaction price] is not the same as the net day one gain [gross day one gain less origination costs incurred in the same period]).

23 In conclusion, there is a difference between (1) the transaction price paid by the retail investor and (2) the wholesale price that the originator would pay the transferee. That difference arises because the retail investor (in (1)) and the originator (in (2)) are paying for different things:

a The retail investor must pay the originator for both (i) the origination activity and (ii) the subsequent provision of the investment management service. The retail investor cannot bypass the originating activity by going straight to the wholesale market, and so cannot avoid paying for the origination activity.

b The originator must pay the transferee for the subsequent provision of the investment management service, but need not (and rationally would not) pay for the origination activity. Thus, the originator could retain the amount paid by the retail investor for the origination activity.

24 Of course, from the retail investor’s perspective, the whole of the fee it pays is for the investment management service. But it does not necessarily follow that the provider of the service must recognise the same amount. Indeed, if both parties to a contract had to recognise the same amount, this would have the following consequences:

a when the retail investor and originator enter into the contract, they would both measure the contract initially at zero.

b suppose the originator then transfers the contract immediately to the transferee at a price of, say, 0.3%. The transferee would pay that amount to the originator. At that point, the two parties to the contract are the retail investor and the transferee. Because the retail investor recognises no asset or liability, the

transferee would recognise no liability or asset. Thus, the transferee would recognise no asset, even though it had paid the originator 0.3%.

***Exit price includes a service margin***

25 The exit price will include the entire margin that market participants would require for providing the services required under the contract (that margin may not always be material). Many respondents to the discussion paper on insurance contracts (DP) found this point difficult to understand. They understood the need for what the DP called a risk margin (reward required for bearing risk) but not the need for what the DP called a service margin (reward, if any, required by market participants for services other than bearing risk). To illustrate the need for a service margin, the DP contained an (artificially simple) example in which a fund manager supplies services under a contract that exposes the fund manager to no risk whatsoever, but for which fund managers would still require a profit. By definition, the risk margin is zero, so there must be a service margin. (The same principle would apply in a more realistic example). If market participants would require a service margin, gains are likely to arise at initial recognition if the service margin is omitted from the initial fair value of a contract to provide services.

***Is the transaction price an exit price in any market?***

26 In previous discussions in the fair value measurement project, Board members have argued that one party's entry price is the other party's exit price. Therefore, the Board has been inclined to the view that it is less helpful to distinguish between an entry price and exit price than it is to determine the market in which the transaction would occur.

27 When the reporting entity holds an asset previously held by the other party, it is clear that price paid by the reporting party (its actual entry price) was the other party's actual exit price. However, the notion of an exit by the other party is less clear when the item being measured is a contract to provide services. Consider the above example again. The originating fund manager's entry price is the transaction price paid by the retail investor. However, the origination of the contract does not represent an exit by the retail investor: the contract creates new rights and obligations and does not eliminate any existing rights and obligations of the retail investor. If anything, the

price paid by the retail investor is also the entry price to the retail investor of the contractual rights it acquires by entering into the contract.

28 Moreover, the price paid by the retail investor is not an exit price for the originator: the originator can exit in the wholesale (secondary) with other fund managers, but cannot exit in the retail (primary) market between retail investors on one side and fund managers on the other side.

***Transfer versus settlement***

29 The Board has discussed several times how the transfer notion embodied in an exit price compares with the notion of a settlement with the original counterparty (the retail investor in the above example). Some points are worth noting:

a As noted above, after the transfer, the transferee has exactly the same performance obligations as the originator had immediately before the transfer. Thus, exit price reflects the amount, timing and uncertainty of the cash flows required to provide those services.

b Exit price excludes any entity-specific factors (factors that are relevant to the existing holder of the asset or liability but are irrelevant to other market participants).

c The price for a settlement with the counterparty will be the result of a negotiation between the parties. Most likely, the party that initiates this negotiation will be in the weaker position:

i In the above example, if the fund manager (originator) initiates the negotiation, the retail investor will require it at least to refund any amounts prepaid for future services and quite possibly pay more, for example, if the retail investor would have to pay more for the same services at current market rates.

ii If the retail investor initiates the negotiation, the fund manager may be able to charge a cancellation fee.

iii The likely settlement price will also depend on factors such as consumer protection laws, regulatory attitudes and the extent of the fund manager's desire for good public relations.

## Recommendations and question for the Board

30 The staff recommends that the Board confirm the following for a contract to provide services:

a the only true exit market for the provider is the secondary (wholesale) market with other providers, not the primary (retail) market with customers.

b the exit price for the provider reflects the perspective of the provider, not the perspective of the customer.

c at initial recognition, the exit price for the provider is likely to differ from the transaction price because the provider will typically price the transaction to recover its direct and indirect origination costs and to provide a reasonable return on the origination activity. In contrast, a transferee would not require payment for the origination activity performed by the original provider.

31 The recommendation in paragraph 30c does not contradict the Board's tentative decision (consistent with SFAS 157) that transaction costs do not form part of exit price:

a a market participant would incur **transaction** costs to transfer an asset or liability to another market participant. They do not change the asset or liability and so are an attribute of the transaction, not an attribute of the asset or liability.

b a rational entity providing goods or services (or creating a new financial instrument) prices the transaction not only to generate an appropriate return for providing the goods, services or cash flows required under the contract, but also to recover the direct and indirect **origination** costs and to provide a reasonable return on the origination activity.

32 **Does the Board agree?**

### Other points not addressed in this paper

33 This paper does not address the following points:

a IAS 39 adopts the transaction price presumption for financial instruments (unless another fair value is supportable using observable market data). The normal result is that most financial instruments are measured initially at transaction price. However, if the origination activity is significant, which may be the case for some instruments originated for retail customers, the exit price of those instruments may differ from the transaction price at which they are originated.

b As noted in the papers for the Board's meeting in December 2008, there are different views about the "deposit floor" in IAS 39, and this paper does not attempt to resolve those views:

i Some view the deposit floor as expressing the view that the fair value of a deposit excludes the fair value of any intangible asset that exists alongside the deposit.

ii Others view the "intangible asset" as an artificial construct that is not separate from the deposit.

c This paper does not discuss day one losses. We have spent some time at the Insurance Working Group discussing the implications of contracts that appear to generate significant losses at initial recognition. We intend to discuss that issue with the Board (and the FASB) in due course in the project on insurance contracts.