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January 10, 2005

Mr. Lawrence W. Smith
Director, TA&I – FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: SFile Reference: FSP8524A

Re: Proposed FASB Staff Position No. 85-24-a, Application of EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge," When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received from Third Parties

Dear Mr. Smith:

We are pleased to comment on the proposed FASB Staff Position No. 85-24-a, Application of EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge," When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received from Third Parties (FSP 85-24-a or the proposed FSP).

We agree that *income statement* recognition is appropriate at the time the Rights¹ to receive future fees are sold to a third party when the distributor does not retain recourse or continuing involvement with the Rights. We also agree that any deferred costs related to the sold Rights should be recognized concurrently in earnings. Accordingly, we generally support the issuance of the proposed FSP as a final position of the FASB staff, with certain modifications. While we agree that income statement recognition is appropriate, we do not agree that the sale of Rights should be characterized as revenue for the reasons discussed below.

Our detailed comments on the proposed FSP follow.

1. The proposed FSP states that *revenue* results from the sale of the Rights. We disagree. We believe that FASB Statement of Financial Accounting Concepts (SFAC) No. 6, Elements of Financial Statements, indicates that the sale of Rights would be categorized more appropriately as a *gain*. SFAC No. 6 describes gains and losses as a result from incidental or peripheral transactions of an enterprise with other entities and from other events and circumstances affecting it. In contrast, revenues result from an entity's ongoing major or central operations or activities.

The sale of an unrecognized asset to a third party (the sale of Rights) is an incidental or a peripheral transaction of the distributor, not a component of its ongoing major or central operation or activities. Recognition and classification as revenue is appropriate when cash is received from the receiver of the distribution services (the fund). However, in the transaction contemplated by the proposed FSP cash is received from a third party in exchange for an

¹ Rights referred to herein are B share asset-based fees (12b-1 fees) and contingent deferred sales charges (CDSC), as defined in the proposed FSP.

existing unrecognized asset. As the third party did not receive services or goods produced by the transferor, we believe the transaction should not be classified as revenue but should be recognized as a gain (net of any related costs).

- 2. The proposed FSP indicates that "recognition is appropriate at the time cash is received from a third party," placing an emphasis on the receipt of cash as the triggering event for recognition. While this guidance parallels the accounting in Issue 85-24, the accounting issue here differs; Issue 85-24 dealt with revenues earned pursuant to an agreement where the amount of revenue will vary with future asset levels and other future circumstances. Accordingly, as the transaction at question differs from the transaction in Issue 85-24, we question whether the receipt of cash is the triggering event for recognition of the sale. That is, in a sale of an asset to a third party, where the sales price is fixed and determinable, we believe recognition of the sale is appropriate when the consideration is realized or realizable. The proposed FSP places an undue emphasis on the collection of cash.
- 3. The proposed FSP indicates that it applies only to "third party" cash receipts. Thus, the proposed FSP leaves open questions regarding the accounting for sales of Rights to related parties (including sales to parties in the consolidated group and the impact in the separate component financial statements of the distributor). We believe the staff should expand the scope to address the accounting for these transactions. In addition, the scope of the FSP excludes enhanced and board-contingent 12b-1 plans. The staff should consider providing the rationale for this scope decision in the final FSP.
- 4. Paragraph 3 indicates that a distributor incurs other expenses related to the distribution of mutual funds shares including advertising, marketing, and financing costs. The distributor is compensated for these costs by charging a distribution fee. It is unclear from paragraph 3 whether the other expenses incurred (services provided by the distributor) have been rendered at the time of sale of the Rights. Paragraph 21 states that the staff believes the Rights derive from past services provided by the distributor. That is, the distributor is not required to provide any additional service to receive the Rights. Further paragraph 21 would preclude treatment as a sale if there is a future service obligation. Accordingly, the staff should clarify in paragraph 3 that that proposed FSP only applies to situations in which the Rights are derived from past services as any obligation to provide future services would preclude sale accounting.
- 5. We are unsure whether Paragraph 9 enumerates three conditions that essentially define the phrases no recourse and no continuing involvement or provide examples of recourse or continuing involvement that are not all inclusive. For example, would restricting a change in the investment objective of the fund or a change in the compensation or timing of the CDSC fee (or providing for a payment by the seller to the buyer if such actions occur) constitute continuing involvement (or recourse)? We recognize that if the requirements of no recourse or no continuing involvement are to be broadly interpreted that the guidance can not address every potential situation. However, we suggest additional clarification pointing toward the objective being sought.

In addition, these criteria appear to introduce the notion that sale accounting (and thus income statement recognition) is permitted in situations where less than 100% of the risks and rewards are transferred to the buyer. That is, sale accounting is acceptable even when risks and rewards are retained, so long as the risk and reward retained relates only to the proportion of the (unrecognized) asset not sold. Retaining risk and rewards in a sold asset suggests a bifurcation of the asset into component cash flows, a concept that has been historically

limited to transfers of financial assets. The final FSP should explain the rationale for applying a components approach to a sale of a nonfinancial asset.

Alternatively, one might conclude that continuing involvement exists when the distributor retains any non-trivial risk or reward related to the Rights, even if the Rights "retained" expose the distributor only to risks and rewards that are proportionate to the buyer. Under this approach, one might view the retention of any risk and reward as an impediment to sale treatment (therefore not permitting bifurcation of the Rights). If the FSP does not contemplate the bifurcation of the asset into component cash flows, the transaction would appear to be treated as a financing where the retention of proportionate risk may suggest the existence of a derivative indexed to the sold Rights embedded in the financing.

- 6. Paragraph 12 prohibits analogizing to the guidance in the proposed FSP. As we have indicated in prior comment letters, we are supportive of accounting standards that are based upon objectives and principles. As such we question why analogy would not be appropriate unless the guidance in this FSP is an exception to a more fundamental principle. Clarification in the final FSP regarding why analogies are inappropriate would be helpful.
- 7. Paragraph 20 discusses the FASB staff's conclusion that other preexisting arrangements, where other members in the consolidated group are obligated to provide services and receive fees, do not constitute continuing involvement. While we agree with the staff that such services are distinct in nature and are separate from the distribution service, it is unclear to us if the staff also considered whether the consideration (the fees) in the arrangements is separable. That is, in order to separate the continuing services from the distribution fees sold, it would seem that an entity must also demonstrate that the fees received for the continuing services are representative of the fair value of such services. We suggest additional clarification.
- 8. Paragraph 22 addresses "provisions" that limit members of the seller's consolidated group from undertaking certain actions. It is not clear whether the paragraph only addresses limits required by the purchaser of the Rights or whether it also applies to limits that may have been originally required when the Rights were initially created. We suggest clarification.
- 9. Paragraph 25 addresses "standard representations and warranties as to the validity of the Rights." This appears to be one example of the many representations regarding factual matters that a seller might make to a buyer. It would seem appropriate to also permit the seller to make representations about other factual matters as of the date of the sale. It also might be helpful for the staff to include examples they may have encountered in their research, of representations and warranties that would and would not constitute continuing involvement.

If you have any questions concerning our comments, please contact Bob Uhl at (203) 761-3705 or Jim Kroeker at (203) 761-3726.

Yours truly,

Deloitte & Touche LLP