

EITF ABSTRACTS

Issue No. 85-24

Title: Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge

Dates Discussed: June 27, 1985; February 6, 1986

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
FASB Staff Position EITF85-24-1, "Application of EITF Issue No. 85-24, 'When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received from Third Parties,'" posted March 11, 2005
FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*
FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*
FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*
FASB Invitation to Comment, *Accounting for Certain Service Transactions*, dated October 23, 1978
AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*
APB Opinion No. 20, *Accounting Changes*
APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*
AICPA Industry Audit Guide, *Audits of Investment Companies* (1973)
AICPA Statement of Position 95-3, *Accounting for Certain Distribution Costs of Investment Companies*
Proposed AICPA Audit and Accounting Guide, *Audits of Investment Companies*, dated January 15, 1985
Proposed AICPA Statement of Position, *Accounting for Service Transactions*, dated April 21, 1978

ISSUE

Distributors of mutual funds that do not have a front-end sales charge receive fees that are designed to compensate them for the distribution of fund shares. The fees are sometimes received over a specified future period.

The issue is whether the fees that are expected to be received over a specified future period should (1) be accrued at present value and recognized at the time of the distribution, along with all costs of performance (the income accrual method) or (2) be recognized when received, along with the amortization of deferred incremental direct costs and the expensing of indirect costs when incurred (the cost deferral method, which is the existing accounting practice).

EITF DISCUSSION

The Task Force reached a consensus that the existing accounting practice, the cost deferral method, should not be changed—that is, the fees should be recognized when received, the deferred incremental direct costs should be amortized, and the indirect costs should be expensed when incurred.

FASB Staff Position (FSP)

On March 11, 2005, the Board directed the FASB staff to issue FSP EITF 85-24-1 that addresses whether receipt of cash from a third party, that is, a party other than the mutual fund or the investor in the mutual fund, for the rights to future cash flows from distribution fees can be recognized as revenue. The FSP refers to 12b-1 fees and contingent deferred sales charges (CDSC) for shares previously sold collectively as the Rights.

The FASB staff believes that revenue recognition is appropriate when cash is received from a third party for the Rights if the distributor has neither continuing involvement with the Rights nor recourse. Deferred costs for the shares sold to which the Rights pertain should be expensed concurrent with the recognition of revenue consistent with the requirements of this Issue.

The FASB staff believes that the condition described in the preceding paragraph, of neither continuing involvement nor recourse, is met when neither the distributor nor any member of the consolidated group that includes the distributor (a) retains any disproportionate risks or rewards in the cash flows of the Rights that are sold; (b) guarantees or assures in any way the purchaser's

rate of return or return on investment related to the Rights that are sold; or (c) restricts the ability of the consolidated group or the mutual fund independent board to remove, replace, or subcontract any of the service providers of the fund.

The FSP states that retention of a proportionate or pro rata interest by any member of the consolidated group that includes the distributor does not affect revenue recognition in the distributor's separate-company financial statements.

The FSP does not address the accounting for the Rights by a mutual fund, an investor in a mutual fund, or a third party investor that obtains the Rights. Mutual funds should continue to follow the guidance in SOP 95-3.

For each period in which a distributor recognizes revenue as the result of receiving cash from a third party for the Rights, the distributor should disclose the amount of revenue recognized and the related amount of deferred costs that have been expensed.

The guidance in the FSP should not be analogized to other transactions.

Effective Date and Transition

The guidance in the FSP is effective for reporting periods beginning after March 11, 2005. The effect of initially applying the guidance in the FSP should be recognized as a cumulative effect of a change in accounting principle pursuant to the guidance in Statement 3 and Opinion 20. This guidance should be applied based on the terms of the arrangements that exist at the end of the reporting period for which the guidance is first effective.

Early application of this guidance is permitted in periods for which financial statements have not yet been issued. If early application is elected, an entity initially should apply the guidance in the FSP based on the terms of the arrangements that exist at the end of the period of adoption.

STATUS

The AICPA Stockbrokerage Auditing Subcommittee presented a draft Issues Paper, *Accounting for: 12b-1 Mutual Fund Selling Fees*, dated January 31, 1986, to the AICPA Accounting Standards Executive Committee (AcSEC) on the accounting by mutual fund distributors for mutual funds that do not have a front-end sales charge. The Subcommittee disagreed with the Task Force consensus and urged its reconsideration. Based on a review of the draft Issues Paper, AcSEC agreed with the Task Force and concluded that the cost deferral method is the appropriate accounting by the distributor. The draft Issues Paper has not been issued.

On August 12, 1987, the AICPA finalized its proposal dated January 15, 1985, and issued Audit and Accounting Guide, *Audits of Investment Companies*. It supersedes the 1973 Industry Audit Guide.

No further EITF discussion is planned.