

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Eric Smith (ext. 337)

Subject: Minutes of the October 27, 2004 Board Meeting Date: November 1, 2004

cc: Bielstein, Smith, Petrone, Leisenring, Westerlund, Hamilton, Gabriele, Polley, Getz

Topic: Proposed FSP FAS 140-b, "Application of EITF Issue No. 85-24, 'Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge,' When Future Distribution Fees Are Sold to Unrelated Third Parties"

Basis for Discussion: Memorandum dated October 6, 2004

Length of Discussion: 11:00 a.m. to 11:30 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schipper, Seidman, Trott

IASB Board/Staff present: None

Board members absent: Schieneman, Leisenring

Staff in charge of topic: E. Smith

Other staff at Board table: L. Smith, Westerlund, Hamilton

Outside participants: None

Summary of Decisions Reached (Action Alert):

The Board discussed proposed FSP FAS 140-b, "Application of EITF Issue No. 85-24, 'Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge,' When Future Distribution Fees Are Sold to Unrelated Third Parties," and made the following decisions:

1. The scope of that proposed FSP should be expanded to address situations in which the application of Issue No. 85-24 could result in revenue recognition upon sale of the right to future 12b-1 fees.
2. Continuing involvement should be evaluated as it relates to the control group to which the distributor belongs and as it relates to retention of risks and rewards in the 12b-1 fees.
3. Recourse obligations should be recognized consistent with existing guidance.

The Board directed the staff to redraft proposed FSP FAS 140-b and to present it to the Board for consideration by the end of November.

Objective of the Meeting:

The objective of the meeting was to obtain the Board's concurrence with the staff recommendations:

- The scope of the proposed FSP should be expanded to address situations in which the application of Issue 85-24 could result in revenue recognition upon sale of the right to future 12b-1 fees.
- Continuing involvement should be evaluated as it relates to the control group to which the distributor belongs and as it relates to retention of risks and rewards in the 12b-1 fees.
- Recourse obligations should be recognized consistent with existing guidance.

Matters Discussed and Decisions Reached:

Mr. E. Smith stated that proposed FSP FAS 140-b was posted for comment at the beginning of August; ten comment letters were received through the period that ended September 2. Mr. E. Smith stated that the Staff and Mr. Trott met with industry representatives to discuss the proposed FSP on August 25.

Mr. E. Smith stated that the proposed FSP prohibits sales of the right to future 12b-1 fees from being accounted for under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as such rights are not recognized financial assets and Statement 140 includes in its scope only transfers of recognized financial assets. Mr. E. Smith stated that the proposed FSP directed preparers selling the rights to future 12b-1 fees to EITF Issue No. 88-18, *Sales of Future Revenues*, a consensus that provides guidance on the classification of proceeds from sales of future revenues; Issue 88-18 requires that six criteria must be evaluated to determine whether the classification of proceeds from the sale of the rights to future 12b-1 fees would be recognized as debt or deferred income.

Mr. E. Smith stated that constituents generally agreed that the sales of the right to future 12b-1 fees should not be accounted for under Statement 140. He stated that most constituents also agreed that evaluation of the six criteria of Issue 88-18 would result in classification of the proceeds as deferred income; however, those constituents argued that because there was no ongoing performance obligation on the part of the distributor selling the right to future 12b-1 fees there was no reason to “defer” income recognition. He stated that constituents argued that, once the rights were sold, there were no longer issues regarding the fixed or determinable amount of the 12b-1 fees (another reason not to recognize income).

Mr. E. Smith stated that at the meeting with industry representatives on August 25, the Board and industry representative discussed two of the six criteria in Issue 88-18 that individually create a rebuttable presumption that proceeds (the sale of the 12b-1 fees) should be classified as debt, continuing involvement and recourse. He stated that industry representatives argued that the distributor’s performance is completely fulfilled upon sale of the mutual fund shares and therefore there is no continuing involvement in the 12b-1 fee stream. He

commented that representatives also delineated the limited situations in which recourse could arise.

Mr. E. Smith presented three alternatives for proceeding with the FSP:

- Proceed with the FSP as written. This would require addressing several ancillary issues raised in the comment letters (transition, income recognition, basis for conclusion, etc.)
- Address income recognition for those distributors selling the right to future 12b-1 fees in EITF Issue No. 85-24, *Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge*. This alternative could allow income recognition upon receipt of cash (though the cash comes from a third party rather than the mutual fund) in situations where there is no continuing involvement and with recognition of recourse, if present.
- Reconsider in its entirety the consensus of Issue 85-24 (to address income recognition for all distributors and not just those selling the right to future 12b-1 fees) as well as the conclusions reached in SOP 95-3.

Mr. E. Smith stated that the staff recommends the second alternative—that the FSP be revised to address income recognition for distributors selling the right to future 12b-1 fees in Issue 85-24, including guidance on how continuing involvement and recourse obligations might impact revenue recognition. He stated that the staff is requesting the Board's concurrence with this recommendation.

Mr. Trott stated that he supports the staff's recommendation; however, he would prefer to address the broader issue of when to recognize revenue as presented in the third alternative (reconsider in its entirety the consensus of Issue 85-24 as well as the conclusions reached in AICPA Statement of Position No. 95-3, *Accounting for Certain Distribution Costs of Investment Companies*). He stated that he supports the staff's recommendation because the Board's revenue recognition project will likely address when to recognize revenue for the broader group of distributors, including those selling the right to future 12b-1 fees.

Ms. Seidman also supported the staff's recommendation and shares Mr. Trott's views. Ms. Seidman stated that she would prefer not to reference Statement 140, specifically with reference to guidance relative to recourse obligations, in the guidance provided on this issue because this EITF issue is outside of the scope of Statement 140. Ms. Seidman also requested that the staff clarify in its guidance that the receipt of cash relative to the sale of 12b-1 fees is in exchange for **past services** (emphasis added) and not future services in order to distinguish those transactions from other transactions where the receipt of cash from a third party would not result in revenue recognition.

Ms. Schipper asked the staff to clarify why, in its recommendation, revenue will be recognized when 12b-1 fees are sold to a third party, but a related obligation will not be recognized, in other words why not reconsider SOP 95-3. Mr. E. Smith stated that the staff recommends not to readdress SOP 95-3 for several reasons, including:

- The related liability is a liability of multiple sources, the investor and the mutual fund, which presents reliability issues
- A liability with a duration of one-year at most could be recognized due to the requirement that 12b-1 fees have to be approved by the Board of the mutual fund on an annual basis, which would not be comparable with the related revenue recognized
- 12b-1 plans would effectively be eliminated if a related liability was recognized due to regulatory constraints of the mutual fund industry.

Ms. Schipper stated that she believes full reconsideration of EITF Issue 85-24 and SOP 95-3 is the best solution, but due to the limited resources of the FASB, resources are best suited elsewhere, and therefore she supports the staff recommendation.

Mr. Herz supported that staff's recommendation, but echoed the concerns presented by Ms. Seidman. He more specifically highlighted situations in which there could be the perception of continuing involvement when an affiliate of the distributor within a consolidated group continues to act as the advisor to the mutual fund. He stated that he does not want the decisions reached in this FSP to be analogized to other similar situations.

Mr. Herz asked if any Board members objected to the staff recommendation that:

- The scope of the FSP be expanded to address situations in which the application of Issue 85-24 could result in revenue recognition upon sale of the right to future 12b-1 fees.
- Continuing involvement should be evaluated as it relates to the control group to which the distributor belongs and as it relates to retention of risks and rewards in the 12b-1 fees.
- Recourse obligations should be recognized consistent with paragraph 113 of Statement 140.

No Board members objected.

Follow-up Items:

The staff plans on presenting a draft version of the FSP to the Board by the end of November.

General Announcements:

None.