MEMO# 18321

December 9, 2004

FASB ISSUES REVISED PROPOSAL ADDRESSING DISTRIBUTOR ACCOUNTING FOR SALE OF RIGHTS TO FUTURE 12B-1 FEES

[18321] December 9, 2004 TO: ACCOUNTING/TREASURERS COMMITTEE No. 31-04 RE: FASB ISSUES REVISED PROPOSAL ADDRESSING DISTRIBUTOR ACCOUNTING FOR SALE OF RIGHTS TO FUTURE 12B-1 FEES The Financial Accounting Standards Board recently issued a proposed FASB Staff Position addressing fund distributor accounting for cash received in consideration for the sale of rights to future 12b-1 distribution fees.1 The proposed FSP permits revenue recognition at the time cash is received from the purchaser of the rights, provided that the distributor does not retain recourse or continuing involvement with the rights. Any deferred costs relating to mutual fund shares sold to which the rights pertain should be written off to earnings concurrent with the recognition of revenue. Comments on the proposed FSP are due to the FASB on January 7. We have scheduled a conference call on Friday, December 10 at 11:00 a.m. Eastern time to discuss the FASB proposal. To participate in the call, please dial 888-566-5774 and enter passcode number 55762. Background Certain fund distributors sell the rights to future 12b-1 distribution fees to third parties in order to finance commission payments on B shares. Earlier this year, the FASB issued a proposed FSP that would have required cash consideration received for the sale of rights to future 12b-1 distribution fees to be treated as debt or deferred revenue.2 In response to comments received, the FASB issued the revised proposal permitting current revenue recognition, provided the distributor does not retain recourse or continuing involvement with the rights. The revised proposal indicates that current revenue recognition is appropriate because the receipt of cash eliminates any uncertainty regarding the fixed or determinable 1 FASB FSP EITF 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. The proposed FSP is available on the FASB website http://www.fasb.org/fasb_staff_positions/prop_fsp_eitf85-24-a.pdf. 2 See Institute Memorandum to Accounting/Treasurers Committee No. 25-04 [17864], dated August 4, 2004. 2 nature of the amount to be received by the distributor where there is no continuing involvement or recourse. Under the proposal recourse or continuing involvement would exist if the distributor or any member of the consolidated group that includes the distributor (a) retains any disproportionate risk or reward interest relative to the rights sold; (b) guarantees or assures in any way the purchaser's rate of return or return on investment relative to the rights sold; or (c) restricts the ability of the consolidated group or the mutual fund independent board to remove, replace, or subcontract any of the entities or individuals

providing services to the fund. A disproportionate interest would exist where the amount received by the distributor fluctuates as a result of changes in NAV or shareholder redemptions. The FASB staff considered whether services provided to the mutual fund by other entities in the complex constitute continuing involvement that should preclude revenue recognition. The staff concluded that services provided by a related advisor or administrator are of a distinct nature and are separable from the services provided by the distributor and therefore should not be considered continuing involvement that would preclude revenue recognition. Provisions providing for repayment to the purchaser based on standard representations and warranties as to the validity of the rights are not considered continuing involvement and, therefore, would not preclude revenue recognition. The proposal requires distributors recognizing revenue from sale of rights to 12b-1 plan fees to third parties to disclose the amount of revenue recognized and the related amount of deferred incremental direct costs amortized in the period. The FSP does not address accounting for 12b-1 fees by mutual funds, investors in funds, or third party purchasers of rights to future 12b-1 fees. Mutual funds should continue to follow the guidance in AICPA SOP 95-3, Accounting for Certain Distribution Costs of Investment Companies. Effective Date and Transition If the proposed FSP is approved, it will be effective as of the beginning of the period in which the final FSP is posted to the FASB website. The impacts of applying the FSP's requirements to previously recognized transactions should be recognized as a cumulative effect of a change in accounting principle pursuant to the guidance in FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and APB Opinion No. 20, Accounting Changes, in the period the FSP is posted to the FASB website. Gregory M. Smith Director - Operations/Compliance & Fund Accounting

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