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STATEMENT OF POSITION 95-3

AICPA

July 28, 1995

Accounting for Certain Distribution Costs of Investment Companies

Amendment to
AICPA Audit and Accounting Guide
Audits of Investment Companies

Prepared by the
Investment Companies Committee
Approved by the Accounting Standards
Executive Committee

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

NOTE

Statements of position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA statements of position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this statement of position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This statement of position (SOP) applies to investment companies that adopt plans that comply with rule 270.12b-1 of the Investment Company Act of 1940.

It requires—

- Investment companies with enhanced 12b-1 plans to recognize a liability, with a corresponding charge to expenses, for excess costs. Changes in the liability should be recognized in the statement of operations as an expense or reduction in expense.
- Reporting of the liability at its present value, calculated using an appropriate current interest rate, if certain conditions are met.
- Investment companies with board-contingent plans to recognize a liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, when the company's board commits to pay such costs.
- Certain disclosures for both traditional and enhanced plans.

This SOP amends the Audit and Accounting Guide *Audits of Investment Companies*. It is effective for annual financial statements for fiscal years beginning after December 15, 1995, and for interim financial statements for periods in such years. The cumulative effect of changes caused by adopting this SOP should be reflected in the calculation of net asset value on the first day of the fiscal year of adoption.

Accounting for Certain Distribution Costs of Investment Companies

Introduction and Background

1. The Audit and Accounting Guide *Audits of Investment Companies* (the Guide) describes how to account for distribution costs of open-end investment companies that are registered under the Investment Company Act of 1940 (1940 Act), as amended, and that have adopted plans of distribution pursuant to rule 270.12b-1 of the 1940 Act. Paragraph 8.35 of the Guide states the following:

> Rule 270.12b-1 of the 1940 Act permits an investment company, in compliance with specified conditions, to pay for costs incurred to distribute its shares. Payments are made pursuant to a plan, commonly known as a "12b-1 plan," adopted by the board of directors. There are many forms of such plans, and the auditor should review their provisions. Distribution expenses paid with an investment company's assets are accounted for as operating expenses. [Rule 6-07.2(f) of Regulation S-X]

2. Open-end investment companies, referred to in this SOP as funds, are permitted to finance the distribution of their shares under a plan pursuant to rule 270.12b-1 of the 1940 Act. Under rule 270.12b-1, a fund's board of directors is required to perform an annual review of the plan and determine whether to continue or terminate it. Under a **traditional 12b-1 plan**,[1] a fund's **distributor** may be compensated or reimbursed for its distribution efforts or costs through one or more of the following methods:

- A 12b-1 fee, payable by the fund, based on an annual percentage of the fund's average net assets (a **compensation plan**) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting **contingent-deferred sales loads (CDSLs)** received by the distributor (a **reimbursement plan**).

[1] Words that are defined in the accompanying glossary are set in boldface the first time they appear.

Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.

- A front-end load, which is assessed on purchasing shareholders at the time fund shares are sold.
- A CDSL imposed directly on redeeming shareholders. The CDSL usually is expressed as a percentage, which declines with the passage of time, of the lesser of redemption proceeds or original cost. The CDSL normally ranges from 4 percent to 6 percent and typically is reduced by 1 percent (for example, from 6 percent to 5 percent) a year until the sales charge reaches zero percent.

3. Rule 12b-1 plans historically have provided that a fund's board of directors may terminate the plan with no penalty to the fund. (Termination of the plan does not necessitate termination of the fund.) Redeeming shareholders still would be subject to the CDSL, which would be paid to the distributor that sold the shares to those shareholders. However, with a traditional 12b-1 plan, the 12b-1 fees normally would be discontinued on plan termination. Some traditional reimbursement 12b-1 plans provide that, when the plan is terminated, the fund's board of directors has the option, but not the requirement, to pay the distributor for any costs incurred by the distributor in excess of the cumulative CDSL and 12b-1 fees the distributor has received. Such a plan is referred to in this SOP as a **board-contingent plan**. Under traditional reimbursement 12b-1 plans, including board-contingent plans, CDSL payments by shareholders continue to be remitted to the distributor until excess costs are fully recovered, after which the CDSL payments usually are remitted to the fund instead of the distributor.

4. With an **enhanced 12b-1 plan**, the fund is required to continue paying the 12b-1 fee after termination of the plan to the extent the distributor has **excess costs**. CDSL payments by shareholders would continue to be remitted to the distributor to further offset excess costs. Thus, the major distinction between traditional and enhanced 12b-1 plans is the requirement for the fund to continue such payments upon plan termination.

5. The following table summarizes the 12b-1 plan attributes enumerated above.

	Traditional			*Enhanced*
	Compensation	*Reimbursement*		
		Nonboard Contingent	*Board Contingent*	
Annual review and approval of plan by board, with ability to terminate plan	X	X	X	X
*Fund Payment Terms**				
Payment based on average net assets	X	X	X	X
Annual or cumulative limitation, or both, based on actual distribution costs		X	X	X
Upon termination of 12b-1 plan, board has option, but not obligation, to pay excess costs			X	
Upon termination of 12b-1 plan, fund is required to continue paying 12b-1 fee to the extent the distributor has excess costs				X

* Excludes front-end and CDSL payments, which are made by shareholders and not the fund.

Scope

6. This Statement of Position (SOP) applies to annual and interim financial statements of investment companies that adopt plans that comply with rule 270.12b-1 of the Investment Company Act of 1940.

Conclusions

7. A liability, with a corresponding charge to expense, should be recognized by a fund with an enhanced 12b-1 plan for excess costs. The amount of the liability should be equal to the cumulative **distribution costs** incurred by the distributor less the sum of (*a*) cumulative 12b-1 fees paid, (*b*) cumulative CDSL payments, and (*c*) future cumulative CDSL payments by **current shareholders**, if reasonably estimable. Any future cumulative CDSL payments should be based on (*a*) current net asset value per share, (*b*) the number of shares currently outstanding and the number of years that they have been outstanding, and (*c*) estimated shareholder **persistency** based on historical fund data or, if historical fund data are not available, group or industry data for a similar class of shares. Changes in the liability should be recognized in the statement of operations as an expense or reduction in expense.

8. The liability should be reported at its present value, calculated using an appropriate current interest rate, if (*a*) the amount and timing of cash flows are reliably determinable and (*b*) the distribution costs are not subject to a reasonable interest charge. If these conditions are not met, the liability should be calculated without discounting to present value.

9. A liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded by a fund with a board-contingent plan when the fund's board commits to pay such costs.

10. For both traditional and enhanced plans, funds should disclose in their financial statements the principal terms of such plans and any plan provisions permitting or requiring payments of excess costs after plan termination. For board-contingent and enhanced plans, the aggregate amount of distribution costs subject to recovery through future payments by the fund pursuant to the plan and through future CDSL payments by current shareholders should be disclosed. For enhanced plans, funds should disclose the methodology used to estimate future CDSL payments by current shareholders.

11. An excess of cumulative 12b-1 fees and CDSL payments to date and future CDSL payments by current shareholders over the cumulative costs incurred by the distributor should not be reported as an asset.

Effective Date and Transition

12. This SOP is effective for annual financial statements for fiscal years beginning after December 15, 1995, and for interim financial statements for periods in such years. The cumulative effect of changes caused by adopting this SOP should be reflected in the calculation of net asset value on the first day of the fiscal year of adoption.[2] Restatement of financial statements presented for comparative purposes, including financial highlights, is not permitted. Pro forma financial information is not required. Early application is encouraged.

Basis for Conclusions

13. This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

14. For enhanced 12b-1 plans, AcSEC considered three alternatives with respect to accounting for excess costs: (1) immediate recognition of a liability when the distributor incurs excess costs; (2) recognition of a liability upon termination of the plan; and (3) no recognition of a liability.

15. AcSEC believes that a fund is unconditionally committed to pay excess costs at the formation of an enhanced 12b-1 plan and that a liability for such costs should be reported by the fund when the costs are incurred by the distributor. Although an enhanced 12b-1 plan requires annual board approval for its continuance, the payment for excess costs is not contingent on such approval. Termination of the plan by the fund's board would not change the obligations under the plan. Any operational

[2] Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 74, *Disclosures Regarding Accounting Standards Issued But Not Yet Adopted,* expresses the SEC staff's views concerning disclosures of the impact that recently issued accounting standards will have on the financial statements when adopted in a future period. The impact of this standard should be disclosed for all investment companies, including those not subject to SAB No. 74.

difficulties, such as the daily calculation of the share net asset values, does not change the fact that the fund is liable for excess costs.

16. The amount of the liability, as calculated pursuant to paragraph 7 of this SOP, includes a reduction for the future cumulative CDSL payments by current shareholders, if reasonably estimable. That is analogous to accounting for the disposal of a segment of a business when the anticipated future cash flows that will result from an original lease and a sublease are taken into account in determining the overall gain or loss on the disposal.[3] In the case of a terminated 12b-1 plan, future CDSL payments on redemption by shareholders pursuant to the prospectus terms reduce the fund's obligation to the distributor, although the amount of those payments is subject to estimation.

17. Funds account for 12b-1 fees as expenses, in accordance with Regulation S-X and the Guide. AcSEC observes that accounting for excess costs as expenses is consistent with that and the way that funds account for other costs of raising capital (such as state registration fees and legal fees). That accounting is based on the principle that raising capital is an integral part of a fund's business. Such costs are analogous to ordinary and necessary period costs in nonfinancial businesses.

18. AcSEC believes that the liability for excess costs should be accounted for at its present value, if (*a*) the amount and timing of cash flows are reliably determinable and (*b*) the distribution costs are not subject to a reasonable interest charge. That is consistent with the consensus in Emerging Issues Task Force (EITF) Issue 93-5, *Accounting for Environmental Liabilities.*

19. Board-contingent plans provide that on a plan's termination, the fund's board of directors has the option, but not the obligation, to pay the distributor for any excess costs incurred. AcSEC believes that a liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded for a board-contingent plan only when the fund's board commits to pay such costs and communicates its intent to do so. A commitment by the board, in effect, converts a board-contingent plan into an enhanced plan. That is, the fund is then obligated to continue to pay the 12b-1 fee after termination of the plan to the extent that the distributor has excess costs.

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[3] FASB Interpretation No. 27, *Accounting for a Loss on a Sublease,* paragraph 3.

20. AcSEC believes that the disclosures required for traditional and enhanced plans are necessary to provide users with adequate information regarding the assumptions used to compute the liabilities for certain distributions costs of enhanced 12b-1 plans and contingent excess costs for traditional 12b-1 plans.

APPENDIX A

Illustration

To illustrate application of this SOP, the following assumptions are made for a fund with an enhanced 12b-1 plan:

Total distribution costs incurred	$5,000,000
12b-1 payments	(750,000)
CDSL payments received by distributor	(250,000)
	4,000,000
Estimated future CDSL payments to be received by distributor from current shareholders at current asset levels*	(1,000,000)
	$3,000,000

Assuming that the 12b-1 fee is paid at the end of the year, the following calculation would be made:

Current fund net assets (10 million shares at $10.00 per share)	$100,000,000
12b-1 fee as a percentage of net assets	.0075
Annual 12b-1 fee payments (75 basis points)	$ 750,000
Estimated number of years to pay excess costs ($3,000,000 ÷ $750,000/year)	4
Present value of 12b-1 payments of $750,000 for 4 years, discounted at an assumed rate of 8 percent (assuming discounting is appropriate)	$ 2,484,000

Accordingly, upon adoption of the SOP on January 1, 19X1, the fund would recognize a liability of $2,484,000 and a corresponding expense, which would be reported as the cumulative effect of a change in accounting principle pursuant to Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes.*

*Assuming amounts are reasonably estimable.

The following illustrates the impact of adopting this SOP in the 19X1 financial statements after making the following additional assumptions:

There are no further distribution costs incurred or capital share activity during 19X1.

CDSLs received during 19X1 are $250,000, and anticipated CDSLs with respect to current shareholders expected to be received after 19X1 are $750,000 (that is, the assumption at the beginning of 19X1 that $1,000,000 of CDSLs would be received still is considered valid).

Statement of Operations

Investment income	$X,XXX,XXX
Expenses	
Distribution fees	—
Interest	199,000*
Other	X,XXX,XXX
Realized and unrealized gains	X,XXX,XXX
Net increase in net assets resulting from operations before cumulative effect of change in accounting principle	X,XXX,XXX
Cumulative effect of change in accounting principle (Note)	(2,484,000)
Net increase in net assets resulting from operations	$X,XXX,XXX

* $2,484,000 at 8 percent.

The statement of changes in net assets should separately reflect the inclusion of the cumulative effect of the accounting change in a similar manner.

The liability at the end of 19X1 would be $1,933,000 ($2,484,000 + $199,000 of interest amortization – $750,000 of annual 12b-1 fees paid) and would be reflected on the statement of assets and liabilities as accrued distribution expenses payable. That amount can be proved as the present value of three consecutive payments of $750,000, which represents the fund's undiscounted liability of $2,250,000.

Financial Highlights

Net asset value — beginning of year	$ .XX
Net investment income	.XX
Realized and unrealized gains	X.XX
	X.XX
Cumulative effect of adoption of accounting standard (Note)	(.25)
Net increase in net assets resulting from operations	$X.XX

Note

Effective January 19X1, the fund adopted AICPA Statement of Position No. 95-3, which requires that a fund record a liability and expense for excess costs, as defined, for enhanced 12b-1 plans. Prior thereto the fund recognized an expense under its 12b-1 plan based on a percentage of the fund's net assets. Under an enhanced 12b-1 plan, the fund is obligated to reimburse the distributor for any costs it has incurred in excess of cumulative 12b-1 and CDSL payments it has received. As of January 1, 19X1, the fund has recorded a liability of $2,484,000 for such costs, representing the cumulative effect of the change in accounting. It is equal to the $4,000,000 of aggregate costs incurred by the distributor in excess of cumulative 12b-1 and CDSL payments through that date, less future estimated CDSL payments of $1,000,000, discounted at 8 percent. At December 31, 19X1, the liability of $1,933,000 represents the aggregate excess costs of $3,000,000 less estimated future CDSL payments of $750,000, discounted at 8 percent. Future CDSL payments were estimated based on the net asset value per share of the fund as of December 31, 19X1, the number of shares currently outstanding and the number of years that they have been outstanding, and estimated shareholder persistency based on historical fund data.

Change in Estimate

Assume that at the end of 19X1, actual CDSLs received in year one exceed those anticipated by $250,000 and the distributor's estimate of future CDSLs after 19X1 is increased by a further $500,000. The undiscounted liability would be reduced from $2,250,000 to $1,500,000; the discounted liability would be $1,337,000. In this situation, the distribution fees included in the 19X1 statement of operations would be a contra expense of $596,000 (interest expense would be unchanged) and not an adjustment of the cumulative effect of adoption.

If it is assumed instead that year-end CDSLs fell short by $250,000 and the estimate of future CDSLs from current shareholders fell by another $500,000, the undiscounted liability would increase to $3,000,000. The discounted liability

would increase to $2,484,000, and the 19X1 statement of operations would include distribution fees of $551,000.

In practice, the periodic remeasurement of the liability also will have to incorporate new fund share sales, additional costs incurred during the period, and the effect of changes in net asset value on the discounting process. In addition, such calculations would have to be made at each net asset value determination date.

APPENDIX B

Discussion of Comments Received on the Exposure Draft

B-1. An exposure draft of a proposed statement of position, *Accounting for Certain Distribution Costs for Investment Companies,* was issued for public comment in April 1994 and distributed to a variety of interested parties to encourage comments by those that would be affected by the proposal. The conclusions proposed in the exposure draft on how to account for such costs have been adopted in this SOP. A majority of commentators supported or did not object to the conclusions proposed.

B-2. A minority of commentators objected to the conclusion that investment companies should account for excess costs under enhanced 12b-1 plans as liabilities and expenses. One objection acknowledged that the SOP may be based on existing accounting theory, but objected to it on the grounds that it will not afford equal and fair treatment to fund shareholders. Another commentator objected because of the belief that the likelihood of the termination of a 12b-1 plan is "highly unlikely, remote," as defined in FASB Statement No. 5, *Accounting for Contingencies.*

B-3. As to the first objection, AcSEC observes that Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* in discussing the concept of neutrality, states: "Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest."

B-4. The second objection fails to recognize that the promise made at the inception of an enhanced 12b-1 plan to pay unconditionally any distribution costs creates a liability. That liability is measured by the amount of excess costs. Terminating an enhanced 12b-1 plan only determines when the existing liability is to be paid.

B-5. A further objection to reporting enhanced 12b-1 excess costs as expenses is that doing so may cause a violation of regulatory limitations on 12b-1 fees. This objector argues that, if excess costs are accounted for as liabilities, a portion of those costs should be recorded as an asset to recognize the future economic benefits of increased fund assets. In considering this objection, AcSEC relied on the concept of neutrality cited above and notes that items are frequently treated differently for GAAP and regulatory purposes. Further, AcSEC believes that the benefits cited—lower expenses (on a pro rata per share basis) and increased cash flows that enhance investment strategy—do not meet the

essential characteristic of an asset in paragraph 26 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, that, "(a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows."

Glossary

Board-contingent plan. A reimbursement 12b-1 plan that provides that, on the plan's termination, a fund's board of directors has the option, but not the requirement, to pay the distributor for any excess costs incurred by the distributor.

Compensation plan. A plan that provides for a 12b-1 fee, payable by the fund, based on a percentage of the fund's average net assets. The 12b-1 fee may be more or less than the costs incurred by the distributor.

Contingent-deferred sales load (CDSL or back-end load). A sales charge imposed directly on redeeming shareholders based on a percentage of the lesser of the redemption proceeds or original cost. The percentage may decrease or be eliminated based on the duration of share ownership (frequently decreases by one percent a year).

Current shareholders. Shareholders of a fund, or a class of shares of a fund, at an evaluation or measurement date. Amounts attributable to current shareholders are based on shares outstanding at that date and do not include estimates of future reinvestments or other share purchases.

Distribution costs. Costs, as defined in a distribution agreement between a distributor and a fund, incurred by a distributor in distributing a fund's shares. Such costs may include commission payments to sales representatives, promotional materials, overhead allocations, and interest.

Distributor. Usually the principal underwriter that sells the fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at net asset value and selling shares through dealers or to the public (see definition of *underwriter* in section 2(a)(40) of the Investment Company Act of 1940).

Enhanced 12b-1 plan. A reimbursement 12b-1 plan that provides that, on termination of the plan, the fund is required to continue paying the 12b-1 fee to the extent the distributor has excess costs.

Excess costs. The cumulative distribution costs incurred by the distributor less the sum of (*a*) cumulative 12b-1 fees paid, (*b*) cumulative CDSL payments, and (*c*) future cumulative CDSL payments by current shareholders, if reasonably estimable.

Persistency. The length of time a shareholder owns shares of a particular fund or class of shares of a fund before redemption.

Reimbursement plan. A plan that provides for a 12b-1 fee, payable by the fund, that may not exceed the lesser of an annual percentage of the fund's average net assets or actual costs incurred by the distributor net of CDSL received by the distributor.

Traditional 12b-1 plan. A compensation or reimbursement plan pursuant to rule 270.12b-1 of the Investment Company Act of 1940 that permits the use of a fund's assets to pay distribution-related expenses under certain conditions. The 12b-1 fees under traditional 12b-1 plans are normally discontinued upon plan termination, but may continue to be paid after plan termination under a board-contingent plan (see above).

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