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Technical Accounting Alert

Customer acquisition commissions paid to intermediaries

Introduction

The purpose of this alert is to discuss arrangements in which a service provider pays an intermediary to introduce new customers. It focuses on arrangements on which the commission payments are based on the revenues generated from the customers.

The issues discussed are:

- Determination of whether or not the commission arrangement is a financial instrument within the scope of IAS 39;
- If applicable, classification of and accounting for changes in the carrying value of the financial instrument;
- Revenue recognition by the entity receiving commission; and
- Expense or asset recognition by the entity paying commission.

Although this alert discusses customer acquisition commissions, the underlying principles also apply to some other types of commission and royalty contracts.

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 11 Construction Contracts	AASB 111 Construction Contracts
IAS 18 Revenue	AASB 118 Revenue
IAS 32 Financial Instruments: Presentation	AASB 132: Financial Instruments: Presentation
IAS 38 Intangible Assets	AASB 138 Intangible Assets
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

In some industry sectors it is common for one entity to pay another for the introduction of new customers. Many such arrangements present no special difficulty. An example of a simple arrangement is an insurance broker that receives a single fee from an insurance provider for selling an insurance contract. Complications arise when the arrangement:

- Involves future payments for services that have already been rendered; and
- When those payments are variable based on a factor that neither party controls.

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Examples of this type of arrangement include:

- An investment manager engaging a financial advisor to sell units in managed funds, when the manager compensates the adviser on a "trail commission" basis. A trail commission is an arrangement under which the adviser receives annually a stated percentage of the management fee that the investment manager earns from the investors in its funds as long as they stay invested in the fund; and
- A mobile phone retailer selling mobile phones to users. In conjunction with the phone sale, the customer enters into a contract with the network operator. In effect, the retailer "signs up" a customer on behalf of the network operator. In return for the customer contract the network operator pays the retailer amounts based upon the usage made by the customer during the contract term.

The commercial intention of such arrangements is to provide an incentive to the intermediary to introduce high value customers to the service provider.

Detailed Guidance

Is the arrangement a financial instrument within the scope of IAS 39?

A contract is a financial instrument within the scope of IAS 39 if it creates a right of one party to receive cash and an obligation of the counterparty to pay cash. A contract to pay commission in exchange for new customer introductions is therefore outside the scope of IAS 39 **before** the introduction service has been provided. Once the service has been provided, the contract is a financial instrument unless the service provider has an unconditional right to avoid payment.

The fact that the amount of commission is wholly or partly contingent on the actions of a customer does not prevent the contract meeting the definition of a financial instrument (see IAS 32.AG8). This applies even if the contingency in question is "remote" (see IAS 32.BC17). However, if the service provider is able to control the contingency (ie if it is not under any obligation to provide services and can thereby avoid paying commission), the contract is not a financial instrument.

Financial assets and liabilities within the scope of IAS 39 should be recorded at fair value on initial recognition, plus or minus any transaction costs if applicable (IAS 39.43). Fair value will usually need to be estimated based on the expected cash flows to be paid and received. A quoted price in an active market will not be available in most cases (see IAS 39.AG74 to AG82).

Financial instruments and contracts for services

This alert addresses the accounting treatment at the point the intermediary has performed its services (ie has introduced the customer). Before that point, the arrangement is for one party to provide services in exchange for cash, which fails the IAS 32.11 definition of a financial instrument. Such a contract is therefore also outside the scope of IAS 39 whilst it remains "executory" (unless the non-financial item is readily convertible into cash and is not for own use - see IAS 39.5 and 6. This is unlikely to capture contracts for services). Once the services have been provided, the contract becomes a financial liability of one party (unless that party is able to avoid payment - see below) and a financial asset of the other.

It needs to be considered whether the party that pays the commission is able to control the contingency. This question can also be expressed as "does that party have an unconditional right to avoid payment?" A contingent obligation to transfer cash (or another financial asset) is regarded as a financial liability unless the entity is able to control the outcome of the future events or circumstances

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that affect the future payments (see IAS 32.25 and AG8). Judgement is likely to be required to determine whether the contingency is controllable, particularly when the contingency relates to a customer of one of the parties.

In the context of the trail commission and mobile phone examples, we consider that an unconditional right to avoid making payments to the intermediary by cancelling the customer contract would amount to an ability to control the contingency (even if this is commercially unrealistic). However, this would only be the case if:

- The investment manager or network operator either has no contractual obligation to provide services to the customer or has an unconditional right to cancel that contract; and
- The intermediary (mobile phone retailer or investment adviser) would not have rights of redress in this event.

Grant Thornton considers that an ability to "escape" an obligation only by closing down a fund or network does not represent an unconditional right to avoid making payments.

Classification and accounting for changes in the carrying value of the financial instrument

The financial asset recorded by the receiving entity should be classified in accordance with the definitions in IAS 39.9. This will often result in classification within "loans and receivables", provided the payments are considered fixed or determinable and the other conditions in IAS 39.9 are met. After initial recognition, loans and receivables are measured at amortised cost using the effective interest method.

Changes in the amounts and timing of estimated cash flows give rise to gains and losses which should be recorded in the statement of comprehensive income (IAS 39.AG8). Grant Thornton's preferred approach is that these changes are reported as other income or expense, not as revenue (or negative revenue).

The financial liability recorded by the paying entity will also usually be measured at amortised cost after initial recognition. Subsequent changes in the carrying value of the financial liability should be recorded in the statement of comprehensive income.

Consequences of financial instrument classification

In summary, the main consequences will be that:

- The service provider and the intermediary will record a financial liability and a financial asset respectively;
- On initial recognition, these amounts are recorded at fair value plus or minus transaction costs if applicable (IAS 39.43);
- The financial liability and financial asset need to be classified in accordance with the usual IAS 39 principles. These are not discussed in detail here. However, classification of the asset within loans and receivables has the effect that subsequent measurement is at amortised cost using the effective interest rate (IAS 39.9 and 46(a)). The financial liability will be measured on the same basis in most cases (IAS 39.47);
- Fair values will usually need to be estimated based on expected cash flows, discounted at a market rate of interest; and

- If the measurement basis is amortised cost, interest income or expense is recognised as the discount unwinds (IAS 39.9). Changes in cash flow estimates will affect the carrying value and this is reflected in the statement of comprehensive income (IAS 39.AG8).

In some cases, the intermediary might "sign up" a customer for a fixed period. However, the service provider might be committed to make further payments to the intermediary if the customer renews or extends the contract. This raises an issue as to whether the expected cash flows at inception should include expected cash flows from renewal or extension. This is an ambiguous area. However, in most cases the service provider is likely to have an absolute discretion not to renew or extend the contract with the customer. On this argument, we consider that it is acceptable for both the intermediary and the service provider to value the financial instrument based on the original contractual period. This is also likely to be a more practical approach.

Revenue recognition for the entity receiving commission

If the receiving entity has provided services and recognises a financial asset, it should determine the amount of revenue to be recorded in accordance with IAS 18. The fact that the entity has received a financial asset in exchange for services provided indicates that it may also be appropriate to record an equal amount of revenue (see IAS 18.9 and 21). However, the entity should also evaluate the extent to which it is **probable** that the economic benefits associated with the transaction will be received (see IAS 18.20(c) and 22). If some of those benefits are considered less than probable, a corresponding amount of revenue should be deferred. Deferred revenue should be recognised as actual revenue if and when receipt becomes probable.

If some or all of the deferred revenue is not received, the adjustment should be offset against the corresponding reduction in the carrying value of the financial asset.

As noted above, IAS 39 requires initial recognition at fair value of all financial instruments within its scope. Any uncertainty as to reliability will be reflected in the determination of fair value. The basic principle in IAS 18 is that revenue is measured at the fair value of the consideration received or receivable (IAS 18.9). On this basis, it seems appropriate to recognise revenue equal to the fair value of the financial asset received (ie on the same measurement basis as required in IAS 39).

However, IAS 18.20 gives further guidance on revenue recognition for the rendering of services. When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue should be recognised by reference to the stage of completion of the transaction at the reporting date. The outcome of the transaction can be estimated reliably when all the following conditions are satisfied:

- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity;
- The stage of completion of the transaction at the reporting date can be measured reliably; and
- The costs incurred for the transaction and the costs to complete the transactions can be measured reliably.

IAS 18 sets a different threshold for revenue recognition (compared to IAS 39's requirement to recognise all financial instruments at fair value). For this reason, we consider that the inclusion of a financial asset on the statement of financial position does not automatically entitle the intermediary to recognise the same amount of revenue. Revenue should be deferred to the extent that the ultimate collectability of the asset recorded is considered less than probable. The term "probable" is not clarified further in IAS 18.

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Changes in the carrying value of the financial asset

As noted above, changes in the carrying value of the financial asset resulting from changes in estimated cash flows will result in gains or losses in the statement of comprehensive income. Such changes will occur as customers generate greater or lower revenue than originally predicted. Grant Thornton's preferred treatment is that changes in the carrying value of the asset are presented as other income or expense, not as adjustments to revenue. This is because the intermediary is not providing any additional service (or reduction in service). The change in the carrying value of the asset results from the intermediary's exposure to customer behaviour rather than to any revenue-generating activity.

The counter-argument is that this arrangement requires revenue to be based on estimates and that changes in estimates are generally recorded in the same line item as the original transaction. There is support for this approach by analogy to **IAS 11 Construction Contracts** (see IAS 11.12). We therefore consider that recording such changes within revenue is an acceptable alternative. However, IAS 18.34 is clear that credit losses (ie amounts due but uncollectible) should **not** be recognised as adjustments to revenue.

Expense or asset recognition by the entity paying commission

For contracts in which the service provider pays for the introduction of a customer, an evaluation should be made as to whether an intangible asset should be recorded. IAS 38 should be applied in making this determination. Because the service provider has paid an intermediary for the customer introduction, the requirements on separately acquired intangible assets (at IAS 38.25 -32) should be applied.

In cases when the service provider acquires a customer contract, we consider that the conditions to record an intangible asset will often be met. This is because the contract provides a basis on which the entity can control future economic benefits (see IAS 38.13). However, purchased customer information (eg a customer list) and customer relationships can also meet the recognition criteria.

The cost of an acquired intangible asset should be based on the fair value of the financial liability assumed, plus any other directly attributable costs (see IAS 38.27).

If an intangible asset is recorded, it should be accounted at cost less amortisation. The IAS 38 revaluation model is also available if those assets are traded in an active market, which is expected to be rare (see IAS 38.72 to 87). The cost model requires that a useful life is determined in accordance with IAS 38.88 to 96. If the intangible asset is a customer contract, the useful life should not exceed the contractual period (IAS 38.94). The intangible asset should be reviewed for impairment if indications of impairment exist (such as cancellation or lower than expected customer revenue).

Examples

Example 1 - mobile phone retailer and network operator

Mobile phone retailer A signs up three customers for network operator B on 1.1.X1. Each customers' contract is a 12 month, non-cancellable agreement with a minimum spend of $50/month ($ 600/year). Retailer A does not provide any further services to B in relation to those customers. Operator B agrees to pay retailer A commissions of 5% of customer revenue, including any additional revenue if the customer extends the contract. However, operator B has no obligation to continue to provide services to the customers beyond the 12 month period.

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Retailer A and operator B make the following estimates:

- The estimated customer revenue in each case over the 12 month contract period is $ 1,200 such that estimated commissions are $ 60;
- The fair value of the expected commission payments from each contract is $ 56 at inception (based on the discounted estimated commission of $ 60);
- Retailer A considers that only the minimum spend is "probable". Hence the "probable" level of commission is $ 30 (with a fair value of $ 28).

Subsequently, over the 12 month period:

- Customer 1 spends exactly the amount predicted ($ 1,200, resulting in commissions of $60);
- Customer 2 spends only the contractual minimum ($ 600, resulting in commissions of $30);
- Customer 3 spends double the amount predicted ($ 2,400, resulting in commissions of $120).

Analysis - Retailer A

On 1.1.X1 retailer A receives three financial assets from operator B. This is the case because the arrangement between A and B entitles A to receive cash. A is not required to perform any further services. Also, the customer contracts provided to operator B are non-cancellable, so B does not have an unconditional right to avoid payment. Retailer A should recognise the three financial assets at their fair value, which reflects expectations of future cash flows. At 1.1.X1, A's contractual entitlement relates only to the 12 month period. Although A will receive further payments if the customers extend their contracts, in this case B is under no obligation to continue to provide service beyond the 12 month period.

Because A has determined that only the contractual minimum payments are probable, the amount of revenue recognised on 1.1.X1 reflects only that portion of the fair value of the financial asset. (This is a somewhat artificial scenario for illustrative purposes. It is unlikely in practice that there would be such a large difference between the expected cash flows used to estimate fair value and the "probable" cash flows used for revenue recognition purposes - especially as probable is interpreted as more likely than not).

The respective entries on 1.1.X1 are as follows:

Initial Recognition	Debit	Credit
Financial Assets (56 x 3)	$168	
Revenue		$84
Deferred revenue		$84

As the revenue generated from customer 1 is as expected, the deferred revenue is "released" to revenue over the course of the following 12 months and the financial asset is realised as the cash flows are received:

Subsequent accounting - Customer 1	Debit	Credit
Cash	$60	
Financial asset		$56
Revenue		$28
Interest income		$4
Deferred revenue	$28	

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In customer 2's case, the financial asset becomes impaired. This loss is recorded in the statement of comprehensive income. Grant Thornton's preferred approach is that this is presented as an "other expense", not a reduction in revenue. The deferred income also needs to be derecognised. This results in a gain which should also be presented outside revenue. In practice, we consider that it would be appropriate to offset the deferred revenue against the reduction in the carrying value of the asset due to impairment. (Although offsetting is not generally permitted in IFRS, in this case the derecognition of the deferred revenue does not to meet the basic Framework definition of income. The suggested approach avoids presenting "income" in relation to the deferred revenue).

Subsequent accounting - Customer 2	Debit	Credit
Cash	$30	
Financial asset		$56
Interest income		$2
Other income - derecognition of deferred revenue		$28
Other expense - loss on financial asset*	$28	
Deferred revenue	$28	

* shown gross for illustrative purposes, but we suggest offsetting these amounts in the statement of comprehensive income.

Customer 3's revenue exceeds the original estimate. Hence, a gain is recorded as a result of re-estimation of the cash flows from the financial asset. As above, we consider it preferable that this gain is recorded as "other income", not as revenue. The entries are as follows:

Subsequent accounting - Customer 3	Debit	Credit
Cash	$120	
Financial asset		$56
Revenue		$28
Interest income		$4
Other income - gain on financial asset		$60
Deferred revenue	$28	

Network Operator B

Operator B has a financial liability to pay A in exchange for the three customer contracts. The contracts provide legally enforceable rights and meet all the conditions to be recognised as intangible assets. These assets should be amortised over the 12 month contract period.

The respective entries on 1.1.X1 are as follows:

Initial recognition	Debit	Credit
Intangible assets (56 x 3)	$168	
Financial liabilities		$168

In the first case, the payments to retailer A are as expected. The financial liability is settled and is not re-estimated. The intangible customer contract asset is amortised over the 12 month period:

Subsequent accounting - Customer 1	Debit	Credit
Cash		$60
Financial liabilities	$56	
Interest expense	$4	
Amortisation of intangible asset - statement of comprehensive income	$56	
Intangible asset		$56

For customer 2, the cash flows from the customer are less than expected, which reduces the expected payments to retailer A. This results in a decrease in the liability to A, and hence a gain in the statement of comprehensive income. The intangible asset might become impaired, although not necessarily. This is because even the minimum contractual cash flows from the customer appear to support a recoverable amount in excess of the carrying value of the intangible asset. As a result, a timing mismatch could occur between the recognition of a gain in relation to the financial liability and the amortisation of the intangible asset. The entries over the 12 month period are:

Subsequent accounting - Customer 2	Debit	Credit
Cash		$30
Financial liabilities	$56	
Interest expense	$2	
Other income - reduction in financial liability		$28
Other expense - amortisation of intangible asset	$56	
Intangible asset		$56

For customer 3, the increase in expected cash flows from the customer increases the expected cash flows payable to retailer A. This results in an increase in the liability to A and a corresponding expense. The intangible asset is also worth more. However, because intangible assets are measured at cost less amortisation, this value increase is not recorded in the statement of comprehensive income. The operator will of course recognise higher than expected customer revenues, but timing mismatches may arise.

The entries over the 12 month period are:

Subsequent accounting - Customer 3	Debit	Credit
Cash		$120
Financial liabilities	$56	
Interest expense	$4	
Other expense - increase in financial liability	$60	
Amortisation of intangible asset - statement of comprehensive income	$56	
Intangible asset		$56

Example 2 - Trail commission

Investment manager C engages financial advisor D to sell units in funds to the general public that C manages. C compensates D on a trail commission basis. Under this arrangement, D receives annually 5% of the management fee that C earns from the investors in its funds that were introduced by D. This continues for as long as those investors remain invested in the fund. D does not provide any additional services to C or to the investor that it originally advised.

When one of the investors redeems its units and divests from the fund, C will discontinue the payment of commission to D if that investor was one that D secured.

Units in C's funds are offered to the public in general. C does not have any unilateral right or ability to refuse to allow the customers to hold units in normal circumstances.

Analysis

The arrangement is mostly very similar in substance to the mobile phone example. The main difference is that this is an open-ended rather than a fixed-period arrangement. Investment manager C is not able to control how long its customers stay invested in the fund and hence has a financial liability to adviser D. D has an equivalent financial asset. Because the arrangement is open-ended, the duration (and useful life of any related intangible asset recorded by C) will need to be estimated. This

should be based the time period over which the investor will stay invested in the fund. This will be a critical estimate.

Example 3 - Royalty contract

Manufacturer E makes and sells products that incorporate patented technology owned by company F. Manufacturer E agrees to pay F a fixed royalty for every product sold.

Analysis

Assuming that E has no obligation to make sales of the products concerned, this arrangement does not represent an obligation to transfer cash until products are actually sold. Hence the obligation and related expense is recognised by E as sales are made. Company F recognises revenue on the same basis.

Subsequent accounting - Customer 3

On November 12 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 30. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 30. Work has begun on phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 WAS ISSUED IN AUSTRALIA AS AASB 9 FINANCIAL INSTRUMENTS WITH AN EFFECTIVE DATE OF 1 JANUARY 2013 AND THEREFORE AASB 9 REQUIREMENTS HAVE NOT BEEN CONSIDERED FOR THE PURPOSE OF THIS ALERT.

Further Information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au