Accounting for: no load mutual fund distribution fees; Issues paper (1985 December 11)

American Institute of Certified Public Accountants. Stockbrokerage Auditing Subcommittee

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ISSUES PAPER

ACCOUNTING FOR:

NO LOAD MUTUAL FUND DISTRIBUTION FEES

Prepared by
Stockbrokerage Auditing Subcommittee
American Institute of Certified Public Accountants

Accounting for No Load Mutual Fund Distribution Fees

Introduction: The AICPA Stockbrokerage Auditing Subcommittee (the "Subcommittee") was requested by an industry member to discuss the alternative methods of accounting for mutual fund distribution fees.

The Subcommittee understood that the request emanated from the consensus reached by the Emerging Issues Task Force at its June 27, 1985 meeting after their discussion on alternative methods of accounting for mutual fund distribution fees "...that existing accounting practice should not be changed..." and that the "existing accounting practice" differed from the method utilized by the industry member's firm. The Subcommittee also understood that several Task Force members suggested at that same meeting "... that some other group more familiar with this industry might address the issue."

The industry member pointed out to the Subcommittee that it was his understanding that consensus views of the Task Force are supposed to reflect practice rather than establish it and that this particular consensus resulted in limiting alternative methods of accounting before a complete discussion of existing practice had taken place and before existing practice had the opportunity to fully develop.

At the September 23, 1985 meeting, the Subcommittee discussed the two methods of accounting that had been discussed at the Emerging Issues Task Force meeting, termed the Income Accrual method and the Cost Deferral method. The methods are explained in the Emerging Issues Task Force minutes as (a) the accrual of fees at present value, recognized at the time of distribution along with all costs of performance and (b) the recognition of fees at the time received, along with amortization of deferred incremental direct costs and expensing of indirect costs when incurred.

This Issues paper discusses the two methods of accounting for mutual fund distribution fees discussed by the Emerging Issues Task Force and the Subcommittee and adds two additional methods of accounting which are also used in practice today.

To understand the various methods of accounting used by broker-dealers acting in the capacity as seller/distributor of mutual funds for the fees associated with the no load mutual fund, it is necessary to also understand the accounting methods used by broker-dealers to record the fees associated with front loaded funds and the business reasons for the development of the no load fund.

Broker-Dealer Compensation - Front Loaded Funds

Compensation to the broker-dealer for the distribution and management of front loaded funds usually consists of the two fees described below. Selling fees are typically charged to customers (not the mutual fund) when the shares are sold; no fee charged when the shares are redeemed. -

Advisor, Administrative Fees

Management, portfolio advisor and administrative fees (sometimes lumped together and called management fees) are charged to the fund by the manager and administrator for ongoing services. Such charges, ranging from ½% to 1% of the principal amount of the fund, are normally much lower than the selling fee and often decrease percentage-wise as the size of the fund increases.

Selling Fees

Typically, the selling broker-dealer is paid a sales commission in the range of 5% to 7% of the dollars invested by the customer at the time of the sale. Salesmen generally receive a net commission payment of 45% to 50% of the sales commission.

Accounting - Front Loaded Funds

The administrative fee is generally recorded over the life of the fund as the services associated with the transaction are performed over time. At the time of sale of the mutual fund securities to a customer, the selling broker-dealer has performed all the sales services associated with the transaction and, therefore, records the selling fees together with the related commission expense to its salesmen.

Broker-Dealer Compensation - No Load Funds

The front loaded fund resulted in a serious sales drawback because the commission or selling fee resulted in an immediate 5% to 7% reduction in the customer's investment and related earnings base. As a result, a method was designed under which the selling broker-dealer collected the selling fee over a five year period. This method spreads the charge and softens the decrease in the value of mutual fund investment. The fees associated with the distribution and management of this type of fund are described below.

Advisor, Administrative Fees

As with the front loaded funds, the element of compensation for management, portfolio advisor and administration services continues on an ongoing basis at an annual rate of ½% to 1% of the fund's assets.

Selling Fees

Under this arrangement the selling broker-dealer receives amounts from either and/or both the customer and the fund, generally as follows. The customer pays a charge, under a sliding scale rate schedule, at the time he redeems his shares. For example, 5% of his purchase price if redeemed within a year of purchase, 4% if redeemed in the second year, 3% in the third year and so on, with no charge to the customer if the investment is held for more than five years. Recognizing that this sliding scale charge places the selling broker-dealer in the potential position of not receiving the full selling fee to which he had become accustomed, the originators of this mutual fund product introduced a new element, i.e., a "distribution fee" typically set at 1% per year of the lower of the Fund's assets or the initial sales price of the fund shares. The combined effect of the declining customer redemption charge and the 1% annual distribution fee results in the broker-dealer receiving a total of 5% in compensation during the first five years of the mutual fund's existence, regardless at what point the shares are redeemed. As with the front loaded funds, the salesmen of the selling broker receives his normal commission compensation of 45% to 50% of the first five years of selling fees at the time of the sale.

Accounting - No Load Funds

The administrative fee is recorded over the life of the fund as in the case of the front loaded funds. Several accounting methods have been used for the recognition of the selling fee and is the purpose of this discussion. These methods are (1) The Cost Deferral Method; (2) The Income Accrual Method; (3) The Cost Recovery Method; and (4) The Cash Method. Some in the industry believe that other variations of these four methods are also in use. Because funds of this nature in significant amounts have only recently begun to be offered, this matter is just now receiving the attention of the financial management of the broker-dealer industry. The four methods of accounting are described under the topic "diversity in practice."

Scope: The scope of this paper applies to the accounting of no load mutual fund distribution fees and related direct expenses by broker-dealer (and other) distributors. It does not apply to the accounting treatment of the distribution fee by the mutual fund.

Authoritative Accounting Literature: A 1978 FASB Invitation to Comment on "Accountin for Certain Service Transactions" incorporated a proposed AcSEC SOP that included the following comments and recommendations regarding service revenue recognition and related costs.

3. The fundamental standard for profit recognition is set forth in ARB No. 43, Chapter 1A, Rule 1: "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." APB Statement 4, which describes the basic concepts and accounting principles underlying financial statements of business enterprises, further explains the principles for profit recognition:

> Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place (parargaph 150).
>
> Revenue from services rendered is recognized . . . when services have been performed and are billable. Revenue from permitting others to use enterprise resources . . . is recognized as time passes or as the resources are used (paragraph 151).
>
> Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned (paragraph 155).
>
> Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation (parargaph 147).

10. Revenue from service transactions should be recognized based on performance, because performance determines the extent to which the earnings process is complete or virtually complete. Performance is the execution of a defined act or acts or occurs with the passage of time. Accordingly, revenue from service transactions should be recognized as follows:

(a) Specific performance method—Performance consists of the execution of a single act and revenue should be recognized when that act takes place. For example, a real estate broker should record sales commissions as revenue upon the consummation of a real estate transaction (also see paragraph 17).

(b) Proportional performance method—Performance consists of the execution of more than one act and revenue should be recognized based on the proportionate performance of each act.[3]

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[3] Such measurements need to be made only if the acts are performed in more than one financial accounting period.

15. The following definitions related to costs have been adopted for purposes of this statement of position:

(a) Initial direct costs are costs incurred that are directly associated with negotiating and consummating service agreements. They include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and installment paper processing fees. In addition, the portion of salespersons' compensation, other than commissions, and of the compensation of other employees that is applicable to the time spent in the activities described above with respect to service transactions are also included in initial direct costs. The portion of salespersons' compensation and of the compensation of other employees that is applicable to the time spent in negotiating service transactions that are not consummated are not included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, is included in initial direct costs.

(b) Direct costs are costs that have a clearly identifiable beneficial or causal relationship (i) to the services performed or (ii) to the level of services performed for s group of customers, for example, servicemen's labor and repair parts included as part of a service agreement.

(c) Indirect costs are all costs other than initial direct costs and direct costs. They include provisions for uncollectible accounts, general and administrative expenses, advertising expenses, and general selling expenses. Indirect costs also include the portion of salespersons' compensation and of the compensation of other employees that is applicable to the time spent in negotiating service transactions that are not consummated, as well as all allocations of facility costs (depreciation, rentals, maintenance, and other occupancy costs).

Indirect Costs

16. Indirect costs should be charged to expense as incurred.

Initial Direct Costs and Direct Costs

17. Cost recognition under the specific performance and completed performance methods—If revenues are recognized on a service transaction under the specific performance or completed performance methods as described in paragraphs 10(a) and 10(c), all initial direct costs and direct costs should be charged to expense at the time revenues are recognized. Initial direct costs and direct costs incurred before the service is performed should be deferred and allocated over the term of service performance in proportion to the recognition of service revenue (see paragraphs 21 and 22).

20. Cost recognition under the collection method—If the degree of uncertainty surrounding realization of service revenue is so significant that revenues are recognized only when collected, initial direct costs and direct costs should be charged to expense as incurred (see paragraph 22).

The FASB concluded, after the close of the comment period on January 22, 1979, that r further separate action should be taken on this subject, but rather that the matter should be dealt with as part of the Recognition and Measurement phase of the Conceptual Framework. The Board's conclusions on this subject were published in SFAC No. 5 in December, 1984. SFAC 5 contains the following commments:

> 37. Final results of incomplete cycles usually can be reliably measured at some point of substantial completion (for example, at the time of sale, usually meaning delivery) or sometimes earlier in the cycle (for example, as work proceeds on certain long-term, construction-type contracts), so it is usually not necessary to delay recognition until the point of full completion (for example, until after receivables have been collected and warranty obligations have been satisfied). Guidance for applying recognition criteria to components of earnings (paragraphs 78-87) helps define earnings by aiding in making those determinations.
>
> 38. Earnings focuses on what the entity has received or reasonably expects to receive for its output (revenues) and what it sacrifices to produce and distribute that output (expenses). Earnings also includes results of the entity's incidental or peripheral transactions and some effects of other events and circumstances stemming from the environment (gains and losses).[23]
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> **Revenues and Gains**
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> 83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.
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> a. *Realized or realizable*. Revenues and gains generally are not recognized until realized or realizable.[50] Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
> b. *Earned*. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations,[51] and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

84. In recognizing revenues and gains:

a. The two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery).[52]

d. If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.

g. If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

Expenses and Losses

85. Further guidance for recognition of expenses and losses is intended to recognize consumption (using up) of economic benefits or occurrence or discovery of loss of future economic benefits during a period. Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits.

Consumption of Benefits

86. Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period:[55]

a. Some expenses, such as cost of goods sold, are matched with revenues—they are recognized upon recognition of revenues that result directly and jointly from the same transactions or other events as the expenses.
b. Many expenses, such as selling and administrative salaries, are recognized during the period in which cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after.
c. Some expenses, such as depreciation and insurance, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.

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[55]Concepts Statement 3, pars. 84-89.

SFAC 5 makes frequent reference to SFAC 3, Elements of Financial Statementa of Busines Enterprises. Applicable excerpta from SFAC 3 are as follows:

20. An asset has three essential characteristics: (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, (b) a particular enterprise can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred. Assets commonly have other features that help identify them—for example, assets may be acquired at a cost[10] and they may be tangible, exchangeable, or legally enforceable. However, those features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the enterprise in producing or distributing other goods or services. Similarly, although the ability of an enterprise to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if its receipt by the enterprise is otherwise probable.

Revenues

63. Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.[30]

Characteristics of Revenues of Business Enterprises

64. Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise's ongoing major or central operations during the period. The assets increased by revenues[31] may be of various kinds—for example, cash, claims against customers or clients, other goods or services received, or increased value of a product resulting from production. Similarly, the transac-

[30]Timing of recognition of revenues—including existing recognition procedures, which usually recognize revenues when goods are delivered or services are performed but may sometimes recognize them when cash is received, when production is completed, or as production progresses—is major subject matter for the Board's conceptual framework project on accounting recognition criteria. This Statement contains no conclusions about recognition of revenues or of any other elements.

tions and events from which revenues arise and the revenues themselves are in many forms and are called by various names—for example, output, deliveries, sales, fees, interest, dividends, royalties, and rent—depending on the kinds of operations involved and the way revenues are recognized.

Expenses

65. Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods,[32] rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Charecteristics of Expenses of Business Enterprises

66. Expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise's ongoing major or central operations during the period. The assets that flow out or are used or the liabilities that are incurred[33] may be of various kinds—for example, units of product delivered or produced, kilowatt hours of electricity used to light an office building, or taxes on current income. Similarly, the transactions and events from which expenses arise and the expenses themselves are in many forms and are called by various names—for example, cost of goods sold, cost of services provided, depreciation, interest, rent, and salaries and wages—depending on the kinds of operations involved and the way expenses are recognized.[34]

The issue summary reviewed by the Emerging Issues Task Force contained the following information relative to SEC Rule 12b-1.

Rule 12b-1 under the Investment Company Act of 1940, as amended, was adopted by the Securities and Exchange Commission on October 28, 1980. Under Rule 12b-1, open-end diversified management investment companies (funds) may use their assets to finance distributions, if done pursuant to a written plan which has been approved by a vote of a majority of the fund's outstanding voting securities and a majority of its directors who have no financial interest in the plan or any related agreements. Furthermore, for a fund to avail itself of the rule, the selection and nomination of its disinterested directors must be committed to the discretion of the current disinterested directors.

Generally, Rule 12b-1 further provides: (a) that the plan must be approved annually by directors; (b) any person authorised to direct disposition of monies pursuant to the plan shall provide quarterly written reports of the amounts expended to the directors who shall review such reports; (c) the plan may be terminated any time by a majority of the fund's shareholders or disinterested directors; and (d) the plan must provide that it may not be amended to increase materially the amount to be spent under the plan without shareholder approval and that all material amendments of the plan be approved by the directors.

Similar to the process for approving an investment advisory contract, when approving the implementation or continuation of a plan, directors are required by the rule to request and evaluate such information as may be reasonably necessary to make an informed determination. The directors must conclude, in the exercise of their reasonable business judgment and in light of their fiduciary duties, that there is reasonable likelihood that the plan will benefit the fund and its shareholders.

Once approved by the fund's shareholders, the distribution agreement continues in effect from year to year provided such continuance is approved at least annually by a vote of the fund's boards of directors, including a majority vote of the fund's independent directors. The agreement may be terminated at any time, without penalty, by vote of a majority of the independent directors or by vote of the holders of a majority of the fund's outstanding shares. Shareholder approval is required to increase materially the amount the fund is authorized to pay the distributor. These provisions, which prevent the legal form of the distribution agreements from being noncancellable, are required by Rule 12b-1.

The following information has been extracted from the Prudential-Bache Government Plus Fund, Inc. prospectus. It explains the plan of distribution, the adviser fees, the administrator fees, and the contingent deferred salea charge.

Plan of Distribution

Upon the commencement of the continuous offering of the Fund's shares, Prudential-Bache will act as Distributor of the Fund's shares pursuant to a Distribution Agreement (the "Distribution Agreement") with the Fund. The Distributor and other broker-dealers pay commissions to account executives, the cost of printing and mailing prospectuses to potential investors and any advertising expenses incurred by them in connection with their distribution of Fund shares. To compensate the Distributor for the services it provides and for the expenses it bears under the Distribution Agreement, the Fund has adopted a Plan of Distribution under Rule 12b-1 (the "Plan") under the Investment Company Act of 1940, as amended (the "Investment Company Act"), pursuant to which the Fund pays the Distributor compensation accrued daily and paid monthly at the annual rate of 1% of the lesser of (a) the aggregate gross sales of the Fund's shares since the inception of the Fund (not including reinvestments of dividends or capital gain distributions), less the aggregate net asset value of the Fund's shares redeemed since the Fund's inception upon which a contingent deferred sales charge has been imposed or upon which such charge has been waived, or (b) the Fund's average daily net assets. The Distributor also receives the proceeds of contingent deferred sales charges imposed on certain redemptions of shares. See "How to Redeem Shares — Contingent Deferred Sales Charge."

Adviser

The Prudential Insurance Company of America ("Prudential"), the investment adviser to the Fund, is a major mutual life insurance company. Incorporated in 1873 under the laws of the State of New Jersey, its corporate office is located at Prudential Plaza, Newark, New Jersey 07101. As of December 31, 1984, Prudential managed investment portfolios including holdings of approximately $30 billion in publicly-traded fixed income investments, which holdings included approximately $10 billion in U.S. Government securities. In addition, Prudential serves as investment adviser to substantially all of the investment companies that, together with the Fund, comprise the "Prudential-Bache Mutual Funds." See "Administrator and Distributor."

Pursuant to the Investment Advisory Agreement with the Fund, Prudential, subject to the supervision of the Fund's Board of Directors and in conformity with the stated policies of the Fund, is responsible for managing the investment operations of the Fund and the Fund's portfolio, including the purchase, retention, disposition and lending of securities, futures and other investments. Prudential is obligated to keep certain books and records of the Fund in connection therewith. The investment advisory services of Prudential to the Fund are not exclusive under the terms of the Investment Advisory Agreement, and Prudential is free to, and does, render investment advisory services to others.

Pursuant to a Service Agreement between Prudential and its wholly-owned subsidiary, The Prudential Investment Corporation ("PIC"), PIC furnishes to Prudential such services as Prudential may require in performing its obligations under the Investment Advisory Agreement with the Fund. Prudential continues to have responsibility for all investment advisory services undertaken by it in the Investment Advisory Agreement and supervises PIC's performance of such services.

The Fund pays Prudential an annual advisory fee of .25 of 1% of the average daily net assets of the Fund. Prudential has agreed to waive its fee until the earlier of three months from the date of this Prospectus, or the date the Fund's net assets reach $25 million.

Administrator and Distributor

Prudential-Bache Securities Inc., One Seaport Plaza, New York, New York 10292 ("Prudential-Bache," the "Administrator," or the "Distributor"), is a corporation organized under the laws of the State of Delaware. It is engaged in the securities underwriting and securities and commodities brokerage business and is a member of the New York Stock Exchange, other major securities and commodities exchanges and the National Association of Securities Dealers. Prudential-Bache is also engaged in the investment advisory business. It has acted as a sponsor of a number of series of Municipal Investment Trust Funds, Corporate Income Funds, Government Securities Income Funds, International Income Funds and Equity Income Funds and as a sponsor and managing underwriter of a number of series of Corporate Investment Trust Funds and as a principal underwriter and managing underwriter of other investment companies. Prudential-Bache, in addition to participating as a member of various selling groups or as agent of other investment companies, executes orders on behalf of investment companies for the purchase and sale of their securities and sells securities to such companies as a broker or dealer in securities. Prudential-Bache is an indirect, wholly-owned subsidiary of Prudential.

Prudential-Bache is either manager or administrator and distributor, and Prudential is the investment adviser for each of fifteen other investment companies that, together with the Fund, comprise the Prudential-Bache Mutual Funds as set forth below:

Fund	Approximate Net Assets December 31, 1984
	(000)
MoneyMart Assets Inc.	$3,347,669
Prudential-Bache Adjustable Rate Preferred Stock Fund, Inc.	190,719
Prudential-Bache California Municipal Fund	13,637
Prudential-Bache Equity Fund, Inc.	47,500
Prudential-Bache Global Fund, Inc.	9,504
Prudential-Bache Government Securities Trust	
Money Market Series	253,247
Intermediate Term Series	35,015
Prudential-Bache High Yield Fund, Inc.	257,888
Prudential-Bache High Yield Municipals, Inc.	261,596
Prudential-Bache Municipal Series Fund	70,140
Prudential-Bache New Decade Growth Fund, Inc.	58,160
Prudential-Bache Option Growth Fund, Inc.	51,627
Prudential-Bache Quality Income Fund, Inc.	30,137
Prudential-Bache Research Fund, Inc.*	153,467
Prudential-Bache Tax-Free Money Fund, Inc.	196,551
Prudential-Bache Utility Fund, Inc.	97,904

* Prudential-Bache serves as the investment adviser for this fund.

In addition, Prudential-Bache is the administrator and distributor, and Prudential is the investment adviser, for three investment companies offered in connection with the Prudential-Bache Command Account program. Prudential-Bache also acts as investment adviser to various individual and institutional clients whose portfolios include corporate, U.S. Government and municipal securities.

Prudential-Bache has entered into agreements with the Fund under which Prudential-Bache acts as administrator and distributor to the Fund. Under the Administration Agreement, Prudential-Bache administers the Fund's corporate affairs, subject to the supervision of the Fund's Board of Directors and, in connection therewith, furnishes the Fund with office facilities, together with those ordinary clerical and bookkeeping services which are not being furnished by State Street Bank and Trust Company (the Fund's Custodian, Transfer and Dividend Disbursing Agent).

The Fund pays to Prudential-Bache as Administrator an annual fee of .25 of 1% of the Fund's average daily net assets. Prudential-Bache has agreed to waive its administration fee until the earlier of three months from the date of this Prospectus, or the date the Fund's net assets reach $25 million. Additionally, Prudential-Bache has voluntarily agreed to subsidize the expenses of the Fund (excluding the advisory, administration and distribution fees, brokerage commissions, amortization of organization expenses and extraordinary expenses) until the Fund's net assets reach $35 million.

Prudential-Bache may also act as a broker for the Fund. In order for Prudential-Bache to effect any portfolio transactions for the Fund, the commissions, fees or other remuneration received by Prudential-Bache must be reasonable and fair compared to the commissions, fees or other remuneration paid to other brokers in connection with comparable transactions involving similar securities being purchased or sold on an exchange during a comparable period of time. This standard would allow Prudential-Bacha to receive no more than the remuneration which would be expected to be received by an unaffiliated broker in a commensurate arms-length transaction.

Contingent Deferred Sales Charge

A contingent deferred sales charge will be imposed on any redemption by a stockholder which reduces the current value of the stockholder's shares of the Fund to an amount which is lower than the dollar amount of all payments by the stockholder for the purchase of Fund shares during the preceding five years. However, no such charge will be imposed to the extent that the net asset value of the shares redeemed does not exceed (a) the current net asset value of shares purchased more than five years prior to the redemption, plus (b) the current net asset value of assets purchased through reinvestment of dividends or distributions, plus (c) increases in the net asset value of the investor's shares above the total amount of payments for the purchase of Fund shares made during the preceding five years. In addition, the contingent deferred sales charge is waived for certain redemptions (i) upon the death or disability of a stockholder or (ii) in connection with distributions from an IRA or other qualified retirement plan. See "Waiver of Contingent Deferred Sales Charge" in the *Statement of Additional Information*. The amount of any contingent deferred sales charge will be paid to and retained by the Distributor. See "Management of the Fund — Administrator and Distributor."

Accordingly, stockholders may redeem, without incurring any contingent deferred sales charge, amounts equal to any net increase in the value of their shares above the amount of their purchase payments made within the past five years, and amounts equal to the current value of shares purchased through reinvestment of dividends or distributions. The contingent deferred sales charge will be imposed, in accordance with the table shown below, on any redemptions within five years of purchase which are in excess of these amounts.

The amount of the contingent deferred sales charge, if any, will vary depending on the number of years from the time of payment for the purchase of Fund shares until the time of redemption of such shares. Solely for purposes of determining the number of years from the time of any payment for the purchase of shares, all payments during a month will be aggregated and deemed to have been made on the last day of the month. The following table sets forth the rates of the contingent deferred sales charge:

Year Since Purchase Payment Made	Contingent Deferred Sales Charge as a Percentage of Amount Redeemed
First	5.0%
Second	4.0%
Third	3.0%
Fourth	2.0%
Fifth	1.0%
Sixth and thereafter	None

In determining the rate of any applicable contingent deferred sales charge, it will be assumed that a redemption is made of shares held by the stockholder for the longest period of time within the applicable five-year period. This will result in any such charge being imposed at the lowest possible rate. For federal income tax purposes, the amount of the contingent deferred sales charge will reduce the gain or increase the loss, as the case may be, on the amount recognized on redemption or repurchase of shares.

Listed below are some typical 12b-1 mutual funds, their approximate size and their fee structure.

Fund	6/30/85 Assets (millions)	Admin. & Advisory Fee	Distribution Fee	Total
Hutton Invest. Series - Gov't	$1,788	.65%	1.00%	1.650%
Pru-Bache Gov't. Plus	1,952	.50	1.00	1.500
Dean Witter U.S. Gov't.	3,404	.50	.75	1.250
American Capital Gov't. Sec.	2,219	.71 (a)	.25	0.96
Colonial Gov't. Sec. Plus	1,400	.65	.25	0.90
Merrill Lynch Fed. Sec.	2,735	.50	.25	0.75
Shearson Managed Gov'ts.	642	.65	N.A.	0.65
Franklin U.S. Gov't.	4,663	.475 (b)	N.A.	0.475

(a) .75% to $200 million
.72 next 200 million
.69 thereafter

(b) .625% to $100 million
.500 next 150 million
.450 thereafter

Attached is also a Wall Street Journal article discussing no load mutual funds.

THE WALL STREET JOURNAL THURSDAY, AUGUST 8, 1985

Critics Say Brokerage Firms Hide Fees On Their New 'No-Load' Mutual Funds

YOUR MONEY MATTERS

By KAREN SLATER
Staff Reporter of THE WALL STREET JOURNAL

Article not included in Web version

Diversity in Practice: The four methods of accounting for no load mutual fund distribution fees are described below.

The Cost Deferral Method - Under this method of accounting, the selling fee (both the redemption charge and the distribution fee) is recorded when received. The direct costs incurred for distribution activities, consisting of sales commissions and incentive compensation, are deferred and amortized over the five year period. All other indirect distribution costs are expensed when incurred.

This accounting results in the deferral of a large amount of costs to future accounting periods for the purpose of matching with their related fee receipt. Additionally, current periods are charged with indirect costs which are not clearly incremental in nature, but which are related to the revenues recognized in the subsequent accounting periods.

The Income Accrual Method - Because some distributors believe realization of an amount of cash flow equal to the selling fee, i.e., the full 5% is assured over the stipulated five year period following the sale, these distributors recognize the present value of such amount at the time the sales service is performed -- i.e., when each sale of fund shares occurs. Correspondingly, all costs (direct and indirect) related to the distribution activities are expensed as incurred.

The Cost Recovery Method - Under this method all direct costs, including salesmen's compensation are deferred, and all revenues received (both the administrative fee and the distribution fee) are credited against the deferred balance until it is fully recovered. Subsequent thereto, revenues are recorded as received.

The Cash Method - This method charges all costs to the income statement when incurred and recognizes income only when received. This method results in the salesmen's compensation and other direct costs being charged in the year of sale and income recognition in the years subsequent to the sale.

Exhibit 1 on pages 23 and 24 are examples of the alternative methods of accounting for no load mutual fund distribution fees as well as an example of the accounting method used for a typical front end loaded fund.

__Pros and Cons__: Supporters of the deferred cost method believe that method is appropriate because it is conservative and that the matching process of cost and revenue should be deferred until the revenue amount is assured beyond a reasonable doubt and is completely calculable. They argue that cost deferral should be used when there is an element of doubt concerning the amount of income to be recorded in the future. They believe that since the plan of distribution requires annual Board of Director approval, the amount of revenue is uncertain and therefore cannot be recorded. They argue further that the earnings process is incomplete until the approval of the Board of Directors is received.

Supporters of the income accrual method argue that the selling broker-dealer has performed all services in connection with the transaction and has fully earned its selling fee at the time the mutual fund shares are sold to its customers. They also argue that the income is assured beyond a reasonable doubt because of the combination of the distribution fee and the redemption charge. Therefore, from an accounting standpoint, the broker-dealer should record the revenue connected with the transaction just as it had done previously with the front loaded fund. Supporters of this method also maintain that the only substantive difference in the circumstances of the no load fund from the front loaded fund is that the selling fee will be received over time in the form of the distribution fee and/or the redemption charge. This difference, in the timing of the expected receipt, is recognized for financial reporting purposes by recording the commission receivable at the time of sale at its present value amount in accordance with APB 21 "Interest on Receivables and Payables." Supporters of this method also point out that the income accrual method results in less revenue in the year of sale than previously recognized when the commission was received from the front loaded fund by the broker at the time of sale. They believe this reduction in revenue is appropriate, since receipt of the asset is delayed.

Supporters of the income accrual method also argue that, if the Board of Directo approval creates doubt significant enough to dispel the notion that the income is not assured beyond a reasonable doubt, then it should also create enough doubt to dispel the notion of certainty with respect to the future recoverability of the deferred cost associated with the cost deferral method of accounting. These costs are substantial since they include the salesmen's commission paid at the time of sale. Proponents of this method argue further that to their knowledge, there are approximately 400 12b-1 funds in existence and although history is limited to their recent growth in popularity, there have been no instances of Boards of Directors not approving the annual distribution fee. In addition, they point out that the SEC has mandated the daily accrual of the distribution fee even though the fee will not be reviewed by the Board of Directors until a future date. Typically, the Board of Directors have been chosen by the broker-dealer that has created the fund and that now acts as its sole distributor, therefore from a realistic point of view, the Directors are aware of the development this fee and, in fact, will approve payment if supported by legitimate expenses and mark-ups of the broker-dealer. If they did not they would be forced to search for a new distributor in order to assure the funds continuance. It is reasonable, therefore, to expect that the Directors will recognize that the deferred distribution arrangement works to the benefit of the funds as compared to the front loaded fund. It should be noted also that a substantial portion of the income recognized by the broker-dealer may be received from the selling shareholders and therefore is not subject to this Board of Director approval.

Some individuals object to the income accrual method, because they believe the broker-dealer cannot accrue a receivable that is not reflected as a payable of the fund. Supporters of the income accrual method counter that this position, if valid, would also prevent the acceptability of the cost deferral method, since that method defers costs which are in excess of the fund's accrued distribution fee. Board of Director approval of the distribution fee, required by SEC Regulation 12b-1 helps support the fund's deferral of the expenae until future periods. Symmetry is not appropriate in thia case and the accounting for the distribution fee in the financial statementa of the mutual funds is proper because there is an uncertainty as to the amount of the sales fee to be paid to the selling broker-dealer by the fund. No uncertainly exists for the broker-dealer because he has two available sources that will pay its sales commission, namely the distribution fee from the fund or a sliding rate redemption charge from the selling stockholders. Since the proportion of each is not known at the time of accrual, the fund records only the portion that it will pay.

Supporters of the income accrual method also argue that sales of other products suffer during periods of significant sales of a substantial no load product. They believe that this is additional compelling evidence as to the time period when the selling effort took place. They argue that even the title of the revenue itself, i.e., "distribution fee," supports recognition at the time of distribution, not years subsequent to the distribution.

Supporters of the caah method believe that no other method is appropriate because of the uncertainty associated with the required Board of Director approval. They believe that the uncertainty of approval is so great that the income cannot be estimated or recognized until received.

Supporters of the cost recovery method feel that no revenue should be recorded until all direct costs have been recovered.

__Other Issues__: Industry representatives also note that if there are 400 12b-1 funds, there are also 400 different plans of distribution. Under these circumstances, one should not generalize as to the accounting method to use. Each distribution plan is contractually different and, therefore, the accounting method must be determined by the facts and circumstances of each case. Industry representatives argue that the action taken by the FASB's Emerging Issues Task Force was a generalization that was not appropriate under these circumstances.

Industry representatives point out that the Investment Companies Special Committee of the American Institute of Certified Public Accountants could not reach a consensus as to whether or not the distribution fee for the mutual fund should be charged to operations or to capital because of the variety of the types of arrangements adopted by the 12b-1 funds. A majority of this special committee in fact opposed the elimination of alternative methods of accounting because they believed that the accounting method should be selected based on the facts and circumstances of each situation as judged by the particular fund and its management. It is suggested, therefore, that this decision by a committee of knowledgeable members of the mutual fund community indicates that generalization cannot and should not be made about the accounting for these fees.

EXAMPLES OF THE ALTERNATIVE METHODS OF ACCOUNTING FOR NO LOAD MUTUAL FUND DISTRIBUTION FEES AND A TYPICAL FRONT END LOADED FUND

Front End Fund	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Distribution Fee	5000	--	--	--	--	5000
Direct Expenses	(2500)	--	--	--	--	(2500)
Indirect Cost	(1000)	--	--	--	--	(1000)
Profit	1500	0	0	0	0	1500

Cost Deferral Method	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Distribution Fee	1000	1000	1000	1500	500	5000
Direct Expenses (Amortization)	(500)	(500)	(500)	(750)	(250)	(2500)
Indirect Expenses	(1000)	--	--	--	--	(1000)
Profit (Loss)	(500)	500	500	750	250	1500

Income Accrual Method	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Distribution Fee	4055	--	--	--	--	4055
Interest Income	189	189	189	284	94	945
Direct Expenses	(2500)	--	--	--	--	(2500)
Indirect Expenses	(1000)	--	--	--	--	(1000)
Profit	744	189	189	284	94	1500

Cost Recovery Method	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Distribution Fee	--	--	500	1500	500	2500
Indirect Expense	(1000)	--	--	--	--	(1000)
Profit (Loss)	(1000)	0	500	1500	500	1500

Cash Method	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Distribution Fee	1000	1000	1000	1500	500	5000
Direct Expenses	(2500)	--	--	--	--	(2500)
Indirect Expenses	(1000)	--	--	--	--	(1000)
Profit (Loss)	(2500)	1000	1000	1500	500	1500

(see assumptions listed on Page 2 of the exhibit)

EXAMPLE ASSUMPTIONS

Investor Purchases $100,000 of Mutual Fund at beginning of Year 1
Investor Redeems One-Half of Investment at beginning of Year 4 (results in 2% charge)
Distribution Fee is 1% Annually
Redemption Charge is 5%, 4%, 3%, 2%, 1%
Direct Costs (principally broker compensation) at 50% of Gross Distribution Fee Income for first five years
Indirect Costs at 20% of the first five years Gross Distribution Fee Income
Discount Rate 10%
Market Value of Investment Remains Constant

* *

Advisory Conclusions

The FASB Emerging Issues Task Force discussed the topic at its June 27, 1985 meeting and reached a consensus that the "cost deferral method" — believed to be existing practice by the Task Force — should not be changed. Several members of the Task Force suggested, however, that some other group more familiar with the industry might address the issue. The minutes of the Task Force are as follows:

> <u>85-24: Accounting for distribution fees by distributors of mutual funds that do not have a front-end sales charge</u>
> This issue involves recognition of fees received from certain kinds of mutual funds designed to compensate mutual fund distributors for the distribution of fund shares. The question is whether fees expected to be received over a specified future period (a) should be accrued at present value and recognized at the time of the distribution, along with all costs of performance, or (b) should be recognized when received, along with amortization of deferred incremental direct costs and expensing indirect costs when incurred, which is the existing accounting practice.
>
> The Task Force member who raised the issue suggested a change to method (a) from method (b). Several Task Force members suggested that some other group more familiar with this industry might address the issue. The Task Force

discussed the proposal and existing practice, and reached consensus that existing accounting practice should not be changed.

The Stockbrokerage Auditing Subcommittee of the American Institute of Certified Public Accountants also discussed this issue at its September 23, 1985 meeting and did not reach a consensus on a single accounting method. A majority of the members present believed, however, that the cost deferral method and the income accrual method may be appropriate depending on the underlying facts and circumstances. The summary highlights of the meeting are repeated below.

> Accounting for mutual fund distribution fees. Mr. Helmick explained that the Subcommittee had been asked by an industry member to discuss the topic of accounting for mutual fund distribution fees and the two accounting methods that had evolved for the recognition of income and related expenses. He recapped the two methods that were more thoroughly explained in the materials distributed by Mr. Harfst:
>
> - the Income Accrual method, with its current recognition of fee income (at present value) and direct costs, and
>
> - the Cost Deferral method, with its recognition of fee income when received and corresponding deferral of direct costs over time.

He further explained that the FASB Emerging Issues Task Force discussed the topic at its June meeting and reached a consensus that the "cost deferral method"---believed to be existing practice by the Task Force---should not be changed. Mr. Helmick added that several members of the Task Force suggested, however, that some other group more familiar with the industry might address the issue, which resulted in the request that the Subcommittee address the topic.

Ms. Demichelis and Mr. Helmick clarified that the purpose of the discussion was to convey its results to James Leisenring, Chairman of the Emerging Issues Task Force, for possible further consideration by that group. They added that the purpose was not to decide if one or both methods is GAAP, as the Subcommittee has no such authority to set accounting standards.

Mr. Harfst led the discussion on the specifics of the topic and the following comments were made by various members:

<u>Arguments for both methods:</u>

- A key element in recognizing income that has been earned is assurance of collectibility beyond a reasonable doubt. Historical experience has demonstrated that collection of the sales fees in these situations meets that criterion.

- Annual Board of Directors approval for receiving the fee is virtually automatic.

- Experience has shown that Boards of Directors have not withheld approval of distribution fees.

- Parallels can be drawn between the recognizing of income before Board approval and the completion of certain construction contracts where income is recorded as the project is completed even though management has not yet "approved" the completed stage.

- Policy by Boards to approve the fees annually has not kept pace with the growth in sales of these funds. Once Boards and management realize that they may have to defer what is now a large amount of revenue because of annual Board approval requirement, policies will change.

- The SEC currently requires the mutual funds to accrue the distribution fee expense on a monthly basis even though the Board has not yet approved the payment of the fee to the distributor.

<u>Arguments against the "Cost Deferral" method</u>:

- The cost deferral method in effect is a cash basis method for the recording of income and the cash basis method is not appropriate in these situations.

Arguments in favor of "Cost Deferral" only:

- Some accounting literature does exist, for example APB No. 30 regarding the accounting of discontinued operationa, for recognizing in income estimated future revenue limited, however, to the amount of any loss recognizable from the disposal. Any remainder would be accounted for as income when realized. This situation however is not the test for recognition of income in this situation.

- Boards of Directors do not "automatically" rule on certain issues, hence their approval each year is not assured.

- The lack of having Board approval is a major reason for not recognizing the full sales fee in the current year. Therefore, a key ingredient for recognizing income is missing.

Additional commenta were expreased and debated on whether accounting literature supports the income accrual method and on the need for practice to evolve for these new products before ruling out alternative methods.

The Task Force took the following straw vote on the opinions of the 14 members at the end of the discussion:

	No. of Members
Believe that both methods may be appropriate depending on the underlying facts and circumstances.	8
Believe that only the Cost Deferral method is appropriate.	3
Prefer to abstain from voting for further discussion.	3
	14