Financial accounting and reporting for high-yield debt securities by investment companies: January 28, 1993, amendment to AICPA Audit and accounting guide, Audits of investment companies; Statement of position 93-1;

American Institute of Certified Public Accountants. Investment Companies Committee

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Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies

January 28, 1993

Amendment to AICPA Audit and Accounting Guide Audits of Investment Companies

Prepared by the Investment Companies 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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This statement of position (SOP) provides guidance on financial reporting by investment companies for high-yield debt securities held as investments. Although the focus of this SOP is on high-yield debt securities, certain guidance is also applicable to other debt securities held as investments by investment companies.

It recommends —

- Using the effective-interest method to report interest income on payment-in-kind (PIK) bonds and step bonds.
- Writing off interest receivable on defaulted high-yield debt securities in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and allocating the writeoff between income for the portion that was recognized as income and the cost of the related investment for the portion purchased.
- Reporting capital infusions in support of high-yield debt securities as additions to cost and reporting workout expenditures as realized losses only to the extent that they are incurred as part of negotiations of the terms and requirements of capital infusions or are expected to result in a plan of reorganization. Ongoing expenditures to protect or enhance an investment or expenditures incurred to pursue other claims or legal actions should be treated as operating expenses.
- Procedures to be considered by auditors for reviewing valuations of high-yield debt securities to be reported in financial statements.
Introduction

1. High-yield debt securities consist of high-yielding corporate and municipal debt obligations. These securities are frequently referred to as junk bonds. The issuance of high-yield debt securities has increased significantly over the past decade. They have supplied significant capital for business expansion and corporate restructuring. These securities are inherently different from investment-grade issues. They present additional credit, liquidity, and market risks for all participants in this marketplace: holders, issuers, underwriters, and broker-dealers.

2. Recent estimates place the U.S. high-yield debt securities market at between $180 and $250 billion, with over 3300 individual security issues outstanding. Mutual funds and insurance companies each hold approximately 30 percent of such securities, and pension funds hold about 15 percent.

3. High-yield debt securities are corporate and municipal debt securities having a lower-than-investment-grade credit rating (BB+ or lower by Standard & Poor's, or Ba or lower by Moody's). Because high-yield debt securities typically are used when lower-cost capital is not available, they have interest rates several percentage points higher than investment-grade debt and often have shorter maturities.

4. High-yield debt securities typically are unsecured and subordinate to other debt outstanding. Many issuers of high-yield debt securities are highly leveraged, with limited equity capital. That, plus a market for such securities that may not always be liquid, may increase the market risk, liquidity risk, and credit risk of those securities.

5. High-yield debt securities may be issued or traded at significant discounts from their face amounts (principal).
6. Interest for some high-yield debt securities is not paid currently. Instead, interest may be deferred and paid at maturity (zero-coupon bonds) or in periodic interest payments that do not commence until a specific date in the securities’ life cycle (step bonds), or interest may be paid in the form of additional debt securities of the issuer bearing similar terms (payment-in-kind bonds, or PIKs).

**Market Risk**

7. In contrast to investment-grade bonds (the market prices of which change primarily as a reaction to changes in interest rates), the market prices of high-yield bonds (which are also affected by changes in interest rates) are influenced much more by credit factors and financial results of the issuer and by general economic factors that influence the financial markets as a whole.

8. Such factors often make it difficult to substantiate the market valuation of high-yield bonds.

**Liquidity Risk**

9. The market risk is often heightened by the absence of centralized high-yield bond exchanges and relatively thin trading markets, which make it more difficult to liquidate holdings quickly and increase the volatility of the market price. There is generally no centralized or regulated procedure for pricing high-yield debt issues.

**Credit Risk**

10. Issues of high-yield debt securities are more likely to default on interest or principal than are issues of investment-grade securities. Most high-yield debt securities currently outstanding have been issued since 1985. Accordingly, there is little long-term record on how they perform over all parts of the business cycle.

11. Adverse economic developments in 1990 and 1991 contributed to defaults on principal and interest payments by many issuers of high-yield debt securities. Those developments emphasized the need for taking great care in valuation, income recognition, and financial statement disclosure by holders of these securities.
Current Literature

12. Although none of the current financial reporting or auditing literature specifically addresses the issues discussed in this statement of position (SOP), various sources in that literature provide indirect guidance, including the following:

- Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, Accounting for Contingencies
- FASB Statement No. 95, Statement of Cash Flows
- FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- Accounting Principles Board (APB) Opinion No. 22, Disclosure of Accounting Policies
- APB Opinion 29, Accounting for Nonmonetary Transactions
- FASB Emerging Issues Task Force (EITF) Issue No. 86-15, Increasing-Rate Debt
- EITF Issue No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate
- AICPA Statement on Auditing Standard (SAS) No. 11, Using the Work of a Specialist
- AICPA Audit and Accounting Guide Audits of Investment Companies

Scope

13. This SOP amends the AICPA Audit and Accounting Guide Audits of Investment Companies and is applicable to entities to which that guide applies.

14. This SOP addresses the following reporting and accounting issues encountered by investment companies holding high-yield debt securities in their portfolios. Securities that have no credit rating should be classified as high-yield debt securities if they otherwise have the characteristics of such securities.
a. How should interest income from step bonds and payment-in-kind bonds be measured and reported in investment company financial statements?

b. How should previously recorded income and purchased interest be treated when recoverability becomes doubtful in connection with defaults or potential defaults by issuers?

c. How should additional expenditures made by investment companies in support of high-yield debt securities be accounted for?

d. What audit procedures to determine the reasonableness of valuations of high-yield debt securities should be considered?

**Accounting for Income on Step-Interest and PIK Debt Securities**

**Discussion**

15. High-yield debt securities (junk bonds) take various forms. The most common forms may include zero-coupon bonds, PIK bonds, and deep-discount step bonds.

**PIK Bonds**

16. Issuers of PIK bonds typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as *baby* or *bunny* bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent PIK bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.

**Step Bonds**

17. Step bonds generally are characterized by a combination of deferred-interest payment dates and increasing interest payment amounts over the bond lives. Thus, they bear some similarity to zero-coupon bonds and to traditional debentures.

**Current Practices: Income Recognition**

**PIK Bonds**

19. The most common methods currently used for revenue recognition on PIK bonds are the effective-interest method and the market-value method.

20. **Effective-interest method.** Under the effective-interest method, also referred to in accounting literature as the interest method, PIK bonds and the additional debt securities issued in connection with interest payments on them are treated as a combined instrument, based on the assumption that all principal amounts will be paid at maturity. Interest income is recorded by the effective interest method, so that at final maturity the bonds’ carrying amount will be equal to the aggregate principal amount of the original bonds and all baby bonds received. The realizable value of the bonds’ interest previously accrued and recorded is evaluated periodically. Any adjustments are recorded as charges to interest income and reserves against interest receivable.

21. **Market-value method.** Under the market-value method, interest income is accrued daily on the basis of the face value and the stated interest rate of the PIK bond. Each day, the related interest receivable is marked to market, thereby reflecting the current economic value of interest income recognized. The market price of the parent PIK bond generally includes accrued interest. To the extent that any accrued interest is determined to have been included in the quoted market price of the parent PIK bond, it is eliminated each day to avoid double counting of interest income.

22. Further, the interest ex-date represents the first date that a PIK bond’s market value does not include an interest component and interest income is fully accrued. From that date through the payment date, generally a period of one to two weeks, the bond theoretically trades without interest. (This is similar in concept to the ex-date for traditional equity securities paying periodic dividends.) Accordingly, from the interest ex-date through the interest payment date, no adjustment is necessary to reduce the bond market value for interest.

23. At the payment date, the basis of the baby bonds actually received is compared with the amount accrued at the interest ex-date based on the current market value of the parent bond. Because
interest receivable is being marked to market daily, no further adjustment to interest receivable generally is necessary. However, if the basis (that is, the current market value) of the baby bonds received and the accrued interest on the parent bond are different, the resulting adjustment is charged or credited to interest income.

24. Should the reporting entity sell a PIK bond between interest payment dates, the proceeds received are allocated to interest accrued and bond basis in a manner that is consistent with the market valuation as of the trade date. The same is true for any purchases made between interest payment dates.

25. One variation of the market-value method is to adjust the amount of interest income accrued by the interest method to the value of the bonds at the interest ex-date.

26. A second variation is to accrue interest income daily on the basis of the coupon rate and adjust the interest income for the market value of the bonds received at the payment date only.

Step Bonds

27. Currently, two methods are most commonly followed for revenue recognition on step bonds.

28. **Effective-interest method.** Under the effective-interest method, also referred to in accounting literature as the interest method, total expected interest—the combination of the aggregate coupon-interest payments and the original issue discount—to be earned over the life of the bond is determined and the effective-interest rate is applied to recognize interest income daily for the bond. This method ignores any adjustment of interest rates and treats the bond as a zero-coupon instrument.

29. **Bifurcation method.** The bifurcation method assumes that the bond is a discount bond only for the portion of its life during which payment of interest is deferred. During that period, an effective-interest rate is used. For the remainder of the bond's life for which a stated coupon rate exists, the stated interest rate is used to record interest income.
Views on the Issues

PIK Bonds

30. Some believe that accounting for PIK bonds should follow the guidance for monetary assets that do not pay interest periodically, such as zero-coupon bonds, and that their interest should be accounted for by accretion by the effective-interest method. That is generally considered to be the method to use in recognizing income for tax purposes. It would allow consistency between tax and financial reporting treatments.

31. Others contend that, because of the significant uncertainties concerning the realizability of income from PIK bonds, income should reflect the current values of the underlying investments regardless of stated coupon rates. They believe that the use of current value presents a more accurate picture of the current value of income received from PIK bonds.

Step Bonds

32. Some believe that because there are differing interest payments throughout the lives of step bonds, including periods of no interest payments, step bonds have the same characteristics as zero-coupon bonds. They would therefore account for interest income by the effective-interest method.

33. Others believe that the contractual nature of the interest payment schedules connected with these bonds should govern the accounting treatment. Thus, for periods of no interest payments, the effective-interest method should be used; when interest payments are being made, they should be used to account for income.

Conclusions

PIK Bonds

34. Because PIK bonds generally possess many of the characteristics of zero-coupon bonds and because the effective-interest method provides the most analogous accounting treatment, it should be used to determine interest income. PIK bonds typically trade flat (that is, interest receivable is included in the market value quote obtained
each day). Accordingly, that portion of the quote representing interest income needs to be identified. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable. To the extent that interest income to be received in the form of baby bonds is not expected to be realized, a reserve against income should be established (that is, it should be determined periodically that the total amount of interest income recorded as receivable, plus the initial cost of the underlying PIK bond, does not exceed the current market value of those assets).

**Step Bonds**

35. Income on step bonds should be recognized using the effective-interest method, which is a systematic and rational method for accruing income throughout a bond's life and is not affected by the timing of cash payments. Additionally, to the extent that interest income is not expected to be realized, a reserve against income should be established. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.

**Securities and Exchange Commission (SEC) Yield Calculations**

36. SEC yield-formula calculations are required to be made using the specific guidelines presented in SEC Release No. 33-6753. Yields calculated that way may not be the same as the effective interest reported in the financial statements. The ultimate realizable value and the potential for early retirement of securities should be considered when computing SEC yields. Management's best estimates of ultimate realizable value must be reasonable. Because current values of many high-yield debt securities have declined significantly, computed yields for many of them may be higher than rates expected to be ultimately realized. To avoid unsound yield information, consideration should be given to capping yields of individual securities at some reasonable level and examining the underlying economic viability of the issuers.

37. An investment company's portfolio should indicate all high-yield and restricted debt securities whose values have been estimated by its directors.
Accounting for Accrued Income and Purchased Interest in Connection With Defaulted Debt Securities

Discussion

38. Interest receivable from debt securities generally comprises two distinct components: interest purchased from the previous bondholder and interest accrued by the investment company during the holding period. If market prices fluctuate significantly or issues of debt securities have defaulted, a judgment to write off interest receivable may be required. Both components of interest receivable must be evaluated.

39. Writeoffs of interest receivable differ from traditional writeoffs of trade accounts receivable. They can significantly affect an investment company's statement of operations, the performance measurement ratios of expenses to average net assets, and net investment income to average net assets.

Current Practices

40. Current practice for the writeoff of interest receivable is diverse. Most investment companies record the writeoff of accrued interest as a reduction of interest income. Many investment companies record the writeoff of purchased interest as an increase to the cost basis of securities, whereas others record such writeoffs as a reduction of interest income.

Views on the Issues

41. Many believe that, to the extent that a writeoff is related to interest recognized by the investment company, it should be treated as a reduction of interest income. They further believe that treatment of interest writeoffs as expenses would present misleading expense ratios to users of financial statements of investment companies and cause difficulties in comparisons of performance information from different investment companies. They also believe that a writeoff of purchased interest is better presented as an adjustment to the cost basis of the security, because it was incurred simultaneously and integrally with the original purchase of the investment. Additionally, because purchased interest is not recorded as income, they believe it should not be treated as an offset to revenue.
**Conclusion**

42. The portion of interest receivable on defaulted debt securities written off that was recognized as interest income should be treated as a reduction of interest income. Writeoffs of purchased interest should be reported as increases to the cost basis of the security and treated as unrealized losses until the security is sold.

43. Those reserves should be recorded when they become probable and estimable in accordance with the guidance provided by FASB Statement No. 5, *Accounting for Contingencies*.

**Accounting for Expenditures in Support of Defaulted Debt Securities**

**Discussion**

44. The market for many high-yield debt securities is relatively thin. When issuers of such securities default, the bondholders often become active in any negotiations and in the workout process. This process often results in new terms that restructure the high-yield obligations to allow the issuer to continue to meet its ongoing interest obligations and maintain some, if not all, of the principal value to the holders of the obligations.

45. Adverse economic developments often lead to increases in the default rates of high-yield debt securities. In addition to occasional capital infusions, professional fees to legally restructure the investments are frequently incurred by the bondholders.

**Current Practices**

46. Current accounting and disclosure practices concerning additional capital infusions to specific projects underlying a bond issue and professional fees incurred in connection with the restructuring of debt securities held as investments are diverse. Some record expenditures for both capital infusions and professional fees as additions to the original investment cost basis; others record expenditures for professional fees as operating expenses.
Views on the Issues

47. Some believe that expenditures incurred to support the operations of a project or operator underlying a bond issue, either in the form of capital infusions or professional fees, should be charged to operations because such expenditures have no certain future economic benefit and do not increase the bond issuer's obligation payable to the bondholder. Others believe that such expenditures should be recorded as additions to the cost basis of the investment because they are made solely to enhance or protect the realizable value of the high-yield security.

Capital Infusions

48. Capital infusions are expenditures made directly to the issuer to ensure that operations are completed, thereby allowing the issuer to generate cash flows to service the debt. Such expenditures are generally nonrecurring. In certain cases, bondholders may receive additional promissory notes, or the original bond instrument may be amended to provide for repayment of the capital infusions. However, regardless of whether or not additional promissory notes are received, some believe capital infusions generate a future economic benefit. They believe that such capital infusions should in all cases be considered additions to the cost of the investment. Further, they note that, because investment companies report their investment portfolios at market values, those additional capital infusions, if treated as additions to the cost of the investment and if unaccompanied by a corresponding increase in market value, will be reflected in net assets through an increase in unrealized losses. Thus, the issue is a matter of classification between gain or loss and net investment income in the statement of operations, and such expenditures generally are viewed as a part of the cost of the investment rather than as a cost of operations.

Workout Expenditures

49. Workout expenditures under this SOP consist of professional fees (legal, accounting, appraisal) paid to entities unaffiliated with the investment company's advisor or sponsor, which generally are incurred in connection with (a) capital infusions, (b) restructurings or plans of reorganization, (c) ongoing efforts to protect or enhance an
investment, or (d) the pursuit of other claims or legal actions. Some believe that such expenditures incurred to maintain an investment company’s position in high-yield debt securities among other bondholders or with the issuer should be reported as operating expenses by the investment company. Others believe that such costs are also incurred principally to maintain or prevent substantial diminution in future realizable value and therefore should be reported as additions to the cost basis.

**Conclusion**

50. All capital infusions, as defined in paragraph 48, should be recorded as additions to the cost bases of related securities because the nature of capital infusions is to enhance or prevent substantial diminution in the value of the investment.

51. Workout expenditures that are incurred as part of negotiations of the terms and requirements of capital infusions, or that are expected to result in the restructuring of or a plan of reorganization for an investment should be recorded as realized losses. Ongoing expenditures to protect or enhance an investment, or expenditures incurred to pursue other claims or legal actions, should be treated as operating expenses.

**Audit Procedures to Be Considered in Evaluating Valuations of High-Yield Debt Securities**

**Discussion**

52. Market-value risk for holders of high-yield debt securities is compounded by the relatively thin trading market in such securities, which increases price volatility and makes it difficult to liquidate holdings efficiently at any specific time. Determination of market prices is difficult given the illiquid or sometimes nonexistent trading market. Furthermore, there are no standardized procedures or central markets for pricing most high-yield debt securities. In addition, few third-party pricing services currently exist, except for those used by investment companies; these could be used by auditors to obtain market prices of issues in support of investment companies’ valuations.
**Current Practices**

53. Auditors generally corroborate market values of investment companies' high-yield debt securities with independent pricing services. Some auditors use one pricing service; others obtain at least two prices for each security by using two or more services. Some auditors perform extensive procedures to determine the reasonableness of valuations obtained from pricing services; others rely on the expertise of the independent pricing services and perform only exception reviews.

54. Based on pricing, high-yield debt securities can be viewed as being one of three types:

a. Securities for which there is an active market and for which independent prices are readily available

b. Securities for which the market is less active and for which limited price information is available

c. Securities for which there is no market or a thin market and that are priced by the investment company

**Views on the Issues**

55. Some believe that the current practice of monitoring prices on an exception basis in connection with obtaining prices from independent pricing services is adequate. They believe it is common knowledge that exact measures of individual high-yield bond values do not exist because there is no central exchange. They further believe that review procedures focused on significant changes in prices would identify unsound price valuations and that, for securities whose values are estimated by the investment company's directors, the combination of reviews of an investment company's portfolio by accounting managers acts as an adequate check to ensure that pricing practices are reasonable.

56. Others believe that more specific guidance on reviewing the reasonableness of prices used is required for auditors. They also believe there is significant diversity in the extent and frequency of reviews of the methods applied by pricing services.
Conclusion

57. Given the complexities of pricing high-yield debt securities, as well as the potentially volatile market conditions surrounding those securities, certain additional pricing valuation audit procedures should be considered by auditors when reviewing the valuations of high-yield debt securities. The auditor may conclude that additional procedures are not warranted based on an assessment of control procedures applied by the investment company.

58. Pricing services may be evaluated in accordance with SAS No. 11, Using the Work of a Specialist. Such procedures may include the following:

- Review of the methods used for determining daily prices and the consistency of those methods from period to period
- Consideration of the experience of the individuals involved in determining prices and of the quality control procedures in place
- Review of recent trading volumes and comparison of prices to those obtained from market makers

59. The SEC’s Financial Reporting Release (FRR) 404.03(b) discusses directors’ valuation of securities for which readily available market prices do not exist. FRR 404.03(c) suggests certain procedures that the auditor should consider when reviewing securities valued in good faith by directors. In addition to those procedures the auditor may also wish to consider the following:

- Review of the methods used by management to determine and update daily prices and of the consistency of this methodology from period to period and across similar securities
- Review of recent trading transactions subsequent to the reporting date to determine whether significant price changes have occurred
- Consideration of the experience of individuals involved in determining prices
- Review of procedures used to assess the credit risk of issuers

SAS No. 57, Auditing Accounting Estimates, provides guidance to auditors on obtaining sufficient competent evidential matter to support
significant accounting estimates in audits of financial statements conducted in accordance with generally accepted auditing standards.

60. Furthermore, good-faith security value estimates may present the auditor with unique reporting problems. The board of directors' fair valuation procedures are designed to approximate the values that would have been established by market forces and are therefore subject to uncertainties.

61. The auditor should not modify the auditor's opinion if he or she concludes, based on an examination of the available evidence, that the process used to estimate value is reasonable, the documentation supportive, and the range of possible values not significant. The auditor may, however, choose to emphasize the existence of the matter by inserting an explanatory paragraph in the audit report.

Effective Date and Transition

62. This SOP is effective for financial statements and for audits of such financial statements for fiscal years ending after December 15, 1993, and for interim periods within such years. This SOP need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are provided with financial statements for fiscal years ending after its effective date. The effect of this SOP should be disclosed in the period in which it is first applied. Early application of this SOP is encouraged.
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