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American Institute of Certified Public Accountants. Accounting Standards Division

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FINANCIAL ACCOUNTING AND
REPORTING BY
INVESTMENT COMPANIES

A Proposed Recommendation to
Financial Accounting Standards Board to
Amend AICPA Industry Audit Guide on
Audits of Investment Companies

Issued by Accounting Standards Division
American Institute of Certified Public Accountants

This exposure draft has been prepared for public comment by the
Accounting Standards Task Force on Investment Companies. The
conclusions herein have not been approved by the Accounting
Standards Division.

This exposure draft has been distributed to Members of Technical
Executive Committees of the AICPA; State Society Presidents and
Executive Directors; Chairmen of State Society Committees on
Accounting Practices; and certain organizations outside the
accounting profession. Copies are available to interested persons
and organizations upon request.

Comments should be sent, in time to arrive not later than
November 15, 1976, to—

Thomas P. Kelley, CPA
Director, Accounting Standards
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036

File Reference 3170
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Audits of Investment Companies

Proposed Amendment to Industry Audit Guide

Introduction

The AICPA Industry Audit Guide, Audits of Investment Companies, notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A number of changes and new developments have taken place since the Guide was published in 1973 which, the Division believes, should be reflected in an amendment to the Guide.

This proposed amendment presents the Division's views on the following matters:

- Money market funds (an addition to the Guide)
- Put and call options (supersedes discussion in the Guide)
- Organization expenses (an addition to the Guide)
- Amortization of deferred costs (an addition to the Guide)
- Payment of fees for research (an addition to the Guide)
- Valuation of short-term investments (an addition to the Guide)

Money Market Funds

Background

Money-market funds are open-end management investment companies that invest principally in money-market instruments (short-term government obligations, commercial paper, banker's acceptances, ...
certificates of deposit, etc.) with the objective of preserving capital, maintaining liquidity, and obtaining current income. As such, money-market funds are subject to the provisions of the AICPA Industry Audit Guide, Audits of Investment Companies.

At the time the Guide was published in October 1973, only a few money-market funds were in operation and the Guide did not discuss such funds specifically. However, many more have commenced operations since that date, and the Division believes that specific guidance for money-market funds is now desirable.

Distribution Policies

Investors in money-market funds are interested in short-term return on their investment. Accordingly, many of these funds declare dividends daily, thereby maintaining net asset value per share at or near a fixed amount, depending on which of the following distribution policies is adopted.

<table>
<thead>
<tr>
<th>Distribution Policy</th>
<th>Effect on Net Asset Value Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Define income for dividend purposes as the sum of net investment income, net realized gain (loss), and net unrealized appreciation (depreciation). If income, as defined, is a negative amount for any day, that amount is first offset against dividends accrued during the month in each shareholder account. If a negative amount remains, outstanding shares are reduced by treating each shareholder as having contributed shares to the fund to the extent of such negative amount.</td>
<td>Net asset value remains fixed.</td>
</tr>
</tbody>
</table>
Distribution Policy

(b) Define income as in (a) above, but take no action for any day in which such income is a negative amount.

(c) Define income for dividend purposes as the sum of net investment income and net realized gain (loss).

(d) Declare daily dividends from net investment income only, distribute net realized gain annually.

Effect on Net Asset Value Per Share

1. Net asset value remains fixed unless income, as defined, is a negative amount, in which case net asset value will be less than the fixed amount until restored to the fixed amount through subsequent income, as defined.

2. Net asset value varies from the fixed amount to the extent of unrealized appreciation or depreciation. Also, it is reduced if income, as defined, is a negative amount (net realized loss exceeds net investment income).

3. Net asset value varies from the fixed amount to the extent of the sum of undistributed realized gain (loss) and unrealized appreciation (depreciation).

Long-term capital gains, as defined in the Internal Revenue Code, may be distributed only once every twelve months unless a specific exemption is obtained. Therefore, a fund which expects to realize long-term gains and which follows distribution policy (a), (b), or (c) will wish to request exemption from Section 19(b) of the Act.

See page 22 for a discussion of the valuation of short-term investments.

Statement of Changes in Net Assets

A modification of the format suggested in the Guide for the statement of changes in net assets is required to report clearly

1/ Section 19(b) and Rule 19b-1 of the 1940 Act.
the effects of following one of the distribution policies described in (a), (b), or (c) in the preceding section.

A fund that follows distribution policy (a) or (b) should include a subtotal for net investment income and net realized gain (loss) and unrealized appreciation (depreciation) in the statement of changes in net assets. This subtotal represents income as defined for dividend purposes.

The following format is appropriate for the statement of changes in net assets (shown in part) of a money-market fund that has adopted distribution policy (a) or (b).

<table>
<thead>
<tr>
<th>From Investment Activities:</th>
<th>19 X 5</th>
<th>19 X 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment income</td>
<td>$100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Net realized gain (loss) on investments</td>
<td>2,000</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Increase (decrease) in unrealized appreciation of investments</td>
<td>(3,000)</td>
<td>1,000</td>
</tr>
<tr>
<td>Total available for distribution</td>
<td>99,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Dividends declared</td>
<td>99,500</td>
<td>80,000</td>
</tr>
<tr>
<td>Decrease in net assets derived from investment activities</td>
<td>(500)</td>
<td></td>
</tr>
</tbody>
</table>

2/ A decrease in net assets derived from investment activities would be reported only by a company following distribution policy (b) and then only if the company incurred a net loss (realized and unrealized) on investments which was not offset by net investment income and net gains (realized and unrealized) prior to the end of the reporting period.
The following format is suggested for the statement of changes in net assets (shown in part) of a money-market fund that follows distribution policy (c) (i.e., it distributes the sum of net investment income and net realized gain or loss daily).

<table>
<thead>
<tr>
<th>From Investment Activities:</th>
<th>19 X 5</th>
<th>19 X 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment income.............................</td>
<td>$100,000</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Net realized gain (loss) on investments...........</td>
<td>2,000</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Total available for distribution...</td>
<td>102,000</td>
<td>79,000</td>
</tr>
<tr>
<td>Dividends declared...............................</td>
<td>(102,000)</td>
<td>(79,000)</td>
</tr>
<tr>
<td>Increase (decrease) in unrealized appreciation of investments...</td>
<td>(3,000)</td>
<td>1,000</td>
</tr>
<tr>
<td>Increase (decrease) in net assets derived from investment activities...</td>
<td>(3,000)</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Money-market funds that follow distribution policy (d), or that do not declare dividends daily, should follow the sample presentation on page 101 of the Guide.

**Supplementary Information**

The per-share data included in the financial statements as "Supplementary Information" should be presented on a basis consistent with the presentation of the statement of changes in net assets, as illustrated or discussed above. A fund that follows distribution policy (a) and that has treated each shareholder as having contributed shares to the fund when income, as defined, is a negative amount, should include an additional line item in the per-share data to show the effect of such action.
The investment policies of money-market funds are such that gains and losses, whether realized or unrealized, are usually incidental to the realization of investment income. Also, the dividend policy adopted by a fund should have no effect on the reported ratio of income to average net assets, because the purpose of the ratio is to indicate the effective rate of earnings, regardless of when the earnings are distributed. Accordingly, the most significant ratio for a money-market fund to report is the ratio of (a) net investment income plus or minus realized and unrealized gains or losses to (b) average net assets. When supplementary information is provided by a money-market fund, this ratio should be reported instead of the ratio of net investment income to average net assets, which is included in the illustration of "Supplementary Information" in the Guide.

It may be appropriate for a fund that distributes only net investment income (distribution policy (d)) to provide a breakdown of the ratio, in a footnote or parenthetically, indicating the portion applicable to realized and unrealized gains, if those gains are significant.

When yield information is presented as "Supplementary Information" or elsewhere in the financial statements, a description of the method of computation should be provided.
Reporting Gains and Losses

When short-term instruments, including discounted instruments, are sold prior to maturity, realized gains and losses should be recorded as such, based on the differences between the proceeds from sale and amortized cost.

Since net realized gains and losses from sales of investments of a money-market fund are usually insignificant compared with the dollar amount of sales, it is usually acceptable to omit reporting the proceeds from sales and the cost of securities sold in the statement of operations, and to report therein only the amount of net realized gain or loss.

Changes in unrealized appreciation or depreciation should be reported following the presentation on page 100 of the Guide.

Federal Income Taxes

A fund that includes unrealized appreciation or depreciation in dividends may have distributed more or less than its taxable income in a particular year. Accordingly, a fund that follows such a policy should pay particular attention to the provisions of the Internal Revenue Code relating to the distribution of taxable income, as discussed more fully in Chapter 5 of the Guide.
PUT AND CALL OPTIONS

Background

In recent months, an active public market has been developed in listed call options and trading in listed put options is expected in early 1977. Although there has been an over-the-counter market in options for many years and the public has participated to some degree, the advent of listed options has increased trading volume substantially, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Division believes that sections of Audits of Investment Companies covering options should be amended to give appropriate guidance with respect to an investment company that purchases or sells listed options. This Statement of Position supersedes the following sections of the Guide:

- "Valuation of Put and Call Options Purchased"—(Chapter 3, "Investment Accounts," page 37)
- "Valuation of Put and Call Option Contracts Written by the Investment Company"—(Chapter 3, "Investment Accounts," page 38)
- "Put and Call Options"—(Chapter 5, "Taxes," page 69)

Option Trading

The following glossary of terms should be helpful in understanding the mechanics of option trading.
Exchange-Traded Option—A put or call option traded on an exchange (hereinafter referred to as an "option"). It gives the buyer of the option ("holder") the right to sell (put) or buy (call) the number of shares or other units of the underlying security covered by the option to or from the seller ("writer") at the stated exercise price prior to the fixed expiration date of the option. The designation of an option includes the underlying security, the expiration month and the exercise price; e.g., "XYZ July 50" means that a unit of trading (typically 100 shares) of XYZ stock may be sold or purchased at $50 per share until the option expires on the expiration date in July. Options of like designation are said to be of the same "series."

Underlying Security—The security subject to sale or purchase upon the exercise of the option.

Unit of Trading—The number of units of the underlying security designated as the subject of a single option. In the absence of any other designation, the unit of trading for a common stock is 100 shares.

Exercise Price—The price per share or other unit at which the holder of an option may sell or purchase the underlying security upon exercise. The exercise price is sometimes called the "striking price."
• **Expiration Date**—The last day on which an option may be exercised.

• **Premium**—The aggregate price of an option agreed upon between the buyer and writer or their agents in a transaction on the floor of an exchange.

• **Opening Purchase Transaction**—A transaction in which an investor becomes the holder of an option.

• **Opening Sale Transaction**—A transaction in which an investor becomes the writer of an option.

• **Closing Purchase Transaction**—A transaction in which a writer of an option liquidates his position as a writer by "purchasing" in a closing purchase transaction an option having the same terms as the option previously written. Such a transaction has the effect, upon payment of the premium, of canceling the investor's pre-existing position as a writer, instead of resulting in the issuance of an option to the investor.

• **Closing Sale Transaction**—A transaction by which a holder of an option liquidates his position as a holder by "selling" in a closing sale transaction an option having the same terms as the option previously purchased. Such a transaction has the effect of liquidating the investor's pre-existing position as a holder, instead of resulting in the investor's assuming the obligation of a writer.
• **Covered Writer**—A writer of a call option who, as long as he remains a writer, owns the shares or other units of underlying security covered by the option. The writer of a put option is "covered" when he executes a short sale in the shares or other units of the underlying security.

• **Uncovered Writer**—A writer of an option who is not a covered writer; sometimes referred to as "naked."

**Option Writing**

As consideration for the rights and obligations represented by an option, the buyer pays and the writer receives a premium. The premium is determined in the exchanges' option markets on the basis of supply and demand, reflecting factors such as the duration of the option, the difference between the exercise price and the market price of the underlying security, and the price volatility and other characteristics of the underlying security. The writer of a call option gives up, in return for the premium, the opportunity for profit from an increase in the price of the underlying security above the exercise price as long as the option obligation continues, but retains the risk of loss should the price of the security decline. Moreover, unlike the owner of securities not subject to a call option, the option writer has no control over the date of sale of the optioned securities, since the option holder may exercise the option and purchase the securities at the designated price at any time prior to the expiration date of the option.
As long as a secondary market in options remains available on each of the exchanges, the writer of an option traded on an exchange is able to liquidate his position prior to the exercise of such option by entering into a closing purchase transaction. Such a transaction has the effect of canceling the investor's pre-existing position as a writer. The cost of such a liquidating purchase, however, can be greater than the premium received upon writing the original option.

Because the purchaser or writer has the ability to enter into a closing transaction, exchange-traded options are exercised less frequently than was the case with over-the-counter options. Nevertheless, it cannot be assumed that a call option will never be exercised. The exercise of an option takes place only through the Options Clearing Corporation (OCC), which is the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is then "assigned" by the clearing corporation to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. This broker is then obligated to deliver the underlying security against payment of the aggregate exercise price. The assigned broker is randomly selected from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

**Accounting**

Portfolio securities underlying call options should be valued by investment companies at their market price and reflected in net
asset value accordingly. Premiums received by an investment company from the sale of outstanding call options should be included in the liability section of the statement of assets and liabilities as a deferred credit and subsequently adjusted (marked-to-market) to the current market value of the option written. For example, if the current market value of the option exceeded the premium received, the excess would be an unrealized loss and, conversely, if the premium exceeded the current market value, such excess would be an unrealized gain. Current market value of listed options should be the last sales price or, in the absence of a transaction, the mean between the closing bid and ask prices. The change in unrealized depreciation or appreciation resulting from the mark-to-market may be included with unrealized gains or losses on the portfolio in the statements of operations and changes in net assets, with disclosure as to the amount, or may be reported as a separate line item. Portfolio securities covering call options sold should be designated as such in the schedule of investments. All outstanding call options (covered and uncovered) should be disclosed. The disclosure should include the expiration dates of the options and the contract and current market value of the securities subject to call.

Subsequent to the sale of a call option, any one of three events may occur: the option may expire on its stipulated expiration date, the writer may enter into a closing transaction, or the option holder may exercise his right to call the security. The first two
events result in a realized gain (or loss if the cost of the closing transaction exceeds the premium received when the option was sold) for the investment company option writer and should be accounted for as such. The third possible event, the exercise of an option by the holder, results, in the case of a covered writer, in the sale of the underlying securities. The proceeds should be increased by the amount of premium originally received and realized gains or losses resulting from such sales should be accounted for in the conventional manner. Uncovered ("naked") option writing results in substantial risk on the part of the writer. If an uncovered option is exercised, the writer must purchase the underlying securities in order to meet his obligation to the option holder. In such situations, the writer's realized loss resulting from the simultaneous purchase and sale of the securities should be reduced by the premium originally received and the net realized loss should be accounted for in the conventional manner.

The foregoing describes the accounting for the sale of call options. The same principles are applicable to the sale of put options. However, it is assumed few investment companies will write this type of option because of investment policies which prohibit short sales of securities (short sales are used to cover the sale of put options).

Actively traded put and call options purchased by an investment company should be accounted for in the same manner as marketable portfolio securities. The cost of portfolio securities acquired or sold through the exercise of put and call options should be adjusted for the premium paid to purchase the put or call.
Transactions in options not listed on a national exchange or not actively traded should be accounted for as described in the foregoing paragraphs, except that the determination of unrealized gain or loss during the contract period of the option must be based on the fair value of the option as determined by the investment company's Board of Directors. Among the many factors to be considered in the determination of fair value are the price of the underlying securities, the liquidity of the market, and the time remaining prior to expiration date.

Federal Income Taxes

The following paragraphs are intended to supersede only that portion of Chapter 5 of the Guide ("Taxes") dealing with put and call options. Reference to that Chapter should be made for other information pertinent to the taxation of investment companies.

For Federal income tax purposes, premium income from the sale of options is deferred until expiration or exercise of the option, or until a closing purchase transaction takes place. If the option expires, the premium constitutes a short-term capital gain. If the option is exercised and the underlying securities are sold, the premium is added to the proceeds from the sale of the securities in determining capital gain or loss. Such gain or loss is short-term or long-term depending upon the holding period of the underlying securities. If the option is closed in a closing purchase transaction, the difference between the amount paid for the option purchased and the premium received on the original sale is a short-term capital gain or loss.
Under the Internal Revenue Code, an investment company cannot qualify as a regulated investment company unless, among other things, less than 30% of its gross income is derived from gains from the sale or other disposition of securities held for less than three months ("30% rule"). Therefore, in order to be taxable as a regulated investment company, its ability to write options with exercise periods of less than three months or to effect closing purchase transactions within three months of writing options is restricted. The holding period for the sale of an option commences on the day it is written.

An investment company must receive at least 90% of its gross income from dividends, interest, and gain from the sale or other disposition of stock or securities ("investment income"), in order to qualify as a regulated investment company in any taxable year. For tax purposes, income received from expired call options and from profits in executing a closing purchase transaction for an amount less than the call premium received qualifies as investment income.

ORGANIZATION EXPENSE

Expenses incurred by a newly-formed investment company in connection with its organization and the initial registration and public offering of its shares are in some instances borne by the company's investment adviser or affiliate. In other instances, such expenses are borne by the investment company, recorded as deferred organization expense, and amortized over a period of time. This latter practice has been adopted in recent years by a
significant number of no-load funds, particularly money-market funds. The Division believes it is now desirable to provide guidance on the composition and accounting treatment of those expenses.

Expenses incurred by a newly-formed company (not only an investment company) prior to commencement of normal operations fall generally into one of the two classes discussed below.

(1) **Organization Expenses** This category includes those expenses which are incurred in order to establish the company and legally equip it to engage in the business for which it is organized.

A newly formed investment company will incur organization expenses unless it is sponsored by a management company that is willing to absorb these expenses.

An open-end investment company, which is organized to offer shares of capital stock to the public continuously and to invest the proceeds from sale of such capital stock, cannot be considered to be organized until it has registered securities with the Securities and Exchange Commission. Therefore, except as indicated below, expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expense. Expenses incurred after that registration statement has been cleared by the SEC, such as
printing a supply of prospectuses to be used for sales purposes, are not organization expenses and should be accounted for in accordance with the generally accepted accounting principles that apply to established operating enterprises.

As stated in Audits of Investment Companies, "closed-end companies charge all registration fees against paid-in capital at the time the shares are sold."

(2) Development Stage Expenses This category includes those expenses incurred subsequent to the company's organization which are required in order to provide the physical and personnel assets necessary to conduct its operations. These expenses include those described in paragraph 9 of Statement of Financial Accounting Standards No. 7 as follows:

...financial planning; raising capital; exploring for natural resources; developing natural resources; research and development; establishing sources of supply; acquiring property, plant, equipment, or other operating assets, such as mineral rights; recruiting and training personnel; developing markets; and starting up production.

Investment companies that employ agents as investment adviser, custodian, and underwriter, will seldom be able to identify a development stage because those activities usually associated with development stage enterprises (as indicated in paragraph 9 of FASB Statement No. 7) will not be present to any appreciable extent.
Accordingly, once the company has been organized to do business, it immediately engages principally in the activities for which it was organized, that is, sales of capital stock and investment of funds. The training of employees, development of markets for the sale of capital stock, and other activities normally associated with a development stage enterprise, are usually performed by the investment adviser or other agent.

Certain companies (generally those that do not employ agents to manage their portfolio and perform other essential functions) may engage for a period of time during and subsequent to their organization in activities, such as training of personnel and developing markets for sale of capital stock, that indicate that they are, for such period of time, in a development stage. The costs of these activities during the development stage should be accounted for in accordance with the generally accepted accounting principles that apply to established operating enterprises, as indicated in FASB Statement No. 7. An investment company that includes in operating expenses significant costs identified with a development stage must also provide the additional information specified in paragraph 11 of FASB Statement No. 7.

**AMORTIZATION OF DEFERRED COSTS**

Costs deferred by an investment company should be subject to the same assessment of recoverability that would be
applicable to any established operating company. Such costs should be amortized to income over the period expected to realize a benefit therefrom, which period may vary according to the type of expense. Some are listed below.

(a) **Organization Expenses** Generally such expenses are amortized over a period of not more than sixty months from the date of commencement of operations. Straight-line or other acceptable methods of amortization may be utilized.

If such expenses are amortized on the basis of assets expected to be managed over the period selected, the projected growth rate initially used as the basis for establishing an amortization table should be reviewed frequently and adjusted, if necessary, to reflect actual experience.

(b) **Cost of Printing Prospectuses** Costs deferred in connection with printing a supply of prospectuses for sales purposes should be amortized, generally on a straight-line basis, over the period during which the prospectus may be used, which is limited to a period ending 16 months after the date of the financial statements. If during the period it becomes evident that the prospectus will be effective for a shorter period
than originally anticipated, amortization should be accelerated so that no costs remain deferred at the end of such shorter period.

(c) **Registration Fees** Deferred SEC registration fees and, where significant, state registration fees should be written off as the registered shares of stock are sold, but in any event over not more than sixty months from the date of commencement of operations.

Disclosures made of an investment company's significant accounting policies should include the company's accounting for deferred costs.

**PAYMENT OF FEES FOR RESEARCH**

Prior to May 1, 1975, brokerage commissions were generally at fixed rates and were intended to cover in certain instances the cost of research provided. Amendments made in 1975 to the Exchange Act eliminate fixed rate brokerage commissions, but permit payment for research services in the form of higher brokerage commissions when the amount is determined to be reasonable by the investment advisor (section 28(e)(1) of the 1934 Act). Some investment companies have amended their investment advisory contracts and prospectuses to provide that brokerage commissions include consideration for research, while others provide for separate payment for research.
When the cost of research is included as part of the brokerage commission, such amount may not be separately determinable by the fund, in which case the aggregate fee may be accounted for as brokerage commissions and capitalized as part of the cost of investment securities. This situation is not substantially different from that which existed prior to May 1, 1975.

When payments for research are separately identifiable, they should be accounted for as expenses charged to investment income.

**VALUATION OF SHORT-TERM INVESTMENTS**

The discussion of the valuation of short-term investments on Page 39 of the Guide states that "original cost plus amortized discount or accrued interest...usually approximates market value." This statement was made when holdings of short-term investments generally constituted a small portion of an investment company's portfolio. It was not intended to modify the principle that "all investment companies should report their securities portfolio at value." In all cases, the Board of Directors should be satisfied that investments, including money market instruments, are carried at amounts which approximate market or fair value. Accordingly, the Division believes that the discussion entitled "Short-Term Investments" on page 39 of the Guide should be amended by the addition of the following paragraph:
Although the amortized cost of Treasury bills and other money market instruments that mature within a relatively short period of time ordinarily approximates market value, it must be recognized that unusual events, such as the impairment of the credit standing of the issuer, can significantly affect the value of short-term investments. Changes in interest rates can also have a significant effect on the value of money-market instruments with longer terms to maturity. In such cases, amortized cost might not approximate the market value of these investments. When amortized cost does not approximate market value, the investments should be valued on the basis of quoted sales prices, bid and asked prices, or fair value based upon appraisals furnished by market makers or other appropriate evidence.