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American Institute of Certified Public Accountants. Accounting Standards Division

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION
ON
ACCOUNTING FOR MUNICIPAL
BOND FUNDS

JANUARY 16, 1978

Issued by the Accounting Standards Executive Committee of the
American Institute of Certified Public Accountants
For Comments From Persons Interested in Accounting and Reporting

Comments should be received by March 16, 1978, and addressed to
Dennis G. Alfredo, Manager, Accounting Standards Division, File No. 3170
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To Practice Offices of CPA Firms; Members of Council; Technical Committee Chairmen; State Society and Chapter Presidents, Directors, and Committee Chairmen; Organizations Concerned With Regulatory, Supervisory, or Other Public Disclosure of Financial Activities; Persons Who Have Requested Copies:

An exposure draft of a proposed statement of position entitled Accounting for Municipal Bond Funds accompanies this letter.

Comments and suggestions on any aspect of the enclosed draft are sought and will be appreciated. They should be addressed to Dennis G. Alfredo, Manager, Accounting Standards Division, File Ref. No. 3170, at the AICPA, by March 16, 1978. The Accounting Standards Executive Committee and the Investment Companies Committee will be particularly interested in the reasoning underlying comments and suggestions.

Sincerely yours,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards
Executive Committee

Dennis G. Alfredo

Dennis G. Alfredo, Manager
Accounting Standards Division

TABLE OF CONTENTS

PROPOSED STATEMENT OF POSITION ON ACCOUNTING FOR MUNICIPAL BOND FUNDS

INTRODUCTION

1. The AICPA Industry Audit Guide, *Audits of Investment Companies,* as amended, 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 recent development in the investment company industry is the municipal bond fund (or tax-exempt bond fund) in corporate form made possible by the Tax Reform Act of 1976. For the first time, the law allows an investment company organized in corporate form to distribute tax-free income to its shareholders. Before the 1976 Reform Act, two forms of mutual funds that specialized in municipal bonds were unit investment trusts and limited partnerships.

2. Tax-exempt municipal bond funds are investment management companies that invest principally in municipal bonds. Municipal bonds are obligations of local governments (such as state, county, and city), and the interest paid on those bonds is exempt from federal income tax. The interest on certain of those bonds may also be exempt from state and local income tax.

3. This proposed addition to the audit guide presents the Committee's views on accounting and reporting matters and other considerations relating to municipal bond funds. While the discussion of taxes and distribution policies refers specifically to municipal bond funds in corporate form, the discussion of valuation and other matters applies to municipal bond funds in corporate form, partnership form, and unit investment trusts.

DEFINITION OF AND MARKET FOR MUNCIPAL BONDS AND NOTES

Municipal Bonds

4. Municipal bonds are usually issued to obtain funds for a variety of public purposes, including the construction of a wide range of public facilities such as airports, bridges, highways, housing, hospitals, mass transportation, schools, streets, and water and sewer works. Municipal bonds may also be issued to refund outstanding obligations, obtain funds for general operating expenses, and obtain funds to lend to other public institutions and facilities.

5. Industrial development bonds are issued by or on behalf of public authorities to obtain funds to finance privately operated industrial or commercial facilities. These obligations may be classified as municipal bonds, provided that the interest paid on them is exempt from federal income tax.[1]

6. The two principal classifications of municipal bonds are general obligation bonds and revenue bonds. General obligation bonds represent the issuer's unqualified pledge, based on its faith, credit, and taxing power, to pay principal and interest when due. Revenue bonds are payable from the revenues derived from a particular class of facilities or from other specific revenue sources. Tax-exempt industrial development bonds are usually revenue bonds and generally do not carry the pledge of the credit of the issuer.

7. The yields on municipal bonds depend on a variety of factors, including money market conditions, municipal bond market conditions, maturity date, and ratings assigned to the issue.

Municipal Notes

8. Municipal notes generally mature in less than three years. They are usually designated as tax, revenue, or bond anticipation notes because they are redeemable on receipt of anticipated taxes or revenue or on refinancing from the proceeds of municipal bonds. They include short-term tax-exempt project notes issued by public housing or urban renewal agencies of local communities, with payment of principal and interest guaranteed by the United States government.

Market

9. There are estimated to be more than 40,000 issuers and well over 1 million issues of municipal bonds, counting each maturity as a separate issue. The bonds are traded in a dealer market in which little published price information exists. As a result, new issues of

[1] See Internal Revenue Code, section 103.

municipal bonds are usually sold by competitive bids. Subsequent market quotations for municipal bonds may be obtained from dealers in those securities. If there is little trading activity or if a thin market exists, dealer quotations may not indicate the prices at which a municipal bond may be bought or sold.

PORTFOLIO INVESTMENTS

Valuation

10. In considering the values assigned to municipal bonds, the fund and its auditor should follow the direction given in the Industry Audit Guide, *Audits of Investment Companies,* for the valuation of over-the-counter securities:

> A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker/dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any one of these policies is considered to be acceptable if *consistently* applied. . . .
>
> Ordinarily, quotations for an over-the-counter security should be obtained from more than one broker/dealer unless available from an established market-maker for that security, and quotations for several days should be reviewed. In all cases, the quotations should be from *unaffiliated persons*. . . . Where quotations appear questionable, consideration should be given to valuing the security at fair value as determined in good faith by the board of directors. [emphasis added, pp. 34–35.]

11. In addition, the auditor is provided with the following guidance:

> In the case of over-the-counter securities for which quotations were not available from published sources, the auditor should consider obtaining quotations as of the valuation date from *more than one independent source*. . . . If the auditor is not fully satisfied with valuation date results, he may wish to obtain further quotations at a subsequent date or dates or consider having the security valued by the board of directors. [emphasis added, pp. 46–47.]

Determining Market Value

12. A fund may obtain quoted bid and asked prices directly from dealers. Unless the dealer is a significant factor in maintaining the market for the issue, consideration should be given to obtaining more than one quotation. The portfolio should be valued consistently, using either the bid price or the mean between bid and asked prices.

13. A number of funds have engaged bond dealers or other pricing services to value their portfolios for a fee. The pricing services have access to a number of dealers from whom they are able to obtain daily quotations. This method gives the fund the advantage of not having to contact other dealers daily. The fund's and the auditor's understanding of the pricing service's procedures in obtaining the daily quotations should be sufficient to satisfy both the fund and the auditor that the procedures enable the pricing service to obtain representative quotations. If the fund's control procedures do not provide reasonable assurance that material pricing errors would be prevented or detected, a visit to the pricing service's facilities by the auditor may be necessary to review the procedures used.

Fair Value and Matrix Pricing Methods

14. Municipal bonds for which market quotations are not readily available or for which management believes market quotations are unreliable should be valued at fair value as determined by the board of directors. For those determinations, the board may authorize the use of matrix pricing or pricing based on reliable quotations of similar securities. In determining fair value, the board should consider the provisions of accounting series releases on the subject, especially ASRs nos. 113 and 118.

15. A mathematical technique known as *matrix pricing* is used to determine securities valuations based on market data available with respect to the issue and similar issues without exclusive reliance on quoted market prices.[2] If the fund or its pricing service uses matrix pricing, the auditor's understanding of the procedures should be sufficient to satisfy him that the procedures produce a reasonable and fair valuation. The auditor should perform test calculations he deems necessary in the circumstances.

"When Issued" Securities

16. Municipal bond funds deal in securities sold on a "when issued" basis to a greater degree than most other types of funds. A municipal securities underwriter solicits expressions of interest in a proposed issue, sends unpriced confirmations at a later date to those investors having an interest in the issue, and, sends a final priced confirmation against which delivery is made at a later date when the terms of the issue are known. The securities will normally begin trading on a "when issued" basis at the time the priced confirmation is issued and begin trading as if they had been issued a few days before the actual closing date. For federal income tax purposes, the holding period of the securities does not begin until they are issued.[3]

17. While there have been cases

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[2] Matrix pricing uses electronic data processing techniques to determine valuations for normal institutional-size trading units of debt securities without exclusive reliance upon quoted prices. The use of data processing techniques enables one to consider factors such as the issue's coupon interest rate, maturity, and rating by a service and those of similar issues for which quoted prices are available to develop a calculation of what the current market yields would be for the issue in question. Those techniques may also consider market indices and other market data.

[3] I. T. 3721, 1945 C.B. 164, modified by Rev. Rul. 57-29, 1957-1 C.B. 519.

of securities offerings that are aborted after "when issued" trading commences, these situations are rare. The asset and liability relating to a "when issued" security should be recorded when the priced transaction confirmation is issued, and the investment should be valued thereafter. Because these securities do not earn interest until the settlement date, they should be identified in the financial statements. The same accounting method should be used for securities purchased on a delayed-delivery basis.

Portfolio Insurance

18. A number of municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance that guarantees the collection of principal and interest when due. The insurance normally applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to a purchaser of the security. This arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the security and transferable upon changes in ownership. If the insurance applies to the fund's portfolio only, it does not have any measurable value in the absence of default of the underlying securities or indications of the probability of such default.

19. Probability of default may be indicated if the market value of insured bonds held by the fund declines significantly and the decline appears to be related to the credit worthiness of the issuer; in which case, the value of the insured bonds may not be fairly indicated by the quoted values of uninsured bonds of the same issue. Such insured bonds should be valued at fair value as determined by the board of directors, or by the trustee of a unit investment trust, giving consideration to the value of the insurance.

20. Problems with the credit worthiness of the bonds can be recognized through comparison with market values of similar securities or by a downgrading of credit ratings. To determine the fair value of the securities, the board would have to consider the terms of the insurance policy, the intention and ability of the fund to hold the bonds until maturity, and the ability of the insurer to perform under the policy in the event of default.

21. Proceeds of insurance in lieu of defaulted interest is exempt for federal income tax purposes.[4]

22. Insured securities that have been valued by the board of directors or trustees at a value in excess of the market value (those giving consideration to the value of the insurance), should be identified in the financial statements as being carried at fair value, based on the director's or trustee's reliance on a party other than the issuer for collection. Disclosure should also be made of the intention of the fund to hold the securities until maturity in order to realize the benefits of the insurance.

Presentation

23. Regulation S-X requires classification of investments by type of business, if practicable. Municipal securities should be grouped either by state or municipality within the state or by purpose of issue, whichever is more meaningful.

24. Although not required, bond ratings of the portfolio of investments are often disclosed. If the auditor has not agreed the ratings to published sources, they should be identified as unaudited.

TAX AND OTHER CONSIDERATIONS

Qualification as a Regulated Investment Company

25. To enjoy the benefits of paying tax-free dividends to shareholders, a municipal bond fund must first qualify as a regulated investment company. Because the Internal Revenue Code states that gross income excludes tax-exempt income, municipal bond funds must pay particular attention to meeting requirements in the following respects:

a. Section 851(b)(3) of the code requires that in order to be qualified as a regulated investment company, less than 30 percent of a fund's gross income be derived from gains (disregarding losses) from the sale or other disposition of securities held for less than three months. Because the amount of taxable income realized by a municipal bond fund is usually a small percentage of its total income, the base used to determine the effect of the three-month test is usually very small. Consequently, a municipal bond fund with a small amount of taxable income may lose its right to qualify as a regulated investment company if it realizes any gains from the sale of securities held for less than three months.[5]

b. If a municipal bond fund realizes taxable income, it is usually a very small amount. Nevertheless, 90 percent of that amount as well as 90 percent of tax-exempt income must be distributed. Declaring dividends in proportion to taxable and tax-exempt income may prevent an inadvertent under-distribution of taxable income.[5]

26. Because premiums paid on purchases of obligations of a state,

[4] Revenue Ruling 76-78.

[5] The proposed Technical Corrections Bill of 1977 will resolve this problem by providing that "gross income" for purposes of the 90 percent and 30 percent tests includes tax-exempt interest. In addition, the bill will disallow any loss recognized within 31 days of the date of purchase of shares in a tax-exempt mutual fund to the extent of any tax-exempt interest dividend received by a shareholder.

territory, or possession of the United States, or their political subdivisions, must be amortized for federal income tax purposes, most funds have chosen to amortize those premiums for book purposes. Original issue discount on tax-free bonds is generally amortized periodically for book and tax purposes.

27. Because investment companies carry securities at value, amortization of premium or discount has no effect on net asset value. Amortization of bond premium results in a decrease in interest income with a corresponding increase in unrealized appreciation of investments, and vice versa for amortization of bond discount. As a result, a policy of amortization may affect net investment income but would not affect total income from investments (net investment income plus realized and unrealized gains and losses). The accounting policy for amortization should be disclosed in the financial statements.

28. For determining the amortization of premium on tax-exempt securities, the Internal Revenue Service has ruled that bond premium in excess of the call price, if any, must be amortized to the earliest call date and the basis of the bond reduced accordingly (Rev. Rul. 60-17). The portion of the premium equivalent to the difference between the call price (or total premium if a bond is purchased for less than its call price) and the maturity value is amortized over the period from the call date to maturity.

Equalization

29. Funds that do not declare dividends daily may use equalization accounting, as described in chapter 2 of the audit guide. A municipal bond fund that realizes a significant amount of taxable income (usually interest on investments in short-term securities) should allocate equalization debits and credits between undistributed tax-exempt income and taxable income.

30. In defining earnings and profits of a municipal bond fund I.R.C. sec. 852(c) and I.R. reg. 1.852-5 (b) state that "earnings and profits . . . for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year." The result of this may be taxation of a distribution of income equalization credits as ordinary income, as illustrated below.

	Book	Tax Basis	
	Undistributed Income	Earnings & Profits Current	Earnings & Profits Accumulated
Nontaxable interest income	$100,000	$100,000	$100,000
Expenses	(16,000)[1]		(16,000)
Income equalization credits	12,000		
Balance	96,000	100,000	84,000
Dividends paid[2]			
Exempt interest dividends	84,000[3]	84,000	84,000
Ordinary dividends	12,000[4]	12,000	—
Total dividends	96,000	96,000	84,000
Undistributed income at year end	$ —[5]	$ 4,000	—

1. Not deductible from current earnings and profits (Reg. sec. 1.852-58).
2. Assumes that the fund's policy is to distribute all its net equalization credits.
3. Exempt interest dividend = $84,000 ($100,000 − $16,000).
4. Distribution in excess of exempt interest dividend may be taxed as ordinary income (Reg. sec. 1.852-5(b)).
5. Assumes dividend payment on the last day of each month. The undistributed balance of current earnings and profits has no federal income tax significance since fund has distributed its net tax-exempt income (I.R.C. sec. 852).

Distribution Requirements

31. The Tax Reform Act of 1976 provides that a regulated investment company that meets certain tests in addition to those enumerated above may pass tax-exempt interest through to its shareholders as "exempt interest dividends." A dividend will qualify as an exempt interest dividend only if:

a. At the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the regulated investment company consists of certain tax-exempt government obligations.

b. The dividend is designated by the regulated investment company as an exempt-interest dividend in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year.

32. If a fund is disqualified from treating distributions as tax-exempt dividends, it may still qualify as a regulated investment company if it meets the other applicable tests.

Distribution Policies

33. Municipal bond funds whose investment policies require that 100 percent of its assets be invested in tax-exempt securities will realize only tax-exempt income except for any net gains realized on the sale of investments, which are taxable.

34. In addition to following the requirements prescribed by the code, a municipal bond fund must also consider the tax effect on its shareholders when deciding on its distribution policies. Because gains realized on redemption of capital shares are taxable to the redeeming shareholders, dividends from net investment income are frequently declared daily in order to maximize the amount received by the redeeming shareholder as tax-exempt income. Dividends are usually paid quarterly or monthly, but redeeming shareholders may receive unpaid dividends at the time of redemption.

Allocation of Expenses

35. The code requires that a municipal bond fund's allowable deductions be allocated between its taxable and tax-exempt income. Capital gains are excluded from this calculation. The only acceptable basis for allocation appears to be the ratio of tax-exempt income to gross investment (tax-exempt plus taxable) income. The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.

TRANSITION

36. An accounting change to adopt the provisions of this statement of position should be made prospectively. The change should be made as of the date of this statement but no later than December 31, 1978. Disclosures should be made in the financial statements in the period of change in accordance with paragraph 28 of APB Opinion 20.