University of Mississippi

eGrove

Statements of Position

American Institute of Certified Public Accountants (AICPA) Historical Collection

1998

Comment letters on Proposed Audit and Accounting Guide "Audits of Investment Companies"

American Institute of Certified Public Accountants (AICPA)

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_sop

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

American Institute of Certified Public Accountants (AICPA), "Comment letters on Proposed Audit and Accounting Guide "Audits of Investment Companies"" (1998). *Statements of Position*. 706.
https://egrove.olemiss.edu/aicpa_sop/706

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Statements of Position by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

A Team AICPA Note

DATE: January 25, 1999

TO: Library Services

FROM: Sheila Yu

SUBJECT: Comment Letters

Enclosed is a complete set of comment letters received on the September 22, 1998 proposed Audit and Accounting Guide "*Audits of Investment Companies*". They should be made available for public inspection for a period of one year.

Exposed 9/22/98
Accounting Standards Executive Committee (AcSEC)

File 3170

List of Respondents to the Proposed Audit and Accounting Guide *"Audits of Investment Companies"*

Letter number	Commentator	Affiliation
1.	Gilbert Bergsman	Eichler Bergsman & Co., LLP
2.	John M. Davis	Nationwide Insurance
3.	Kathryn J. Hyatt	The Vanguard Group
4.	Timothy J. Jacoby	Colonial Management Associates
5.	Robert Giambrone	Morgan Stanley Dean Witter Advisors
6.	Gregory Coco	
7.	Salvatore Schiavone	Scudder Kemper Investments
8.	W. Thomas London	Massachusetts Financial Services Co.
9.	Peter G. Djinis	Unites States Department of the Treasury
10.	Richard A. Silver	Fidelity Management & Research Company
11.	Gregory M. Smith	Investment Company Institute
12.	Brent A. Silva	Society of Louisiana of CPAs
13.	John J. O'Leary et al	New York State Society of CPAs
14.	Catherine D. Mathews	T. Rowe Price Associates, Inc.
15.	Dave Longhurst	SAFECO Asset Management Company
16.	Tony Hynes	Capital Research and Management Co.
17.	Ernst & Young LLP	Ernst & Young LLP

List of Respondents to the Proposed Audit and Accounting Guide *"Audits of Investment Companies"*

Letter number	**Commentator**	**Affiliation**
18.	John A. Fazio	New Jersey Society of CPAs
19.	Andy Mintzer	California Society of CPAs
20.	Henry J. Matecki	Commodity Futures Trading Commission
21.	Arthur Tollefson	PricewaterhouseCoopers LLP
22.	Tracey Barber	Deloitte & Touche LLP
23.	KPMG LLP	KPMG LLP
24.	Ronald M. Kloss	Merrill Lynch
25.	Marc Hyman	AICPA's Financial Services Industry Taxation Committee – Investment Companies Subgroup

Eichler Bergsman & Co., LLP
Certified Public Accountants
404 Park Avenue South • New York, New York 10016
Tel 212•447•9001 Fax 212•447•9006

Philip A. Baumgarten
Gilbert Bergsman
Paul Eichler
Richard M. Plutzer
Michael E. Silverman

November 19, 1998

AICPA Investment Companies Committee
AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
1211 Avenue of the Americas
New York, NY 10036-8775

Attn: Sheila H. Yu, Technical Manager
Accounting Standards, File 3170

The exposure draft, Proposed Audit and Accounting Guide, Audits of Investment Companies, continuing to require the reporting requirement of SOP 95-2 misses the mark as to the realities of the nonpublic closely held limited investment partnership. The schedule of investments should be voluntary at the discretion of the fund manager for the following reasons:

(1) The portfolio is so liquid that by the report date the make up of the portfolio may be completely changed.

(2) The limited partners have no input in portfolio selection and the belated knowledge of the securities held can have no influence on the manager. The limited partners' decision to invest is generally based on personal knowledge of the manager's past performance and general (not detailed) knowledge of his investment strategy.

(3) A participant is limited as to joining or withdrawing from the partnership, generally quarterly, so that detailed knowledge of the portfolio at the audit date is irrelevant.

(4) Disclosure of certain investment strategies such as arbitraging convertible bonds long vs. common stocks short or investments in anticipation of merger or acquisition activities, if disclosed, might mislead the investors in the fund because the rationale or strategy for particular investments is generally not disclosed. In addition, public knowledge of particular investments or accumulations of positions might affect the manager's strategy for achieving gains.

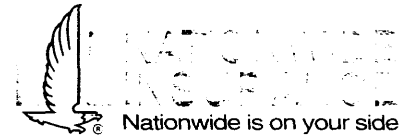
(5) Industry practice is evolving and many of the limited investment partnerships are now not disclosing the portfolio, requiring the auditors to qualify their reports, with no apparent complaints from investors.

Very truly yours,

Gilbert Bergsman

(1)

HOME OFFICE: ONE NATIONWIDE PLAZA
COLUMBUS, OH 43215-2220



December 17, 1998

Ms. Sheila H. Yu, Technical Manager
Accounting Standards, File 3170
American Institute Of Certified
Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Yu:

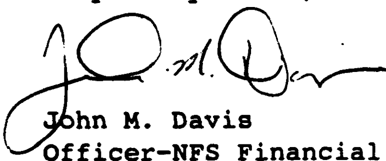
On behalf of Nationwide Life Insurance Company and Nationwide Life and Annuity Insurance Company, we appreciate the opportunity to comment on the PROPOSED AUDIT AND ACCOUNTING GUIDE for AUDITS OF INVESTMENT COMPANIES.

We direct our comments to paragraph 10.62, Note 5. Unit Fair Values. We do not believe the presentation of five years of units outstanding and unit fair values provides useful disclosure to a financial statement user. This is not required for filings under SEC Form N-4, and there is presently no GAAP guidance for such a presentation. Most of the variable accounts for our companies currently offer more than thirty sub-accounts, and each of the sub-accounts contain two or more series. A five year presentation for each series would provide a large volume of empirical data which at best would be difficult to interpret and at worst be totally confusing. Accordingly, we recommend a presentation of units outstanding and unit fair values only for the current reporting period.

In addition, we do not believe the underlying fund expenses should be included in the presentation of Ratio of Expenses to Average Net Assets. These expenses are deducted at the time the underlying fund's net asset value is calculated, and therefore, are not a direct expense of the reporting entity. We believe, notwithstanding parenthetical notation, their inclusion may be misleading to the statement user. Further, mutual fund expenses are often not available on a timely basis to meet regulatory mailing and filing requirements of separate account financial statements. And, the fiscal reporting period of the mutual fund may not coincide with that of the separate account which may require further calculation and additional footnote disclosure. We recommend that underlying mutual fund expenses not be included in the presentation of Ratio of Expenses to Average Net Assets.

If you need additional information, please contact Gary Berndt at (614) 249-7647. Again, we appreciate the opportunity to comment and we ask your thoughtful consideration of the foregoing recommendations.

Very truly Yours,



John M. Davis
Officer-NFS Financial Operations

December 21, 1998

Sheila H. Yu
Technical Manager, Accounting Standards
File 3170
AICPA
1211 Avenue of the Americas
New York NY 10036-8775

Re: Proposed Audit and Accounting Guide
Audits of Investment Companies
File 3170

Dear Ms. Yu:

The Vanguard Group[1] appreciates the opportunity to comment on the proposed Audit and Accounting Guide - *Audits of Investment Companies* (the "Proposed Guide"). We commend the AICPA Investment Companies Committee and AcSEC for their efforts in revising this industry's audit guide, and have only a few areas in which we believe further modifications are needed.

Schedule of Investments

Vanguard strongly supports the proposed changes to limit the required disclosure of individual investment securities. The current presentation, which gives equal prominence to each security regardless how small the position, detracts from the meaningfulness of the Schedule of Investments. We believe the financial statements will be greatly enhanced by allowing funds to limit disclosure of individual securities to the larger positions, focusing investors' attention on material security holdings and industry or geographical concentrations. Our only concern in this area is that paragraph 7.13 (b) of the Proposed Guide appears to

1 The Vanguard Group, headquartered in Valley Forge, Pennsylvania, is the nation's second largest mutual fund firm and a leading provider of company sponsored retirement plan services. Vanguard serves 10 million clients and manages nearly $420 billion, including more than $130 billion in participant-directed defined contribution retirement plans. Vanguard offers 97 funds to U.S. investors and 20 additional funds in foreign markets.

Post Office Box 2600 ▪ Valley Forge, Pennsylvania 19482-2600 ▪ (610) 669-1000

require that securities be classified by security type, by industry, <u>and</u> by country/geographic region. Not all classifications are meaningful for all funds. For example, an international index fund should not be required to classify its holdings both by country and industry when the only factor involved in selection of investments is inclusion in the target index. We believe a fund should have the flexibility to categorize securities in whatever way is most meaningful considering its investment objectives and the materiality of its holdings in the various categories of investment security types, industries and geographic areas. We suggest paragraph 7.13(b) be modified to eliminate the requirement for categorization at all three levels.

Fund Distributions

We support the proposal to present total distributions as a single line item in the Statement of Changes in Net Assets and Financial Highlights, with information on the tax character of distributions provided in the notes to financial statements. We agree that this change will alleviate confusion by disclosing distributions in the way that is most familiar and important to shareholders. The Proposed Guide appears to require that the tax basis components of distributions be provided only in total dollars; we believe the notes to financial statements should also include this information on a <u>per share</u> basis for the most recent two reporting periods. We also believe it is important to provide information to help shareholders assess the extent to which distributions arise from the relatively steady stream of net income earned by the fund, as opposed to short term gains on sales of securities or other items that cannot be expected to recur (e.g. foreign currency gains). Accordingly, we propose that the notes to financial statements include disclosure of the aggregate per share amounts of distributions attributed to short term gains and other components of tax basis ordinary income that are not included in net investment income for financial statement purposes.

Financial Highlights Presentation of Purchase and Redemption Fees

Paragraph 7.64(f) requires separate disclosure of the per share amounts of "purchase premiums, redemption fees, or other capital items." Several Vanguard index funds charge a transaction fee on fund share purchases, the purpose of which is to offset the transaction costs associated with investing the subscription proceeds in portfolio securities. These fees are monitored and the fee rate adjusted periodically, to achieve the desired neutral effect on fund performance. We believe the per share effect of such transaction fees is appropriately included

in the caption "Realized and Unrealized Gain (Loss) on Investments" to offset the transaction costs included therein. By contrast, redemption fees assessed when shareholders redeem before holding their fund shares for a specified time period are appropriately disclosed as a separate line item in the Financial Highlights.

Mandatory Amortization of Premiums and Discounts

We oppose the mandatory amortization provisions of the Proposed Guide. Even though Vanguard funds already amortize most premiums and discounts, the imposition of mandatory amortization requirements for financial statement purposes for the remaining securities would be costly to implement and provide no value to our funds' shareholders. Mandatory financial statement amortization will likely create book/ tax differences that introduce an unnecessary level of complexity and potential for confusion. Additionally, amortization has no effect on total return, SEC yield, net asset value, tax basis distributions or other measures commonly used to assess or compare funds' performance. The tax character of income and distributions is the relevant information for funds and their shareholders, and we question the meaningfulness of financial statements that reflect amortization policies different from those the fund has adopted for tax and distribution purposes. Funds should continue to be able to conform their financial accounting policies to their tax amortization policies as is allowed under the current Audit Guide.

Fund of Funds Issues

The statement in paragraph 5.48 that "the most typical fund of funds arrangement is a master feeder structure" is inaccurate and confusing, and should be eliminated. We also suggest the addition of language specifically stating that a fund of funds should not consolidate investee funds even if ownership exceeds 50%. While this may be inconsistent with SFAS 94 requirements, consolidation of partially owned investment companies would result in fund of funds financial statements that would be extremely confusing to shareholders.

Separate Disclosure of Corrections of Investment Restriction Violations

Paragraph 7.68 of the Proposed Guide would require payments from the adviser to the fund intended to reimburse the fund for losses realized on the sale of securities that were

purchased in violation of the fund's investment restrictions to be reported as a separate line item in the Statement of Operations. Such payments occur very infrequently and, when they do occur, the purpose is to effectively "unwind" the non-compliant transaction. We believe any such reimbursements should be netted against the related loss, so that the accounting is consistent with the purpose of the transaction. If material, the reimbursement should be disclosed in the notes to financial statements.

We hope that our comments on the Proposed Guide will help the Committee to produce an updated Audit Guide that serves the interests of fund shareholders by setting standards for more meaningful and informative fund financial statements. If you have any questions on the comments contained in this letter, please contact the undersigned at 610-669-6140.

Sincerely,

Kathryn J. Hyatt
Assistant Fund Treasurer

December 21, 1998

Sheila H. Yu
Technical Manager, Accounting Standards
File 3170 AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Yu:

We appreciate the opportunity to comment on the proposed audit guide and would like to commend the tremendous effort put into this project. The ICI comment letter, which we fully support, addresses many issues. We have chosen to comment only on one specific topic of the guide. This area is the requirement to amortize bond premium and accrete discount on debt instruments.

We acknowledge that when taken at face value, the answer to the question - "should premiums be amortized and discounts accreted?" – is yes. This is a fundamental GAAP concept. Accordingly, we have taken this issue very seriously and make our recommendation only after a careful study of the effect of this proposal on the readers of fund financial statements.

There are three main reasons why requiring premium amortization and discount accretion for investment companies does not make sense. They are:
(1) It does not add value to investment company financial statements and in fact can make them confusing and less meaningful to shareholders;
(2) Allowing flexibility leaves no room for abuse;
(3) It creates an unnecessary duplication of effort.

Confusing and Meaningless Impact on the Financial Statements:

The most important objective of a financial statement is to clearly communicate meaningful information regarding the financial position and operations of an enterprise. This is highlighted in the AICPA's "CPA Vision Project." In the mission statement, the first way in which CPA's deliver value is by "communicating the total picture with clarity and objectivity." We purport to show that requiring the amortization of premium and accretion of discount for investment company financial statements does not meet this first, and in our opinion, most important, way in which CPA's deliver value.

There are several components of the shareholder reports that are of great importance to investors. It is critical that these areas be presented to shareholders in a meaningful and accurate manner. Among the most meaningful items from our perspective are:

- Net asset value
- Total return
- SEC yield
- Distribution rates

- Expense ratios
- Portfolio holdings
- Portfolio turnover rate

Requiring a fund to amortize premium or accrete discount has no impact on any of these significant aspects of investment company financial statements. This is shown in the attached sample financial statements.

The investment company industry has been continually moving toward financial statements that more clearly reflect an investment company's income, gains, distributions and total returns to shareholders in a manner consistent with how shareholders understand and realize them. The requirement to amortize premium and accrete discount would move us away from this positive trend.

Most shareholders understand income and gain by the manner in which they are impacted by them (i.e. by their character when distributed). Requiring the amortization of premium and the accretion of discount will not change how fund distributions are characterized. Distributions are based on their tax character. Most investment companies recognize premium and discount in a manner consistent with their character for distribution purposes. Requiring this to change would be more confusing than helpful to shareholders.

This point is clearly demonstrated in the attached sample financial statements. Specifically, in the Statement of Changes in Net Assets, the current column, using our simplifying assumptions, shows the net investment income ($37,500,000) and the Net Realized Gain ($5,000,000) to be the same as the corresponding distribution amounts. In the proposed column, which reflects the premium amortization, those corresponding amounts differ greatly, given the difference in how the premium is treated for income/gain purposes. Shareholders relate most to how they receive a fund's income or gain. Using the proposed method in our example, shareholders will never receive income or gain in a manner shown in the financial statements. It only makes sense to allow investment companies to reflect income and gain/loss in a manner most meaningful to the readers of the financial statements.

No Room for Abuse:

The investment company industry has existed now for decades and we are unaware of any abuse that has been caused by or could be caused by allowing this flexibility with regard to amortization and accretion. Whether or not a fund amortizes premium or accretes discounts has no impact on many of the key data used by readers of investment company financial statements. Indeed, SEC-mandated standardized measures of total return and yield preclude the opportunity for abuse.

Duplication of Effort:

Associated with this requirement will be a substantial effort to create the systems to accommodate this requirement. Fund complexes will need to not only spend significant systems resources to comply with the requirement but will also expend significant effort going forward maintaining separate sets of book and tax records for premium and

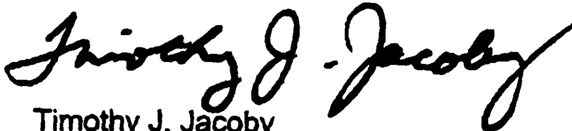
discount. The cost of this duplication will inevitably be passed on to shareholders through increased costs and lower returns. We believe these costs outweigh any "benefits."

Conclusion:

In summary, this requirement adds no value to the financial statements, will result in a more confusing communication to shareholders and will result in significant duplication of effort and costs on the part of mutual fund systems and accounting departments. Further, the current permitted flexibility results in no potential for abuse. Based on these facts we strongly recommend that the audit guide not require the amortization of premium and accretion of discount.

If, for whatever reason, it is decided to require premium amortization and discount accretion, please move the implementation date out, so as not to force investment companies to have to deal with the related systems requirements, while focused on Year 2000 issues.

Sincerely,



Timothy J. Jacoby
Treasurer
Colonial Funds

(H)

Sample Financial Statements

Assumptions

- 5% coupon on all holdings
- 125 basis point expense ratio
- Straight line premium amortization (5 years)
    - $90 million of premium
    - $900 million face purchased at 110 (cost $990,000,000)
- Beginning of period appreciation of $7,000,000
- Assume more appreciation during the year
- No capital activity
- No change in distributions
- Gain
    - 25% turnover rate (~ $250,000,000 in security sales)
    - 10% premium = $23,000,000 =~ $4,000,000+ realized premium per year
    - $4,000,000 premium amortization realized and $14,000,000 change in unrealized
- SEC method used for determining net investment income per share.

Financial Statement Impacts (shown as shaded):

Statement of Assets and Liabilities: Investments at Cost are reduced. This statement is presented to shareholders at market value. Investments at cost is typically a parenthetical note next to the investments line. There is no change in net asset value.

Statement of Operations: Investment income is reduced with a corresponding increase to net realized gain and change in net unrealized gains. There is no impact on the net increase in assets resulting from operations.

Statement of Changes in Net Assets: Investment income, realized gain and the change in unrealized gains have changed as discussed above. The net impact of these changes is zero. Distributions have not changed, because tax requirements and not GAAP determine them.

Financial Highlights: There is no impact on the per share amounts reported. Net investment income, distributions to shareholders, the beginning and ending NAV and the total return all remain unchanged. The only change in the financial highlights would be on the ratio of net investment income to average net assets, a measure of little meaningfulness to shareholders.

Statement of Assets and Liabilities

	Current	Proposed
Assets:		
Investments*	$1,000,000,000	$1,000,000,000
Interest Receivable	$500,000	500,000
	1,000,500,000	1,000,500,000
Liabilities:		
Accrued Expenses	2,000,000	2,000,000
Net Assets	$998,500,000	$998,500,000
Net Asset Value per Share (90,773,000 Shares)	$11.00	$11.00

(4)

Statement of Operations

	Current	Proposed
Investment Income:		
[illegible]	[illegible]	[illegible]
Expenses:		
Operating Expenses	12,500,000	12,500,000
Net Investment Income	*37,500,000*	*19,500,000*
Realized and Unrealized Gain:		
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
Net Increase in Assets Resulting from Operations	$45,500,000	$45,500,000

Statement of Changes in Net Assets

	Current	Proposed
Increase (Decrease) in Net Assets:		
Operations:		
Net Investment Income	*$37,500,000*	*$19,500,000*
Net Realized Gain	*5,000,000*	*9,000,000*
Change in Net Unrealized Appreciation	*3,000,000*	*17,000,000*
Net Increase from Operations	45,500,000	45,500,000
Distributions:		
From Net Investment Income	(37,500,000)	(37,500,000)
From Net Realized Gain	(5,000,000)	(5,000,000)
Total Increase in Net Assets	3,000,000	3,000,000
Net Assets:		
Beginning of Period	995,500,000	995,500,000
End of Period	$998,500,000	$998,500,000

Financial Highlights

	Current	Proposed
Net Asset Value, Beginning of Period	$10.97	$10.97
Income from Investment Operations:		
Net Investment Income	0.41	0.41
Net Realized and Unrealized Gain	0.09	0.09
Total from Investment Operations	0.50	0.50
Less Distributions to Shareholders		
From Net Investment Income	(0.41)	(0.41)
From Realized Gain	(0.06)	(0.06)
Total Distributions	(0.47)	(0.47)
Net Asset Value, End of Period	$11.00	$11.00
Total Return	4.57%	4.57%
Ratios/Supplemental Data		
Net Assets, End of Period	$998,500	$998,500
Net Expenses to Average Net Assets	1.25%	1.25%
[illegible]	[illegible]	[illegible]
Portfolio Turnover Rate	25%	25%

(H)

MORGAN STANLEY DEAN WITTER ADVISORS

Robert Giambrone
Senior Vice President

December 22, 1998

Sheila H. Yu
Technical Manager
American Institute of
Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: Proposed Audit and Accounting Guide -
Audits of Investment Companies, File 3170

Dear Ms. Yu:

Morgan Stanley Dean Witter Advisors Inc. appreciates the opportunity to comment on the Proposed Audit and Accounting Guide - Audits of Investment Companies (the "Proposed Audit Guide") and supports the efforts of the AICPA Investment Companies Committee and AcSEC to revise the Audit Guide. We recognize the growth and changes that have taken place in the Mutual Fund industry since the last major revision of the Audit Guide and acknowledge the monumental task accomplished in the completion of the proposed update.

We are keenly aware of the importance of providing our shareholders with meaningful information and support those amendments we feel accomplish those goals. The proposed changes to SOP 93-2 *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies* are insightful revisions that both simplify and make the financial information provided to our shareholders more meaningful. These changes include the incorporation of a retained earnings disclosure replacing current components of net assets and the elimination of book basis dividend and capital gain distributions.

While we are in agreement with and supportive of the majority of changes to the Proposed Audit Guide, there are two proposals to which we take exception. The first is the mandatory amortization of premium and discount on fixed income securities. The other is the required

Two World Trade Center • New York, New York 10048 • 212 392 0838

(5)

separate disclosure of payments made by advisors to cover losses from investment restriction violations.

With respect to the mandatory amortization proposal, the three main arguments against the proposal are that 1) it does not provide more meaningful information to shareholders; 2) it creates additional book tax differences, which will add to shareholder confusion; and 3) it requires extensive system changes as well as burdensome record keeping.

Regarding the issue of meaningfulness to shareholders, we recognize the concept that mandatory amortization is a yield adjustment and the fact that such adjustment is consistent with the economic substance of the transaction in a historical cost environment. However, mutual funds operate in a mark to market environment and measure performance through both total return and the SEC Yield. Both performance measures are calculated under the industry standard rules of the SEC and neither of the performance measures will be affected by the adoption of premium amortization. Still while mandatory amortization does impact net investment income per share, it is offset to the same extent in realized and/or unrealized gain or loss and, therefore, it does not affect net asset value per share.

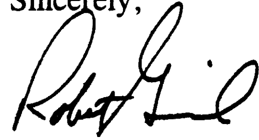
Secondly, regarding the creation of book/tax differences, the proposal calls for mandatory amortization to be calculated retroactively to the date of acquisition. However, Federal Income Tax regulations only allow for a change from the beginning of the tax year in which the election is made. This causes each security acquired prior to the current tax year to have a different cost basis for book and tax purposes, even if the election is made to amortize on a tax basis. Consequently, distributions for tax purposes will vary in amount and character from related financial statement amounts, leading to shareholder confusion.

Finally, the last point regarding mandatory amortization deals with the extensive operational issues and burdensome record keeping it causes. Fund accounting systems will not only have to begin amortization, but as discussed above, will have to calculate amortization retroactive to the date of acquisition. In order to amortize retroactively to the date of acquisition, our fund accounting system provider, which is a major service provider in the industry, requires canceling *every* affected trade and re-recording the transaction. Additionally, the book/tax differences discussed in the previous paragraph will require two sets of books for fixed income securities, a burdensome chore for which there are few, if any, benefits in an industry that must close its books daily.

With respect to the separate line item disclosure of payments from advisors to the Fund for investment restriction violations, no substantive theoretical support is provided. It is not clear why this related party disclosure should differ from the requirements of Statement of Financial Accounting Standards No. 57 - *Related Party Disclosures,* which addresses related party transactions and the associated disclosure requirements.

We thank you again for the opportunity to voice our opinions regarding the proposed changes to the Audit Guide and commend AICPA Investment Companies Committee and AcSEC for their efforts. If you have any questions on these comments, please contact the undersigned at 212-392-0838.

Sincerely,



Robert Giambrone
Senior Vice President

Author: MIME:gcoco@statestreet.com at INTERNET
Date: 12/22/98 6:22 PM
Priority: Normal
TO: Sheila Yu at AICPA3
Subject: Exposure Draft

Ms. Sheila Yu,

I was disappointed upon my review of the audits of investment companies guide to find that there is no mention, let alone guidance, for the Amendments to Rule 2A-7 which came out earlier this year.

Given the complexity and plenitude of the amendments, I had hoped that the draft would address the changes and provide some guidance.

The focus made and significance applied to "Guarantors" of money market instruments (made by the 2A-7 Amendments) has caused a great deal of confusion among investment companies and there unfortunately is very little literature that provides guidance.

Do you anticipate adding any information in the guide regarding these ammendments? I would strongly urge the committee to consider its inclusion.

Sincerely,
Gregory Coco, CPA

SCUDDER KEMPER INVESTMENTS

Scudder Kemper Investments, Inc.
Two International Place
Boston, MA 02110-4103
(617) 295-1000

December 22, 1998

Sheila H. Yu
Technical Manager
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Yu:

Scudder Kemper Investments appreciates the opportunity to comment on the proposed Audit and Accounting Guide – *Audits of Investment Companies* (the "Draft Audit Guide"). In general, we support most of the proposed changes in the Draft Audit Guide and will adopt these changes as soon as the Audit Guide is issued. For example, we support disclosing the top 50 holdings in the investment portfolio and the proposed changes to SOP 93-2 *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distribution by Investment Companies*. We believe these changes along with the SEC's proposed amendments to Regulation S-X will simplify the financial statements and make them more meaningful to shareholders.

In contrast, we are opposed to the mandatory amortization of premium/accretion of discount on fixed income securities. We believe that this change will complicate financial statements, confuse shareholders, and increase administration costs. We are opposed to mandatory premium amortization for investment companies and disagree that it will enhance the meaningfulness of information provided to investors. Mandatory premium amortization will create book/tax differences in net investment income, which will complicate and increase administration costs. We support the Investment Company Institute's comment letter regarding industry wide opposition to mandatory premium amortization.

Also, we suggest that when a fund produces separate shareholder reports by class, only the Financial Highlights for that specific class need be included in the shareholder report. Currently, the Draft Audit Guide would require the Financial Highlights for all classes of a Fund to be included in the report. We do not believe that the Financial Highlights is a part of the core financial statements. Therefore, we are suggesting that the wording in paragraph 5.29 (page 69) be modified so when a fund produces separate shareholder reports by class, only the Financial Highlights for that class need be included

in the shareholder report. This is consistent with the SEC disclosure in Fund prospectuses that include only the Financial Highlights for a specific class that is being marketed.

Attached to this letter is an appendix, which provides comments on specific paragraphs of the Draft Audit Guide. These comments should serve to clarify the proposed guidance.

We hope that our comments will assist in finalizing the Draft Audit Guide. If you have any questions regarding the comments in this letter, please feel free to call me at (617) 295-2663.

Sincerely,

Salvatore Schiavone
Vice President
Fund Reporting

APPENDIX

Chapter 3
Paragraph 3.6/Page 40 - The second line should say "sale of a security.....with an agreement to buy...from....."

Chapter 5
Paragraph 5.13/Page 66 - Simultaneous equations bullet point, last word should be "classes" not "claims".

Paragraph 5.29/Page 69 – Modify the paragraph to indicate that where a fund produces separate shraeholder reports by class, only the financial highlights for the subject class need be included in the shareholder report

Exhibit 5.2/Page 77 - Simultaneous equation method - under "where" - the third parameter says that $10.50 represents the average daily NAV of the Fund. The $10.50 represents the NAV for class A. Also, what if the NAVs of each class have diverged? This will produce a different answer depending on which NAV is used.

Chapter 7
Paragraph 7.31/Page 128 (third line) - need a space between income and less

INVESTMENT MANAGEMENT

We invented the mutual fund℠

MASSACHUSETTS FINANCIAL SERVICES COMPANY
500 Boylston Street, Boston, Massachusetts 02116-3741
617 954 5000

December 22, 1998

(Sent via e-mail: syu@aicpa.org)

Ms. Sheila H. Yu
Technical Manager
Accounting Standards, File 3170
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Sheila:

Massachusetts Financial Services Company is the investment adviser to more than 150 separate investment company portfolios with net assets in excess of $90 billion.

We are pleased to comment on the Exposure Draft Proposed Audit and Accounting Guide for Audits of Investment Companies. We support the AICPA's attempt to provide guidance on financial reporting by investment companies and generally support the proposed accounting and reporting guidance discussed in the Audit Guide, including accounting for excess expense plans and simplification of the schedule of investments.

We do, however, strongly object to the proposed guidance for mandatory amortization of premium/accretion of discount and separate disclosure of corrections of investment restriction violations. We have included in the detailed comments more specific rationale for our objections but, in summary, do not see the benefit to the industry and shareholders of investment companies (funds) for adopting either proposal. It is clear that there is and has been no perceived or actual abuse that would necessitate either change and, in addition, there is no indication in the Guide as to how these proposals would improve the meaningfulness of financial reporting.

We are reporting our detailed comments with related paragraph references for your consideration as follows:

8

PARAGRAPH #	COMMENT
1.27	Financial Reporting to Shareholders Clarify that the schedule of financial highlights is not a part of the basic financial statements under Generally Accepted Accounting Principles (GAAP) and, as a result, it is possible to exclude the financial highlights table for certain classes of funds which may be reported separately. Consistent with this point, guidance should be provided as to the appropriateness of customizing certain footnote disclosures for financial statements prepared for separate share class reporting.
2.33	The Audit Guide recommends ". . . fair value should be estimated in good faith by the investment company's Board of Directors (or by management under procedures established by the Board of Directors) based on consistent application of the company's established pricing policy . . ." following an example that is inappropriate. In instances such as this, many fund companies do not change security prices from last market close and do not believe the Guide should recommend one practice. That decision remains with the respective Board of Directors based upon the relative facts and circumstances.
2.54	The Guide proposes to require the implementation of mandatory amortization of premiums and discounts, using the interest method, on fixed income securities. The proposal has been made with the intent of conforming Investment Companies with GAAP. Like many funds, MFS does not amortize purchased premiums on fixed income securities, for either book or tax purposes, and opposes the proposal based upon the adverse effects it would have on shareholders. Shareholders will face less meaningful, if not more confusing, financial statements, compounded by the creation of artificial book/tax differences, which will result regardless of tax elections made by the fund. The costs of implementing systems changes resulting from the necessity of creating and maintaining separate accounting and tax records will be borne by the shareholders through increased accounting and administrative fees. Programming resources, already stretched to capacity on issues such as the Euro Conversion and Year 2000 Compliance, will be costly and may be unavailable for modifying systems for non-critical matters. Funds are required to report portfolio investments at market (fair) value. The GAAP concept of premium amortization is to reflect the current accounting or economic value of a security purchased at a premium by adjusting the stated interest rate to a current market rate. The daily valuation of any security however, including those purchased at a premium, reflects its true economic worth in the current interest rate environment. The best evidence of fair value is the quoted market price which takes into account future cash flows discounted at current rates. Since investments purchased by investment companies are rarely

(8)

held to maturity, the unamortized premium of a bond, when compared to fair value most accurately reflects the potential gain or loss upon disposition.

The impact to the financial statements of adopting such a policy for book purposes is limited, both in terms of content and value to shareholders. Since funds determine a net asset value daily, the amortization of discount or premium does not impact the stated value of investments, the net asset value, nor the net asset value per share of the fund. It merely represents a reclassification between cost and unrealized appreciation on the balance sheet, and net investment income and realized or unrealized appreciation on the statement of operations and financial highlights. Furthermore, amortization of premium and discount does not impact the fund's total return, expense ratio or the calculation of the SEC yield.

Investment companies are required to distribute to shareholders all of their taxable income, including any net realized gain on investments according to Internal Revenue Service rules and regulations. Distributions to shareholders are determined on a tax basis and, for that reason, most funds adopt amortization policies which conform to income tax regulations that apply to a particular fund. To require funds to amortize discount and premium on all debt issues ignores the fact that book/tax differences will be created or assumes the fund can, and will, elect to amortize discount and premium for tax purposes and that it will use the interest method to do so.

In cases where a fund can elect to amortize discount or premium for tax purposes, it is not likely to do so if such an election does not benefit the shareholder and it is done only to conform to GAAP methodology. Corporate and government bonds may elect to amortize premium for tax purposes. However, unlike the implementation rules for GAAP, which would require a cumulative effect adjustment, once elected, the calculation is prospective for tax purposes and is applicable to all bonds owned at the beginning of the year of election and to all subsequent purchases. In this case, even if an election were made to try to conform tax and financial reporting records, as suggested by the Guide, separate records would have to be maintained for securities requiring prospective rather than retroactive treatment for tax purposes. Because a fund is required to distribute all of its taxable income to avoid taxes, the proposed change would have no impact on the amount a fund distributes to shareholders. Since most corporate and government bond funds are sold to shareholders interested in a steady income stream of cash distributions, it is more likely a fund would not elect to amortize premium for tax purposes only to conform to GAAP.

Municipal bonds, for tax purposes, are required to amortize premium and use the Acquisition Premium Fraction method of amortization when bonds are issued with OID but purchased at an acquisition premium. Although recorded daily, the required use of the interest method for amortizing premium for book purposes would serve only to create the necessity of requiring two sets of amortization tables and cost records for each lot purchased at an acquisition premium. In

(8)

addition, the required use of the interest method does not consider that the fund may be amortizing market discount daily, but has elected to use the straight-line method for tax purposes. In either case described above, the fund may be amortizing discount or premium on a daily basis but using a method other than that required by the proposed audit guide.

Conforming tax elections to GAAP may harm shareholders. For example, Municipal bond funds are required to treat market discount as taxable income to the extent of any gain realized upon disposition of a security or, it may elect to amortize the discount into income on a daily basis and report it as taxable income at year end. To the extent such discount is accrued daily and reported as taxable income and the security has not been sold, the shareholder is disadvantaged in two ways; (1) taxable income has been reported before it has been realized and (2) taxable income may have been overstated to the extent market discount exceeds any gain realized on the sale of the security. Since the shareholder is disadvantaged in either case, it is unlikely the fund would elect to adopt GAAP rules for tax purposes, resulting in the necessity to maintain two sets of accounting records for Municipal funds.

Discount and premium amortization policy, as described in the current version of the AICPA Audit Guide (non-mandatory), is not the first time the AICPA has supported financial statement disclosures based upon tax accounting. The existing guidance allows funds to select an accounting policy for discount and premium, which coincides with tax elections and requirements.

SOP 93-2 provides for reflecting a financial statement return of capital only when it exists for tax purposes. Although the "SOP" states that funds prepare their financial statements on the basis of GAAP, a return of capital based upon book accounting is not disclosed as it is deemed to have little relevance to investment company shareholders. A tax return of capital is disclosed however, as it has a high degree of relevance and must be reported to shareholders for income tax purposes. The "SOP" concluded that reporting a book return of capital when there was not a tax return of capital would be confusing to shareholders. Under the proposed guide, if a fund amortizes premium for book purposes but not for tax, it will distribute more investment income than it earns, but will not report a book return of capital.

Under both the current and proposed audit guides, it states that tax free business combinations are accounted for by a method that most closely approximates the accounting followed for tax purposes. The cases described above document a desire to conform book accounting to tax accounting when the result is more meaningful to the readers of the financial statements, where it reflects the unique tax character of a mutual fund, when there is not a significant impact on the financial statements, or when there is no change in net asset value. Not only is the proposal not meaningful, but we believe the result creates differences between income earned and distributed which would only serve to confuse shareholders.

(8)

3.4 – 3.6	Securities Sold Under Agreements to Repurchase These paragraphs should be updated with or referenced to FASB Statement No. 125 Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.
4.36	Auditing Procedures Item C – As of transactions should not be bold type.
6.72b	Delete the reference "using the calendar year measurement period" as the measurement period for capital gains may be used.
6.82	(a) Distinguish between market premium (purchase price above redemption price) and acquisition premium (purchase price less than redemption price but greater than OID). Discuss Acquisition Premium Fraction as the method required by the IRS for recording acquisition premium on Municipal bonds.
7.1	Financial Statements of Investment Companies Financial Highlights Table for semiannual reports should include the semiannual period and the preceding five years. The Guide indicates only one year. This may be an appropriate place to indicate that financial statements for a specific class may be reported on separately without having to include the financial highlights table for all classes.
7.14	Any security whose fair value has been estimated in good faith by or at the direction of the Board of Directors should be identified in the Portfolio of Investments. Delete the reference to only high-yield and restricted debt securities.
7.28d	Stipulate that tax disclosures should be made as of the last tax year-end to address situations where the reporting period is different than the tax year-end.
7.29	Should be capital "I" in investment.
7.31	Should read as "income less" not "incomeless."
7.33	Remove last sentence referencing affiliated and controlled companies as this SEC disclosure requirement is mentioned in 7.74
7.35H	Clarify that foreign withholding taxes and other foreign taxes are typically excluded from the expense ratio of the Investment Company.
7.37	Involuntary waivers should not include matters that require shareholder vote or Board of Director approval. In these instances, the Investment Company has no right to the fee (i.e. management or distribution) and, therefore it should not be considered a waiver.

7.43 Recommend that the second sentence be replaced with "Registered Investment Companies follow guidance published in Regulation S-X requiring disclosure of net realized gain or loss by major kinds of investment transactions." The Audit Guide appears to indicate incorrectly that GAAP requires disclosure by major kinds of investment transactions.

7.57-7.59 The text details information to be provided when presenting a statement of cash flows using the direct method. As the Guide parenthetically suggests the indirect method is more commonly used and the example provided in 7.82 uses the indirect method. We recommend modifying the text to incorporate more explanation of the indirect method.

7.65b Portfolio turnover rate should not be bold type.

7.65c Changes to Form N-1A Rules have removed the requirement to disclose average amount of borrowings outstanding, weighted average number of shares outstanding, and the average amount of debt per share. Accordingly this paragraph should be removed.

7.68 We question the meaningfulness of separately reporting gains and losses from corrections of investment restriction violations in the financial statements. The purpose of the financial statement is to report financial position, results of operations and changes in net assets and is not intended to be a compliance report. These disclosures may also cause undue concern by regulatory bodies and shareholders as to the adequacy of the fund's internal control structure. The Guide does not indicate what shareholder benefit is attained by separately reporting gains and loss from corrections of investment restriction violations.

Additionally, the proposed requirement may be a disincentive for advisors to make a fund "whole" for losses or retain gains for corrections of investment restrictions in order to avoid reporting. If losses are required to be separately reported in the body of the financial statements this may promote advisors to "play the market" in an attempt to eliminate the loss.

Finally, to the extent separate disclosure is mandated, the Guide does not address consistent application for reporting or accounting of gains or losses. If required, the impact of an investment restriction violation should be consistently disclosed in the footnotes whether it is a gain or loss. Policies and procedures should be adopted to ensure gains or losses are calculated in a consistent manner. Lastly, a level of materiality should be imposed, which may include consideration as to the size of transaction, size of gain/loss, nature of the transaction, etc.

7.79 The statement of net assets example does not adequately disclose the composition of net assets similar to the example in 7.75.

8.5 Excess Expense Plans

The duration of an excess expense plan should not be a consideration in determining whether a liability has been incurred by a fund.

The Guide makes reference to expense limitation agreements and indicates that "such agreements may also provide that reimbursement is not required after a specified date or upon conclusion of specified period from initially incurring the expense, **such as three years**." The Guide should not have to make reference to a specific period as in this example and should be careful not to suggest that three years is or is not a reasonable period of time for excess plans to exist.

While the SEC, in approving fund registration statements, has informally indicated that up to three years is a reasonable time horizon for expense reimbursement arrangements to exist, the basis for conclusion, as discussed in Paragraphs 12.10 through 12.14, should focus more appropriately on considerations from FASB Statement #5 Accounting for Contingencies, and SFAC #6 Elements of Financial Statements, and specifically, in reviewing criteria for defining a liability.

12.3a — Consider clarifying that a capital infusion or bailout is a voluntary action and the full impact of the transaction should be disclosed in accordance with FASB Statement #57 Related Party Transactions.

12.3b — The broad assumption that the payment by an investment advisor to make the fund whole "is in essence a payment in lieu of settlement of a potential lawsuit for negligence" is incorrect. An investment advisor has a fiduciary responsibility to the funds it manages and has advisory agreements stipulating standards of care; however, some compliance violations may be determined only after taking careful consideration of all the facts and circumstances surrounding the transaction. A payment by an advisor to a fund to make it whole serves to remove the financial effect of ever having made the investment. Therefore, it may be argued that no separate disclosure of the transaction is warranted.

12.32 — In the last sentence the Audit Guide states "Until SEC requirements are modified, however, the disclosure requirements by SOP 93-2 would continue to be required to comply with Regulation S-X." In light of the recommendations made in this Guide in Sections 7.52c, does GAAP now apply and SOP 93-2 not? In other words, wouldn't Regulation S-X look to the Audit Guide for appropriate presentation and disclosure of distributions in the Statements of Changes in Net Assets and Financial Highlights table?

Appendix B

Table 1 — Include Acquisition Premium Fraction for tax exempt obligations

Table 2 — For tax exempt obligations (include ^ for long term bonds and indicate interest income is taxable

We respectfully submit the above comments to help clarify and strengthen the arguments of the Audit and Accounting Guide for Audits of Investment Companies. We hope you will give our comments serious consideration before issuing the Guide.

If I may be of any further assistance, please do not hesitate to contact me.

Very truly yours,

W. Thomas London
Senior Vice President
tlondon@mfs.com
617-954-5251

(8)

Author: MIME:CharlesK@fincen.treas.gov at INTERNET
Date: 12/21/98 7:30 PM
Priority: Normal
TO: Sheila Yu at AICPA3
Subject: File 3170

United States Department of the Treasury
Financial Crimes Enforcement Network
Suite 200
2070 Chain Bridge Road
Vienna, Virginia 22182-2536

December 21, 1998

Sheila H. Yu
Technical Manager, Accounting Standards, File 3170
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Yu:

Thank you for this opportunity to comment on the proposed AICPA Audit and Accounting Guide Audits of Investment Companies that would supersede the AICPA Industry Audit Guide Audits of Investment Companies and Statement of Position 93-2, Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies.

I offer only one general comment - the need for the audit guide to acknowledge and provide guidance on the vulnerability of the investment company industry to abuse by money launderers. Money laundering is a phenomenon which affects virtually every form of financial services provider, including investment companies. As such, it represents a real risk, both legally and financially, to such entities. Investment companies are increasingly becoming aware of this risk, and developing control procedures to better manage this risk.

Attached is a document that I believe would be useful to consider in formulating this Audit and Accounting Guide. The risk of money laundering to the investment company sector, as with all financial institutions is serious, and I believe that it may be useful to provide some description of this risk to those who audit investment companies. We believe that the accounting profession should and must play a critical role in the development of an effective anti-money laundering program, and it is in that spirit that I provide you with this suggestion. If I can be of any further assistance to you or to your important efforts, please feel free to call me at (703) 905-3930 or Charles Klingman at (703) 905-3602.

□Sincerely,

□Peter G. Djinis
□Associate Director

DRAFT

Proposed Addendum to AICPA AUDIT AND ACCOUNTING GUIDE AUDITS OF INVESTMENT COMPANIES

Investment Companies Industry Developments –

Money Laundering Risk and Related Regulatory Developments

(9)

Money Laundering Risk

Criminals use bank and non-bank financial institutions and professional advisors to launder the proceeds of crime, and investment companies are vulnerable. As discussed in Investment Companies Industry Developments – 1997/98 (*AICPA Audit Risk Alert: Investment Companies Industry Developments – 1997/98*, pp. 7-9) the evolving dynamics of the industry – mergers and acquisitions, broader product lines and new distribution channels generate important business opportunities, but they also generate risks for companies and auditors, including increased money laundering vulnerability. As these industry trends continue, as money launderers increasingly look for conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other non-bank financial institutions make it more difficult for them to evade detection, the investment company industry will become increasingly vulnerable to money laundering and more attractive to money launderers.

As the SEC becomes increasingly focused on internal control and risk management, the compliance risk for investment companies increases. The Know-Your-Customer principles of the investment company industry, traditionally focused on consumer protection, are rapidly evolving to also incorporate the meaning long-embraced by other financial institutions – to know the background and character of the customer, the source of his funds, and the purpose of his business activity.

What is money laundering?

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from $300 billion to $1 trillion.[1]

While money laundering activity and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes -- placement, layering, and integration.

Placement is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by bank and non-bank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends and law enforcement strategies and techniques in order to keep their proceeds concealed, their methods secret, and their professional resources anonymous. The most common placement techniques include structuring[2] cash deposits into legitimate bank and other financial institution accounts, converting cash into other monetary instruments and using these instruments to make investments.

Layering is the process of generating a series or layers of transactions in order to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include outbound electronic funds transfer, usually directly or

[1] By definition, money launderers are in the business of cloaking their activities and revenue, making approximation difficult.

[2] "Structuring" means breaking up large amounts of currency into smaller amounts in order to conduct transactions in such a manner as to avoid suspicion and detection.

(9)

subsequently into a "bank secrecy haven" or a jurisdiction with more liberal record-keeping and reporting requirements, and withdrawals of already-placed deposits in the form of highly-liquid monetary instruments, like money orders and travelers checks.

Integration, the final money laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions. An important placement technique is customers' making large deposits with laundered proceeds in the form of monetary instruments.

The world's largest and wealthiest economies tend to serve as the primary hosts for money launderers and their operations. These economies tend to harbor the greatest demand for illegal drugs, still the primary predicate money laundering activity. Also, sophisticated money launderers need similarly sophisticated financial services sectors in order to successfully launder -- to place, layer, and integrate proceeds.

Professional Guidance

The most applicable U.S. professional guidance for money laundering is provided by Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 54, *Illegal Acts by Clients*.

The SAS No. 82 discussion of risk factors and assessment of risk is useful in dealing with money laundering as well as fraud. One important distinction is that money laundering is less likely to affect financial statements than other types of fraud and consequently is less likely to be detected in financial statement audits because the activity tends to use the business entity more as a conduit than as a direct hit on assets and operations.[3] A second important distinction is that fraudulent activity usually results in the loss or disappearance of assets or revenue whereas money laundering usually results in large quantities of illicit proceeds that need to be distanced from their source as quickly as possible in an undetected manner. For this reason, money laundering is more likely to cause misstatements upward than downward, and shorter-term fluctuations rather than cumulative changes. In applying SAS No. 82 to money laundering, judgment should similarly be used in identifying risk factors related to money laundering that may be present at an investment company, including the following:

- A failure by management to display and communicate an appropriate attitude regarding internal control (see the AICPA's publication entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883), pp. 109-111):

- Lack of Board / Senior Management oversight of critical processes

- Management's inattention to establishing independent reporting lines for key assurance functions, like internal audit and compliance

- Management's displaying a significant disregard for regulatory authorities

[3] One notable exception is that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

(9)

- Known history of securities law violations or claims against the entity or Senior Management alleging fraud or violations of securities laws

- Inadequate or insufficiently empowered compliance function, lack of professional resources, or lack of applicable experience

- The lack of an independent internal audit compliance program.

- Evidence of unusual operating characteristics:

  - Significant assets held for or deposits made in the form of currency or monetary instruments (money orders or travelers checks) by a customer

  - Large deposits of sequentially numbered checks into a customer's account

  - Significant deposits emanating from "high risk" jurisdictions, notably "bank secrecy havens" and OFAC (Treasury's Office of Foreign Asset Control) targeted jurisdictions, that seem unusual or inconsistent with what is known about or expected for that customer

  - Shipments of currency or monetary instruments by a customer from abroad

  - Establishment of relationships with multiple affiliates (e.g. family of funds) for customers for whom this activity would be inconsistent or unusual.

- A lack of background checks on new hires

- Weak or non-existent ethics policies and related training programs

- Unreasonably infrequent or non-existent reviews of security software and systems.

While the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations that may indirectly effect the financial statements, this discussion underscores the importance of auditors responsibilities with regard to possible illegal acts by clients. Auditors should design their audits to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statements amounts. However, an audit performed in accordance generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Auditors should, however, be aware of the possibility that such illegal acts have occurred. Specific guidance in this area is set forth in SAS No. 54, *Illegal Acts by Clients*.

* * * * *

(9)

Legislative and Regulatory Developments

Bank Secrecy Act

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions, to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties. Investment companies are defined as financial institutions under the Act (Title 31 USC 5312(a)(I)).

Suspicious Activity Reporting

Investment companies are not currently required to report suspicious activity either by employees or by customers to the Treasury Department. However, a number of major investment companies are voluntarily complying with this provision. Investment companies that are subsidiaries of bank holding companies are required to report suspicious activity by the Federal Reserve (12 CFR 225).

Currency Transaction Reporting

BSA implementing regulations require financial institutions including investment companies to file Currency Transaction Reports (CTRs) for cash transactions greater than $10,000. (31 CFR 103.22)

Other BSA Reporting Rules

Other BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs) and foreign bank and financial accounts (FBARs) have not been modified since 1989 and 1987 respectively. However, on January 16, 1997 (see Federal Register) the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

State Statutes

According to the National Association of Attorneys General, thirty states have enacted legislation prohibiting money laundering. Additional states are currently considering such legislation.

European Union Directive on Money Laundering

On July 13, 1998 the European Union expanded the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This directive would apply to the audits of the European operations and subsidiaries of domestic clients.

(9)

Fidelity Investments

Fidelity Management & Research Company

82 Devonshire Street
Boston, MA 02109-3614
Phone: 617 563-7000

December 21, 1998

Ms. Shelia H. Yu
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File 3170
Exposure Draft – Proposed Audit and Accounting Guide: Audits of Investment Companies

Dear Ms. Yu:

Fidelity Management & Research Company, the investment adviser to the Fidelity Investments group of funds,[1] appreciates the opportunity to provide comments on the Exposure Draft – Proposed Audit and Accounting Guide: Audits of Investment Companies (the "Guide"). Fidelity has spent considerable time reviewing the Guide and has identified a number of proposals that cause us concern. Our comments and suggestions relating to these proposals fall into three categories. We begin in Section I by addressing the five proposals that we believe should be deleted or substantially modified:

- Premium Amortization
- Capital Contributions
- Corrections of Investment Restriction Violations
- Valuation and Disclosure of Portfolio Securities
- Complex Capital Structures

[1] Fidelity Investments is the nation's largest mutual fund company and one of the leading providers of financial services. Fidelity offers investment management, retirement, brokerage, and shareholder services directly to individuals and institutions, and through financial intermediaries. The firm is also the number one provider of 401(k) retirement savings plans, the second largest discount brokerage firm, and the third largest provider of 403(b) retirement plans for not-for-profit institutions in the United States. Fidelity currently manages over $675 billion in assets. Fidelity Management & Research Company is the investment adviser to the Fidelity Funds.

10

Second, we discuss in Section II three areas that we believe warrant further consideration and revision:

- Financial Statements and Schedule of Investments
- Taxes
- Overall Suggestions

Third, we present in Appendix I the areas that we believe require minor modification or clarification. In an effort to streamline our suggestions, we have listed in tabular form the 107 relevant sections and our corresponding comments. We believe these sections are vague, inconsistent, or unclear and thus would prevent the Guide from achieving its goal of providing authoritative guidance to promote uniformity in practice.

SECTION I

A. PREMIUM AMORTIZATION

Paragraph 2.54 of the Guide would for the first time make amortization of premium and discount on securities mandatory for investment companies. For the reasons discussed below, we believe that this change would provide no benefit to shareholders and would require most fund complexes to commit significant resources at a significant cost at an inopportune time. Therefore, we strongly recommend deletion of this requirement from the Guide.

Departure from Current GAAP

Paragraph 2.54 represents a complete departure from current GAAP as stated in FASB Statement No. 91 (FAS 91) issued December, 1986, which observes that the general requirement of GAAP to amortize premium and discount on loans and securities does not apply to assets carried at market value. FAS 91 does not merely fail to include such assets in the category subject to premium and discount amortization, (i.e., assets otherwise carried at historical cost), but rather expressly and unequivocally excludes them from such requirements.[2] Inexplicably, paragraph 12.6 of the Guide cites the very same FAS 91 as support for the *opposite* conclusion, (i.e., that premium amortization is preferable GAAP for investment companies, which carry *all* assets at market value), because such "accounting literature clearly supports recording interest income in a manner that is consistent with the substance of the transaction."

The Guide also cites APB Opinion No. 21 (APB 21) issued August, 1971. An examination of APB 21, however, reveals that its stated objective is not to create any new accounting principles, but to refine the manner of applying existing accounting principles. Thus, neither APB 21 nor FAS 91 creates new GAAP, but merely restates and refines well established principles which recognize that the economic substance objective is necessarily met where assets are carried at market value. The Guide is silent as to why the economic substance requirement is not satisfied under current GAAP.

Indeed, the Guide fails to offer any support or analysis for any aspect of its disavowal of the pronouncement of FAS 91 excluding assets carried at market value from the general requirement to amortize premium and discount applicable to assets otherwise carried at historical cost.

---

[2] Paragraph 34 of FAS 91 states, "The Board concluded that this statement should not apply to fees and costs and premiums or discounts associated with loans that are carried at market value, because carrying loans at market value obviates the need for accounting guidance for recognition of fees and costs and premiums or discounts associated with those loans."

Finally, the Guide does not include any explanation or support for limiting such a complete reversal of current GAAP solely to investment companies.

Benefits Unclear

Requiring amortization of premium and discount does not produce any tangible benefits to shareholders or funds. Mandatory amortization will have absolutely no impact on a fund's net asset value, SEC yield or total return, the major indicia of performance to which investors look in evaluating a fund. In fact, SEC yield was adopted precisely to provide a uniform yield calculation for all funds and thereby create comparability. [See SEC Release Nos. 33-6753; IC-16245; File No. 7-23-86 (February 10, 1988).] Nor will the proposal necessarily have any impact on fund distributions, which must conform to the requirements of Subchapter M of the Internal Revenue Code and are based upon federal tax rules governing the accrual of income on debt securities, including taxpayer-specific elections. The only tangible effect of a shift to mandatory amortization is a geographical realignment of certain amounts on a fund's statement of operations. The Guide itself accurately characterizes the modest nature of this change to mandatory amortization as "merely a reclassification between net investment income and realized or unrealized appreciation." Precisely how this change causes "the information provided [to] be more meaningful to investors," however, is far from clear. Although, as indicated in the Guide, the proposed change will affect the ratio of net investment income to average assets, the value of this change would be negligible as the industry has suggested that this ratio be eliminated because it is "meaningless." [See the Investment Company Institute's (the "ICI") letter to the SEC re: Improving Shareholder Reports, dated August 11, 1998.] In fact, the change ironically may have the opposite result since, as discussed below, shareholders may not understand why tax-based distributions differ from book accruals of income.

Increased Costs and Operational Complexity

Mandatory amortization of premium and discount will be very expensive and operationally complex. The current Guide does not address whether an investment company must amortize premium and discount. Consequently, most fund complexes simplify their operations by conforming book amortization to tax. Although applicable federal income tax rules generally require amortization of certain items, such as original issue discount on all bonds and premium on tax-exempt bonds, these rules also allow funds to elect whether or not to amortize other items, such as market discount on all bonds and premium on taxable bonds. Current industry practice regarding premium is divided – some fund complexes amortize premium on all fixed income securities, while many others amortize premium only on tax-exempt securities. In contrast, it is our understanding that most fund complexes do not amortize market discount. Therefore, mandatory amortization would force many fund complexes to expend significant resources, and complicate daily processes, without any benefit to shareholders. Fidelity estimates that its cost

of converting to a mandatory amortization regime would be at least $1 million. In addition to the dollar cost, mandatory amortization may disrupt daily operating processes by adding time-consuming processes and volumes of new data.

Fund complexes that do not currently amortize all premium and discount would face two unattractive alternatives. First, they could attempt to maintain conformity between book and tax by amortizing all premium and discount in both cases. Such a changeover, however, is not easily accomplished. Although most accounting systems are capable of amortizing all premium and discount, a changeover in amortization methodology generally could be implemented only on a prospective basis to newly purchased securities. Assuming paragraph 2.54 is intended to require amortization of all securities that a fund holds as of its effective date, existing holdings would have to be converted separately on a lot-by-lot basis, with a cumulative "catch-up" adjustment being made. Even with this changeover, however, fund complexes would still face permanent book-tax differences with respect to their existing holdings. Under applicable tax rules, a fund that elects to begin amortizing premium on its existing holdings must do so on a going-forward basis only, with no catch-up (i.e., the fund starts amortizing from the reduced basis that it would have had if it had amortized from the beginning of the period it has held the security). In contrast, GAAP would require funds to catch up for the previous non-accrual, thus creating a permanent book/tax difference at each lot level holding.

Second, fund complexes may choose to maintain their existing tax policy of not amortizing all premium and discount. This practice, however, will create book-tax differences, requiring the maintenance of two sets of records and thereby adding to the cost and complexity of a fund's record keeping. In addition, as noted above, these book-tax differences will exacerbate current shareholder confusion, since tax distributions will not match book income.[3]

[3] Additional issues will arise regardless of the alternative that a fund complex selects. For example, funds currently do not amortize market discount on tax-exempt securities and instead accrue market discount for book purposes as short-term capital gain at the time it is recognized for tax purposes. Under a mandatory amortization regime, funds generally would have to include taxable market discount accruals in their mil rate. Most fund accounting systems, however, do not differentiate between taxable and tax-exempt accruals in determining the mil rate, but instead assume in the case of municipal bond and money market funds that all accruals are tax-exempt. As a result, under a mandatory amortization regime it would be necessary at year-end for funds to back out the taxable component of their mil rate through a reclassification of prior tax-exempt accruals. Further, funds would have to determine and apply different after-tax factors for the taxable and tax-exempt components of daily mil rates in order to compute tax-equivalent yields. These complicated procedures would add to the cost of the mandatory amortization regime.

Stated Objectives Not Achieved

Finally, while the Guide's objective ostensibly is to narrow diversity of practice, it is not at all clear that the proposal achieves this goal. The Guide provides no details (beyond requiring the "interest method") as to *how* to calculate premium or discount or take various contingencies into account in performing this mandatory amortization. Accordingly, a variety of securities may be subject to disparate treatment – which may or may not accurately track economic reality – under the Guide's new mandatory amortization regime. For example, the Guide provides no guidance as to whether premium or discount on a callable bond should be amortized to the call date or to maturity. In addition, the Guide provides no guidance as to whether the amount of premium or discount on a convertible bond is determined by backing out the value of the embedded option. Nor does the Guide provide guidance on how to determine the amount of premium or discount on variable rate and contingent debt instruments. Unless a specific approach is mandated in these and other instances, it is not clear that mandatory amortization will always be applied consistently by all fund complexes, especially in light of a fund's ability to elect alternative amortization methods for tax purposes.[4]

For all of these reasons, we urge the AICPA to reconsider implementing a mandatory amortization regime, which has no benefits but has significant costs and operational complexity.

B. CAPITAL CONTRIBUTIONS

Paragraph 7.67 would require that payments made by advisers to compensate any fund for losses on its investment holdings should be treated as capital contributions. It also would require that the effect of contributions on the fund's total return be disclosed in a manner similar to disclosure for the effect of voluntary waivers of fees and expenses.

Regulation S-X governs disclosure by registered mutual funds of investments in, investment income from, gain or loss on sales of securities of, and management or other service fees payable to affiliates. Although Regulation S-X currently does not require separate disclosure of capital infusions by affiliates, the SEC has indicated that it is considering revisions to Regulation S-X, and it addressed capital infusions in a "Dear CFO" letter dated November 1, 1994. It is our understanding that the SEC issued this letter soon after several advisers had taken actions to compensate money market funds for losses on investment holdings that threatened those funds' $1 per share value. Broad application of these provisions by the Guide to all funds: registered and unregistered, as well as stable and fluctuating net asset value per share, does not seem warranted given the limited circumstances the SEC seemed to be addressing in the 1994 letter.

[4] Transitional rules also may not reflect economic substance. For example, if funds are required to "catch up" on their existing holdings once mandatory amortization is required, premium and discount on these securities will be amortized over an artificially short period.

We believe that paragraph 7.67 oversteps the boundaries of GAAP by setting forth standards applicable to capital contributions that should be the subject of SEC regulation and should be applied only to public registrants. Accordingly, we suggest that Guide be silent on this matter. Otherwise, discussion set forth in the Guide as a GAAP requirement could conflict with future revisions to Regulation S-X the SEC may eventually make.

C. CORRECTIONS OF INVESTMENT RESTRICTION VIOLATIONS

Paragraph 7.68 would require payments made by advisers to compensate funds for losses resulting from transactions in violation of investment restrictions to be reported as a separate line item in the statement of operations after net realized gain or loss from investments. Further, this paragraph would require footnote disclosure of gains resulting from similar transactions. These disclosure requirements overstep the boundaries of GAAP. Requiring such disclosure would provide a disincentive to both rigorous compliance monitoring and adviser reimbursement of losses from investment violations.

Although not entirely clear from the Guide, the ostensible purpose of this disclosure is to communicate to shareholders a potential control weakness. We submit that the disclosure would not serve this purpose. First, ironically the Guide would penalize advisers who monitor investment compliance more diligently, because more frequent detection of investment violations may result in greater disclosure. This disclosure may be interpreted by some as an indication of weak internal controls when, in fact, the detective controls that identify such violations are an indication of strong internal controls. Paradoxically, funds with weak internal controls, that fail to detect such violations, would make no disclosure and appear to be better controlled. Also, the magnitude of a gain or loss, which enters into the decision of whether disclosure is appropriate, is fortuitous, based often on market movements beyond the control of any adviser. One instance of a particular investment violation therefore may result in a significant gain or loss, whereas many instances of other violations may not.

The second and more serious concern with this proposal is that some advisers may choose not to reimburse a fund due to the negative implications of disclosure of such reimbursement. Most advisers would not concede "gross negligence," the typical standard of care for investment advisory contracts (not simple negligence as the Guide infers) in most cases. However, most advisers would reimburse a fund even when they believe that they are not legally obligated to do so under their investment advisory contract. By requiring disclosure, some advisers may be less willing to make reimbursements in the future.[5]

---

[5] The distinction between the capital treatment in paragraph 7.67 and the statement of operations treatment in paragraph 7.68 for similar payments is unclear. Assuming the intended distinction is to recognize the voluntary

We strongly believe that matters of internal control, such as the occurrence and detection of investment restriction violations, should be addressed through the audit process and not through financial disclosure. The appropriate vehicle already exists for reporting of any such control weaknesses. Funds registered with the SEC are required annually to file an internal control letter from their auditor.

D. VALUATION AND DISCLOSURE OF PORTFOLIO SECURITIES

Paragraph 7.14 of the Guide would require a fund to indicate all high-yield and restricted debt securities whose values have been estimated in the portfolio of investments. This disclosure requirement and the confused use of the term "estimate" here and in the definition of fair value in Chapter 2 of the Guide cause us considerable concern. While we support the AICPA Investment Companies Committee's (the "Committee") desire to provide guidance on reporting requirements relating to disclosure of material use of Board-approved fair value pricing at a reporting date, we believe the Guide fails to achieve this goal. We believe that the Guide is both overly broad and unclear as to its application. We suggest that revisions by the SEC to Regulation S-X would be a more appropriate means of addressing disclosure changes relating to Board-approved fair value pricing since the Investment Company Act of 1940 (the "1940 Act") clearly governs the pricing and fair value requirements of public registrants. The Guide's proposed guidance in this area would only conflict with SEC requirements.

Overly Broad and Confusing Definition

The Guide is overly broad in its proposed application of disclosure of the use of estimates. The 1940 Act does not use the term "estimate" in its discussion of valuation. Section 2(a)(41) of the 1940 Act defines the "value" of fund assets in terms of (i) securities "for which market quotations are readily available" and (ii) securities valued at "fair value as determined in good faith by the board of directors." Both means of valuation result in the "value of the assets" for purposes of shareholder purchases and redemptions in an open-end mutual fund.

The Guide uses the term "fair value" much more broadly than the SEC or the investment company industry to include all valuations that are not based on readily available quotes from active markets. Paragraph 2.31 improperly implies that the convention used by some funds of valuing securities at the mean of quotes obtained from market maker broker-dealers is an "estimate [of] fair value." The 1940 Act makes it clear that this is an acceptable valuation convention when applied consistently. Moreover, it is generally accepted industry practice that

---

nature of certain of the payments, we would oppose the application of paragraph 7.67 to these payments for similar reasons.

prices obtained from third-party sources do not constitute "Board-approved fair value" even when the valuation method used by third-parties is one that may be used in a fair valuation process as described in paragraph 2.37. SEC ASR 118 does not include securities valued by third parties using these methods within the definition of "Board-approved fair value." In addition, paragraph 2.34 mistakenly implies that all restricted securities must be valued using Board-approved fair value procedures. This is simply not true; many restricted securities trade actively in Section 144A markets and, therefore, do not require Board-approved valuation. [See the ICI's paper, *Valuation and Liquidity Issues for Mutual Funds,* dated February 1997].

Notation of Selected Holdings May be Misleading

Paragraph 7.14 requires that an investment company's portfolio indicate all high-yield and restricted debt securities whose values have been estimated.[6] As discussed above, the Guide's confused definition of "fair value" could encompass high-yield municipal securities, the values of which are provided to many funds by pricing services that utilize matrix pricing. This could result in the need for some funds (e.g., high-yield municipal bond funds) to indicate that most of their portfolio holdings are fair valued. Clearly, this would not provide meaningful information to the shareholder. Further, identifying only high-yield and restricted debt securities could be misleading, as this practice may give the reader the impression that the rest of the portfolio was valued based on market quotations, when in fact this may not have been the case.

The need for new disclosure for valuation policies is unclear because investment companies already are required by SEC rules under Form N-1A and Regulation S-X to disclose security valuation policies. If the purpose of the new requirement is to provide information regarding risk concentrations associated with investments in high-yield and restricted debt securities, then the concepts discussed in FAS 107, as amended, should be applied here. This objective could be achieved through additional disclosure in the footnotes, including the valuation footnote, rather than by specific identification of individual portfolio holdings. Further, in light of the proposal to permit a condensed portfolio listing, this disclosure may be less likely to provide useful information to shareholders.

For all these reasons, we strongly suggest modification of paragraphs 2.28 through 2.39 to clarify and narrow the definition of "fair value," by eliminating the confusing references to the concepts of disclosure of estimates, and conforming it to long-standing SEC and industry norms. We further suggest deletion of paragraph 7.14 altogether.

---

[6] The illustrative financial statements presented in the Guide do not present the clearest example of this requirement. Footnote 2 to these financial statements discusses the valuation of a single restricted common stock, giving the impression that any and all restricted securities should be discussed in detail. This may be interpreted as conflicting with the Guide's statement that, "If several restricted security investments are held, a general statement on the valuation methods may be given rather than individual description as well as the aggregate value of such securities."

E. COMPLEX CAPITAL STRUCTURES

Chapter 5 attempts to provide comprehensive guidance on a variety of complex structures for the first time. We believe that the guidance in this area is generally helpful, however, we believe the chapter would benefit significantly from structural reorganization for clarity.[7] In addition, Chapter 5 should differentiate the requirements applicable to public complex investment structures from those applicable to non-public complex investment structures and should define a fund-of-funds structure as a separate complex structure rather than a type of master-feeder structure subject to the same disclosure requirements.

In the case of master-feeder and fund-of-fund structures that are governed by regulatory regimes other than that imposed by the SEC, we suggest that the Guide recommend certain factors to be considered by management in the determination of appropriate reporting. We do not believe that SEC regulatory requirements should be imposed on non-registered investment companies. While the SEC reporting requirements for registered investment companies may and should be a factor to consider, they should not be controlling and may actually conflict with the controlling government regulations.

For example, the requirements of paragraphs 5.30 through 5.41 would universally apply SEC guidance that requires master financial statements to be included with the financial statements for the feeder funds. We suggest that the Guide clarify that the SEC generally requires this in connection with the registration process of a feeder fund, as it is our understanding that no formal regulation imposes such a requirement. Further, we suggest that this SEC requirement should not be applied to non-registered investment companies.

We also believe that the look-through and aggregation requirements of paragraph 7.17 are unclear as to their application to the various complex structures. If these requirements were applied to an unaffiliated registered fund-of-funds structure, the calculation of a reporting company's indirect proportional interest in an investee would be extremely complicated, and in some cases impossible. This calculation would be particularly difficult if the underlying funds have different year-ends or are managed outside the reporting company's complex. Some funds as a matter of policy do not make their holdings available to outsiders. The Guide allows for this by permitting disclosure to that effect. However, guidance should be provided to suggest that funds should avoid potentially misleading partial aggregation of some, but not all, underlying funds' holdings. Further, we suggest that the paragraph be redrafted to clarify its application to

---

[7] We suggest that the chapter be reorganized into three sections: (1) mutli-class, (2) master-feeder, and (3) fund-of-funds. Within each section, we suggest the following sub-sections (i) background and regulation, (ii) accounting matters, (iii) operational matters, (iv) financial reporting, and (v) auditing considerations. Within each sub-section, registered and unregistered products should be addressed separately, keeping in mind that SEC requirements should not apply to non-registered investment companies. Furthermore, we suggest that all tax discussion be deleted from this chapter.

the various complex structures, including privately placed unregistered master-feeder or fund-of-funds products.

Finally, the 1940 Act registered fund-of-funds structure raises a number of unique issues not addressed effectively in the Guide. We suggest that rather than apply the master-feeder requirements, the Committee should consider the more pertinent issues raised in the fund-of-funds context.

SECTION II

A. FINANCIAL STATEMENTS AND SCHEDULE OF INVESTMENTS

Disclosure of Portfolio Securities

We support the Guide's proposal to permit a condensed schedule of investments, which in most cases would result in more meaningful disclosure to investors regarding a fund's risk profile and investment strategy.

However, further clarification of the application of the proposals for a condensed portfolio listing is needed in the following areas:

- Paragraph 7.13a should be clarified as to how investments in futures, short sales and other financial instruments should be treated. For example, it is unclear whether the underlying security value or margin value of futures should be measured for purposes of determining a fund's 50 largest investments.

- Paragraph 7.13b should be clarified to indicate that all three categorizations for purposes of presenting its portfolio holdings are not necessary. The Guide should clearly state, as it does in the example in paragraph 7.76, that securities may be arranged by groupings that are the most meaningful to users. Also, the Guide clearly should allow for flexibility in presenting portfolio information as a percent of net assets, total assets, or market value.

Components of Net Assets

The Guide proposes in paragraph 7.28d that financial statement footnotes disclose the tax-based components of net assets: undistributed ordinary income, undistributed long-term capital gains, capital loss carryforwards and unrealized appreciation (or depreciation). The Guide, however, does not indicate how to determine these tax-based components. For example, it is not clear whether temporary timing differences should be included in the tax-based components of retained earnings. Under current guidance (Statement of Position 93-2), the undistributed accounts presented on the balance sheet include temporary timing differences.[8]

---

[8] The Guide seems inconsistent because its introduction specifically states that SOP 93-2 is superceded; yet paragraph 12.32 states that SOP 93-2 must still be followed to comply with Regulation S-X. Regulation S-X does not appear to require disclosure of the tax-based components of net assets.

In addition, since the categories of ordinary income and long-term capital gains are tax-based, they can only be finalized at a fund's fiscal year-end. Therefore, the Guide should specifically allow for the application of federal income tax law for the purposes of determining undistributed ordinary income, long-term capital gains, and unrealized appreciation (depreciation) for both semiannual and annual reporting. This will help to ensure consistent application within the industry of these new requirements.

B. TAXES

While we commend the Guide's attempt to provide a comprehensive summary of the taxation of RICs, we believe that the material contained in the Chapter 6 entitled "Taxation of Regulated Investment Companies" is likely to lead readers to reach erroneous conclusions on a variety of issues. The Guide begins by noting in paragraph 6.10 that the tax law is complex and that the Guide's summary should not be considered a detailed explanation. Unfortunately, the Guide then proceeds to discuss in apparent detail numerous tax-related issues. Instead of a summary, the Guide reads more like an abbreviated (and incomplete) treatise, particularly in light of its specific citations to the Internal Revenue Code and a number of other sources. These citations, which appear sporadically and in some cases are rather selective, may well suggest to readers that the Guide is making definitive statements on the tax law, when in fact these statements are mere generalizations.

We believe that the Guide should adhere to its stated purpose of providing only a summary of the taxation of RICs. This may be accomplished by removing a considerable amount of detail (including many citations and discussions of the treatment of specific types of investments) and adding references to appropriate secondary authorities.[9] We also suggest that all relevant tax discussion included throughout other chapters of the Guide should be centralized in this chapter.

C. OVERALL SUGGESTIONS

Presentation and readability of the Guide would be enhanced if the chapters followed a more parallel structure. Most of the chapters could do a much better job of logically separating material into sections focused on: (i) background and regulation; (ii) accounting matters; (iii) operational matters; (iv) financial reporting; and (v) auditing considerations.

We believe that a more thorough discussion of the basis for conclusions would greatly enhance overall understanding of the changes from the current Guide. Finally, several of the chapters

[9] In particular, we believe that paragraphs 6.75 through 6.131 of the Guide should be deleted. In the event that theses sections are retained, however, we have provided specific comments on these sections in Appendix I.

would benefit if the material were updated to address new regulatory and other developments in the industry. We discuss most of these areas either in the body of the letter, or in Appendix I.

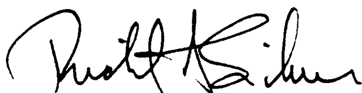
* * * * * * * * *

Of necessity, the Guide deals with many inherently complex topics. We appreciate how much effort has been required to revise the Guide. Unfortunately, we believe that the Guide, as proposed, falls short in several critical respects and will generate significant problems for many fund complexes and their shareholders. Two distressing themes are evident throughout the Guide. First, in certain areas, proposed guidance oversteps the bounds of accounting and reporting and inappropriately discusses regulatory matters or applies regulatory regimes too broadly. Second, in other areas, the Guide unfortunately would apply "one size fits all accounting" where product and market considerations, and common sense, point to the need for and benefit of specialized treatment.

The Guide needs significant additional revision before it is issued in final form. We therefore respectfully request that AcSEC issue another exposure of the Guide prior to finalization.

We appreciate your time and consideration of our comments. If you have any questions or wish to discuss any of the issues addressed in this letter, please contact the undersigned at (617) 563-5265, or John H. Costello at (617) 563-6270.

Very truly yours,



Richard A. Silver
Treasurer of the Fidelity Funds

Appendix

	Topic	Paragraph Reference	Comments
1	Requirements of No-Load Funds	1.9	Delete the words "board contingent" prior to "12b-1 plan." Whether a 12b-1 plan is board contingent or enhanced has no bearing on whether the fund is characterized as load or no-load.
2	Approval of Advisory Agreement	1.16	Annual renewal of investment advisory agreements need not be approved by a majority of a fund's outstanding shares.
3	Registration Statements	1.23	Suggest incorporating discussion of fund profile/rule 498 into discussion of investment company registration/forms.
4	SEC Financial Statement Simplification	1.27	Clarify whether three separate statements will still be required if the SEC permits combination of the Statement of Operations and the Statement of Changes in Net Assets.
5	Recording Securities Transactions	1.32	The following statement "Established practice in accounting for security purchases and sales is to record transactions as of the trade date" should be clarified to apply only to financial statements not daily NAV calculation.
6	Calculation of NAVs by Closed-end Funds	2.19	NASD recently modified MFQS to incorporate closed-end funds. Therefore, many closed-end funds calculate and disseminate NAVs daily.
7	Maturities of Money Market Fund Holdings	Chapter 2 - Footnote 20	Money market funds may purchase securities with ultimate maturities greater than 13 months (e.g., certain variable rate, floating rate and adjustable rate securities). See rule 2a-7(d).
8	Securities Loans	2.64	Securities loans: add statement that securities loaned out remain in the portfolio at mark to market value. Also add statement that when securities are received as collateral they typically are not reflected as an asset on the fund's books.
9	Fair Value	2.124	Second bullet: insert "or by management under procedures established by the board of directors".
10	Financial Instruments	3.3	Define "relatively short period" in first sentence (e.g., 60 days).
11	Repos and Reverse Repos	3.6	The perspective of the paragraph should be consistent with that of paragraphs 3.4 and 3.5.
12	Futures Contracts	3.35	Define the term "member firms" in final sentence.

#	Topic	Paragraph Reference	Comments
13	Futures Contracts	3.36	Should be updated for those who are CFTC-registered commodity merchants.
14	Mortgage Dollar Rolls	3.46	Insert "reverse" subsequent to "regular" in second sentence.
15	Sales Loads	4.4	Third sentence erroneously implies that all back-end loads are contingent.
16	Honoring Redemptions	4.11	Second sentence indicates funds do not honor redemptions where purchase was recently made by personal check. Change language to indicate funds honor redemptions – but hold redemption proceeds until purchase check clears.
17	Shareholder Transactions	4.17	Another procedure should be to review the service auditor's SAS 70 report on the transfer agent.
18	Dividend Reinvestment	4.26	Second sentence should clarify that reinvestment occurs on next day, but at the ex-date's NAV.
19	Dividends to Shareholders and Reinvestments	4.45	Discussion of limits on payment of capital gains. Suggest adding a footnote to the effect that funds may apply to the SEC to make additional distributions of LTCG per rule 19b-1(e).
20	Multiple Class Structures	5.4	Class A may also charge a distribution or service fee. Class D should be deleted. Should discuss institutional/wrap fee classes.
21	Master-Feeder Structures	5.6	The words "offshore master and feeder" should not be in italics. Sentence is confusing.
22	SEC Rule 18f-3	5.8	Delete the last sentence, because the rule generally permits any reasonable method.
23	Multiple Class NAVs	5.9	Delete last sentence. Not true for funds that make capital gains distributions.
24	Multiple Class Structures	5.11	Delete paragraph. Discussed in tax chapter.
25	Multiple Class Structures	5.12	Delete tax discussion. Discussed in tax chapter.
27	Multiple Class Dividends	5.16	Insert word "typically" in the last sentence.

	Topic	Paragraph Reference	Comments
28	Master-Feeder Funds	5.20	In the unregistered fund world, the separation between investment management and distribution is often blurred. First sentence may be true for U.S. registered products, but is not always the case for unregistered.
29	Master-Feeder Accounting	5.22	Delete tax discussion – too much detail.
30	Master-Feeder Funds	5.23	Delete this discussion. Superficial and incomplete.
31	Multiple Class Financial Statements	5.26	Guide should be modified to permit presentation of class level expense items in the footnotes.
32	Multiple Class Financial Statements	5.27	Guide should be modified to permit presentation of changes in class level capital items in the footnotes.
33	Multiple Class Financial Statements	5.27	Delete tax discussion, or, if not, move it to Chapter 6.
34	Multiple Class Footnotes	5.28	Delete last bullet. Fund level disclosure should suffice.
35	Auditing Multiple Class Funds	5.45	Delete third bullet. More recent authority overrides.
36	Fund Management Issues	5.52	This section should be revised because it discusses fund management issues, not accounting, reporting, tax or audit issues.
37	Multiple Class Financial Statements	5.61	Guide should be modified to permit presentation of class level fee waivers in the footnotes.
38	Taxes	Chapter 6	Delete all references to Short 3 requirements - repealed.
39	Various Taxes	6.4	It seems inconsistent to apply FASB No. 109 for financial statement presentation of foreign taxes and not other taxes.
40	Diversification	6.8	Non-diversified funds would not have these "differing" diversification requirements.
41	Qualification as a RIC	6.11	Footnote 3 should be moved to after "IRC" in same sentence.
42	Computation of RIC	6.13	The Guide defines regular taxable income and it should make clear that the operating loss reference is not to

	Topic	Paragraph Reference	Comments
	Taxable Income		current year losses. Also, this is not a complete list of the adjustments that are required to calculate investment company taxable income.
43	Net Investment Losses	6.14	Last sentence is misleading. Any RIC can offset NOLs against short-term gains.
44	Offsets to Income and Gains	6.16	Paragraph does not address the new designation rules under 97-64 and the concept of bifurcation of the tax year.
45	Taxation of Shareholder Distributions	6.18	The Guide should indicate that capital loss carry forwards do not reduce current E&P.
46	Taxation of Shareholder Distributions	6.20	The Guide should address the timing of the 5452 filing.
47	Pass-through of Foreign Taxes Paid	6.22	Pass-through is available if *more than 50%* is invested in foreign securities, not *at least 50%.*
48	Pass-through of Foreign Taxes Paid	6.22 d.	Last sentence was repealed.
49	Exempt-interest Dividends	6.23 d.	Incomplete. Several other provisions could result in character of gain/loss being ordinary, such as contingent debt rules or conversion transaction rules.
50	Capital Gain Dividends	6.24 a.	Net long-term capital gain minus net short-term capital loss is "net capital gain;" use this term for consistency.
51	RIC Qualification	6.31 b.	Tax authority is unclear as to whether an affirmative election to be a RIC is required.
52	Gross Income Test	6.33 a.	Delete last sentence. Informal position does not belong in basic overview of tax rules.
53	Gross Income Test	6.33 b.	Isn't true if it is a securities partnership. The Guide should include grantor trusts in addition to partnerships.
54	Gross Income Test	6.33 b.	Last sentence applies to any gross revenue of any partnership not just rental partnerships. Cite to 6.34 is wrong; it's good income if derived from sources listed at the beginning of 6.33.

	Topic	Paragraph Reference	Comments
55	Gross Income Test	6.34	Delete this paragraph.
56	Gross Income Test	6.35	Delete this paragraph. Misleading.
57	Short 3	6.36-6.41	Delete these sections. 30% test is repealed.
58	Diversification	6.42	Wording for 5% issuers is confusing.
59	Diversification	6.44	Clarify last sentence to indicate it's 20% of *each* corporation's voting power, not 20% of combined voting power of both corporations (e.g., 30% and 10% of 2 corporations).
60	Diversification	6.45	Delete. Or, at least clarify that the rule for all options, including index options, is to look through to issuer(s) of underlying stock. Statement in first sentence -- "except for index instruments" -- therefore is somewhat misleading. Reference to GNMAs is wrong -- these are government securities because U.S. guarantees them, not because U.S issues them. Also, GNMA is not a stock index as the last sentence suggests.
61	Derivatives	6.46	Paragraph should be deleted. Unclear why derivatives are discussed in detail, but no other "issuer" issues are discussed (e.g., guarantees, conduit issuers, etc). Why focus on futures and options, when other derivatives might be more problematic (e.g., when-issueds, swaps, etc.)? There is really no clear authority on these issues. We do not believe GCMs are necessarily controlling and much of this information is subject to many interpretations.
62	Diversification	6.47	We do not necessarily agree with parenthetical which states that the cure period does not apply to first quarter of the first taxable year. This section is subject to varying interpretation.
63	Distribution Test	6.49	Should read "equal to the sum of 90% of ICTI plus 90% of net tax exempt income".
64	Distribution Test	6.51	Tax only on undistributed taxable income.
65	Distributions	6.53	Delete paragraph. So oversimplified that is not helpful.
66	Spillback	6.55	Modify the last sentence as follows: "The distribution is deemed paid during the year for regular tax

(67)

	Topic	Paragraph Reference	Comments
	Distributions		purposes".
67	Equalization	6.58	Discussion of book equalization is not relevant. Delete.
68	Capital Gain Dividends	6.62	Move this paragraph to the excise tax section.
69	Excise Tax	6.71	Last sentence is incorrect.
70	Excise Tax	6.72	Not an exhaustive list and may be misleading.
71	Excise Tax	6.73 c.	Delete. Redundant.
72	Taxes	6.82 b.	"Long-term bond" is not defined in IRC or elsewhere. Statement that short-term municipals are treated like short-term taxable bonds is wrong
73	Taxes	6.83 c.	Reference to tax-exempt bonds in first sentence should be deleted. Need to note that interest expense may be deferred. Explain de minimis rule. Second sentence inaccurate for OID bonds, as set forth in last sentence. Need to explain that a fund is required to recharacterize gain as ordinary income *only to the extent that market discount has accrued* at time of sale, redemption, or maturity.
74	Taxes	6.83 d.	Should state explicitly that acquisition discount rules don't apply to municipal securities. Mention somewhere that a fund may elect to treat all discounts as OID (as many money market funds do).
75	Taxes	6.90	Losses in excess of the unrealized gain on the offsetting position are deductible.
76	Stock Redemption Costs	6.93	Remove discussion of redemption fees. These are deducted from proceeds, not an income inclusion item.
77	Foreign Currency Transactions	6.103	Delete discussion of cash basis RICs – too obscure.
78	PFICs	6.120	PFIC makes election, not RIC.
79	Offshore Funds	6.125	"Ten Commandments" have been repealed (but no mention of state tax nexus issues).

	Topic	Paragraph Reference	Comments
80	Financial Highlights	7.1 Footnote 4	New N-1A rules require 5 years in prospectus. Footnote 4 references old N-1A requirement of 10 years. (N-2 hasn't changed). Footnote 4 should be updated to reference item 22 of N-1A, not item 23. Also, in semi-annual reports registered investment companies are required to present semi-annual plus latest 5 years.
81	Statement of Net Assets	7.9	With regard to the Schedule of Net Assets, this paragraph indicates that details of other assets and liabilities should be presented in the statement of net assets. Under the current guide, the details of other assets and liabilities can be presented either in the statement or in the notes to the financial statements if the amounts are material to total assets or total liabilities. Rule 6-05 of Regulation S-X states that disclosure be provided in the notes for certain liabilities required under Rule 6-04. The proposed Guide should allow the option, consistent with S-X and the current Guide, of presenting the details of other assets and liabilities in either the statements or in the footnotes to the financial statements.
82	Investments in Securities	7.13 c. (ii)	This is unclear - is b(iii) intentionally not included as a category for other investments? The proposed Guide should provide the option of categorizing other investments by industry.
83	Cash	7.18, 7.75	Paragraph 5.12 of the current guide requires disclosure of foreign currency balances if they are material. The proposed Guide should also require disclosure of foreign currency balances only if they are material.
84	Liabilities	7.24	The proposed Guide states that separate disclosure is required for related party payables. Regulation S-X Rule 6-04 requires for other liabilities, the fund state separately (a) amounts payable for investment advisory, management and service fees; and (b) the total amount payable to: (1) officers and directors; (2) controlled companies; and (3) other affiliates. It is not clear whether the related party payables, other than for investment advisory, management and service fees, could be aggregated and shown as one line item. The Guide should clarify what is meant by "separate disclosure" and allow for aggregation of related party payables except for amounts payable for investment advisory, management and service fees.
85	Liabilities	7.26	Should clarify that a liability is only recognized when collateral is cash, or securities with transfer of effective control.
86	Net Assets	7.28 d.	This paragraph should state that the footnotes should disclose the tax basis components of **retained earnings**, not net assets.
87	Net Assets	7.28, 7.83	The illustrative financial statement footnotes 4 and 7 show two different unrealized appreciation amounts on a

	Topic	Paragraph Reference	Comments
			tax basis, which will be confusing to a shareholder (i.e., unrealized appreciation/depreciation on the portfolio based on the tax cost of securities and tax unrealized appreciation/depreciation as a component of retained earnings). Need further explanation on how to determine unrealized appreciation on a tax basis and indicate if this could result in an amount different than the unrealized appreciation/depreciation based on tax cost that is required by regulation S-X Rule 12-12.
88	Expenses	7.39 and 7.40	The Guide should allow the option of combining "fees paid indirectly" with "fees waived" into one line item on the statement of operations, as long as details about each category are included in the footnotes to the financial statements. This will help to simplify the statement of operations.
89	Net Realized Gain or Loss	7.47	The major components of unrealized appreciation or depreciation should be cross-referenced to paragraph 7.43, not 7.48.
90	Capital Share Transactions	7.52 d.	Guide should be modified to permit presentation of changes in class level capital items in the footnotes.
91	Financial Highlights	7.65 c.	N-1A does not require disclosure of weighted average shares outstanding during the period.
92	Financial Highlights	7.66	Reference to average commission rate disclosure for open-end investment companies should be deleted based on revised N-1A requirements.
93	Other Disclosure Requirements	7.69 and Footnote 26	This section needs updating. For example, there are references to SFAS 105 and SFAS 119. These are to be superseded by SFAS 133 and SFAS 107, as amended.
94	Illustrative Financial Statements	7.79	The example should include disclosure of the total cost of the portfolio holdings.
95	Illustrative Financial Statements	7.80	One would expect to see separate realized and unrealized gain/loss disclosure for written options, short sales, and futures, as applicable in the Statement of Operations given the related balances in the Statement of Assets and Liabilities.
96	Illustrative Financial Statements	7.80	Securities lending income is shown separately, yet it does not appear to be material (less than 5% of gross income).
97	Illustrative Financial	7.83	The generic statement about economic and political developments in the Significant Accounting Policies

(17)

	Topic	Paragraph Reference	Comments
	Statements		footnote on security valuation does not add any value or provide any meaningful information to the reader.
98	Illustrative Financial Statements	7.83	The discussion of the use of estimates in the Significant Accounting Policies footnote is excessive. A brief sentence that states that the financial statements have been prepared in conformity with generally accepted accounting principles, which permit management to make certain estimates and assumptions at the date of the financial statements, would be sufficient.
99	Illustrative Financial Statements	7.83	Financial Futures Footnote – Changes in daily variation margin on open futures contracts should be treated as unrealized gain/loss.
100	Illustrative Financial Statements	7.83	The Guide should require disclosure of the tax character of distributions paid on a per-share basis in addition to the total dollar amounts, as this would provide meaningful information to the shareholders.
101	Investment Advisory	8.2	The Guide should discuss the frequency of computation of performance fee adjustments. Should cite the SEC authority for the minimum performance fee accrual for interim payments on rolling plans.
102	Expenses	8.6	Paragraphs 8.6 and 8.7 should be rewritten to eliminate redundancies and separate NASD rules discussion. NASD rules and releases should be cited in the body or in a footnote.
103	Business Combinations	8.32	Second and third sentences should be modified: (i) there are many other reasons for a reorganization in addition to the two mentioned, and (ii) the composition of the acquired fund is important for many reasons, not the least of which is the taxability of the transactions. Last sentence should consider addressing situations where merging funds have different valuation policies (e.g., use of bid vs. mean of bid/ask).
104	Business Combinations	8.35	Consider clarifying and discussing instances when merger-related expenses may be borne by the acquiring fund vs. the target fund(s).
105	Diversification of Assets	8.41	Consider deletion of this discussion. If asset diversification discussion is retained, discussion should also address the new 2a-7 requirements. If compliance discussion is retained, some audit guidance should be included.
106	Variable Contracts – Insurance	10.14	Delete the third sentence – gives the impression that the initial payment would be the same for both fixed and variable annuities. Covered correctly in paragraph 10.20.

	Topic	Paragraph Reference	Comments
	Companies		
107	Variable Contracts – Insurance Companies	10.43	The first sentence discusses taxation of distributions but includes only two forms (lump sum and annuitization). It should also discuss partial withdrawals.

INVESTMENT COMPANY INSTITUTE

December 22, 1998

Sheila H. Yu
Technical Manager
American Institute of
Certified Public Accountants
1211 Avenue of the Americas
New York NY 10036-8775

Re: Proposed Audit and Accounting Guide -
Audits of Investment Companies
File 3170

Dear Ms. Yu:

The Investment Company Institute[1] appreciates the opportunity to express its views on the proposed Audit and Accounting Guide – *Audits of Investment Companies* (the "Proposed Guide"). We applaud the AICPA Investment Companies Committee (the "Committee") and AcSEC for their efforts in revising the industry's audit and accounting guide. The exposure draft represents the first comprehensive update to the audit guide in more than a decade, a period of time in which the investment company industry has undergone substantial growth and change.

Investment companies play a critical role in helping Americans save for their future. We believe it is imperative that shareholder reports and financial statements provide investors with meaningful information on the performance and financial position of their funds in a manner that is readily understood by the average shareholder. Certain changes to the format and content of investment company financial statements in the Proposed Guide are consistent with these objectives. For example, we support proposed changes that would permit

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,373 open-end investment companies ("mutual funds"), 450 closed-end investment companies and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.061 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

1401 H STREET, NW ▪ WASHINGTON, DC 20005-2148 ▪ 202/326-5800

investment companies to disclose their top 50 holdings in the statement of net assets. This change will focus investors' attention on those holdings which have the greatest impact on a fund's performance. We have asked the Securities and Exchange Commission ("SEC") to modify Regulation S-X so that publicly offered investment companies can comply with this proposed change.[2]

In addition, we support the proposed changes to SOP 93-2 *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*. The proposed changes would replace disclosure of the detailed components of net assets currently required (i.e., paid-in-capital, undistributed net investment income, undistributed net realized gains, and unrealized appreciation) with two line items, paid-in-capital and retained earnings. Similarly, separate disclosure of dividends from net investment income and capital gains would be replaced with one line item, "distributions" in the statement of changes in net assets and the financial highlights table. Distributions which represent a return of capital for tax purposes would be separately disclosed. The Proposed Guide would require disclosure of the tax-basis components of net assets and distributions in the financial statement footnotes. We believe disclosure of the tax-basis components of net assets and distributions is more meaningful to investors since distributions to shareholders are based on investment income and capital gain as determined under the Internal Revenue Code of 1986, as amended ("IRC").

In contrast, however, proposed changes relating to mandatory amortization of premium and accretion of discount on fixed-income securities ("Mandatory Amortization") and separate disclosure of corrections of investment restrictions violations will unnecessarily complicate financial statements and prove confusing to shareholders. We oppose these changes, as discussed below, because among other things we are unaware of any problem or abuse that would necessitate making them. Also, we have substantial concerns regarding the purpose and scope of Chapter 6 – *Taxation of Investment Companies*.

Attached to this letter is an appendix which provides comments on specific paragraphs of the Proposed Guide. We believe that many of the comments contained in the appendix are non-controversial and should serve to clarify the proposed guidance or supplement it with descriptions of prevailing industry practice.

---

[2] See letter from Craig S. Tyle, General Counsel, Investment Company Institute to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, August 11, 1998.

(1)

A. Mandatory Amortization

We are opposed to Mandatory Amortization for three broad reasons. First, we disagree with the Committee's contention that Mandatory Amortization will enhance the meaningfulness of information provided to investors. The amount of net investment income or net investment income per share disclosed in a fund's financial statements has little significance to investment company shareholders. Moreover, alternate measures of fund performance (i.e., total return and SEC yield) are readily available and widely understood by shareholders. Second, Mandatory Amortization will create book/tax differences in net investment income, realized gains, and unrealized appreciation/depreciation that unnecessarily complicate the administration of investment companies. The *Basis for Conclusions* mistakenly represents that "tax elections may be made for conformity between tax accounting and financial reporting accounting." Tax amortization methods for certain securities differ from the financial accounting amortization method required by the Proposed Guide (i.e., interest method), leading to book/tax differences, *even if an investment company were to attempt to conform tax to book*. Increases in administrative costs associated with tracking book/tax differences may lead to decreased returns for shareholders. Third, there are several instances in which the Committee and AcSEC have recognized the importance of conforming financial accounting policies to tax requirements due to the quasi "pass-through" treatment provided to investment companies by Subchapter M of the IRC. We believe an investment company, consistent with the current Investment Company Audit Guide, should have the ability to conform its financial accounting policy for fixed-income securities to its tax amortization policies.

1. <u>Meaningfulness to Investors</u>

The *Basis for Conclusions* indicates that the economic substance of an investment in a debt security is that the discount or premium paid is an adjustment of the stated interest rate to a current market rate and that amortization of premium is consistent with the economic substance of the transaction. For those issuers that employ a historical cost-based accounting model and measure the results of operations through net income or earnings per share, amortization of premium and discount is appropriate, and indeed is required by APB 21, *Interest on Receivables and Payables*. In contrast to "smokestack" industries, investment

companies measure performance through mark-to-market total return, which is calculated under rules promulgated by the SEC and disclosed in shareholder reports, prospectuses and advertisements.[3] The amount of net investment income or net investment income per-share bears little significance for investment company shareholders. Indeed, it would seem strange to suggest that a shareholder should evaluate fund performance through reference to the level of net investment income per-share.

The *Basis for Conclusions* indicates that "It appears inconsistent to accrete discounts but not amortize premiums (or to accrete discounts and amortize premiums in some funds but not in others) based solely on the tax elections made by a particular fund." We concede that current guidance may result in funds with substantially similar investment portfolios reporting differing levels of net investment income based solely on differences in their accounting polices. However, SEC rules require that any fund that advertises a yield quotation must calculate yield in accordance with a standardized SEC-mandated formula.[4] This formula is based on a "yield to maturity" model which incorporates amortization of premium and accretion of discount.[5] The standardized formula ensures that funds with substantially similar investment portfolios will report the same SEC yield, irrespective of differences in financial or tax accounting policies.

The *Basis for Conclusions* indicates that Mandatory Amortization "results in no net increase or decrease in the net gain or loss from investment activities reported in the statement of operations and financial highlights (merely a reclassification between net investment income and realized or unrealized appreciation)." Indeed, the proposed change will not affect a fund's net assets, net asset value per-share, total return, SEC yield, expense ratio, portfolio turnover rate, or dividend distributions per-share.[6] We believe investors are more familiar with these

---

[3] *See* Items 9(a) and 22(b) of Form N-1A (requiring disclosure in shareholder reports), Items 2(c)(2) and 9(a) (requiring disclosure in the prospectus), and rule 482(e) under the Securities Act of 1933 (which requires total return to be included in any advertisement that includes performance data).

[4] *See* rule 482(e) under the Securities Act of 1933.

[5] *See* Item 21(b)(2) of Form N-1A.

[6] Dividend distributions per-share would be affected if the investment company changes its tax amortization policies to conform them to its financial accounting policies. However, we have been advised by our members that currently do not amortize premium for book or tax purposes that they generally will not change their tax amortization policies if the Proposed Guide is adopted in its current form.

attributes and find them more useful than the level of net investment income or net investment income per-share for purposes of evaluating fund performance. Accordingly, any increased precision in the measurement of net investment income attributable to Mandatory Amortization would be of little, if any significance to investors and is unnecessary in light of SEC-mandated standardized measures of fund performance.

2. Creates Book/Tax Differences

Investment companies may elect to be treated as a regulated investment company ("RIC") under Subchapter M if they satisfy certain requirements with respect to the source of their income and the diversification of their assets. If the RIC satisfies these and certain other requirements, it will be taxed in many respects like a conduit, with its income "passing through" to shareholders without any fund level tax. This "conduit-like" treatment is achieved by allowing a RIC to deduct the amount of dividends paid to its shareholders in computing the fund's taxable income.

RICs must also satisfy certain distribution requirements to qualify for pass-through status. Generally, a fund must distribute 90% of its ordinary income to qualify for conduit treatment. As a practical matter, funds generally attempt to distribute *all* of their taxable income so that the dividends paid deduction eliminates all tax at the corporate level. To ensure that no tax is due at the corporate level, funds take great care to calculate and distribute taxable income and typically conform financial accounting policies to tax requirements whenever possible. In this way, funds minimize the burden and expense associated with maintaining two sets of books and tracking book/tax differences.

Mandatory Amortization will create book/tax differences since funds that currently do not amortize premium for tax purposes will generally continue their current tax policies. Further, even if a fund were to decide to change its tax policies to conform to the proposed change in financial accounting policy, it would *not* be able to do so in certain circumstances. For example, the exposure draft indicates that the transition to Mandatory Amortization should be accounted for as the cumulative effect of a change in accounting policy under APB No. 20 *Accounting Changes*. This involves *retroactive* recomputation of an amortized cost basis for each security held as though amortization had been followed since the security was first acquired. In contrast, if a fund elects to change its tax amortization policies, the change is *prospective* from

the beginning of the tax year in which the election is made[7] and each security will have a different cost basis for book and tax purposes.

With respect to any bond purchased after April 30, 1993, tax-exempt income funds are required to treat market discount as taxable income to the extent of any gain realized on disposition of the security.[8] Alternatively, they may elect to accrete the discount into income on a daily basis and distribute it to shareholders as taxable income at year-end.[9] Funds typically choose the former in order to defer the distribution of taxable income to shareholders. If tax-exempt funds were to attempt to conform tax accretion policies to the proposed financial accounting policy, they would accelerate distribution of taxable income to shareholders.

Funds may use the straight-line method of amortization for tax purposes in certain circumstances (e.g., ratable accrual of market discount),[10] rather than the proposed interest method, and may be *required* to use other amortization methods for specific securities (e.g., the acquisition premium fraction method for municipal securities issued with original issue discount).[11] Accordingly, even if a fund were to choose to conform its tax amortization policies to the proposed financial accounting policy, it would be unable to do so in certain circumstances. We are concerned that the resulting book/tax differences will complicate administration of investment companies, increase costs, and reduce returns to shareholders.

3. Tax Basis Information in Financial Reporting

There are several instances in which the Committee and AcSEC have recognized the importance of tax basis information for financial reporting purposes. For example, the current investment company audit guide indicates that "Because an investment company carries its investments at value and reports both realized and unrealized gains and losses, accretion of discounts or amortization of premiums does not affect its net asset value or results of operations. For that reason, most investment companies adopt an amortization policy that

---

7 *See* Section 171(c) of the IRC.

8 *See* Section 1276 of the IRC.

9 *See* Section 1278(b) of the IRC.

10 *See* Section 1276(b)(4) of the IRC.

11 *See* Sections 1288 and 1272(a)(7) of the IRC.

conforms to the income tax regulations that apply to the fund." We are unaware of any problem or abuse associated with the current guidance.

SOP 93-2 indicates that "Although book returns of capital may occur, they have little relevance to investment company shareholders. In contrast, tax returns of capital have a high degree of relevance and must be separately reported to shareholders for income-tax purposes." The SOP indicates that reporting book returns of capital when such returns have not occurred for tax purposes would be confusing to shareholders.

In sum, we believe Mandatory Amortization a) is unnecessary in light of SEC mandated standardized measures of yield and total return, b) will increase the costs and burdens associated with administering investment companies, and c) fails to recognize the unique tax status of investment companies under the IRC.

4. Departure From GAAP

The *Basis for Conclusions* seemingly suggests that FASB Statement No. 91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* provides support for Mandatory Amortization. FASB No. 91 requires purchase premiums and discounts on loans to be amortized using the interest method. However, the final sentence of the Statement's third paragraph notes that it does not apply to nonrefundable fees and costs associated with originating or acquiring loans that are carried at market value. Paragraph 34 of FASB No. 91 elaborates on paragraph 3 and notes:

> The Board concluded that this Statement should not apply to fees and costs and premiums or discounts associated with loans that are carried at market value because carrying loans at market value obviates the need for accounting guidance for recognition of fees and costs and premiums or discounts associated with those loans.

This scope exclusion recognizes that accretion of discount and amortization of premium on fixed-income securities are unnecessary for market value-based entities. Further, we note that the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* at paragraph 4.39 indicates that broker-dealers should "consider" accretion of discount and amortization of premium when reporting interest income on their fixed-income securities. Paragraph 4.39 recognizes that amortization of premium and accretion of discount are not necessary in order to accurately portray broker-dealers' results of

operations because they employ a mark-to-market accounting model, similar to that followed by investment companies.

B. Separate Disclosure of Corrections of Investment Restriction Violations

Paragraph 7.68 of the Proposed Guide would require payments from the adviser to the fund intended to reimburse the fund for losses realized on the sale of securities that were purchased in violation of the fund's investment restrictions to be reported as a separate line item in the statement of operations immediately after the *net realized gain or loss from investments* caption. We are concerned that the proposed disclosure requirement may act as a disincentive for advisers to reimburse the fund for these types of losses, to the detriment of shareholders. Further, we question whether fund financial statements are the appropriate vehicle to report "compliance" concerns and would argue that information currently required to be filed with the SEC would identify any material weakness in the fund's system of internal accounting control. We believe the accounting for these types of payments should be consistent with the intent or purpose of the transaction.

1. Disincentive

We are concerned that the proposed disclosure requirement may act as a disincentive for advisers to reimburse the fund for losses attributable to securities that are inconsistent with the fund's investment restrictions. While advisers have customarily reimbursed funds they manage for losses attributable to transactions in securities that are inconsistent with their investment restrictions, they are not required to do so.[12] We believe the incidence of these types of losses is rare[13] and question the need for separate disclosure, particularly to the extent it may prove contrary to shareholders' interest.

2. Compliance

Paragraph 40 of FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* indicates that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and

---

[12] While investment advisers owe a fiduciary duty to the funds they manage, advisory contracts typically provide that the adviser will be liable only for acts involving willful malfeasance, reckless disregard of duty or gross negligence.

[13] Many investment advisers employ automated compliance systems that "pre-clear" proposed transactions by comparing orders for purchase of securities to the fund's investment restrictions prior to entry of the order for execution.

(6)

the effects of transactions, events, and circumstances that change resources and claims to those resources. Paragraph 42 indicates that financial reporting should provide information about an enterprise's financial performance during a period and that creditors and investors often use information about the past to help in assessing the prospects of an enterprise. Financial statements are intended to provide information on an entity's financial position, results of operations, and cash flows (or changes in net assets). They are not intended to serve as a compliance report.

To the extent there are material weaknesses in the fund's internal accounting control system, those weaknesses would be noted in a public filing made with the SEC. Any managed investment company registered with the SEC must file annually a report prepared by its independent public accountant on the fund's system of internal accounting controls. The report is to be based on the auditor's review, study and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities made during the audit of the financial statements. To the extent the auditor detects any material weaknesses in these systems, they must be noted along with any corrective actions taken or proposed. This report, which is to be addressed to the fund's board of directors and shareholders, is filed with the SEC annually as an exhibit to Form N-SAR, semi-annual report for registered investment companies.[14]

3. <u>Existing Disclosure Adequate</u>

The intent of the payment to the fund is to make the fund whole for any loss, as though the non-compliant transactions had never take place. We believe any reimbursement should be netted against the related loss so that the accounting is consistent with the purpose of the payment. We note that FASB Statement No. 57 *Related Party Disclosures* currently requires disclosure of material related party transactions.

C. Chapter 6 – Taxation of Investment Companies

We question the need for, and benefit of, the detailed discussion of the taxation of financial instruments held by investment companies. Specifically, we are concerned that Chapter 6 appears to provide detailed and authoritative guidance on a variety of highly technical tax issues. If this is the Proposed Guide's intention, we submit that the goal cannot be

---

[14] *See* SEC Form N-SAR, Item 77B: Accountant's Report on Internal Control.

reached. First, the law in this area changes quite frequently; the Proposed Guide most likely will be out of date in at least some areas, and therefore inaccurate, before it is published. Second, the degree to which specific rules and exceptions to those rules are discussed varies from topic to topic. Any auditor who relies upon the Proposed Guide because he/she does not have a thorough understanding of the detailed tax rules to which investment companies are subject will not appreciate when the Proposed Guide's discussion covers all of the rules and when it does not. To address our concern, we suggest that the first paragraph of Chapter 6 encourage readers to consult a tax advisor with respect to tax issues that may arise in an audit and that much of the detailed discussion be replaced. Specific language to implement these suggestions are included in our detailed, attached comments.

D. Effective Date and Transition

The Proposed Guide is scheduled to be effective for fiscal years beginning after December 15, 1999. As noted above, certain of the proposed changes will require corresponding changes to Regulation S-X in order to be implemented by SEC registered investment companies. We note that the SEC recently issued a policy statement declaring a moratorium on the implementation of new Commission rules that require major reprogramming.[15] Under the moratorium, no new Commission rules requiring major reprogramming of computer systems by SEC-regulated entities will be made effective between June 1, 1999 and March 31, 2000. We suggest that the Proposed Guide be effective for fiscal years beginning after June 15, 2000, or ideally, at such time as the SEC adopts conforming changes to Regulation S-X.

****

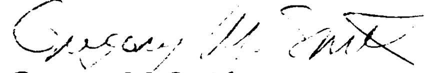
We hope that our comments on the Proposed Guide will assist the Committee and AcSEC in developing an audit and accounting guide that provides guidance to both auditors and issuers of financial statements, and most importantly, serves the interests of fund shareholders. If you have any questions on the comments contained in this letter, or the

---

15 *See* SEC Release No. IC-23416 (August 27, 1998).

attached appendix, please contact the undersigned at 202/326-5851. Questions or comments on our proposed changes to Chapter 6 should be directed to Deanna Flores at 202/326-5436.

Very truly yours,



Gregory M. Smith
Director – Operations/
Compliance & Fund Accounting

Attachment

APPENDIX

**COMMENTS OF THE INVESTMENT COMPANY INSTITUTE
ON THE
AICPA AUDIT AND ACCOUTING GUIDE
AUDITS OF INVESTMENT COMPANIES
File Reference No. 3170**

Chapter 1 – Investment Company Industry

1. Paragraph 1.9/Page 3 – We suggest deletion of "board contingent" prior to "12b-1 plan" in the penultimate sentence. Whether a 12b-1 plan is board contingent, enhanced, or a compensation type plan has no bearing on whether the fund is characterized as load or no-load.

2. Paragraph 1.14/Page 4 – We suggest you define the term "administrator" in the second sentence.

3. Paragraph 1.16/Page 5 – This paragraph suggests that a fund's (initial) investment advisory contract must be approved by a vote of a majority of the fund's outstanding shares. In a no-action letter to the Investment Company Institute (pub. avail. Nov. 6, 1992), the SEC staff stated that a fund no longer would be asked to undertake, in its initial registration statement, to hold a shareholders' meeting to approve the fund's investment advisory contract.

4. Paragraph 1.23/Page 7 – We suggest incorporation of a discussion of the fund "profile" which may be used to offer fund shares pursuant to rule 498 under the Securities Act of 1933 into the discussion of investment company registration forms.

Chapter 2 – Investment Accounts

1. Paragraph 2.13/Page 15 – This paragraph addresses funds' obligation to document placement of orders for securities in an internal record that details information pertaining to the transaction. In order to conform the language to rule 31a-1 under the 1940 Act, we suggest you insert "or other compensation paid" subsequent to "the commission rate or amount" in the first sentence of this paragraph.

2. Paragraph 2.19/Page 16 – The final sentence of this paragraph indicates that closed-end companies may compute net asset value less frequently, such as weekly or semimonthly. The NASD recently modified its Mutual Fund Quotation Service to incorporate net asset values for closed-end funds. We suggest this sentence be modified to indicate that while closed-end funds may calculate net asset values less frequently than open-end funds, certain closed-end funds calculate and disseminate their net asset value on a daily basis.

3. Paragraph 2.33/Page 18 – We suggest that "approved" be substituted for "established" in the parenthetical in the final sentence in this paragraph.

4. Paragraph 2.34/Page 19 – The parenthetical in the first sentence in this paragraph mistakenly suggests there are no market quotations for restricted securities and that these

securities should be valued in good faith by the companies board of directors. Many restricted securities trade actively in rule 144A markets and do not require application of board approved fair valuation procedures.

5. Footnote 20/Page 20 – Money market funds can purchase securities with a maturity greater than 13 months (e.g., certain variable rate, floating rate and adjustable rate securities). *See* rule 2a-7(d) under the 1940 Act.

6. Paragraph 2.64/Page 23 – We suggest addition of language which describes standard industry practice for accounting and disclosure of securities loans. In particular, cash collateral received, (or securities purchased with cash collateral) are recognized as fund assets. In contrast, securities collateral received, which under standard industry lending agreements may be recalled on short notice, are not recognized as fund assets. Further, securities loaned out are reflected in the statement of net assets at their mark to market value since the fund retains the risk of loss attributable to changes in value. Fees or rebates paid to borrowers are combined with income earned on invested cash collateral and income on the lending transaction is reported on a net basis. We believe these practices to be consistent with FASB No. 125 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and SEC guidance (*See* letter from John S. Capone, Assistant Chief Accountant to Frank J. Maresca, Bear Stearns & Co. Inc., September 16, 1997).

7. Paragraph 2.103/Page 30 – Securities Exchange Act of 1934 Section 10A and rule 10A-1 require audits to include procedures designed to provide reasonable assurance of detecting illegal acts that have a direct and material effect on a company's financial statements, and to notify the directors and the SEC of material illegal acts under certain circumstances. We recommend these paragraphs include a brief description of auditors' responsibilities under these provisions.

8. Paragraph 2.104/Page 30 – We note that the Proposed Guide omits one of the principal audit objectives contained in the current Audit and Accounting Guide (i.e., there is reasonable assurance that the investment company has complied with restrictions under its stated investment objectives and policies). We support this change. As noted above, under generally accepted auditing standards and the federal securities laws, auditors are charged with detecting illegal acts that have a *material* effect on the fund's financial statements. We see little benefit in requiring auditors to perform (and funds to pay for) procedures designed to test compliance with investment objectives and policies in light of the auditor's responsibility to detect illegal acts that have a material effect on the financial statements.

9. Paragraph 2.124/Page 36 – We suggest you insert "or by management under procedures approved by the board of directors" subsequent to "as determined by the board of directors" in the second bullet in paragraph 2.124.

<u>Chapter 3 – Financial Instruments</u>

1. Paragraphs 3.2-3.3/Page 39 – Funds other than money market funds may use amortized cost to value their investments in short term debt instruments. SEC Release No. IC 9786 (May 31, 1977) permits debt securities with remaining maturities of 60 days or less to be valued at

(11)

amortized cost. We suggest the phrase "relatively short period" in paragraph 3.3 be clarified or supplemented with a reference to Release No. IC 9786.

2. 3.6/Page 40 – The first sentence of this paragraph describes a repurchase agreement (rather than a reverse repurchase agreement) or is drafted from the perspective of the counter-party broker-dealer. *See* paragraph 2.82 of the current Audit and Accounting Guide.

3. Paragraph 3.27/Page 45 – We suggest you substitute "but profits only to the extent of the premium received if the underlying security increases in value" for "but cannot profit from an increase in fair value" in the third bullet of this paragraph.

4. Paragraph 3.35/Page 47 – Does the phrase "member firms" in final sentence of this paragraph refer to brokers or futures commission merchants?

5. Paragraph 3.36/Page 47 – The SEC adopted rule 17f-6 under the 1940 Act on December 11, 1996. The rule permits (but does not require) RICs to maintain their assets (i.e., margin) with futures commission merchants in connection with commodity futures and options transactions. Accordingly, the three party special segregated custody account (with the custodian and FCM) referenced in 3.36 is no longer required. *See* SEC Release No. IC-22389 (December 11, 1996).

6. Paragraph 3.46/Page 49 – We suggest you insert "reverse" subsequent to "regular" in the second sentence of this paragraph.

<u>Chapter 4 – Capital Accounts</u>

1. Paragraphs 4.4-4.7/Page 52 – We suggest the discussion of sales charge arrangements incorporate recent amendments to 1940 Act rule 6c-10, which authorizes "installment" or non-contingent deferred sales loads. *See* SEC Release No. IC-22202 (September 9, 1996).

2. Footnote 2/Page 52 – We believe the reference to 1940 Act Rule "22c-2" should be changed to Rule 22c-1.

3. Paragraph 4.8/Page 52 – This paragraph discusses alternate means a shareholder may employ to redeem fund shares (e.g., debit cards, teller machines, check writing, etc.). Certain fund families have established Internet web sites which permit shareholders to conduct transactions in fund shares. We suggest you add a reference to Internet web sites in this paragraph.

4. Paragraph 4.17/Page 54 – We suggest the terms "transfer agent's control account" and "suspense accounts" be defined or explained in this paragraph.

5. Paragraph 4.22/Page 55 – We suggest you insert "or as of" subsequent to "These entries are made on" in the fourth sentence of this paragraph. Purchase and redemption orders received from sub-transfer agents or retirement plan record keepers may be received by the fund's transfer agent on T+1 and booked "as of" the trade date.

6. Paragraph 4.45/Page 60 – This paragraph describes limitations on regulated investment companies' ability to declare distributions of long-term capital gain. Notwithstanding the limits

(11)

described in this paragraph, funds may apply to the SEC to make additional distributions of long-term capital gain per rule 19b-1(e) under the 1940 Act. We suggest you add a reference to this provision in this paragraph or in a footnote.

<u>Chapter 5 - Complex Capital Structures</u>

1. Paragraph 5.10/Page 64 – The final sentence of this paragraph indicates that expenses that can be specifically attributed to a particular class *are* designated as class-level expenses. Certain expenses that can be specifically attributed to a particular class (e.g., transfer agent fees) *may* be allocated at the class level at the option of the fund. *See* rule 18f-3(a)(1)(ii) under the 1940 Act.

2. 5.12/Page 65 – Given the lack of binding IRS guidance on this issue, we suggest that you delete sentences 5 through 8, beginning with "Fund management must also ensure that such waivers…."

3. Paragraph 5.13/Page 65 – The first bullet indicates that relative net assets method is required to be used for allocations in periodic dividend funds. While such funds typically use the relative net assets method, they could also elect to use the simultaneous equations method or "other board approved" method. *See* rule 18f-3(c) under the 1940 Act.

4. Paragraph 5.13/Page 66 – The final sentence of this paragraph indicates that funds may use other allocation methods not specified in Rule 18f-3 so long as that method is approved by the fund's directors. Rule 18f-3(c)(v) imposes a second condition which we suggest be incorporated into this paragraph. This condition requires that the annualized rate or return between classes differ only by the expense differentials between classes.

5. Paragraph 5.14-5.15/Page 66 – The discussion of the record share method of dividend distribution calculations should clarify that daily dividend funds that utilize this method should divide net investment income available by settled shares outstanding (rather than total shares outstanding) when calculating dividend rates.

6. 5.21/Page 67 – We suggest that you add a discussion of Revenue Procedure 94-71 to this paragraph.

7. 5.23/Page 68 – To reflect the repeal of the "Ten Commandments," in the fourth sentence we suggest that you delete "If the master's principal office is offshore, and assuming the offshore feeder is organized in a tax haven jurisdiction" and begin the fourth sentence with "A foreign person's investment in an offshore feeder . . ." We further suggest that you delete the last sentence of the paragraph.

8. Paragraph 5.29/Page 69 – We suggest this paragraph be modified to indicate that where a fund produces separate shareholder reports by class, only financial highlights for the subject class need be included in the shareholder report.

9. Paragraph 5.48/Page 72 – The second sentence indicates that the most typical fund of funds arrangement is the master-feeder structure. The characterization of a master-feeder fund as a fund of funds is confusing. As indicted in the prior sentence, a fund of funds typically invests

(1)

in multiple investment companies, whereas a feeder fund in a master-feeder structure, per §12(d)(1)(E)(ii) of the 1940 Act, may invest in only one other investment company.

10. Paragraph 5.48-5.49/Page 72 – We suggest the addition of language indicating that top tier fund in a fund of funds arrangement should not consolidate investee funds (even where they own more that 50%). While this may be inconsistent with SFAS 94 *Consolidation of All Majority-Owned Subsidiaries*, consolidation of partially owned investment companies may result in misleading financial statements. The "equity method" of accounting does not work well in the market value based accounting model employed by investment companies. Also, proposed statement of financial accounting standards *Consolidated Financial Statements – Policy and Procedures* (issued October 16, 1995) would exempt investment companies and other mark to market entities from its scope (*See* paragraph 4) – an acknowledgment that consolidation is not appropriate for investment companies.

11. Paragraph 5.58/Exhibit 5.1/Page 75 – It may be helpful to include an exhibit illustrating the simultaneous equations allocation method.

12. Paragraph 5.64/Exhibit 5.3/Page 83 – The total return for class A in 19X4 should be 1.84% rather than 0.84%.

<u>Chapter 6 - Taxes</u>

1. As a global comment, we suggest that you replace "an RIC" with "a RIC".

2. Paragraph 6.3/Page 94 – We suggest you delete "realized gains or losses" from the first sentence and replace it with "net realized gains on" because there is no tax imposed on losses. Also, the rules for capital loss carryovers operate differently for RICs and non-RICs.

3. Paragraph 6.4/Page 94 – The final sentence of this paragraph is unclear. We suggest that you either delete the sentence or clarify its intended meaning.

4. Paragraph 6.6/Page 94 – We suggest that "on each income recognition date" be deleted from the first sentence as redundant. Funds accrue tax on the same date that the income accrues. We also suggest that you delete the last sentence or replace "is received" with "becomes known."

5. Paragraph 6.8/Page 94 – We suggest that you insert "may" before "differ" in this paragraph to reflect the potential overlap on specific points addressed by the SEC and Subchapter M diversification requirements.

6. Paragraph 6.9/Page 95 – To reflect amendments to Subchapter M of the IRC, we suggest that you delete "part 1 of" in the first sentence of the paragraph and revise footnote 2 to read: "Subchapter M consists of sections 851 to 860L of the Internal Revenue Code of 1986, as amended (IRC), and provides special tax rules for RICs, real estate investment trusts ("REITs"), real estate mortgage investment conduits ("REMICs") and financial asset securitization investment trusts ("FASITs"). The rules affecting RICs are found in sections 851 through 855 and 860 of the IRC."

(U)

7. Paragraph 6.10/Page 95 – For the reasons discussed in our cover letter, we suggest that you make this the first paragraph of Chapter 6 (i.e., renumber it as paragraph 6.1) and then renumber the following paragraphs accordingly. We also suggest that you replace "guidance" in the first sentence with "general educational background." To further emphasize the general nature of the tax discussions in Chapter 6, we suggest that you replace the last sentence of this paragraph with the following: "Thus, the auditor should consult a tax advisor with respect to tax issues that arise in the course of an audit and should not attempt to resolve them independently based solely on the general background information provided in this chapter."

8. Paragraph 6.11/Page 95 – For clarification, we suggest that you move footnote three so that it follows "IRC" in the same sentence. Since "RICs" do not "avoid" tax under Subchapter M, but rather may eliminate their tax obligations at the fund level, we suggest that in the fourth sentence, you replace "avoid" with "eliminate."

9. Paragraph 6.12/Page 95 – To reflect amendments to the IRC, we suggest that you replace the citation in footnote four with "851(g) of the IRC."

10. Paragraph 6.13/Pages 95-96 – Under the IRC, "investment company taxable income" is regular taxable income, subject to certain adjustments. We therefore suggest that in the second sentence you: (1) delete "begins with regular" and replace with "is regular" and (2) delete "and is adjusted as follows:" and replace with ", subject to certain adjustments including".

11. Paragraph 6.13b/Page 96 – Under the definition of "investment company taxable income" in the IRC, disallowed net operating losses are prior year losses. We therefore suggest that you insert "for prior years" after "losses."

12. Paragraph 6.14/Page 96 – To clarify that any RIC can offset net operating losses against short term gains, we suggest that you delete the last sentence of this paragraph and replace it with "RICs cannot carry forward any net investment losses."

13. Paragraph 6.15/Page 96 – As suggested in comment 8 above, we suggest that you delete "avoid paying any federal income taxes," in this paragraph and replace it with "eliminate federal income tax liability,".

14. Paragraph 6.16/Page 96 – To reflect new IRS guidance, we suggest that you revise this paragraph to discuss the new capital gain designation and bifurcation rules under Notice 97-64.

15. Paragraph 6.17a/Page 96 – As suggested in comments 8 and 13 above, we suggest that in second sentence, you replace "avoiding" with "eliminating."

16. Paragraph 6.18/Page 97 – Under the IRC, capital loss carryforwards also do not reduce current E&P. We therefore suggest that at the beginning of the fourth sentence you insert "Capital loss carryforwards," and make the "e" in "Expenses" lowercase. To provide additional guidance, we also suggest that you add a citation to Regulation 1.312-6 in footnote 12.

(11)

17. Paragraph 6.20/Page 97 – Given the technical difficulties created by calendar year reporting requirements and tax year-ends of certain RICs, we suggest that you add a discussion about "timing" issues associated with the Form 5452 filing.

18. Paragraph 6.21a/Page 97 – To reflect the revised effective date under the Taxpayer Relief Act of 1997 and to clarify the description of the holding period, we suggest that you replace the first sentence of this paragraph with the following: "For dividends received or accrued after September 4, 1997, a dividend does not qualify for the dividends received deduction if the stock on which the dividend was paid is held for less than forty-six days over a ninety-day period beginning forty-five days before the date on which the stock becomes ex-dividend. Certain preferred stock must be held by a corporate shareholder for at least ninety-one days over a 180-day period beginning ninety days before the date on which the stock becomes ex-dividend."

19. Paragraph 6.22/Page 98 – To reflect the requirements of the IRC, we suggest that in the first sentence you replace "at least 50 percent" with "more than 50 percent" and insert "creditable" before "foreign taxes". To cross-reference the foreign tax credit rules, we suggest that you add a citation to Section 853(e) in footnote 18.

20. Paragraph 6.22a/Page 98 – To reflect technical corrections made by the IRS Restructuring and Reform Act of 1988 and to clarify the discussion, we suggest that you replace first sentence with second and third sentences of paragraph 6.22b and then insert "RICs electing flow through treatment may deduct any tax that, because the RIC failed to hold the stock for at least 16 days around the record date for the dividend, cannot be claimed as a credit by its shareholders.[cite – Sections 901(k) and 853(e) of the IRC] A RIC electing flow through treatment is not otherwise entitled to an entity-level tax deduction for creditable foreign taxes to which the election applies."

21. Paragraph 6.22b/Page 98 – For the reasons stated in comment 20, we suggest that in the first parenthetical in the first sentence that you insert "creditable" before "foreign taxes". We further suggest that at the end of the first sentence you insert "and passed through to them."

22. Paragraph 6.22d/Page 98 – To reflect technical corrections made by the IRS Restructuring and Reform Act of 1998, we suggest that you delete the last sentence of this paragraph.

23. Paragraph 6.23b/Page 99 – To incorporate the definition of "dividends" for tax purposes and to clarify the discussion in this paragraph, we suggest that in the first sentence you (1) replace "will" with "may" and (2) after "ordinary dividends" insert ", rather than as a return of capital"[insert appropriate citations]. In light of the foregoing suggestions, we also recommend that you delete the second sentence.

24. Paragraph 6.24a/Page 99 – To clarify that the income described in this paragraph is "net capital gain," we suggest that after "exceed" you insert "net capital gain, i.e.".

25. Paragraph 6.24b/Page 99 – To clarify that the "actual" holding period described in this paragraph is that of the shareholder, we suggest that before "actual" you insert "shareholder's" and replace "of the stock" with "in the shares".

(11)

26. Paragraph 6.27/Page 100 – In the first sentence, we suggest that you replace "interest" with "interests" to correct an apparent typographical error.

27. Paragraph 6.31d/Page 101 – We suggest that you delete this paragraph in light of the repeal of the "short-short" diversification test by the Taxpayer Relief Act of 1997.

28. Paragraph 6.33a/Pages 101 - 102 – Given that the IRS has issued no formal guidance regarding the exclusion of foreign currency gains from "qualifying income," we suggest that you (1) begin the first sentence with "While" and insert ", no such guidance has been issued" at the end and (2) delete the last three sentences of the paragraph.

29. Paragraph 6.33b/Page 102 – To correct a citation error, in the second sentence we suggest that you replace "6.34" with "6.33 above." For clarity, we also suggest that at the beginning of fourth sentence you replace "In addition" with "For example,".

30. Paragraph 6.34/Page 102 – Given that many more items than could be discussed adequately may require "special treatment" under the 90 percent diversification test, we recommend that you delete this paragraph.

31. Paragraph 6.35/Page 102 – Given the differing authorities and views with respect to this issue, we suggest that you delete the third sentence and move footnote 33 to end of immediately preceding sentence.

32. Paragraphs 6.36-6.41/Pages 102-103 – For the reason stated in comment 27 above, we suggest that you delete these paragraphs.

33. Paragraph 6.42/Page 103 – In light of the foregoing paragraphs, we suggest that you insert "(except as described above)" at the end of this paragraph.

34. Paragraph 6.43/Page 103 – To clarify the IRC requirements, we suggest that you delete "all investments in" and replace "that" with "if they" in this paragraph. To reflect changes to the IRC, we suggest that you replace citation in footnote 40 with "Section 851(b)(3)(A) of the IRC."

35. Paragraph 6.44/Page 104 – To indicate that the 20 percent test applies to each corporation's voting power, we suggest that you insert at the end of the last sentence "of each corporation." To reflect changes to the IRC, we suggest that you replace citation in footnote 41 with "Section 851(b)(3)(B) of the IRC."

36. Paragraph 6.45/Page 104 – Consistent with our comments in the cover letter, we suggest that you delete the existing text and insert "In some cases, fair value determinations for derivative instruments are difficult to make under the diversification tests."

37. Paragraph 6.46/Page 104 – Consistent with our comments in the cover letter and given the lack of binding IRS guidance, we suggest that you delete this paragraph.

38. Paragraph 6.47/Pages 104-105 – To accurately reflect the IRC requirements, we suggest that you delete the existing text (except for footnote 50) and replace it with the following: "A RIC that fails to meet the investment diversification requirements at the end of one taxable quarter

(11)

may cure such failure within thirty days by eliminating the discrepancy between the diversification requirements and its holdings. However, any such discrepancy will not be treated as a failure to meet the diversification requirements unless it is due (in whole or in part) to the RIC's acquisition of a security or other property. [footnote 50]"

39. Paragraph 6.49/Page 105 – To clarify the IRC requirements, we suggest that you insert "the sum of" before "its investment company taxable income" in the first sentence.

40. Paragraph 6.51/Page 105 – To clarify the IRC requirements, we suggest that in the second sentence you insert "undistributed" before gains.

41. Paragraph 6.53/Page 105 – We suggest that you revise this paragraph to reflect the requirements of Revenue Procedure 96-47.

42. Paragraph 6.54/Pages 105-106 – To reflect the distinction between "dividends" and "distributions" for tax purposes, we suggest that in the first sentence you (1) delete the first word, "Dividends", and replace it with "Distributions" and (2) insert "to the extent of earnings and profits" after "previous year".

43. Paragraph 6.55/Page 106 – We suggest that you clarify or delete the last sentence of this paragraph.

44. Paragraph 6.58b/Pages 106-107 – This section appears to discuss equalization for book accounting purposes. We therefore suggest that you delete sentences 5 through 8 of this paragraph, beginning with "Under federal corporate tax rules . . . ."

45. Paragraph 6.60/Page 107 – In light of paragraph 6.10 (which we suggest you renumber as paragraph 6.1) and comment 7 above, we suggest that in the first sentence you delete "While" and insert a period after "income tax rules." We further suggest that you delete the remaining text and insert "However, the precise method of calculating the E&P attributable to the redeemed shares is not particularly clear."

46. Paragraph 6.62/Page 107 – We suggest that you move this paragraph to follow paragraph 6.55 (immediately before paragraph 6.56 "Deficiency Dividends").

47. Paragraph 6.71/Page 108 – To clarify the IRC requirements, we suggest that in the last line of the last sentence you insert "amount on which excise tax was imposed" in place of "excise tax."

48. Paragraph 6.72/Page 108 – To clarify that the subparagraphs are not a complete list of all relevant adjustments, we suggest that at the end of second line (i.e. after "net short-term capital gains") of the paragraph you insert "with certain other adjustments such as."

49. Paragraph 6.73a/Page 108 – To reflect amendments to the IRC, we suggest that after "1256 contracts" you insert "and passive foreign investment company stock,". We also suggest that you update the cites in footnote 67, including adding a reference to Section 4982(e)(6) of the IRC.

(11)

50. Paragraph 6.81/Page 109 – For the reasons explained in our cover letter, we suggest that you delete all text after "Bond Discount and Premium" and insert the following: "Special, detailed rules prescribe the calculation and treatment of "discount" and "premium" on taxable and tax-exempt securities. While a discussion of these rules is beyond the scope of this guide, the auditor should be aware that application of these rules may affect the recognition and characterization of income and the deductibility of interest expense for tax purposes."

51. Paragraphs 6.82-6.83/Pages 109 - 112– For the reasons explained in our cover letter, we suggest that you delete these paragraphs.

52. Paragraph 6.84/Page 112 – For the reasons explained in our cover letter, we suggest that you delete the existing text after "Section 1256 Contracts" and insert the following: "Certain financial instruments ("section 1256 contracts") held by a RIC may be subject to "mark-to-market" rules. [cite Section 1256 of the IRC] A 1256 contract generally includes regulated futures contracts, certain foreign currency contracts and options traded on (or subject to the rules of) a qualified board or exchange that are not equity options. Under these detailed rules, a RIC is treated for tax purposes as selling any section 1256 contract held on the last day of its taxable year for fair market value. Gain or loss on an actual or deemed disposition of a section 1256 contract is treated as 40 percent short-term capital gain or loss and 60 percent long-term capital gain or loss, regardless of the holding period for the 1256 contract. A detailed discussion of these rules is beyond the scope of this guide."

53. Paragraphs 6.85-6.91/Pages 112 - 113 – For the reasons explained in our cover letter, we suggest that you delete these paragraphs.

54. Paragraph 6.98/Page 114 – We suggest that you insert the first sentence of paragraph 6.99 at end of the paragraph.

55. Paragraph 6.99/Page 114 - 115 – For the reasons explained in our cover letter, we suggest that after moving the first sentence of the paragraph to the end of paragraph 6.98, you delete the remaining text.

56. Paragraphs 6.100- 6.105/Pages 115 – 116 – For the reasons explained in our cover letter, we suggest that you delete these paragraphs.

57. Paragraphs 6.107-6.113/Pages 116 -117 – For the reasons explained in our cover letter, we suggest that you delete these paragraphs.

58. Paragraph 6.114/ Page 117 – For the reasons explained in our cover letter, we suggest that you delete the existing text and replace it with the following: "Certain foreign companies may be treated as passive foreign investment companies (PFICs) for US tax purposes if they receive a significant percentage of their income from passive sources (e.g., dividends or interest) or hold a significant percentage of "passive assets" (e.g., stocks or bonds). [cite Section 1297 of the IRC]. Under special tax rules, income received by a shareholder from a PFIC investment (including any disposition gains) is treated as ordinary income and an interest charge is imposed on certain deferred income. [cite Section 1291 of the IRC] A detailed discussion of the tax rules applicable to a PFIC investment is beyond the scope of this guide."

(11)

59. Paragraphs 6.115-6.119/Pages 117-118 – For the reasons explained in our cover letter, we suggest that you delete these paragraphs.

60. Paragraph 6.120/Page 118 – For the reasons explained in our cover letter, we suggest that you delete the existing text after "Elections" and insert "A RIC holding shares of a PFIC generally may avoid adverse tax consequences under the PFIC rules by electing "mark-to-market" treatment for its PFIC stock. [cite Section 1296 of IRC] Under the mark-to-market election, any excess of the fair market value of the stock in the PFIC as of the close of the taxable year over the taxpayer's adjusted basis in the stock is treated as ordinary income. Special rules apply to determine when a RIC may deduct mark-to-market losses for its PFIC stock."

61. Paragraphs 6.121-6.123/Pages 118 - 119 – Given the infrequent application of the QEF election and for the reasons explained in our cover letter, we suggest that you delete these paragraphs.

62. Paragraph 6.128/Page 119 – To correct an apparent typographical error, we suggest that you replace the last reference to "IRC" in first sentence with "RIC."

<u>Chapter 7 – Financial Statements</u>

1. Footnote 4/Page 122 – The reference to "Item 3(a)" of Form N-1A should be changed to "Item 9(a)." Also, the period to be presented in the fund's prospectus should be changed from ten years to five years.

2. Paragraph 7.9/Page 124 – The second sentence indicates that details of other assets and liabilities should be presented in the statement of net assets. Rule 6-05 of Regulation S-X seemingly permits other assets less liabilities to be presented as one amount. If material, details can be provided in financial statement footnotes, rather than on the face of the statement.

3. Paragraph 7.11/Page 124 – The second sentence presents a list of securities. We suggest you insert "includes, but is not limited to" prior to "stocks, bonds, debentures," etc.

4. Paragraph 7.13/Page 124 – We are concerned that subparagraph b regarding presentation of investments may be read to require that securities be classified by type, by industry, <u>and</u> by country/geographic region. Industry practice for international and global funds is to present investments by security type and by country or region. These funds generally do not present the industry breakdown within each country or region. We recommend paragraph 7.13 be clarified accordingly.

5. Paragraph 7.14/Page 125 – We are unsure of the purpose or origin of the proposed disclosure. Publicly offered investment companies are currently required to provides extensive disclosures on any restricted securities held. *See* Rule 12-12 of Regulation S-X. Further, funds must describe their security valuation procedures in their SEC registration statement and in the financial statement footnotes. Finally, if the auditor determines that the valuation procedures for "fair valued" securities are inadequate or unreasonable, he would be required to modify his opinion on the financial statements. *See* paragraph 11.10 of the Proposed Guide. If the proposed disclosure is retained, we suggest you clarify that values may be estimated by directors *or by management under procedures approved by the board of directors.*

(11)

6. Paragraph 7.28/Page 128 – Subparagraph d would require footnote disclosure of tax basis components of net assets. While we support the proposed changes to SOP 93-2, we are concerned that disclosure of the components of net assets on a tax basis as of the semi-annual period will prove difficult to administer. The tax effects of certain transactions are only applicable as of year-end and do not apply as of the semi-annual period. For example, Section 1256 contracts (i.e., futures contracts, options on futures, and certain other contracts) owned by the fund as of the end of the tax year are treated as sold for their fair market value. Generally, the resulting "capital gain" is treated as 40% short term and 60% long term. It is unclear whether funds would be required to perform this mark to market for purposes of providing the tax basis components of net assets as of the semi-annual period, and if so, whether it would be meaningful. Investments in real estate investment trusts, "passive foreign investment companies" and "wash sales" create similar concerns. Would the calculation assume that tax-loss carry forwards are utilized? An alternative to the proposed semi-annual disclosure would be to require the semi-annual report to disclose the tax basis components of net assets as of prior year-end adjusted for any "spillover" distributions, (i.e., distributions occurring in the current year that relate to the prior period.

7. Paragraph 7.38/Page 130 – The reference to section 30(d)(5) should be changed to 30(e)(5).

8. Footnote 22/Page 131 – The reference to section 30(d)(6) should be changed to 30(e)(6).

9. Paragraphs 7.51-7.53/Pages 132-133 – We understand the Committee has submitted recommendations to the SEC to modify Regulation S-X. (*See* letter from Steven E. Buller, Chair, AICPA Investment Companies Committee to Lawrence A. Friend, Chief Accountant, Division of Investment Management, April 25, 1996). Among other things, the recommendations would allow an investment company to present a combined statement of operations and statement of changes in net assets. We assume the Proposed Guide would not prohibit such presentation.

10. Paragraph 7.52/Page 132 - Subparagraph c would require disclosure of the tax basis components of distributions paid. For the reasons expressed in our comments on Paragraph 7.28, the tax basis components of distributions paid as of the semi-annual period end are subject to change. We believe investment companies would have to qualify disclosures made in semi-annual reports in response to this paragraph as preliminary and subject to change.

11. Paragraphs 7.57-7.61/Pages 134-135 – The text describes a statement of cash flows based on the "direct method." However, paragraph 7.57 indicates that "indirect method" is more commonly used and the example statement provided in Paragraph 7.82 illustrates the indirect method. We suggest the text in this section be revised to describe the indirect method to be consistent with example and prevailing industry practice.

12. Paragraph 7.62/Page 135 – We recommend that this paragraph be modified consistent with our comments on paragraph 5.29 on page 69.

13. Paragraph 7.62-7.66/Page 135-137 – From time to time the SEC modifies the information required to be presented in the financial highlights. For example, the SEC recently eliminated the requirement to disclose average commission rate paid in the financial highlights (*See* SEC Release No. IC 23063, March 13, 1998). The SEC amended the financial highlights in 1992 by

requiring disclosure of the annual total return and eliminating disclosure of the number of shares outstanding. We understand that the SEC is currently considering additional modifications to the financial highlights, including eliminating the per share information for money market funds that have adopted a policy of maintaining a stable net asset value. We are concerned that the referenced paragraphs may be read to require the information described in paragraphs 7.63-7.66, notwithstanding any changes which may be adopted by the SEC subsequent to completion of the Proposed Guide. We suggest the addition of language that clarifies that registered investment companies look to their respective SEC registration forms in order to determine the information to be disclosed in the financial highlights.

14. Paragraphs 7.62-7.66/Pages 135-137 – We suggest the Proposed Guide include guidance on restatement of the financial highlights table for fund share splits.

15. Paragraph 7.65/Page 136 – We note that the portfolio turnover rate referenced in subparagraph b need not be disclosed for money market funds. The information required in subparagraph c applies to closed-end funds *if* they have debt outstanding.

16. Paragraph 7.66/Page 137 – As indicated above, average commission rate per share need not be disclosed in the financial highlights.

17. Paragraph 7.69/Page 138 – We note that SFAS No. 119 *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* has been superseded by SFAS No. 133. Similarly, footnote 26 on page 154 should be modified to reflect adoption of SFAS No. 133.

<u>Chapter 8 – Other Accounts</u>

1. Paragraph 8.6/Page 159 – This paragraph indicates that under a 12b-1 plan a fund's distributor may be compensated in one of several methods (i.e., a 12b-1 fee, a front-end load or a CDSL). We note that a fund need not adopt a 12b-1 plan in order to charge a front-end load or a CDSL. We recommend the third sentence in this paragraph be modified accordingly

2. Paragraph 8.25/Page 164 – The Proposed Guide requires UITs to charge offering costs to paid-in-capital when the units are sold to the underwriter. The *Basis for Conclusions* notes that this method serves to appropriately match offering costs with the proceeds received from the offering of the units, and that the capital raising process is complete upon the sale of the units to the underwriter. We disagree. Sponsors create UITs with the intent of selling units to public investors (not the underwriter, which in many instances is affiliated with the sponsor). Accordingly, the offering process should not be viewed as complete until the units are ultimately placed with public investors. We believe that offering costs of unit investment trusts should be amortized to expense over the offering period, analogous to the treatment afforded open-end funds and closed-end funds offered on a continuous basis.

<u>Chapter 9 – UITs</u>

1. Paragraph 9.1/Page 167 – In the third sentence of this paragraph we suggest you insert "or sponsor" subsequent to "trustee." In the fourth sentence of this paragraph we suggest you substitute "earnings" for "dividends." In the penultimate sentence in this paragraph we suggest you substitute "relatively fixed" for "static." We suggest the final sentence read "In

(1)

general, securities may only be sold for limited purposes (i.e., to generate proceeds to pay a redeeming unit holder)."

2. Paragraph 9.5/Page 167 – We suggest you substitute "regular" for "consistent" in the first sentence of this paragraph. Fixed-income UITs that are insured or that invest in government obligations typically include preservation of principal in their investment objective. Certain fixed-income UITs, such as those that invest in high yield securities, may not include preservation of principal in their investment objective. We suggest you delete "and to preserve principal" in the first sentence of this paragraph.

3. Paragraph 9.9/Page 168 – We suggest you insert "generally" subsequent to "UIT" in the first sentence in this paragraph.

4. Paragraph 9.13/Page 169 – Due to their increased popularity, many equity UITs hold substantial assets and can invest in a large number of equity securities. Frequently, these equity UITs may satisfy the diversification and other criteria for qualifying under Subchapter M. We recommend that "that invest principally in taxable bonds" be deleted from the first sentence of this paragraph. Also, we suggest you insert "However" prior to "most UITs" in the third sentence.

As noted in the final sentences of this paragraph, the taxable income of a grantor trust flows through to the unitholder as it is earned and income recognition to the beneficiary does not depend on cash distributions by the trust. Investors are taxed based upon the receipt of taxable income or payment of deductible expenses by the trust, regardless of when cash is distributed to them. The *Basis for Conclusions* suggests it is inconsistent to accrete discounts and not amortize premiums based solely on tax elections. UITs organized as grantor trusts do not make these elections. Instead, income tax elections for premiums and discounts are made individually by the investor. The concern expressed in the basis for conclusions does not apply to UITs organized as grantor trusts. We recommend that UITs be excluded from mandatory amortization of premium.

5. Paragraph 9.15/Page 170 – This paragraph indicates that audited financial statements are provided to prospective investors in the prospectus. We note that the SEC proposed Form N-7, a new registration form for UITs in 1987 (*See* SEC Release No. IC 15612). Proposed Form N-7 would permit UITs to omit audited financial statements from the prospectus and forego annual audits if the UIT satisfied certain requirements. While the SEC has not adopted proposed Form N-7, we believe this proposal, or those portions of the proposal relating to omitting audited financial statements will be actively considered by the SEC in the near future. We recommend language similar to that included below be added to this section to alert readers to pending changes regarding the annual audit requirement.

> The SEC proposed Form N-7, a registration form for UITs, that would replace Form S-6, in 1987. As proposed, Form N-7 would require the financial statements included in the initial offering prospectus and the first annual update of that prospectus to be audited. Thereafter, UIT financial statements included in the prospectus need not be audited so long as the UIT satisfies certain requirements, including (i) the trustee's financial statements are audited annually, and (ii) the trustee receives an unqualified report on the internal

(1)

accounting controls of its trust operations. While the proposed form has not been adopted as of the date of this Audit Guide, readers are encouraged to check the status of this proposal.

<u>Appendix B – Pages 227 – 229</u>

1. Consistent with our comments in the cover letter, we suggest that you delete Appendix B. If Appendix B is retained, however, we suggest that you incorporate substantive comments on the tax amortization rules that you receive from other interested parties into Tables 1, 2 and 3. For example, in Table 1 no reference is made to the accrual period rule of Treas. Reg. 1272-1(b) which generally allows a taxpayer to select any accrual period that is not in excess of one year.

<u>Appendix C – Pages 230 - 232</u>

1. To clarify IRC requirements, we suggest that you add the following footnote after "Assets (as of the close of each quarter)"

> "NOTE: Pursuant to section 851(d), a RIC that would be deemed not to meet the diversification requirements of section 851(b)(3), as applied at the close of any quarter, nevertheless shall be considered to have met such requirements if the discrepancy otherwise causing such failure is corrected within 30 days after the end of such quarter."

2. We also suggest that you remove all references to the "short-short" diversification test in light of its repeal by the Taxpayer Relief Act of 1997.

<u>Appendix E – Page 236</u>

1. The "pro forma" financial statements provided in Appendix E appear to reflect a merger of two funds that has already taken place. For example the footnotes are labeled "Notes to Financial Statements of the Combined Entity Immediately After Acquisition" and indicate that on December 31, 19X4 Fund A acquired all the net assets of fund B pursuant to a plan of reorganization approved by Fund B shareholders on December 26, 1994. We suggest you consider including pro forma financial statements that would typically be included in a prospectus/proxy filed on Form N-14. We believe both issuers and auditors would find sample pro forma financial statements helpful in preparing a prospectus/proxy filed on Form N-14 in connection with a proposed merger of two funds.

Pro forma financial statements filed in connection with a proposed combination of funds typically include a combined portfolio of investments, a combined statement of assets and liabilities and a combined statement of operations. The pro forma statement of assets and liabilities, and the pro forma statement of operations typically include four columns. These columns present amounts related to Fund A, amounts related to Fund B, "adjustments", and pro forma combined amounts. Adjustments to the statement of operations might include changes in the pro forma management fees attributable to breakpoints in the fee rate schedule. Adjustments in the statement of assets and liabilities might include a reduction in assets and paid-in capital attributable to expenses associated with the combination. Footnotes to the pro

(4)

forma financial statements would typically explain these adjustments. Finally, the pro forma financial statements would be marked "unaudited."

(1)

Author: MIME:Bascpa@aol.com at INTERNET
Date: 12/21/98 7:05 PM
Priority: Normal
TO: Sheila Yu at AICPA3
Subject: Response to Exposure Draft "Proposed Audit and Accounting Gu

Enclosed is the Society of Louisiana CPAs "Accounting and Auditing Standards Committee" response to the Exposure Draft "Proposed Audit and Accounting Guide to Investment Companies."

If there are any questions or comments please feel free to contact me at Bascpa@aol.com or call me at 504-626-8299.

December 21, 1998

Ms. Sheila H. Yu, Technical Manager
Accounting Standards, File 3170
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Ms. Yu:

We have reviewed the following Exposure Draft and have the following comments:

Exposure Draft: **AUDITS OF INVESTMENT COMPANIES**

Dated: **September 22, 1998**

Comment Date: **December 22, 1998**

Comments:

The effect of applying changes required by the proposed guide states that these should be reported as a cumulative effect of a change in accounting principle in accordance with APB 20 "Accounting Changes". The Auditing Standards Board will issue a new standard that changes required by the application of new accounting principles will not have to be disclosed as cumulative effect of a change in accounting principles. The proposed guide should reflect this proposed change.

The new guide conforms to the public's view of the investment activity. All prospectuses are driven by "net asset" value and the statement of assets and liabilities is geared toward the liquidity nature of investment firms. The new guide provides adequate background and terminology that helps the user understand the industry's current activity.

It adequately provides guidance on how to account for certain costs (e.g., original issue discounts, offering costs, etc.) that should be deferred and recognized over future periods as well as the disclosure of these costs.

The discussions in Chapter 3 were very informative and educational regarding the financial instruments.

Sincerely,

Brent A. Silva, CPA

12

Committee Member

OFFICERS

GEORGE T. FOUNDOTOS, CPA — PRESIDENT
ALAN E. WEINER, CPA — PRESIDENT-ELECT
RONALD BENJAMIN, CPA — VICE-PRESIDENT
RICHARD A. BERENSON, CPA — VICE-PRESIDENT
DAVID A. LIFSON, CPA — VICE-PRESIDENT
P. GERARD SOKOLSKI, CPA — VICE-PRESIDENT
ANN GOLDEN, CPA — SECRETARY
HUR S. HOFFMAN, CPA — TREASURER
UIS GRUMET — EXECUTIVE DIRECTOR

NEW YORK STATE SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS
530 FIFTH AVENUE
NEW YORK, NY 10036-5101
(212) 719-8300/FAX (212) 719-3364
http://www.luca.com

December 21, 1998

Ms. Sheila H. Yu, Technical Manager
Accounting Standards, File 3170
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Audit and Accounting Guide-Audits of Investment Companies

Dear Ms Yu:

We are pleased to submit our comments related to the above Proposed Audit and Accounting Guide on behalf of the New York State Society of Certified Public Accountants. Comments on accounting matters were prepared by the Financial Accounting Standards Committee of the Society. Comments relating to auditing were prepared by the Society's Auditing Standards and Procedures Committee.

ACCOUNTING COMMENTS

Amortization of Premiums and Discounts

Paragraph 2.54 requires premiums and discounts to be amortized. Because an investment company's assets and liabilities are reported at fair value, amortization, which is an historic cost convention, will not affect reported net assets. It, however, will affect the amount reported as interest income and, consequently, the amounts reported for net investment income and unrealized gain or loss in investments, both of which are components of the increase or decrease in net assets resulting from operations.

Many investment companies currently conform their financial reporting practices for premiums and discounts to the tax treatment used. This is not only for ease, but considers that many investors are concerned with the tax attributes of distributions and potential distributions.

The basis for conclusions set forth in paragraph 12.4 to 12.8 argue under generally accepted accounting principles. Clearly, for zero-coupon bonds and deep-discount bonds, amortization should be required. However, many investments in fixed income securities are purchased at a price close to par with discount or premium being less than 5%. Arguably, the amortization related to such securities would have a minor impact on the components of changes from operations and on yield. To require daily computations of the amortization on each bond in the portfolio does not seem to meet a reasonable cost/benefit relationship as discussed in Statements of Financial Accounting Concepts No. 2.

Offering Costs for Unit Investment Trusts (UITs)

Paragraph 8.25 states that "...offering costs should be charged to paid-in capital...as the units or shares are issued or sold by the trust." Units sold to underwriters on a firm basis are considered sold by the trust. Underwriters or sponsors of UITs usually do not purchase shares for inventory, but for sale to investors. Consequently, we believe that offering costs should be charged to paid-in capital at the time that the ultimate investors purchase the ownership units of a UIT. If any financial statements are published before such ownership units are purchased, such offering costs should be deducted from equity.

Significant Accounting Policies

We believe a reference is needed in paragraph 7.69 to APB 22, Accounting Policies.

Financial Statements

Since the guide may be used for preparation of financial statements and should cover all potential applications, Chapter 7 should contain an illustration of financial statements presented in accordance with SOP 95-2, Financial Reporting by Non-public Investment Partnerships.

AUDITING COMMENTS

Independence

Issues related to the auditor's independence that are specific to investment companies are not addressed in the Exposure Draft. For the most part the auditor's independence requirements are contained in AICPA and SEC publications. However, as a practical matter it would be worth mentioning that under SEC rules the performance of any bookkeeping services for a client is prohibited. This rule applies to developing investment performance statistics for the client as well as bookkeeping.

Fraud

The Exposure Draft addresses the consideration of fraud in the audit of investment companies in paragraphs 2.102 and 103. The discussion of the requirements under SAS No. 82 implies that a separate assessment of fraud is mandated. The assessment of the risk of material financial statement misstatement caused by fraud can be combined with other risk assessments, i.e., it can be part of the evaluation of internal accounting controls. We believe that a reference to the fraud risk implementation guide would be useful, since it has a specific discussion of fraud risk assessment in the context of Investment Companies (and is a very useful complement to the audit guidance in SAS 82 and the Exposure Draft).

Materiality

There is no discussion in the Exposure Draft on the concept of materiality as it specifically relates to investment companies. In contrast the Broker-Dealer Securities Guide has a brief discussion of this issue. If materiality is addressed, the discussion should include materiality considerations in planning the engagement, audit adjustment evaluation and financial statement disclosure. Materiality is particularly significant when planning substantive analytical procedures since audit evaluations should be as precise as those of statistical tests whose upper error limits are a function of materiality.

Computer Assisted Audit Techniques

Computer assisted auditing is not addressed in the exposure draft. In addition, there is no discussion of the audit and evaluation of evidential matter stored only in machine-readable form. The operating environment in which these entities generally operate is highly computerized. We believe that a discussion of auditing in a computer intense environment is warranted.

Illegal Acts

The discussion of illegal acts relates to indirect effects on the financial statements. In many instances such acts may have a material direct effect on financial statements and may trigger different responses by the auditor under Section 10(a) of the 1995 Securities Reform Act. We believe that the reform act legislation is relevant to companies reporting under the Investment Company Act, but AICPA counsel should consider this issue.

Investments in Real Estate and Property Other Than Securities

Chapter 2, paragraph 2.2 makes reference to restrictions on investments in real estate and property other than securities. The Exposure Draft, however, does not contain any guidance on handling these type of investments nor references to other documents on accounting for and auditing these types of investments, if they are included in the entity's's assets.

Capital Accounts

Paragraph 4.44 appears to mandate the confirmation of outstanding capital shares at year end (the audit date). The date of confirmation should be determined by the auditor based on the relevant risk assessment, unless otherwise mandated by law.

Financial Instruments

Chapter 3 should contain a reference to the audit guidance included in Chapter 2. This chapter should also include a reference to the current auditing and accounting standards and other pronouncements on financial instruments.

Principal Auditor Issues

Principal auditor issues occur when one auditor references another auditor's report in the financial statement of the primary entity. This issue becomes contentious when the primary entity's auditor is auditing less than 50%, or another significant amount, of the revenue and/or assets of the consolidated entity. Many firms have established their own guidance on how to handle this matter (as has the SEC). The AICPA has not issued any guidance on this type of situation. The instances when this could occur in "feeder funds" or "fund of funds" entities are numerous. We believe some guidance is needed on this situation in the Exposure Draft.

Management Representations

Consider including an illustrative management representation letter in Chapter 11 for a non-registered investment company

Organization

Audit guidance is not contained in a separate chapter. This is in contrast with the format used, for example, in the Broker-Dealer Securities Guide. The AICPA should use a standard format for presenting audit guidance in accounting and auditing guides.

A discussion of a "fund of funds" is included in Chapter 5, Complex Capital Structure, paragraph 5.48 to 5.57. Consider moving these paragraphs to Chapter 2 where the subject matter seems more appropriate.

We also believe that the document would flow better if paragraphs 2.113 and 2.114 were reversed.

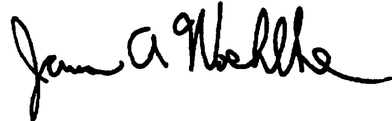
Other Issues

- Will the guide be updated to reflect FASB 133?
- Capitalize the "I" in investments which begins the first sentence of paragraph 7.29.

We hope these comments have been helpful. If you wish to pursue these items further, please let us know and we will request a member of the Committee contact you.

Very truly yours,

John J. O'Leary, CPA
Chair, Financial Accounting Standards Committee



James A. Woehlke, CPA
Director, Technical Services

Vincent J. Love, CPA
Chair, Auditing Standards and Procedures Committee

cc: Accounting and Auditing Committee Chairs

T. Rowe Price Associates, Inc.

P.O. Box 89000
Baltimore, Maryland 21289-9999

100 East Pratt Street
Baltimore, Maryland 21202

410-345-2000

December 21, 1998

Sheila H. Yu

Technical Manager, Accounting Standards

American Institute of Certified Public Accountants

1211 Avenue of the Americas

New York, NY 10036-8775

Re: Proposed Audit and Accounting Guide

Audits of Investment Companies

Exposure Draft dated September 22, 1998

File 3170

ORIGINALLY SENT VIA E-MAIL - DECEMBER 22, 1998
E-MAIL ADDRESS: syu@aicpa.org

Dear Ms. Yu:

I am writing on behalf of T. Rowe Price Associates, Inc. and its affiliate, Rowe Price-Fleming International, Inc. (together T. Rowe Price), to comment on the Proposed Audit and Accounting Guide, *Audits of Investment Companies* (the Proposed Guide). T. Rowe Price acts as a registered investment adviser to, and performs various accounting, transfer, and distribution services for, a family of 87 open-end registered investment companies (TRP funds) and other investment products with assets totaling over $129 billion.

We commend the AICPA Investment Companies Committee and AcSEC for their efforts in revising the industry's audit and accounting guide and appreciate the opportunity to comment on it.

We support most of the new accounting standards in the Proposed Guide, as outlined in the Preface. Specifically, we agree with the decision to require a liability for excess expense plans only to the extent amounts become payable under the terms of the agreement. We support the Proposed Guide's

provisions permitting a condensed portfolio of investments, and endorse the guidance in the new chapter on complex capital structures, consistent with regulatory and tax guidance. Further, we applaud the decision to supersede Statement of Position 93-2 (SOP 93-2), *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies,* to condense capital and distribution disclosures for financial statement purposes, and to add relevant tax-basis footnote disclosure.

We do not agree, however, with the proposed requirement to amortize all premiums and accrete all discounts, believing the distinction between investment income and gain/loss is not significantly meaningful to shareholders of fair-value investment companies to justify the requirement. Additionally, we object to the proposed reporting for correction of investment violations, believing the treatment unduly emphasizes the effect of correcting a servicing error(s) rather than the effectiveness of the investment strategy / program. We address our concerns on these points in the following paragraphs. An Attachment clarifies additional points that we believe are not contentious.

Mandatory Accretion / Amortization

T. Rowe Price opposes mandatory accretion of discount and amortization of premium (accretion / amortization), as prescribed by the Proposed Guide in paragraph 2.54. It is our position that an investment company's accretion / amortization policy for financial reporting purposes should be permitted to conform to its tax policy.

Although the TRP funds generally accrete discounts and amortize premiums, we do not believe it cost-beneficial to require it across all security types. We believe the distinction between investment income and gain or loss on investments, for entities that report changes in value currently in earnings, is not sufficiently meaningful to justify differing accretion / amortization policies for financial reporting and tax. Net assets and net asset value per share are unaffected by accretion / amortization, as are total return and SEC yield – the primary measures of investment company performance. The expense ratio and portfolio turnover rate are also gauges of fund effectiveness, and are unaffected by accretion / amortization.

Different accretion / amortization policies for financial reporting and tax add unnecessary cost, complexity, and possible shareholder confusion. Mandatory accretion / amortization precludes book / tax symmetry for certain types of securities. Specifically, the Proposed Guide calls for retroactive adoption, which is not permitted under the tax law. Additionally, an election to conform tax policy to the requirements in the Proposed Guide could disadvantage shareholders. Accretion of market discount on municipal securities, for example, would result in taxable distributions to tax-exempt shareholders, which otherwise could offset capital losses at disposition. Thus, we do not believe that the benefit of mandatory accretion / amortization for all funds justifies the cost, particularly given the lack of abuse under current practice.

Correction of Investment Violations

T. Rowe Price objects to the requirement to present a payment to correct an investment violation as a separate line item on the statement of operations, as outlined in paragraph 7.68 of the Proposed Guide. We believe a payment intended to restore a fund to the position it should have been in under the terms of its prospectus / advisory agreement does not warrant separate presentation on the face of the statement of operations; it should be reported net of the effect of the error and disclosed in the footnotes if material.

FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 42, indicates that financial reporting should provide information about an enterprise's financial performance during a period, and that investors and creditors often use information about the past to help in assessing the prospects of an enterprise. A payment by an advisor to make a fund whole for an isolated investment violation has no predictive value for a shareholder. Additionally, a payment to reimburse a loss from an investment violation is not indicative of a fund's performance relative to its investment program / strategy, unlike a reimbursement of a loss on a *permitted* investment decision. By separately captioning any such payment, the fund highlights a non-recurring, correction of an error by a service provider (the advisor), with equal prominence as the results of its investment strategy.

Furthermore, a separate line item in the statement of operations that reflects the amount reimbursed to a fund is not an accurate gauge of the fund's compliance environment, nor should it be. An investment compliance error could result in either gains or losses that may or may not be reimbursed. The separate line item treatment may confuse or mislead shareholders as to the significance of the information.

Changes to SOP 93-2

We commend the supersession of SOP 93-2 which, we believe, does not enhance shareholder understanding of distributions and capital accounts, and has been difficult to apply. We suggest further condensing the capital disclosure for financial reporting purposes to a single caption, *Net Assets*. We maintain that the distinction between paid-in capital and retained earnings, on a book basis, is not meaningful to a shareholder. This is because shares are redeemed by relieving paid-in capital at current net asset value, rather than at the value originally contributed. Current net asset value includes original contributed capital as well as undistributed realized and unrealized earnings, and could be greater or less than the value originally contributed. To illustrate, it is possible to deplete paid-in capital in a closing fund and still have balances in the accumulated, undistributed and unrealized accounts. Thus, we suggest financial statement disclosure of a single equity balance, in combination with the footnote disclosure of tax-basis components of capital would be more meaningful to shareholders.

We also request clarification of the semi-annual disclosure requirements of the tax-basis components of net assets. Since the tax effects of certain transactions are determined only as of a fund's tax year-end, their disclosure is not meaningful at semi-annual reporting dates (for example, capital loss carryforwards and tax returns of capital). For semi-annual reporting, therefore, we recommend that preceding tax year-end balances be carried forward without adjustment and clearly indicate the as-of date of the balances. We also request clarification of the semi-annual disclosure requirement for tax-basis distributions. We suggest that distributions be disclosed as declared for semi-annual reporting periods and be adjusted to tax-basis only for annual reporting periods. Significant differences between total income and gain on a tax- versus financial reporting-basis should be explained. Finally, we request that the term *tax-basis* be explained as the ultimate tax character to shareholders.

Thank you for your consideration of our views. You may contact me by phone at 410-345-5738, or by e-mail at cmathews@troweprice.com to discuss any of these points.

Sincerely,

Catherine D. Mathews
Manager of Accounting Policy

Attachment

cc: Doug Bender, PricewaterhouseCoopers
Greg Smith, Investment Company Institute

ATTACHMENT

T. Rowe Price

Comments on the Proposed Audit Guide

Audits of Investment Companies

Chapter 1 – The Investment Company Industry

1.26 The first sentence seems to indicate that article 6 is the only article of Regulation S-X to which investment companies are subject. We suggest the first sentence be clarified to state that the form and content of financial statements for SEC-registered entities are governed by Regulation S-X, and that articles 6 and 12 specifically address investment companies.

1.27 We understand the SEC is considering a proposal to permit a combined statement of operations and changes in net assets. We suggest the Proposed Guide indicate that such a combined statement would be acceptable for generally accepted accounting principles (GAAP), to the extent permitted by SEC rules and regulations.

1.28 We suggest a footnote be inserted in the first sentence after "statement of cash flows", which references Statement of Financial Accounting Standards (FAS) No. 95, *Statement of Cash Flows*. We also note that the word "Activities" in the last sentence should be replaced with *Securities*.

Chapter 2 – Investment Accounts

2.21 The last sentence states that capital stock transactions must be "reflected in the computation [of net asset value per share] no later than the first calculation following such changes." We suggest that the phrase *the date of* be inserted before "such changes". Capital stock transactions

are required by Rule 2a-4 of the 1940 Act to be recorded no later than the day after trade date; we believe this is the intent for GAAP as well.

2.50 We suggest that this paragraph be deleted. We are unaware of any regulatory requirement to separately classify accumulated dividend arrearages and do not believe it a meaningful distinction for readers of investment company financial statements.

2.54 Reference comments in the attached letter at *Mandatory Accretion / Amortization.*

2.55 We suggest adding a statement that if interest is deemed uncollectible, a reserve / valuation allowance should be established to clarify the treatment of uncollectible interest.

Chapter 3 – Financial Instruments

3.6 A reverse repurchase agreement is defined in the same way as a repurchase agreement at paragraph 3.4. In the first sentence, we suggest the word "purchase" be changed to *sale*, "sell" to *buy,* and "to the same counterparty" to *from the same counterparty.*

Chapter 4 – Capital Accounts

4.22 In the fourth sentence, "These entries are made *on*", we suggest that *on* be replaced with *as of.* In practice, capital stock transactions may require adjustment after the trade date, for example, from retirement plan recordkeepers or sub-transfer agents.

Chapter 5 – Complex Capital Structures

5.2 In the second sentence, we suggest the phrase *offers different shareholder services or* should be inserted after, "Each class of shares typically". Rule 18f-3 permits multiple class structures to accommodate different shareholder servicing and / or distribution arrangements for each class.

5.8 In the third sentence, we suggest that the word "must" be replaced with *may*. In the last sentence, delete "as the rule…the SEC". Rule 18f-3 (a)(1)(v) permits allocation by another Board of Directors-designated method.

5.10 In the last sentence, we suggest the word "are" be replaced with *may be*, to clarify that certain expenses must be treated as fund-level, others must be treated as class-level, and the balance may be treated as either fund-level or class-level, based on Board designation (18f-3(a)(1)).

5.13 In the lead-in, replace the phrase "used in practice" with *permitted by Rule 18f-3,* the source of the guidance.

In the first bullet, second sentence, replace the word "required" with *permitted*, since the simultaneous equations method or other Board-designated method may also be used (18f-3(c)).

In the fourth bullet, replace the word "claims" with *classes*. Claims appears to be a typographical error.

5.14 In the first bullet, first sentence, we suggest inserting *or settled shares for daily dividend funds* after "total outstanding shares". Daily dividend funds using the fair value of settled shares outstanding method of allocation should be permitted to use settled shares for determining distributions, as well.

In the first bullet, second sentence; delete the word "outstanding" for the reason above.

5.16 In the first sentence, we suggest replacing the word "is" with *may be*, if the simultaneous equations method is also permitted.

5.17 In the first sentence, we suggest deleting the phrase, "is used for periodic dividend funds and", since it may be used for daily dividend funds, as well.

5.18 At the end of the first sentence, replace *is* in "class is negative" with *has*.

In the last sentence, delete the second use of the word "determined", since return of capital is neither disclosed nor determined at the class level.

5.27 In the last sentence, we suggest the phrase *on the same basis as the distribution giving rise to the return of capital* be inserted after "between the classes", to clarify the method of allocation.

5.45 In the third bullet, we suggest inserting *Rev. Proc. 96-47 or* at the beginning of the sentence, since many funds operate under the revenue procedure rather than private letter rulings.

5.48 We question whether the second sentence is accurate and suggest that it be deleted.

5.64 We suggest that the total return for Class A in 19X4 should be 1.84% rather than .84%, which appears to be a typographical error.

Chapter 6 – Taxes

We support and incorporate by reference the comments submitted by the Financial Services Industry Tax Committee, Investment Company Subgroup (the Tax Committee). T. Rowe Price actively participated in drafting the comments on the tax chapter submitted by the Tax Committee.

Chapter 7 – Financial Statements of Investment Companies

7.1 We suggest that the minimum financial statement requirements for GAAP purposes be listed, with a reference to SEC requirements. For example, the Proposed Guide reflects a requirement for the financial highlights table to include five fiscal years, without addressing whether a change in SEC requirements would result in a change for GAAP. The concern is that by establishing current S-X in the Proposed Guide as GAAP, subsequent changes to S-X will be precluded for GAAP purposes.

Additionally, as written, the Proposed Guide requires separate statements of operations and of changes in net assets. Clarify whether a change to S-X permitting a combined statement, would result in a combined statement being acceptable for GAAP.

Footnote 4 Update to reflect recent Form N-1A revisions, including: (a) Item 3(a) is now Item 9(a) and (b) only five years, rather than ten, are now required in the financial highlights table in the prospectus.

7.4 Related to the first sentence, we suggest that consolidation by a top-tier investment company of an investment company investee, in a fund-of-funds structure, is also inappropriate. While inconsistent with FAS No. 94, *Consolidation of All Majority-Owned Subsidiaries*, this position appears supported by proposed statement of financial accounting standards, *Consolidated Financial Statements – Policy and Procedures* (issued October 16, 1995), which would exempt investment companies from its scope.

7.9 At the end of the second sentence, we suggest inserting *if material* after "statement of net assets", since a statement of net assets will likely be used when other balances are individually immaterial.

7.13b Clarify whether investments are to be categorized by one or all of (i) – (iii). We suggest the Proposed Guide require investments to be categorized in the most meaningful manner based on the investment objective / program of the fund, and subcategorized as appropriate according to the other classifications.

7.14 We are unsure of the purpose or origin of this disclosure, and suggest that it be deleted.

7.17 Related to the second sentence, we question the origin and purpose of the requirement as it applies to fund-of-fund arrangements. Specifically, if a registered investment company holds shares of another registered investment company, the second sentence would seem to require the investor fund to look through the investee fund to determine 5% ownership interests (affiliate interests). Given the nature of such mutual fund investing, the threshold for disclosure

seems too low and could be confusing to a fund-of-funds shareholder. If considered necessary however, disclosure in the footnotes should be permitted.

7.20 We suggest the wording in the second sentence, related to short sales, option contracts, financial futures contracts be made consistent with that for related liabilities, as at paragraph 7.23, third sentence.

7.28 Reference comments in the attached letter at *Changes to SOP 93-2*.

7.31 We suggest that the word "incomeless" should be revised to *income less*.

7.52 Reference comments in the attached letter at *Changes to SOP 93-2*.

7.53 For mutual funds, we suggest the Proposed Guide allow a combined statement of operations and changes in net assets (see 7.1 above).

7.66 Delete "and average commission rate paid".

7.68 Reference comments in the attached letter at *Corrections of Investment Violations.*

7.69 Delete the third and fourth bullets, superseded by FAS No. 133.

7.74 Based on our understanding of proposed changes to Regulation S-X being considered by the SEC, items a, c, d, f, and g may require revision in the near-term. To the extent this paragraph discusses S-X requirements, we suggest the Proposed Guide reflect any changes that are finalized before its issuance.

Author: MIME:DAVLON@SAFECO.com at INTERNET
Date: 12/22/98 8:15 PM
Priority: Normal
TO: Sheila Yu at AICPA3
CC: NEAFUL@SAFECO.com at INTERNET, jack.behrens@ey.com at INTERNET,
DAVLON@SAFECO.com at INTERNET
Subject: Comment Letter

Ms. Yu,

Attached is our comment letter on the Proposed Audit and Accounting Guide--Audits of Investment Companies. Please let me know if I can provide additional information to assist or clarify. My phone number is 425-376-8219.

Dave Longhurst
Assistant Controller
SAFECO Asset Management Company

<<AICPACOM.DOC>>

December 22, 1998

Sheila H. Yu
Technical Manager
American Institute of Certified Public Accountants
1211 avenue of the Americas
New York, NY 10036

Re: Proposed Audit and Accounting Guide-
Audits of Investment Companies
File 3170

We appreciate the opportunity to express our views on the proposed Audit and Accounting Guide for investment companies.

SAFECO Asset Management Company is the investment advisor for 25 open-end investment companies. Seven of these investment companies hold taxable fixed-income securities. Total assets under management approximate $7 billion.

We have not frequently commented on proposed changes to accounting/auditing standards or guides. However, because we feel strongly about one particular issue—mandatory premium amortization—we want to provide feedback.

While mandatory premium amortization has appeal from a conceptual perspective, we believe it does not make sense for investment companies. We are strongly opposed to mandatory premium amortization for the following reasons:

1. It would not provide additional meaningful information to shareholders (the primary users of the financial statements)
2. Resulting book-tax differences would cause shareholder confusion
3. The costs of implementing mandatory premium amortization exceed the potential benefits

Shareholders are interested in information that directly impacts them (e.g., total return, SEC Yield, distribution rates). While total income is relevant, the components of income (e.g., net investment income, realized gain, unrealized appreciation) are not. Shareholders are interested in knowing how much income is attributable to them (i.e., they are interested in distributions per share, which is calculated on a tax basis). To force investment companies to amortize premium for GAAP purposes when they are not required to do so for tax purposes would result in financial statements that are not consistent with other information (e.g., 1099s) that shareholders receive from investment companies.

Thus, mandatory premium amortization, which does not impact total income or distributions, does not provide meaningful information to shareholders and would result in shareholder confusion.

Mandatory premium amortization would also result in book-tax differences. At SAFECO Mutual Funds, we strive diligently to avoid creating book/tax differences because of the added complexity and potential confusion resulting in maintaining two sets of books and because of the potential confusion to shareholders. If book-tax differences can be confusing to the most seasoned accounting professional, we can expect that they are confusing to shareholders.

Maintaining two sets of books is also costly. The cost to implement mandatory premium amortization in our seven taxable bond funds would be approximately $50,000, with ongoing annual costs of at least $15,000. If we perceived additional benefits to shareholders, we would

gladly incur these costs on behalf of our shareholders. However, we see no potential shareholder benefits. On the contrary, we see only added complexity and confusion from mandatory premium amortization.

In summary, we believe that the current practice of allowing investment companies to adopt amortization policies that conform to income tax regulations works well for shareholders and results in less confusion and complexity than would be required under a mandatory premium amortization regime.

Sincerely,

David H. Longhurst
Assistant Controller
SAFECO Asset Management Company

Neal A. Fuller
Controller
SAFECO Asset Management Company

(15)

Author: MIME:Anthony_Hynes@capgroup.com at INTERNET
Date: 12/23/98 12:07 PM
Priority: Normal
TO: Sheila Yu at AICPA3
CC: David_Pritchett@smtplink.capgroup.com at INTERNET,
Lori_Malloy@smtplink.capgroup.com at INTERNET,
Tom_Rowland@smtplink.capgroup.com at INTERNET,
Marcia_Gould@smtplink.capgroup.com at INTERNET,
Sheryl_Johnson@smtplink.capgroup.com at INTERNET,
Bob_Simmer@smtplink.capgroup.com at INTERNET
Subject: Comments re: Proposed Audit Guide

Attached please find comments concerning the Proposed Audit Guide and Accounting Guide, Audits of Investment Companies from Capital Research and Management Company. As indicated in the comment letter, we will be following-up with comments concerning Chapter 6 - TAXES in a separate letter.(See attached file: aicpa comment 1298.doc)

If you have questions, please call me at 714-671-7524.

Tony Hynes

CAPITAL RESEARCH AND MANAGEMENT COMPANY
135 South State College Boulevard. Brea. California 92821 - Telephone (714) 671-7000

December 21, 1998

Via E-Mail to syu@aicpa.org; Letter to follow

Sheila H. Yu
Technical Manager, Accounting Standards, File 3170
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Yu:

This letter is submitted in response to the request for comment on the Investment Companies Committee Accounting Standards Division of the American Institute of CPAs Exposure Draft of the Proposed Audit and Accounting Guide - Audits of Investment Companies. Capital Research and Management Company (CRMC) is the investment adviser to the 28 mutual funds in The American Funds Group, to a series of funds whose shares are offered only to tax-exempt investors and to series of funds that serve as the underlying investment vehicles for variable insurance contracts. Currently, CRMC has more than $100 billion in assets under management.

Provided below are comments concerning all sections of the Proposed Guide except Chapter 6 - TAXES; we will be providing Chapter X comment in a separate letter.

Comments concerning proposed changes to Audit Guide (included in Chapter 12 - BASIS FOR CONCLUSIONS)

A. PREMIUM AMORTIZATION

We oppose mandatory amortization of bond premium for the following reasons:

1. Premium amortization remains an election for federal income tax purposes. Because of the pass-through nature of investment companies, tax treatment should be a strong consideration in determining the accounting treatment of investments.

2. To the extent a fund does not elect to amortize bond premium for federal income tax purposes, income earned on a GAAP basis may not agree with dividends paid to shareholders (which are made based on tax-basis income). Such book-tax differences may lead to shareholder confusion.

3. Mandatory amortization of bond premium may require modification of accounting and computer systems, which may result in increased costs to shareholders.

4. Requiring bond premium amortization for book purposes would not make for more meaningful earnings comparisons across funds because the SEC yield computation already implicitly amortizes bond premium.

5. Statement of Position 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies* (SOP 93-2)

provides that investment companies should adjust their books for permanent book-tax differences because book-basis amounts are of little relevance to investment company shareholders. Because it may create additional book-tax differences, mandatory amortization of bond premium appears to be inconsistent with the intent of SOP 93-2.

B. SCHEDULE OF INVESTMENTS

We support the proposal to limit the required disclosure of portfolio securities to (a) each investment (including short sales) constituting more than 1 percent of the fund's net assets, (b) all investments in any one issuer aggregating more than 1 percent of the fund's net assets, and (c) at a minimum, the fifty largest investments. We agree that content and materiality affect the quality of information presented in financial statements and that focusing investors on material items in the financial statements provides more understandable and useful information.

Other comments

A. Chapter 2 - INVESTMENT ACCOUNTS

1. page 33, section 2.112 the last sentence reads "Additionally, the auditor should confirm all unsettled securities purchased with the party responsible for delivery. For those confirmations not received, the auditor should perform alternative procedures deemed appropriate in the circumstances." We suggest that rather than requiring that all unsettled securities purchased be confirmed, auditors should be allowed to determine, based on their professional judgment, whether alternative procedures may provide sufficient audit evidence for them to rely on such procedures.

B. Chapter 4 - CAPITAL ACCOUNTS

1. Sec 4.6 - currently reads: "The distributor typically uses such 12b-1 payments and CDSC receipts to recover the initial commission that it paid for sales of CDSC shares." This sentence should indicate "The distributor typically uses such 12b-1 payments and CDSC receipts as payments to dealers and sales personnel to compensate them for selling and servicing efforts."

2. Sec 4.7 - currently reads: "Because discounts are not provided on sales commissions for back-end load shares, most multiple class funds limit the dollar amount that may be invested by a retail investor in back-end load shares and require those orders over a certain amount to be treated as orders for front-end shares." Delete "most" and indicate multiple class funds "may" limit.

3. Section 4.11- currently reads: "Funds usually do not honor redemptions unless purchases by personal check were made a prescribed number of days before redemption or purchases were made by federal funds." Replace "federal funds" with "wire transfers".

4. Section 4.25 - currently reads: "For closed-end companies, the ex-dividend date is the first day of trading of fund shares under which purchasers will not be entitled to the dividend." This should be reworded to indicate the following: "For closed-end companies, a purchaser typically is not entitled to a dividend for shares purchased on the ex-dividend date."

5. Section 4.39 - discusses the auditor's responsibility for testing sales and redemption of fund shares. Should also include a discussion of testing in the event of reprocessing shareholder transactions resulting from a correction in the net asset value.

6. Section 4.45 - currently reads: "Dividends based on long-term realized gains from security transactions.... Replace "Dividends" with "Distributions".

C. Chapter 5 - COMPLEX CAPITAL STRUCTURES

1. Exhibit 5.3 - Portfolio turnover rate - should be reported to two decimal places for all years reported in accordance with SEC guidance - i.e. 92.xx%.

2. Exhibit 5.73 - see comment for Exhibit 5.3 - report Portfolio turnover rate to 2 decimal places.

D. Chapter 7 - FINANCIAL STATEMENTS OF INVESTMENT COMPANIES

1. page 122, 5th point under Register Investment Companies - phrase in brackets discussing requirements for financial highlights that reads (for semiannual reports, the semiannual period and the preceding fiscal year) should says (for semiannual reports, the semiannual period and the preceding five fiscal years).

2. page 125, section 7.14 reads "An investment company's portfolio should indicate all high-yield and restricted debt securities whose value have been estimated by its directors. We suggest that **all** fair value securities valued by the board should be indicated rather than only high-yield and restricted debt securities.

3. page 125, last sentence in section 7.15 reads "Where a detailed list of short-term investments is presented, such investments may be summarized by issuer, disclosing their ranges of interest rates and maturity dates." It should not be limited to only short-term securities but also be equally applicable to long-term securities.

4. page 128 - typos - a) section 7.29 first word should be capitalized "Investment", b) section 7.13 first sentence two words run together "incomeless expenses" should be "...income less expenses...", c) footnote 20 at bottom of page second sentence should start with capitalized "Investment"

5. page 137, section 7.66 reads " The method of computing the portfolio turnover rate and average commission rate paid is described in the instructions to Forms N-SAR, N-1A, and N-2." The reference to "average commission rate" should be deleted since this is no longer a SEC requirement and not listed as additional information required in section 7.65.

E. Chapter 8 - OTHER ACCOUNTS AND CONSIDERATIONS

1. page 165, section 8.33 regarding business combinations discusses considerations in determining if the "legal survivor" entity is the same as the "accounting survivor" entity of a merger. But there is no discussion or guidance on the course to follow if its determined that the fund legally dissolved should be considered the accounting survivor. Guidance should be added.

We hope our comments on the Proposed Guide are of benefit to the Committee and AcSEC. If you have any questions, please call Anthony Hynes at 714/671-7524.

15

Sincerely yours,

R. Marcia Gould
Vice President, Fund Business Management Group

Anthony W. Hynes, Jr.
Vice President, Fund Business Management Group

Sheryl Johnson
Vice President, Fund Business Management Group

Robert P. Simmer
Vice President, Fund Business Management Group

David Prichett
Associate, Fund Business Management Group

Lori Malloy
Associate, Fund Business Management Group

ERNST & YOUNG LLP
1285 Avenue of the Americas
New York, New York 10019
Phone: 212 773 3000

December 24, 1998

Ms. Sheila Yu, Technical Manager
Accounting Standards, File 3170
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Proposed Audit and Accounting Guide
Investment Companies

Dear Ms. Yu:

We support the timely issuance of the Proposed Investment Companies Audit and Accounting Guide ("the Guide"). The current industry guide available to practitioners is outdated and as such, does not consider numerous accounting and audit pronouncements relevant to investment companies, most of which have been addressed in the Guide. Our comments that we believe warrant revisions to the Guide prior to its issuance are discussed below.

References to FASB Statements

As indicated on page 39, paragraph 3.1, the Guide recommends consideration be given to certain Financial Accounting Standards Board (FASB) statements in determining the appropriate accounting and financial reporting of financial instruments, including:

- FAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk*,
- FAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, and
- FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Similar references are made to FAS Nos. 105 and 119 on page 138, paragraph 7.69 and page 154, footnote 26. FAS No. 133 is effective for fiscal years beginning on or after June 15, 1999. We suggest the Guide state that FAS No. 133 will supersede FAS No. 105 (certain requirements of which are now included in FAS No. 107, *Disclosures about Fair Value of Financial Instruments*) and FAS No. 119. Further, we encourage updating the Guide to reflect the impact and related changes to existing guidance resulting from FAS No. 133, particularly with regard to the new disclosure requirements and the extent of their applicability to investment companies.

Financial Highlights

Paragraph 7.62 states that the "Financial highlights should be presented in the financial statements for each class of common shares outstanding...". The financial highlights is required pursuant to requirements for SEC filings (Form N-1A and N-2). Since the 1998 SEC rule amendments to Form N-1A now allow for financial highlights of a single class only to be disclosed in class-specific prospectuses, flexibility should be allowed for those annual and semi annual reports which are clearly applicable to only a single shareholder class. Currently, the financial statements of some multiple class investment companies report only class-specific financial highlights to shareholders. As financial highlights are not part of the basic financial statements per AU Section 551.02, paragraph 7.62 should be modified to allow investment companies with multiple share classes to present financial highlights only for those classes of shares included in the semi annual or annual reports for such shareholders. Disclosure that financial highlights for other shareholder classes are included in class-specific reports should be required in the footnotes to the financial highlights.

Management's Representations

An illustrative management representation letter for investment companies is provided beginning on page 213, paragraph 11.23. The existing letter does not include a specific representation related to management's responsibility to identify Passive Foreign Investment Companies (PFICs). It is common practice for management to be responsible for the identification of PFICs (unless a fund's administrator assumes such responsibility). We encourage adding this representation in the illustrative letter to clarify responsibility for PFIC identification.

Capital Contributions

Paragraph 7.67 indicates that contributions received from a fund's adviser to voluntarily reimburse the fund for the effect of a loss (realized or unrealized) on a portfolio investment that declined in value should be reported as a capital contribution. We believe that when the adviser is not a shareholder the appropriate accounting is to recognize the reimbursement as a separate item in the statement of operations with full disclosure consistent with the accounting treatment in paragraph 7.68 for payments made pursuant to a violation of an investment restriction. Capital contributions represent, and should only be used for, amounts received from shareholders.

****

Attachment A to this letter includes our comments on other specific issues.

We would be pleased to discuss our comments and recommendations with members of the Accounting Standards Executive Committee or its staff.

Sincerely,

Ernst + Young LLP

Ernst & Young LLP

(17)

Attachment A

"Investment Companies"

Other Comments on Specific Issues

Reference	Discussion
Page 4, 1.15	This paragraph defines incentive fees and how they are structured. However, no specific accounting guidance is provided regarding how and when to accrue for these fees at the fund level based on how the fee is received by the advisor (i.e., over a specified period of time such as three years). Consideration should be given to providing accounting guidance on the fees.
Page 7, 1.23b	This paragraph describes the registration statement for open-end investment companies, Form N-1A, and related filing requirements. Due to the adoption of SOP 98-5, *Reporting on the Cost of Start-Up Activities*, a statement of operations may be required to be filed with the "seed capital" statement of assets and liabilities. We suggest providing guidance on when a statement of operations for the period prior to the commencement of investment operations or sale of shares to the public should be provided in the initial filing of Form N-1A. In addition, we recommend the Guide clarify the proper accounting and reporting for organization costs incurred prior to the commencement of operations. Under current practice, an investment company that bears its organization costs and that presents a statement of operations only from the commencement of investment operations or sale of shares to the public would not reflect the organization costs as an expense.
Page 8, 1.25	This paragraph states that financial highlights included in registration statements and reports for closed-end funds should be provided for the preceding ten fiscal years. The SEC has made formal statements that, consistent with amendments to Form N-1A issued in April 1998, closed-end funds are required to provide financial highlights for the preceding five years, not ten.

Page 45, 3.27	The second "bullet" describes the risks to the writer of an uncovered (i.e., "naked") call option. A registered investment company may violate Section 18 of the Investment Company Act of 1940 ("the 1940 Act") if the option is not covered. Consideration should be given to expanding the Guide to include discussion on the necessity to "cover" this type of position and how this may be accomplished (i.e., purchase the underlying securities or segregate cash and/or assets in an amount equal to or greater than the exposure).
Page 63	Chapter 5 provides guidance on complex capital structures. We suggest including a description, accounting guidance and required disclosures for preferred stock of closed-end funds.
Page 64, 5.4	This paragraph defines commonly used multiple classes of shares. Reference to conversion features between classes should be considered.
Page 64, 5.9	This paragraph states that because certain expenses are charged to the classes of shares differently, NAV per share and dividends per share must be calculated separately for each class of shares. This statement should be reconsidered as in practice some multiple class money market funds that follow Rule 2a-7 of the 1940 Act (and therefore maintain a stable $1.00 NAV and distribute dividends daily) calculate only one NAV.
Page 81	Exhibit 5.3 illustrates footnote disclosure for a multiple class fund. Consider including reference to conversion features of classes in footnote 1 and a share conversion example in footnote 2.
Page 107, 6.61	This paragraph describes how equalization debits are applicable to distribution requirements. Consideration should be given to including guidance requiring that when equalization debits are used for tax purposes and are determined to be significant relative to overall distributions, disclosure of the policy along with related amounts should be included in the financial statements.
Page 123, 7.6	This paragraph describes the general consolidation requirements for master-feeder arrangements for registered and non-registered investment companies. Specifically, the paragraph states that public investment companies organized as master-feeder structures must provide master financial statements with each feeder financial statement pursuant to SEC requirements. However, the SEC staff has stated that master financial

statements should be provided if either of two criteria are met: first, if greater than 50% of the feeder's net assets at year end were invested in the master and secondly, if greater than 75% of the feeder's average net assets during the year were invested in the master. We recommend including this specific guidance in the Guide.

Page 122, fn 4
Page 196, fn 6 — The footnotes refer to specific instruction "items" for Forms N-1A and N-2. Amendments to Form N-1A in April 1998 and comments made by the SEC staff on Form N-2 subsequent to the issuance of this guidance have resulted in changes to the "items" reference. These references should be updated to reflect the current SEC position.

Page 125, 7.15 — This paragraph states that securities pledged as collateral should be identified in the financial statements. Consideration should be given to more clearly defining "identified" or providing examples of accepted practice (e.g., specifically identifying each security on the schedule of investments or disclosing the total of securities pledged in a footnote to the schedule of investments).

Page 130, 7.40 — This paragraph discusses various expense offset arrangements. Consideration should be given to adding a discussion on unitary fee arrangements.

Page 141 — Exhibit 7.75 illustrates an example of financial statements for investment companies. As management/advisory fees are the most significant expense to a fund, we suggest including a related liability for management/advisory fees on the balance sheet of the example financial statements.

Chapter 8 — We recommend providing a general discussion of the auditor's SAS 8 responsibilities where audited financial statements and opinions are included in other documents such as annual reports, registration statements and proxies where other unaudited financial and performance information (e.g., line graph, MD&A) are included.

Page 159, 8.6 — This paragraph discusses distribution expenses and rule 12b-1 plans pursuant to the 1940 Act. Sometimes contingent deferred sales loads ("CDSLs") are assessed redeeming or exchanging shareholders and such amounts are received by the fund. Reference should be made in the Guide to current SEC staff guidance which requires that, in such circumstances, the

(17)

CDSL fees should be offset against rule 12b-1 expenses in the statement of operations.

Page 194, 11.1 — Consideration should be given to reiterating that financial reporting for publicly registered investment companies is governed by Rules of the SEC (e.g., Regulation S-X) and that there may be differences between the Guide and SEC rules.

Page 196, 11.6 — This paragraph discusses the scope paragraph of the audit opinion in situations where confirmations to brokers or other alternative procedures are used to verify existence of securities of the fund. Consideration should be given to including the following language when broker confirmations are not received and alternative procedures are performed: "...and brokers *or by other appropriate auditing procedures where replies from brokers were not received*".

Page 205, 11.14 — These paragraphs illustrate examples of certain reports required by the SEC under Form N-SAR, Rules 17f-1 and 17f-2 of the 1940 Act and Rule 206(4)2 of the Investment Advisers Act of 1940, and reports required by closed-end fund security rating agencies, and reports on processing of transactions by transfer agents pursuant to SAS No. 70 and rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934. These reports have been updated to reflect SAS 82, *Consideration of Fraud in a Financial Statement Audit* and SAS 85, *Management Representations.* The last paragraph needs to be updated to reflect changes required by SAS 87, *Restricting the Use of an Auditor's Report.*

Page 223, 12.26 — This paragraph states that AcSEC recognized that requiring a UIT to charge its offering costs to paid-in capital at the commencement of its offering (similar to a closed-end fund) or immediately after its units or shares are sold to the underwriters would require the underwriters, and not the shareholders, to bear these costs. AcSEC concluded that those offering costs should be charged to paid-in capital on a pro rata basis as the sale of those units by the UIT occurs. However, the last sentence of the paragraph states the AcSEC concluded that the capital raising effort of the UIT was completed upon the sale of the units to the underwriters. The conclusions appear inconsistent as it would appear that the underwriters would bear the costs of the offering and not the initial UIT holders as the units are sold during the primary offering period. Consideration should be given to clarifying the conclusion.

(17)

Page 230, fn 2 — The footnote specifies that the 30% short-short test is not applicable for tax years beginning after August 5, 1997. The Guide is not anticipated to be effective until fiscal years beginning after December 15, 1999, therefore, the test would no longer be required and reference to the test should be removed.

NJSCPA
New Jersey Society of Certified Public Accountants
1898 • 1998 • 100 Years and Beyond

425 Eagle Rock Avenue
Roseland, New Jersey 07068-1723
(973) 226-4494
Fax (973) 226-7425
FaxCPA (973) 364-0380
http://www.njscpa.org
e-mail: njscpa@njscpa.org

BOARD OF TRUSTEES

PRESIDENT
KENNETH W. MOORE
MOORE, COSTELLO & CO., LLC

PRESIDENT-ELECT
DANIEL J. MEEHAN
ARTHUR ANDERSEN LLP

IMMEDIATE PAST PRESIDENT
DONALD R. RICHARDS
ERNST & YOUNG LLP

VICE PRESIDENTS
JOHN F. DAILEY, JR.
BOWMAN & COMPANY LLP
JAMES E. HEALEY
NABISCO, INC.
JOHN M. LAPILUSA
ABRAMSON, LAPILUSA, SCHWARTZMAN & WEINSTEIN
THOMAS F. ROCHE III
FAZIO, MANNUZZA, ROCHE, TANKEL, D'ANGERIO, L.L.C.
JOSEPH H. SCHWENDT
J.H. SCHWENDT, CPA

SECRETARY
KENNETH E. THOMPSON, JR.
OLSEN & THOMPSON, P.A.

TREASURER
MICHAEL A. POLITO
DELOITTE & TOUCHE LLP

EXECUTIVE DIRECTOR
MERRYL A. BAUER
NEW JERSEY SOCIETY OF CPAS

TRUSTEES
FRIEDA T. ABOYOUN
COOPERS & LYBRAND LLP
LONNY E. BASSIN
MACKLER, BASSIN & COMPANY LLP
MARY T. CARPENTER
BACKOFFICE ASSOCIATES, INC.
DONALD E. CHEATLE
FORD, SCOTT, SEIDENBURG & KENNEDY
KATHLEEN M. CLAYTON
MOORE STEPHENS, P.C.
WILLIAM M. COLLISTER
GINGRAS, COLLISTER, BABINSKI & CO.
JOHN A. DEMETRIUS
DEMETRIUS & COMPANY, L.L.C.
HOWARD P. DORMAN
COHEN, FRIEDMAN, DORMAN, SPECTOR & CO.
LINDA L. FASANO
CURCHIN & COMPANY
MERYL B. GREENWALD
M. GREENWALD ASSOCIATES
JAMES T. KALLAS
JAMES T. KALLAS, CPA
STEVEN KESSLER
STEVEN KESSLER, CPA
ERIC G. KOCH
BERRY, VERDUIN, KOCH & COMPANY
MICHAEL C. LEFANTO
CHAZOTTE LEFANTO & CO., P.A.
JOSEPH P. PALUSCIO
JOSEPH P. PALUSCIO, CPA
MARK H. ROTH
NEW YORK CRUISE LINES, INC.
JOSEPH F. SCUTELLARO
JUMP, GREEN, HOLMAN & CO.
ALAN D. SOBEL
SOBEL & CO. LLC
CARL SPECHT
BERGEN COUNTY COMMUNITY ACTION PROGRAM, INC.
RALPH ALBERT THOMAS
CITIBANK, N.A.

December 17, 1998

Ms. Shelia H. Yu
Technical Manager
Accounting Standards, File 3170
AICPA
1211 Avenue of the Americas
New York, NY 10036-8778

Dear Ms. Yu:

The Auditing and Accounting Standards Committee (the "Committee") of the New Jersey State Society of Certified Public Accountants ("NJSCPA") is pleased to submit its comments on the AICPA Proposed Audit and Accounting Guide, *Audits of Investment Companies* ("The Exposure Draft"). The views expressed in this letter represent the majority of a quorum of the members of the committee and are not necessarily indicative of the full membership of the NJSCPA.

We believe that the Exposure Draft is a comprehensive and helpful tool for auditors of investments companies. We have, however, some specific comments that we believe should be considered:

1. Footnote #4 to ¶1.5 describes a FASB's concern regarding clarity of the scope of the proposed guide, AcSEC responded that they plan to develop a separate SOP to clarify the scope. We suggest that implementation of the guide be postponed until such scope is clarified.

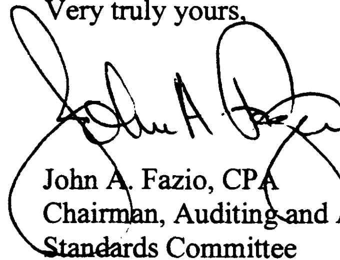
2. There appears to be some inconsistency of presentation.. For example, chapters 2 and 4 have a section on "Audit Procedures" whereas chapter 5 has "Audit Considerations" and chapter 8 has "Other Accounts and Considerations". Furthermore, consideration might be given to either reformatting these sections or including actual pro forma audit programs that practitioners could use as practice aids.

3. Chapter 6 deals with the tax issues involving investment companies, i.e. ordinary vs. capital. This breakout appears to be required in a footnote (page 154). The guide should consider stating specifically what the auditor's responsibility is as to this categorization.

18

4. ¶2.131 deals with pricing by bond dealers or other pricing services. The guide should make it clear that the guidance in ¶2.130 regarding SAS #70 would apply here.

Very truly yours,



John A. Fazio, CPA
Chairman, Auditing and Accounting Standards Committee

cc: Daniel J. Meehan, CPA, President
Paul V. Stahlin, President-Elect
Merryl A. Bauer, Executive Director

(18)

December 16, 1998

Ms. Sheila H. Yu
Technical Manager, Accounting Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

California Society
Certified Public Accountants

RE: File 3170: Proposed Audit and Accounting Guide, *Audits of Investment Companies* (To supercede AICPA Audit and Accounting Guide, *Audits of Investment Companies* and Statement of Position 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies)*

Dear Ms. Yu:

The Accounting Principles and Auditing Standards (AP&AS) Committee of the California Society of CPAs has discussed the exposure draft of the proposed Audit and Accounting Guide, *Audits of Investment Companies* and would like to comment on it.

The AP&AS Committee is the state society's senior technical committee. The committee is composed of 52 members, of whom 8 percent are from national CPA firms, 63 percent are from local or regional firms, 19 percent are sole practitioners in public practice, 6 percent are in industry and 4 percent are in academia.

The AP&AS Committee supports issuance of the proposed Audit Guide but feels that the guide could be improved by following the format utilized in the proposed Audit and Accounting Guide, *Life and Health Insurance Entities* for those paragraphs dealing with auditing. The format utilized in the proposed Audit and Accounting Guide, *Life and Health Insurance Entities* for sections dealing with auditing mirrors the Statement of Accounting Standards No. 78. The sections include paragraphs dealing with the five components of internal control (control environment, risk assessment, control activities, information and communications and monitoring) and conclude with audit consideration charts.

The AP&AS Committee requests clarification of the accounting treatment of tax opinion costs incurred by a new investment company offering shares for sale. Paragraphs 8.22 through 8.24 of the proposed guide describe and summarize the accounting treatment of certain organizations and offering costs. These paragraphs are silent as to the treatment of tax opinion costs that the committee believes may be significant to an investment company. The AP&AS Committee therefore request clarification and inclusion of these tax opinion costs in the proposed guide.

We, on the AP&AS Committee, appreciate the opportunity to respond and would be pleased to discuss our comments further.

Very truly yours,

A Mintzer

Andy Mintzer, Chair
Accounting Principles and Auditing Standards Committee

AM/JJH:sm

c: James R. Kurtz, Executive Director
Diana Sanderson, President

275 Shoreline Drive
Redwood City, CA
94065-1407

(650) 802-2486
www.calcpa.org

19

COMMODITY FUTURES TRADING COMMISSION
300 South Riverside Plaza, Suite 1600 North, Chicago IL 60606
Telephone: (312) 353 - 5990
Facsimile: (312) 353 - 7946
Facsimile: (312) 353 - 3690

DIVISION OF
TRADING AND MARKETS

December 22, 1998

Ms. Sheila H. Yu, Technical Manager
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File 3170, Proposed Audit and Accounting Guide: *Audits of Investment Companies*

Dear Ms. Yu:

Paragraph 7.16 of the above-referenced proposed guide requires that investment partnerships that are exempt from SEC registration under the Investment Company Act of 1940 must disclose the details of any investment which exceeds 5 percent of the entity's net assets. The term "investment partnerships" is defined to include "hedge funds, limited liability companies, limited liability partnerships , limited duration companies, and offshore investment companies with similar characteristics." The entities mentioned in this definition are in many cases regulated by the Commodity Futures Trading Commission, as they are deemed to be commodity pools under the Commodity Exchange Act of 1974. However, footnote 14 to the paragraph exempts commodity pools that are subject to regulation under the Commodity Exchange Act of 1974 from this disclosure requirement. Many hedge funds which are regulated as commodity pools have large investments in securities positions and, absent the exemption provided by footnote 14, would have been required explicitly to comply with the disclosure requirement. Our routine review of hundreds of pool annual reports has given us reason to believe that this exemption may be responsible for the non-disclosure of material information in the financial statements of many commodity pools. Therefore, it is the view of the Division that it would be in the public interest to end this exemption.

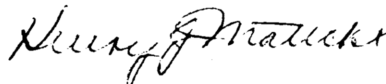
In addition to highlighting this problem with the proposed guide, the recent problems involving Long Term Capital Management and other so-called hedge funds have shown the need for consideration of improved disclosure by hedge funds. The disclosure issues which should be addressed are not just with respect to investments in securities. Hedge funds conduct investment and trading activities of a broad range, including over-the-counter derivatives. The

10

Commission and other financial regulators have expressed their concerns regarding the level of disclosure provided by these entities regarding all of their risk exposures. To our knowledge the American Institute of Certified Public Accountants ("AICPA") has no project currently underway to address this problem. Accordingly, we believe it would be in the public interest if the AICPA would initiate a project in this connection. Ideally, the project would encompass disclosures in connection with all sources of entity risk exposure, including cash securities and commodities, futures and options on futures, forwards, and over-the-counter derivatives, as well as strategies which utilize a combination of instruments. The Commission staff provided considerable assistance to the Stockbrokerage and Investment Banking Committee in its development of the just-published audit practice aid, *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*. We would welcome the opportunity to participate in an AICPA project to address hedge fund disclosure issues, perhaps in the form of a Statement of Position in this area.

The views expressed herein are the views of the Division of Trading and Markets only and are not necessarily shared by the Commission or other Divisions of the Commission. Please call Paul Bjarnason, the Commission's representative on the AICPA Stockbrokerage and Investment Banking Committee, at 202-418-5459 if there are any questions about our views or if we can be of any further assistance.

Sincerely,



Henry J. Matecki
Acting Chief Accountant

(20)

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
1177 Avenue of the Americas
New York NY 10036
Telephone (212) 596 8000
Facsimile (212) 596 8910

December 22, 1998

Ms. Shiela Yu
Technical Manager, Accounting Standards, File 3170
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Yu:

We appreciate the opportunity to comment on the Exposure Draft of the AICPA Proposed Audit and Accounting Guide, *Audits of Investment Companies*, dated September 22, 1998 ("the Guide" or "ED"). The body of this letter will focus on certain key issues raised in our review of the Guide. Accompanying this letter as Attachment I are detailed comments relating to specific paragraphs within the Guide.

Statement of Operations

The investment company statement of operations is unique in presenting an intermediate operating result ("net investment income") before its bottom line ("net increase/decrease in net assets resulting from operations.") We believe that the concept of net investment income is no longer meaningful:

1) Investors are increasingly oriented towards total return and operating expense ratios.
2) To the extent (which we believe is decreasing) that investors are interested in the income component of return at a point in time, the SEC has developed a standardized yield computation which provides for point-in-time comparability across funds, regardless of fiscal year ends.
3) As GAAP net investment income has increasingly diverged from ordinary income for federal income tax purposes, net investment income has become a far less reliable proxy for taxable income. This is evidenced by other revisions to the model financial statements in the Draft Guide, such as consolidating shareholder distributions (other than tax returns of capital) and retained earnings into single line items.
4) The advent of new fund structures (particularly funds-of-funds, which do not directly earn interest and dividends from investment securities, but only recognize investment income when and if dividends are paid by investee funds) and new investments, such

as swaps, have blurred the distinctions between investment income and capital gains, making it more difficult to attribute results of operations between the two.

We have included as Attachment 2 to this letter a revised version of the model statement of operations reflecting this proposed change. While we believe that this model would improve financial reporting for all investment companies, we recognize that it would not necessarily be consistent at present with the format prescribed in Article 6 of SEC Regulation S-X for registered investment companies, and that confusion might result if registered and non-registered companies used substantially different presentations. Accordingly, we believe that the Committee should, preferably, encourage the SEC to first adopt this model for registered investment companies and, if adopted by the SEC, subsequently permit its use by non-registered companies.

Amortization of Premiums and Discounts

Conceptually, we agree that premiums and discounts on investment securities should be amortized by investment companies, as is currently required for reporting entities outside of a value accounting environment under various FASB statements. However, as the current Guide states, neither net asset value nor results of operations are affected by such reclassifications in a value accounting environment. As noted in the above comment regarding the format of the statement of operations, we believe that investors are increasingly oriented towards total return and the distinction between income and gains is accordingly less relevant to users of the financial statements. On that basis, we recommend that the Committee reconsider the benefits which will be achieved from the proposed requirement to amortize premiums and discounts, in light of the difficulties which preparers of financial statements anticipate in implementing this change.

Auditor's responsibilities – compliance

Chapter 2 of the ED appropriately updates the discussion of the auditors' responsibility to assess an investment company's compliance with the terms of its prospectus or offering document and relevant laws and regulations to conform to Statement on Auditing Standards No. 54 "Illegal Acts by Clients", which was issued after the last comprehensive revision to the Guide in 1986. We believe that the current Guide, which suggests that an objective of an audit is to obtain 'a reasonable assurance that the investment company has complied with restrictions under its stated investment objectives and policies', does not provide usable guidance to auditors as to the nature and extent of audit procedures required. The auditor is not in a position to assess compliance with every potential prospectus or regulatory provision which may apply to an investment company, many of which require an extensive knowledge of the law or of finance and portfolio theory, and which often turn on difficult judgmental

questions upon which even legal and investment professionals legitimately disagree. The revised ED guidance properly requires the auditor to consider the investment company's program to prevent, deter or detect noncompliance, thereby focusing the resolution of issues on those best suited to respond to them.

However, we have noted that inconsistencies remain in the ED relative to this issue. For example, paragraph 2.111 states in part "Typically, the auditor tests whether the fund is adhering to certain of its investment restrictions. For a diversified investment company, the auditor should review and test compliance with the related provisions of the 1940 Act." We believe the guidance in paragraphs 2.100 and 2.101 is sufficient and the above noted sentences in paragraph 2.111 should be deleted.

Auditor's responsibility – custody

Although paragraphs 2.107 through 2.109 use the word "consider" throughout when discussing possible audit procedures, it appears to imply an extensive degree of auditor responsibility to review controls at the custodian, much greater than that necessary to obtain reasonable assurance about the investment company's ownership of its assets. We understand the Auditing Standards Board is currently undertaking a project to clarify an auditor's responsibilities when investments are held by a third party. We recommend that these paragraphs be updated upon the completion of that project.

Financial highlights

The ED requires the presentation of "financial highlights." The Guide should clarify that this information is not a primary financial statement and can be presented either as a separate schedule or as part of the notes to the financial statements.

The SEC staff currently permits registered investment companies to disclose financial highlights for only the class of shareholders to which a set of financial statements is directed. Since the only parties likely to be concerned with financial highlights are the shareholders or prospective investors in that class, we believe the ED should permit this approach.

We have also identified significant operational difficulties in applying the financial highlights guidance to private investment companies, such as the following:

- Many private investment companies have "high water mark" incentive arrangements under which an investor's return can be materially affected by the timing of the investor's transactions in prior years. In this circumstance, a single

set of financial highlights might report results that are materially inconsistent with the actual experience of many investors.

- Other private investment companies have a large number of individualized incentive arrangements. In this circumstance, disclosure of financial highlights for each class of investor might differ little from reporting the individual returns of each investor in the financial statements. We do not believe this result was intended, and we are concerned that it could cause substantial confusion by forcing the user to search for meaning from numerous competing highlights presentations within a single set of financial statements.

In the absence of specific guidance for computations in the Guide under these and similar circumstances, we are concerned that investment company financial statements might, in an attempt to simplify the financial highlights presentation, present either substantially inconsistent data (e.g., highlights for a "representative" account) or, in effect, *pro forma* data (e.g., total return for a period less an incentive charge actually experienced by no investor). We believe the ED needs to provide detailed guidance to ensure that the computations are workable and the presentation meaningful and consistent in these complex situations.

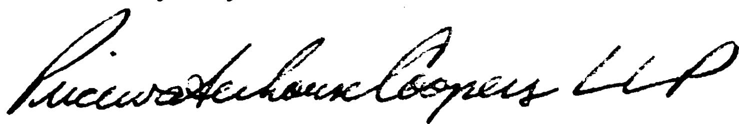
Implementation date

If the requirement to amortize all premiums and discounts is adopted, we recommend a one-year delay in the effective date as it relates to that requirement. We believe this delay is appropriate both to ensure that adequate system resources are available to accommodate the change and that there is an opportunity to explore ways of decreasing its cost. In particular, we do not believe that investment companies should be required to divert resources away from Year 2000 projects, which have high priority throughout the industry, to address this matter which at most only affects classification of items within the statement of operations.

* * *

We would be pleased to discuss our comments with you further; please contact Arthur Tollefson at (212) 596-8437 should you wish to do so.

Yours very truly,



PricewaterhouseCoopers LLP

Attachment I

DETAILED COMMENTARY

General

Unless otherwise indicated, quotation marks indicate text from the ED, with markings to indicate suggested changes.

We understand that the Investment Companies Committee will make conforming changes for new GAAP pronouncements such as SFAS 133 and we have not commented upon such changes herein.

We note that model financial statements throughout should use year 200X.

Chapter 1

1.23(b) At the end of the second sentence add – "...and, in some cases, a statement of operations, principally to reflect the incurrence of initial organization costs."

Chapter 2

2.3 First bullet – "The percentage of the investment company's assets it may invest in the securities of a single issuer, or in issuers of a specific country, geographic region, or industry."

2.6 Footnote 3 should also refer to section 2(a)(5) of the 1940 Act.

2.8 Add to footnote 6 the following sentence – "The SEC staff currently considers the use of an affiliated bank as a custodian to constitute self-custody for purposes of Rule 17f-2."

2.9 First sentence should read – "... the SEC requires a registered investment company to designate certain assets as segregated, either with its custodian or in its accounting records." Also, a footnote should refer to the November 7, 1997 letter by the SEC Division of Investment Management Chief Accountant, which provided for designation in accounting records.

2.21 Insert as second sentence – "For financial reporting purposes, transactions should be recorded on trade date."

2.23 First sentence – "... should also reflect expenses, interest and other income through the date of calculation."

2.36 Second bullet should read – "Business and financial plan of the issuer and comparison of actual results to the plan."

2.39 Third sentence should read – "An estimate of fair value different than reliable market quotations..."

2.41 Add second sentence to footnote 21 – "For purposes of this discussion, LIFO and FIFO are considered variations of the specific identification method."

Attachment I (continued)

2.43 End the second sentence after "reorganizations." Replace the third sentence with – "For financial reporting purposes, a portion of the cost of securities held should be allocated to the securities received in the spin-off."

2.50 While cash paid for preferred dividends in arrears should be considered for separate disclosure, it should not be considered other income.

2.64 Add a second sentence to footnote 25 – "This Statement also describes the circumstances under which collateral received in connection with such an arrangement should be recognized on the statement of assets and liabilities of the lender."

2.64 "Cash is received as collateral which is usually invested in short-term high quality debt instruments." The following should appear immediately after – "In such cases, a negotiated amount of interest on cash collateral is returned to the borrower as a 'rebate', and the balance is retained, after transaction expenses, by the fund as its lending compensation. Prevailing practice is to offset rebates and transaction expenses against interest earned on cash collateral, and not to present those amounts as operating expenses."

2.71 This and the next paragraph regarding considerations when valuing securities in certain foreign markets should be cross-referenced to paragraphs 2.33 and 2.39 regarding the reliability of market quotations.

2.104 The first and second bullets are not audit objectives in and of themselves, but rather means to gain assurance as to the assertion in the fifth bullet. They should be deleted.

2.109 Insert as a fourth sentence – "The principal custodian may perform oversight procedures that are relevant to the auditor when considering whether and to what extent such audit techniques should be applied to subcustodians."

2.110 Add a bullet – "Comparison of interest earned with rebates paid, and a requirement to record material earnings from lending activities on a timely basis."

2.112 Move footnote 31 into the text to increase its prominence.

2.113 Add a bullet – "Loan participations or assignments with the agent bank or assignee."

2.113 Add as a last bullet – "Collateral maintained with third parties in connection with each of the above."

2.115 This section, 2.116 and 2.124 appear to require that transactions be tested. An auditor may obtain sufficient satisfaction through testing of selected controls and year end substantive procedures. Replace "test" with "consider testing."

2.122 Delete the last sentence. This disclosure is not required by GAAP.

2.126 Move footnote 37 into the text to increase its prominence.

Attachment I (continued)

2.131 Consider adding a bullet – "Periodic review of pricing information by portfolio managers and other knowledgeable officials."

Chapter 3

3.6 The definition of a reverse repurchase agreement is incorrect (relative to common usage among registered investment companies) and should read – "A reverse repurchase agreement (reverse repo or resale) is, in its simplest form, the sale of a security with an agreement to repurchase the same or substantially the same security from the same counterparty at a later date at a fixed price." The headings in front of 3.4 and 3.6 should be switched.

3.7 Consider adding a second sentence – "These securities clear through book entry form at the Federal Reserve Bank"

3.7 Consider revising second bullet – "Intermediate securities with original maturities of two to ten years."

3.7 Consider revising third bullet – "Long term debt instruments with original maturities of ten years or longer issued in minimum denominations of $1,000."

3.7 Consider adding a bullet on stripped Treasury securities – "*Stripped Treasury Securities* – Strips are defined as Separate Trading of Registered and Principal Securities (STRIPS). Certain treasury bonds and notes may become Strips when coupon payments are separated from the principal and sold as securities."

3.8 Consider adding as an introductory sentence – "Municipal securities are issued by states, cities, and other local government authorities to fund public projects. The interest on these bonds is normally exempt from federal taxes and under certain conditions is exempt from state and local taxes."

3.8 Consider referencing prerefunded bonds and VRDN's since they are common types of investments and have some distinguishing features – "Prerefunded bonds are collateralized by securities or U.S. treasury obligations. Since many of these are guaranteed by treasury obligations they often maintain a AAA rating and may trade at a premium to municipal bonds." "Variable Rate Demand Notes are floating rate instruments with frequent reset coupon rates and usually have a put feature."

3.14 Third sentence should read – "When-issued securities for which the fund has not taken delivery are required to be identified in a registered investment company's financial statements"

3.16 Revise second sentence to the following – "In some instances the mortgage originator will continue to service the underlying mortgage or the servicing may be sold to a subsidiary or another institution."

3.16 Consider revising the sixth sentence – "Most MBSs are guaranteed in a variety of forms including...."

Attachment I (continued)

3.16 Consider revising the eighth sentence – " FNMA is a publicly owned U.S. Government sponsored agency that purchases mortgages, including mortgages backed by the Federal Housing Administration or guaranteed by the Veterans' Administration and other conventional mortgages."

3.16 Add to end of last sentence – "by the U.S. Treasury."

3.16 Consider adding a paragraph on paydowns and time lags – "Pass – through mortgages pay principal and interest based on a delay depending on their type. The delay is 45 days for GNMAs, 55 days for FNMAs and 75 days for FHLMCs (45 days for gold FHLMCs)."

3.18 Revise fifth line – "Typically, ARM rates are reset……"

3.19 First bullet revise first line – "A CMO bond is a bond collateralized by either a pool of pass-through securities or a pool of mortgage loans and issued in several tranches."

3.21 Consider providing more description on high yield securities, adding a second and third sentence – "Some coupon features on high yield debt securities include paying a fixed rate or deferring interest until maturity or some other period. Commonly seen in many of these securities are call or sinking provisions, stepped up rates or PIK coupon payments."

3.22 Consider deleting entire paragraph, as it constitutes piecemeal guidance on a regulatory computation.

3.27 Bold **Call** and **Put option** since they are defined in the glossary.

3.27 Consider adding after last bullet – "The maximum amount a buyer could lose is the option price. The maximum profit the writer can realize is the option price."

3.27 Add after second sentence in first paragraph – "Options may be exchange traded or over the counter."

3.27 Add after the third sentence in the first paragraph – "Options can be written on a variety of instruments, indices or currencies."

3.30 Update to reflect 1940 Act Rule 17f-6 – "A fund may place and maintain cash, securities, and similar investments with a Futures Commission Merchant, as defined in Rule 17f-6, in amounts necessary to effect the fund's transactions in commodity futures contracts, options on commodity futures contracts and options on physical commodities, subject to certain conditions mentioned in Rule 17f-6."

3.32 Footnote 8 –first line should say – "Rule 4.5 under the Commodity Exchange Act generally excludes……."

3.32 Footnote 8 –last sentence revise – "The auditor should become familiar with those regulations as they relate to commodity pool operators."

Attachment I (continued)

3.32 Last sentence revise – "For futures contracts, the date is a specified delivery month and the contract is typically settled……"

3.34 Second sentence – "The ledger reflects only the cash margin deposit and the daily mark to market for variation margin."

3.35 Change third sentence to read – "In those cases, the restriction on the Treasury bills should be disclosed in the fund's schedule of investments." (Delete "marketability of.")

3.36 See comment on 3.30 – "Alternatively, Rule 17f-6 of the 1940 Act allows an investment company to maintain variation margin and initial margin collateral with a Futures Commission Merchant, providing a minimal amount is maintained and all excess amounts are removed."

3.37 Consider discussing how a forward contract can be distinguished from a delayed delivery trade with an asset and liability grossed up.

3.37 Consider deleting the remainder of the second sentence after "exchange."

3.41 Consider adding – "Trade date is the date of the commitment to enter into the swap. Interest begins accruing on the effective date and cash flows are exchanged on the settlement date."

3.41 Consider discussing equity swaps by adding a paragraph or linking to an existing one – "Some funds may enter into equity swaps to manage their exposure to the equity markets. In an equity swap cash flows are swapped based on a commitment by one party to pay interest in exchange for a market linked return based on a notional amount. The market linked return may include, among other things, the total return of a security or index. These agreements involve elements of credit and market risk. Risks include a possibility that no liquid market exists for these obligations, the counterparty may default on its obligation, or unfavorable changes may exist in the security or index underlying the swap."

3.42 Add after the third sentence – "Interest payments are paid or received periodically."

3.46 First sentence should read – ".......agreements to sell and repurchase substantially similar..."

3.46 Discuss credit risks of counterparty. For example add a line – "If the buyer of securities files for bankruptcy or becomes insolvent, the fund's use of the proceeds may be restricted."

Chapter 4

4.1 Amend first bullet to state – "Rules 2a-4 and 12b-1 of the Investment Company Act of 1940."

4.8 There should also be a reference to the internet as a method for shareholders to redeem shares.

4.11 The last sentence should say – "...dates of purchases by personal checks, to avoid subsequent redemptions against uncollected funds."

Attachment I (continued)

4.25 Add to the end of the paragraph – "When large (in excess of 15% of a fund's net asset value, per New York Stock Exchange requirements) dividends are declared, it is the policy of some stock exchanges to postpone the ex-dividend date until the dividend has been paid. In such circumstances the liability for the dividend distribution should be recorded on the books of the fund on payment date."

Chapter 5

We have included as Attachment 3 illustrative financial statements for a fund of funds; we recommend these be included in this chapter.

5.10 Last sentence should begin – "Expenses that are specifically attributed by a fund ..."

5.11 End of paragraph discusses the old IRS – "de minimis" rule. Since that standard no longer exists, this discussion should be deleted.

5.23 Reference to a master's principal office being offshore appears to be no longer applicable due to the repeal of the "Ten Commandments."

5.26 The Guide should indicate that disclosure of such class-specific expenses in the notes to financial statements is permitted.

5.40 Add the following as a footnote – "The SEC staff have, however, stated that master level turnover must be presented in the financial highlights of the feeder for N-1A presentation. Since financial highlights may be incorporated by reference from the annual report and not separately typeset in the prospectus, omitting a turnover rate may result in a presentation unacceptable to the SEC."

5.50 Guide should note that Funds of Funds seeking to implement daily pricing need to address the issue of the timing of the daily computation, which depends on the daily availability of investee funds' NAVs, particularly for non-affiliated funds.

Chapter 6

We understand that the investment company sub-group of the AICPA's Financial Services Taxation Committee is preparing a comment letter on tax matters. We support its recommendations.

Chapter 7

7.1 The requirements of Form N-1A and Form N-2 differ with respect to the number of years of financial highlights that must be presented. The first sentence of Footnote 4 should be revised as follows – "Item 9(a) of Form N-1A requires financial highlights to be presented in a fund's prospectus for at least the latest five years, all of which must be covered by the auditor's report. Item 4 of Form N-2 requires financial highlights to be presented for the latest ten years in the fund's prospectus." Also, in the last sentence of this footnote the reference to Item 23 of Form N-1A should be changed to Item 22 (b) (2).

Attachment I (continued)

7.12 Note that cost (proceeds in the case of short positions) should be disclosed parenthetically for each category presented in the statement of assets and liabilities. (Regulation S-X 6-03 (d))

7.13 Footnote 9 should also refer to Rules 12-12A, 12-12B and 12-14 of Regulation S-X.

7.13 Insert after loan participations – "and assignments."

7.14 This paragraph requires all investment companies to identify all high-yield and restricted securities whose values have been estimated by its directors. In our view it is more meaningful to disclose the aggregate value of all securities whose values have been estimated by or under the supervision of the fund's directors. This would seem to conform to the requirements of SOP 94-6.

7.15 Footnote 11 should also refer to Rule 12-14 of Regulation S-X.

7.20 This paragraph should also address the appropriate presentation of unrealized gains or losses on forward foreign exchange contracts and what amounts should be disclosed.

7.23 Add a footnote reference to Rules 12-12A and 12-12B of Regulation S-X for securities sold short and open option contracts written.

7.28 Item d) – should note that this requirement is not applicable to semi-annual financial statements. Also, this requirement should not apply to offshore investment companies or other entities for which tax information is not relevant. This should also be noted at 7.52, regarding the tax basis of distributions.

7.33 Last sentence of this paragraph should also have a reference similar to footnote 20.

7.51 Note that combination of the statement of operations and of changes in net assets is permitted, provided that the all disclosures required in each are incorporated into the combined statement.

7.52 Change "reinvestment of dividends and distributions" to "reinvestment of distributions."

7.63 End the sentence in item b after "N-2." Add the following – "Other methods, such as dividing net investment income by average or weighted average shares outstanding, are also acceptable and, if used, should be disclosed in a note to the table by registered investment companies."

7.63 Item e should state that the per share amounts of distributions to shareholders should be the actual amount declared or otherwise authorized by the board.

7.63 Item j should mention the common industry practice that ratios are annualized if calculated for a period of less than a year. (Instructions to Form N-1A also do not have that requirement but do state that a fund may annualize ratios as long as it is disclosed in a note to the financial highlights table.)

Attachment I (continued)

7.64 This paragraph should state that instructions to Item 9 of Form N-1A require that when total return is presented for less than a full year, the fact that it is not annualized should be disclosed in a note to the table.

7.65 Requirements of Form N-1A no longer require average borrowings or weighted average number of fund's shares outstanding during the period, and average amount of debt per share during the period as part of the financial highlights.

7.66 Remove – "and average commission rate paid."

7.67 Add at the end of first paragraph – "on expense ratios."

7.68 This paragraph suggests that the reimbursement of a loss due to the investment adviser purchasing a security that clearly violates a fund's investment restrictions should be shown as a separate line item in the statement of operations. Displaying this type of item in the statement of operations places undue emphasis on a transaction that does nothing more than make a fund whole for a transaction that never should have occurred in the first place. We believe it is sufficient to disclose the reimbursement by the investment adviser in a footnote to the financial statements.

7.68 Consider revising "potential lawsuit for the negligence in the investment decision" to "potential obligation resulting from the violation of the fund's investment restrictions."

7.74 This list does not appear to be complete. For example, a complete portfolio listing is required by Regulation S-X Rule 12-12, including the additional disclosure required by Rule 12-12 (note 7) with regard to securities held in connection with open put and call options or loans for short sales. Also, item g should discuss the additional disclosures required with respect to investments and advances to affiliates by Regulation S-X Rule 12-14.

7.76 U.S. Treasury Bills do not have an interest rate (they are discount notes); indicate that the rate shown is yield at the date of purchase.

7.76 Note + should be revised to say – "Portion of this security is pledged for call options written."

7.79 Same as above at 7.76 (Note +).

7.80 The statement of operations should reflect realized gains and losses from futures, short positions, and options written as required by Regulation S-X 6-07 (7).

7.83 Change "reinvestment of dividends and distributions" to "reinvestment of distributions."

Chapter 8

8.2 The first sentence should be more explicit – "Performance fees should be estimated and recorded at interim dates based on the actual performance during the period."

Attachment I (continued)

8.3 Consider mentioning the common use of recalculation of asset-based fees and variation analysis of other expense items.

8.7 This paragraph refers in general to the NASD rules. More specific reference to Section 26 of the NASD Rules of Fair Practice would be helpful to the user.

8.16 Consider expanding the current paragraph to highlight the importance of reviewing minutes to identify changes in fee structures, fund rates, caps, etc. when auditing expenses.

8.19 This paragraph should be conformed to the chart at 8.22, which shows that legal fees for preparing the registration statement are an offering cost.

8.24 Accounting for rating agency fees incurred by the fund should be addressed – "The initial costs of securing a rating are an offering cost; recurring fees should be amortized by the fund over the rating period (if, for example, required under an indenture for bonds or preferred stock issued by a closed-end fund)".

8.36 Emphasize that costs incurred in connection with the reorganization are not permitted to be added to any existing deferred organization costs.

8.38 Consider noting the adjustments to the portfolio turnover calculation described in Item 9, Instruction 4(d)(iii) of Form N-1A.

Chapter 10

General comments –

A) The discussion of the history of separate accounts appears excessive relative to other discussions in the Guide (for example, Chapter 1 devotes only two paragraphs to the history of investment companies). In particular, paragraphs 10.7, 10.9, 10.11 and 10.12 focus mainly on market conditions at various times, which have little relevance today. We suggest these paragraphs be eliminated, with any information describing product classes relocated into other sections of the chapter.

B) Many new options have been provided in variable annuities over the past several years, such as guaranteed minimum death benefits and indexed annuities. While we recognize that this chapter is not intended to be a primer on variable annuity and life contracts, the discussion of variable products should mention the more common of these new features.

10.1 The last sentence of Footnote 1 should refer more specifically to Chapter 7. Additionally, the references in the footnote to paragraphs 7.35, 7.36 and 7.41 in the AICPA Audit Guide *Audits of Employee Benefit Plans* should be replaced with references to paragraphs 7.36 to 7.39.

10.30 The first line refers to "accumulation reserves." Either this concept should be defined or the reference should be eliminated.

Attachment I (continued)

10.57 "Variable life separate accounts registered as UITs would follow the form of the exhibit, but with three years' statements of operations and of changes in net assets."

10.59 There are evident typographical errors in the sample financial statements (for example, the number of shares of each fund held by ABC Variable Annuity Separate Account I are omitted in 10.59; individual investment income items clearly do not add to the total net investment income in 10.60; the 19X2 net asset value per unit does not compute properly based on other amounts in the table).

10.59 We also note that most variable annuity separate accounts, at a minimum, distinguish in the statement of assets and liabilities and per share information, and often in other financial statements, between units in the "accumulation period" (i.e., held in accounts not yet annuitized) and those in the "annuity period" (i.e., held in accounts which currently receive annuity payments). We believe this distinction should be demonstrated in the sample financial statements.

10.62 We have attached proposed additions to the sample financial statement disclosures as Attachment 4.

Chapter 11

11.14 Consider noting that this report should reflect any material weaknesses present as of the fiscal year end date.

11.15 At the end of the paragraph it might be helpful to add that – "such procedures should be specifically stated and agreed to in a written engagement letter."

11.16 Some mention should be made of the New York Stock Exchange requirement to issue a report regarding the segregation of duties between the transfer agent and registrar functions. Such a report typically covers a period of time rather than being stated as of a specific date.

11.21 Add a second sentence – "It should be noted that certain established criteria preclude a preparer of investment performance statistics from asserting that a computation is in accordance with the criteria if there are departures from any of the criteria; a qualified report is not appropriate in this case." A footnote to 11.22 should reiterate this sentence.

11.23 Add identification of passive foreign investment companies to the list of items to be considered.

11.23 Specific reference should be made to those representations which are required for SEC purposes and therefore should not be included in the representation letter for a non public entity. Representations falling under this category are 11b,c,d,e, and f.

11.23 We understand that representation 11f, which has appeared in the sample representation letter in the Guide for many years, is actually based on a state restriction, not an SEC requirement, and may no longer apply to many funds due to changes in Federal securities law superseding state regulation. We suggest that its deletion be considered.

Attachment 2

Statement of Operations
For the year ended December 31, 200X

Income	
Net realized gain (loss) from	
Investments	$ 1,089,000
Foreign currency transactions	(44,000)
Net unrealized gain (loss) from	
Investments	(1,647,000)
Foreign currency transactions	353,000
Investment income	
Dividends (net of foreign withholding taxes of $20,000)	742,000
Interest	209,000
Income from securities loaned - net	50,000
Investment expenses	
Interest	(55,000)
Dividends on securities sold short	(9,000)
Net Investment Results	688,000
Operating Expenses	
Investment advisory fee	135,000
Professional fees (Note 9)	29,000
Custodian and transfer agent fees	16,000
Distribution expenses (Note 9)	4,000
State and local taxes other than income taxes	15,000
Directors fees	12,000
Total expenses	211,000
Fees paid indirectly	(4,000)
Fees waived	(45,000)
Net expenses	162,000
Net income	$ 526,000

Attachment 3

The following sample financial statements are limited to matters directly related to funds-of-funds. Additional disclosures may be required for those funds which hold a mixture of investments in other investment companies and direct investments in securities. Additionally, funds of funds may offer a multiple class share structure. The sample financial statements in Chapters 5 and 7 should be consulted for relevant disclosures.

Preparers should consider whether an investment in a single underlying fund is so significant to the fund-of-funds as to make the presentation of financial statements in a manner similar to a master-feeder fund (paragraphs 5.65 to 5.73) more appropriate. Preparers should also consider, in light of the fund's circumstances, the extent to which disclosure of the underlying funds' investment policies is appropriate.

FOF Fund, Inc.
Statement of Net Assets
September 30, 200Y

Assets:	
204,100 shares FOF Growth Fund, Inc.	$2,046,762
182,633 shares FOF International Fund, Inc.	2,224,470
96,152 shares FOF Income Fund, Inc.	1,046,134
602,908 shares FOF Money Market Fund, Inc.	602,908
Total Investments (cost $5,617,279)	5,920,274
Cash	9,000
Receivable for Fund shares sold	23,652
Other Assets	2,710
Total assets	5,955,636
Liabilities:	
Payable for Fund shares repurchased	37,123
Accrued expenses	8,327
Total liabilities	45,450
Net Assets (equivalent to $10.73 per share based on 550,810 shares of capital stock issued and outstanding; unlimited shares authorized)	$5,910,186
Components of net assets:	
Paid-in Capital	$5,569,426
Retained Earnings	340,760
	$5,910,186

The accompanying notes are an integral part of these financial statements.

Attachment 3 (continued)

FOF Fund, Inc.
Statement of Operations
Year Ended September 30, 200Y

Investment Income:		
Dividends from investment company shares		$201,942
Expenses:		
Custodian and transfer agent fees	$22,560	
Professional fees	8,318	
Registration fees	1,040	
Directors' fees	1,982	
Total expenses		33,900
Net investment income		168,042
Realized and Unrealized Gain (Loss) on Investments:		
Realized gain on sales of investment company shares	$12,067	
Realized gain distributions from investment company shares	321,939	
Net realized gain		334,006
Change in unrealized appreciation (depreciation) on investments during the year		219,837
Net realized and unrealized gain		553,843
Net increase in net assets resulting from operations		$721,885

The accompanying notes are an integral part of these financial statements.

Attachment 3 (continued)

FOF Fund, Inc.
Statement of Changes in Net Assets
Years Ended September 30, 200Y and 200X *

	200Y	200X
Increase (decrease) in net assets from:		
Net investment income	$168,042	$32,177
Net realized gain on investments	334,006	16,090
Change in net unrealized appreciation	219,837	83,158
	712,885	131,425
Distributions to shareholders	(484,617)	(27,933)
Capital share transactions – net	2,172,589	3,396,837
Net increase in net assets	2,409,857	3,500,329
Net assets		
Beginning of year	3,500,329	-
End of year	$5,910,186	$3,500,329

* The Fund commenced operations on October 1, 200W.

The accompanying notes are an integral part of these financial statements.

Attachment 3 (continued)

FOF Fund, Inc.
Notes to Financial Statements

1. Significant Accounting Policies

FOF Fund, Inc. (the "Fund") is registered under the Investment Company Act of 1940, as amended, as a diversified, open-end management investment company. The Fund invests solely in shares of other funds within the FOF Group of Mutual Funds with the objective of seeking high total return through investments allocated to diverse equity and fixed-income markets.

The following is a summary of significant accounting policies which are in conformity with generally accepted accounting principles and which are consistently followed by the Fund in the preparation of its financial statements. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates.

Security Valuation. Investments in funds within the FOF Group of Mutual Funds are valued at their net asset value as reported by the underlying funds.

Transaction Dates. Share transactions are recorded on the trade date. Dividend income and realized gain distributions from other funds are recognized on the ex-dividend date. Distributions to shareholders, which are determined in accordance with income tax regulations, are similarly recorded on the ex-dividend date. In determining the net gain or loss on securities sold, the cost of securities is determined on the identified cost basis.

Federal Income Taxes. The Fund's policy is to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable income to its shareholders. Thus, no federal income tax provision is required.

2. Investment Transactions

Cost of purchases and proceeds of sales of shares of funds within the FOF Group of Mutual Funds (excluding FOF Money Market Fund, Inc.) for the year ended September 30, 200Y were $2,482,315 and $336,232, respectively. At September 30, 200Y, the cost of investments for Federal income tax purposes was $5,664,583 and gross unrealized appreciation was $302,995; there was no gross unrealized depreciation.

3. Investment Advisory Services and Other Transactions with Affiliates

The Fund receives investment management and advisory services, consisting principally of determining the allocation of the assets of the Fund among designated underlying funds, under a management agreement with FOF Investment Management, Inc. (the "Manager"). The Manager receives no compensation under this agreement; however, the Fund indirectly pays management fees and expenses to the Manager as a shareholder in funds of the FOF Group of Mutual Funds. Additionally, each fund in which the Fund invests (except FOF Money Market Fund, Inc.) pays a distribution fee to FOF Distributors, Inc., the distributor of the Fund, in the amount of 0.25% of average annual net assets. The Fund pays no sales loads or similar compensation to FOF Distributors, Inc. to acquire shares of each fund in which it invests.

Attachment 3 (continued)

FOF Fund, Inc.
Notes to Financial Statements

Because the underlying funds have varied expense and fee levels and the Fund may own different proportions of underlying funds at different times, the amount of fees and expenses indirectly incurred by the Fund will vary.

The Fund paid $1,982 to unaffiliated directors during the year ended September 30, 200Y. No compensation is paid to any Director or officer who is affiliated with the Manager.

4. Capital Share Transactions

Transactions in capital shares were as follows:

	Years ended September 30,			
	200Y		200X	
	Shares	Amount	Shares	Amount
Shares sold	204,017	$2,077,520	354,695	$3,590,241
Shares issued in reinvestment of dividends	41,817	425,255	2,615	27,013
Shares redeemed	(30,948)	(330,186)	(21,386)	(220,417)
Net increase	214,886	$2,172,589	335,924	$3,396,837

5. Components of Capital

Components of capital on a Federal income tax basis at September 30, 200Y were as follows:

Paid-in capital	5,569,426
Undistributed net investment income	11,460
Undistributed net realized gain	26,305
Unrealized appreciation	302,995
	$ 5,910,186

The tax character of distributions paid during the year ended September 30, 200Y and 200X were as follows:

	200Y	200X
	Total	Total
Ordinary income	$160,826	$27,933
Long-term capital gain	323,791	-
	$484,617	$27,933

Attachment 3 (continued)

FOF Fund, Inc.
Financial Highlights

	Year ended September 30, 200Y	200X
Per share data (for a share outstanding throughout the period):		
Net investment income *	$ .38	$ .20
Net realized and unrealized (gain) loss on investments	1.04	.38
Total from investment operations	1.42	.58
Less: Distributions to shareholders	(1.11)	(.16)
Net increase (decrease)	.31	.42
Net asset value:		
Beginning of year ‡	10.42	10.00
End of year	$10.73	$10.42
Total return	13.59%	5.86%
Net assets, end of year (000s)	$5,910	$3,501
Ratio of expenses to average net assets **	-%	-%
Ratio of net investment income to average net assets *	3.59%	1.96%
Portfolio turnover rate	21%	5%

* Recognition of net investment income by the Fund is affected by the timing of the declaration of dividends by the underlying investment companies in which the Fund invests.

** Does not include expenses of the investment companies in which the Fund invests.

‡ Investment operations commenced on October 1, 200W.

Attachment 4

CHAPTER 10 – Proposed Additions To Footnotes Of Variable Annuity Financial Statements

1. Statement of Segregation of Variable Account Assets; to be included in *Note 1, Organization*

Under applicable insurance law, the assets and liabilities of the Separate Account are clearly identified and distinguished from the other assets and liabilities of the Insurance Company. The portion of the Separate Account's assets applicable to the variable (life insurance) (annuity) policies is not chargeable with liabilities arising out of any other business the Insurance Company may conduct.

2. To be included in *Significant Accounting Policies:*

Use of Estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported therein. Actual results could differ from these estimates.

3. New disclosure of purchases and sales of investments:

Purchases and Sales of Investments

The cost of purchases and proceeds from sales of investments for the year ended December 31, 200Y, by sub-account, were as follows:

	Purchases	Sales
Equity Index Sub-Account	$x,xxx,xxx	$x,xxx,xxx
Money Market Sub-Account	xx,xxx,xxx	xx,xxx,xxx
Total	$xx,xxx,xxx	$xx,xxx,xxx

4. New disclosure of changes in units outstanding (does not consider distinction, if any, between units in accumulation and annuity periods):

Changes in Units Outstanding

	Equity Index		**Money Market**	
	200Y	**200X**	**200Y**	**200X**
Units outstanding, beginning of year				
Units issued				
Units redeemed				
Units outstanding, end of year				

Attachment 4 (continued)

5. Addition to tax footnote for variable life separate accounts

Diversification

Under the provisions of Section 817(h) of the Internal Revenue Code, a variable life insurance policy, other than a policy issued in connection with certain types of employee benefit plans, will not be treated as a life insurance policy for federal tax purposes for any period in which the investments of the segregated asset account, on which the policy is based, are not adequately diversified. The Code provides that the diversification requirement may be met if the underlying investments satisfy either a regulatory safe harbor test or diversification requirements set forth by the Secretary of the Treasury. The Internal Revenue Service has issued diversification regulations under Section 817(h) of the Code. The Insurance Company believes, based on representations from the managements of the funds in which the Separate Account invests, that the Separate Account complies with the current requirements of the regulations.

Noted below is the file identifier for word processing.

s:\imsgrp\atmisc\exposure.doc

(2)

Deloitte & Touche

Deloitte & Touche LLP
Ten Westport Road
P.O. Box 820
Wilton, Connecticut 06897-0820

Telephone: (203) 761-3000

December 30, 1998

Ms. Sheila H. Yu
Technical Manager
Accounting Standards, File 3170
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

File Reference No. 3170
Audit and Accounting Guide, Audits of Investment Companies

Dear Ms. Yu:

We are pleased to comment on the proposed AICPA Audit and Accounting Guide, *Audits of Investment Companies* dated September 22, 1998 (the "Exposure Draft"). We support the issuance of the Exposure Draft as a final Audit and Accounting Guide. Some suggestions for clarification are provided below.

Scope

We agree with the observations in footnote 4 regarding the diversity in practice in the application of the existing Guide to venture capital investment companies and that the diversity may have been caused by the apparent contradiction between paragraphs 1.5 and 1.6, which have been carried forward in the Exposure Draft. We understand that after the Exposure Draft was issued, AcSEC agreed to undertake a project to further consider the scope of this Exposure Draft as it relates to venture capital investment companies; we support that project.

Offering Costs

We believe that offering costs for funds with similar characteristics should be treated in the same manner. Paragraph 8.25 of the Exposure Draft requires that offering costs of Unit Investment Trusts (UITs) be charged to paid-in capital when the units are sold to underwriters on a firm basis. The final Guide should clarify that this requirement applies only when the underwriter is an unrelated third party since a sale on a firm basis would

be considered to occur only when the sale is to an unrelated third party. In addition, the final Guide should clarify that offering costs should be deferred and amortized to paid-in capital as units are sold to final shareholders by underwriters when a sale to the underwriters is not considered firm (or the underwriter is a related party.) That would be consistent with the treatment of offering costs for closed-end funds and investment partnerships.

If you have any questions regarding our response, please contact Tracey Barber at (203) 761-3337.

Yours truly,

Deloitte + Touche LLP

kpmg

January 11, 1999

Ms. Sheila H. Yu
Technical Manager
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Yu:

Accounting Standards, File 3170; Proposed Audit and Accounting Guide, *Audits of Investment Companies.*

Thank you for providing us an opportunity to comment on the proposed Audit and Accounting Guide—*Audits of Investment Companies* (the Guide). We believe that the Guide should include a discussion on "synthetic investment contracts" used in "Stable Value Funds". Synthetic investment contracts are becoming more commonplace and have unique characteristics and issues which require specific accounting and auditing guidance for these types of instruments and funds. The guidance should focus specifically on valuation of the synthetic investment contracts and other related measurements (e.g., recognition of income and gains or losses).

In addition we believe the discussion of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, (FAS 125) should be conformed to the discussion contained in the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities* (with conforming changes as of May 1, 1998) (AAG-BRD). Paragraphs 7.26 through paragraph 7.33 from AAG-BRD should be included after paragraph 2.27 of the Exposure Draft.

Additional comments on specific paragraphs are attached as an appendix to this letter. We would be pleased to discuss the above comments at your convenience.

Very truly yours,

KPMG LLP

Attachment

23

Page	Paragraph	Comment
8	1.23	Insert a line between text contained in "i." and "j.".
9	1.27	Add as an additional bullet the phrase "Notes to Financial Statements" since Notes are a part of the basic financial statements.
10	1.35	This paragraph is incomplete regarding the periods available to make changes to auditors. The section should be expanded to clarify the requirements of Section 32(a) and Rule 32a-3 of the 1940 Act.
14	2.9	Add a chart after paragraph 2.11 indicating the general types of investment activities (e.g., long futures, when issued securities, etc.) which require designation of assets as segregated. This would be a helpful tool to the average practitioner when reviewing compliance with segregation requirements for a RIC.
14	Footnote 7	Expand 10666 discussion by inserting language from Footnote 6 on page 46, with an added reference to recent SEC no-action positions on the use of certain equity securities for segregation purposes. We believe that these leverage and segregation concepts are very important for the auditor to understand and should be highlighted in this section where the concept is first introduced.
17	2.25	Clarify that recording securities transactions on trade date accounting is a **required** practice for financial reporting purposes.
17	2.27	Incorporate the following italicized changes to paragraph 2.27: "Financial Accounting Standards ... that are applicable to *various* investment company transactions *including* repurchase and ... borrowed and loaned. *FAS 125 provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or as a secured borrowing.*
28	2.91	Insert the words "accretion of" preceding the phrase 'discount(s) on bonds'. Same change in paragraph 7.33 on page 129.
29	2.93	Change the last sentence from "have been" to "will be" to indicate a future event will occur.
32	2.109	Include a discussion of proposed changes to Rule 17f-5 and roles and responsibilities.
33	2.111	Include the italicized words in the following sentence to narrow the auditors responsibility to the paragraph's topic: "For a diversified investment company ... related diversification provisions of the 1940 Act." If not specific, one might construe the auditor's responsibility to extend to testing compliance with <u>all</u> sections of the 1940 Act.
37	2.130 & 2.131	We believe that the auditor should be able to generally rely on established pricing services for reliable quote information without necessarily documenting, analyzing and testing controls at the pricing service. The external nature of the information along with the fund's internal controls should generally be satisfactory for the auditor in performing their audit.

Page	Paragraph	Comment
37	2.131	Consider eliminating the word "day" at the very end of the fourth bullet and adding the words "or several preceding days". A comparison to several preceding days would provide better evidence that no material errors have occurred.
37	2.132	Consider inserting the word "internal" after "uses" and before "matrix" to avoid confusion with external pricing cervices who use matrix pricing.
40	3.6	Description of reverse repurchase agreement is incorrect, as it is nearly identical to the description of a repurchase agreement in paragraph 3.5. This should be the 'sale of a security ... and ... purchase the same ... security'.
40	3.9	We believe it would be prudent to separately identify municipal lease obligations due to their unusual added risk of non-appropriation each year. The auditor should be made aware of this added risk factor as such MLO's often constitute a significant portion of some state tax-free funds.
41	Footnote 4	Add discussion of recent SEC no-action positions on the use of certain equity securities for segregation purposes. If this becomes redundant with Footnote 7 on page 17, then suggest simply referring back to that discussion.
49	3.46-3.48	Include in Footnote 9 a reference to EITF Topic No. D-52, *Impact of FASB Statement No. 125 on EITF Issues*. Expand the discussion to address Type IV repos and reverse repos (as defined in EITF Topic No. D-52) and the accounting for compensation for mortgage dollar roll transactions.
63	5.1	Include "fund of funds" as an example structure. Suggested language to be added to the end of the existing paragraph: "In addition many organizations are deploying fund of funds which is addressed later in this chapter."
65	5.12	Consider deleting the sentence: "In certain instances fund-level expenses may be waived or reimbursed differently among classes." We believe the existing guidance is problematic given IRS views on preferential dividends as well as inherent subjectivity of Section 18 of the 1940 Act in avoiding problems with the senior security rules.
93	Chapter 6	Throughout the chapter the phrase "an RIC" and "a RIC" are used. The phrase "a RIC" should be used instead of "an RIC."
96	6.13b & 6.14	Add language clarifying that current net operating losses are allowed to the extent they offset short-term capital gains in the current period incurred.
101-103	6.31d. 6.36-6.41	Remove discussion of short-short test from the guide as this test has been repealed.
122	Footnote 4	Update disclosure for the new Form N-1A rule changes (Form N-1A now requires 5 years of financial highlights). Also make specific note that Form N-2 still requires 10 years of financial highlights.
123	7.4	Section title and first line are inconsistent—is the section supposed to be discussing consolidation "by" an investment company or "of" an investment company? We

Page	Paragraph	Comment
		believe that the intended meaning is "by" an investment company and recommend that the section title be modified.
125	7.14	Expand this paragraph to include all securities whose value has been estimated by the Fund's Board of Director's. Also, clarify that the Board may delegate valuation to management under procedures approved by the Board. In its present context, we believe that this paragraph could mislead the auditor into believing that high-yield and restricted debt securities are the only types of securities who values may be estimated by the Board.
128	7.31	Typos - a) insert space between income and less; b) footnote 20, the word 'investment' should be capitalized.
130	7.38	This paragraph indicates that the auditor should be aware of disclosure requirement in Section 30(d)(5) of the '40 Act and may determine compliance by disclosure in the notes to the financial statements or another matter. This could be read to imply that the auditor is responsible for compliance with the disclosure requirements. We suggest modifying the sentence to make clear that management of the fund has responsibility for disclosure. Perhaps change the word 'determine' to 'find' in the last sentence of the paragraph.
134	7.57	The discussion in paragraph 7.57 focuses on the direct method, however it indicates that the indirect method is more commonly used. In addition the example statement of cash flows on page 150 of the Exposure Draft is presented using the indirect method. Revise the text in paragraph 7.57 to describe the indirect method.
135	7.63j	Consider making item 7.63j a separate paragraph which would read "Ratios of expenses and net investment income to average net assets are required to be presented for all investment companies". Paragraph 7.63 reads "The following per share information should be presented for registered investment companies and for investment companies that compute unitized net asset value..."As it currently is written, item "j" does not refer to per share information, but rather to income and expense ratios. In addition, the table at the beginning of the chapter and footnote 3 thereto indicate that all investment companies should present ratio and total return information. Therefore, making "j" a separate paragraph applicable to all investment companies would be consistent with the current format.
137	7.65c	The disclosure requirements for average borrowings, weighted average fund shares outstanding, and average amount of debt per share during the period is no longer required for Form N-1A. However, this disclosure is still required for filers on Form N-2 if the funds have debt outstanding.
137	7.66	Delete reference to average commission rate paid since this is no longer a SEC requirement for disclosure in the financial highlights.
137	7.68	Clarify whether this discussion is setting forth a requirement that any and all violations of a fund's investment restrictions, including those without financial statement impact or an immaterial impact, must be disclosed in the financial statements or notes thereto? For example, would you disclose a Rule 2a-7 procedural violation that has be rectified with no financial statement impact?

Page	Paragraph	Comment
138	7.69	By the time the Guide is effective FASB Statements No. 105 and No. 119 will be superseded by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This section should updated to reflect current accounting literature.
140	7.74h	Delete disclosure of organization costs due to issuance of Statement of Position 98-5, *Reporting on the Activities of Start-Up Activities*..
141	7.75 & 7.81	Conform the presentation of the components of "Increase (decrease) in net assets from operations" on page 149 to the components of net assets as presented on the Statement of Assets and Liabilities. Currently the Statement of Assets and Liabilities only discloses "Retained Earnings" whereas the Statement of Changes in Net Assets disclosed the components as currently required for registered investment companies by the SEC. The disclosure on page 141 should be identified as pending approval by the SEC for registered investment companies.
142	7.76	It is unclear if the Schedule of Investments in Securities is meant to present the top 50 holdings as proposed by the Investment Company Institute for disclosure in the statement of net assets or the disclosure is in accordance with the current requirements of S-X Rule 12-12.
143	7.76	The Schedule of Investments in Securities includes a "Note" on page 143 which discloses aggregate value of segregated securities. Clarify why this disclosure is made and how the amount disclosed is calculated.
159	8.7	We recommend adding the first sentence from paragraph 7.38 on page 130 to the end of this paragraph to add clarity to the disclosure requirements.
159	8.6 et al	Should this chapter of the Exposure Draft contain a discussion of plans established in accordance with Rule 6c-10, *Exemption of Certain Open-End Management Investment Companies to Impose Deferred Sales Loads*, and their potential future use as well as why such plans have not proliferated?
161	8.18	Incorporate the italicized changes to the following sentence: "In a master-feeder arrangement … at the master *and/*or feeder level."
166	8.39	Provide specific guidance on how to apply paragraph 71 of APB Opinion 16, *Business Combinations* (APB 16), in determining the acquirer. In theory, in a taxable business combination (whereby two or more funds are merging into a new fund) this provision of APB 16 would result in one of the funds being identified as the acquirer and therefore carrying over the historical basis in its assets and liabilities rather than achieving an overall step-up to market value as desired in the transaction. We believe the intention of paragraph 8.39 of the Guide is for all of the funds involved in the transaction to step-up the basis to market value. Paragraph 8.39 of the Guide appears to be in conflict with paragraph 71 of APB 16.
177	Chapter 10	Provide guidance on required reporting for a separate account in a stub period, perhaps in a table similar to that presented on page 122. We believe that in practice that there is not any explicit guidance for separate accounts such as exists for management investment companies in S-X Rule 3-18.

Page	Paragraph	Comment
194	Chapter 11	The sample reports included in this chapter need to be updated to reflect the requirements of SAS 87, *Restricting the Use of an Auditor's Report*.

January 15, 1999

Sheila H. Yu
Technical Manager
American Institute of
Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Audit and Accounting Guide - -
Audits of Investment Companies
File 3170

Dear Ms. Yu:

Merrill Lynch Asset Management, L.P. appreciates the opportunity to express its views on the proposed Audit and Accounting Guide – *Audits of Investment Companies*. We recognize and appreciate the time and effort that both the Investment Companies Committee and AcSEC have devoted to this substantial revision of the Guide. The expansion in scope to include complex capital structures and more types of financial instruments will be beneficial to both investment company ("mutual fund") accountants and auditors.

Mutual funds are widely held by many investors; roughly 40 million U.S. households own mutual funds. For this reason, the average investor should be provided with meaningful and informative financial statements to assess the mutual fund's performance and financial position. The Proposed Guide has made significant strides that meet these objectives. However, it includes certain issues that are contrary to the objectives of clarity and meaningfulness of financial information.

This letter highlights the more significant comments we have on the Proposed Guide and the Appendix to this letter includes comments of lesser importance. We would be pleased to share our views with members of the Committee if further clarification is needed.

28

AMORTIZATION OF PREMIUM/DISCOUNT (paragraph 2.54)

We strongly disagree with the proposed changes in amortization of premium and discounts because it does not provide any benefit to shareholders and will only result in confusion in reviewing financial statements with additional book/tax differences. However, we recognize the benefits of the consistent application of standardized amortization methods by all funds for financial reporting purposes, but more importantly, for comparability of distributions. This consistency *can only* be achieved if the industry adopts a specific tax amortization policy and this policy is also used for book purposes.

As you know, the IRS provides alternative amortization methods for market discount (for all securities) and premium (for taxable securities). The amortization method selected directly impacts the amount of taxable income and ultimately the distribution paid by the fund. As a result, a fund could have a significantly higher ordinary income distribution than an identical fund simply by adopting the income-enhancing amortization methods. This can be achieved by electing *not to* amortize premium for a taxable security and by amortizing market discount currently rather than at time of disposition.

We don't believe that the selection of amortization methods that increases income benefits the shareholder if a current tax liability is incurred on income that otherwise could have been deferred to future periods. The specifics of the impact of the income-enhancing alternatives on taxable income are as follows:

Elect not to amortize premium on taxable securities:

- The shareholder loses the offset to current income and therefore may be subject to a current tax liability.
- Realized gains may be reduced which generally are taxed at a lower rate than ordinary income.

Elect to amortize market discount currently versus at time of disposition:

- The shareholder pays current tax on accelerated income that otherwise may not be recognized if no gain is realized when the security is sold.

We strongly believe that tax amortization methods should be selected based on what is in the best interest of the shareholder from a current tax savings perspective. We believe those tax amortization methods should be mandated for the investment company industry. Obviously, accounting standard setters cannot change the tax rules, but GAAP amortization methodologies could be selected based on the tax amortization methodologies most beneficial to shareholders. Therefore, our recommendations for GAAP amortization methods are as follows:

- Record market discount amortization for all securities at time of disposition using the effective interest method (versus the alternative straight-line method).
- Amortize premium for all securities using the effective interest method.
- Amortize OID for all securities using the effective interest method.

Once adopted, a fund that elects to amortize using different methods for tax purposes should be required to disclose in the notes to the financial statements, the impact of the alternative tax amortization policies on net investment income and distribution per share. In addition, the rationale for the selection of the income enhancing policies for tax purposes should be included in the notes to the financial statements.

We also believe any changes adopted for GAAP amortization should be *prospective* from the beginning of the tax year in which the election is made to conform to tax treatment. To treat the change in amortization as a cumulative effect of a change in accounting policy under APB No. 20 *Accounting Changes*, would require recalculation of the amortized cost basis for each security lot as though the new method of amortization had been followed since acquisition. Obviously, this would create further confusion and ambiguity in the financial statements from further book/tax differences.

Accounting standard setters are beginning to focus more and more on disclosure effectiveness and attempting to eliminate disclosures that are less useful in communicating essential information. We strongly believe that mandating definitive tax amortization policies as proposed above would be the most prudent method to meet this objective.

MULTIPLE-CLASS FUNDS (paragraph 5.9)

The Proposed Guide states "funds that declare dividends of all net investment income daily will frequently have a NAV per share that are the same for each class, except for differences that may arise from rounding." The rounding occurs from the difference created in processing capital share activity of the fund at a NAV expressed to the nearest cent versus the unrounded NAV on the fund's records. As a result, the net assets of the fund will decline from subscriptions processed at a NAV rounded down to the nearest cent and from a redemption processed at a NAV rounded up to the nearest cent. Likewise, the net assets of the fund will increase for subscriptions processed at a NAV rounded up to the nearest cent and for subscriptions rounded down to the nearest cent. The amount of the capital share activity relative to the net assets and NAV of the class, along with the direction of the rounding, can cause the NAVs of the various classes to diverge. This is particularly relevant for a multiple class money market fund where the NAV could break the dollar at the class level, but not at the fund level.

We strongly believe that only one NAV should be required for a fund that declares all of its net investment income daily. The primary reason for having two NAVs is because of the expense differentials of the classes, i.e., distribution fees, transfer agent fees, registration fees, etc. The NAVs of the classes will diverge as the expense differentials are accrued. The daily distribution of all net investment income, including expense differential accruals, effectively eliminates any NAV differences and the reason for separate NAVs.

Since the shareholders have borne the expense differential through a reduced daily distribution, they should not potentially be harmed disproportionately to shareholders of other classes simply because their class' capital share activity happens to result in rounding down their NAV. This divergence in NAVs would not occur in an identical fund that uses the unrounded NAVs to process capital share activity for all classes. However, they are still required to maintain separate NAVs by class.

The use of a single NAV for funds that distribute all net investment income daily would reduce the time and effort devoted by the fund accountant, transfer agents and auditors. As a result, more time can be spent ensuring the accuracy and completeness of the day's NAV computation.

24

CONDENSING SCHEDULE OF INVESTMENTS (paragraph 7.13)

This is the area where a significant benefit is realized by everyone involved with a mutual fund. Shareholders will be recipients of a concise, meaningful schedule of investments and will realize lower expenses from preparing, printing and mailing fewer pages for shareholder reports. The time to prepare and audit the reports will decrease, benefiting the fund accountant and, to a lesser extent, the fund's auditor.

The proposed disclosure of investments (or the aggregate of all securities of any one issuer) constituting more than *one percent of net assets* is prudent. We recognize and appreciate that with only this criteria a fund may not be required to report any securities, if all are under one percent. To avoid this from occurring, it is proposed that a minimum of *fifty* securities be disclosed.

We believe more consideration should be given to what appears to be an arbitrary disclosure of a minimum of fifty securities. Instead of a minimum of fifty securities, the information disclosed needs to be informative and meaningful, and presented in a concise manner for shareholders to easily comprehend. To achieve this, we strongly feel that the required disclosure should be aligned with the *type of fund*. That is, specific disclosure requirements should be developed and adopted for each type of fund – equity, taxable money market, single state tax-exempt fund, etc. To illustrate this, would it be meaningful if the securities meeting the above proposed disclosure requirements were all US Treasury Securities? Rather, would it be more informative and useful to a shareholder to show summaries by investment type for a taxable money market fund (e.g., US Treasury Bills, Commercial Paper, CDs) including ranges of interest rates and maturities? As for an equity fund, would it be more meaningful to show the details of the fund's concentration in a particular industry, which represents more than a certain percentage of net assets, rather than a listing of the fifty largest investments? Similar analyses and decisions need to be developed on the appropriate investment disclosure for all types of funds, such as, Corporate Bond Funds, Tax-Exempt Funds (National or Single State), Mortgage-Backed Funds, etc.

To supplement the listing of individual securities and summaries, we feel that graphical presentations of the portfolio by percentage of net assets by industry, country, type of investment, or investment objective should be required. The individual securities listed can be related to these graphical presentations by including, alongside the securities, the attributes used in the graphical presentations (e.g., industry, country).

We also believe that the shares/face and the amount of market value should be eliminated and only the percentage of net assets should be shown for the individual securities listed and the summaries.

Although we understand the SEC must change Regulation S-X before shareholders can reap the benefits of this change; we commend the Committee for including this in the Proposed Guide.

DISCLOSURE OF BOARD VALUED SECURITIES (paragraph 7.14)

The Proposed Guide states that "an investment company's portfolio should indicate all high-yield and restricted debt securities whose values have been estimated by its directors". We strongly disagree with this disclosure requirement. Without being able to fully describe the extensive pricing policies and procedures utilized by fund directors (or their designees such as a Valuation Committee), this indicator on a security may be misconstrued and possibly unduly alarming to a shareholder. Additionally, assuming the revisions are made to S-X and only a limited schedule of investments is presented, specific securities indicators may lose meaning if all securities are not presented. We believe the *Use of Estimates* policy note (paragraph 7.83, page 153) included in notes to financial statements is sufficient to alert the reader that estimation processes are employed by the fund.

DISCLOSURE OF CORRECTIONS OF INVESTMENT RESTRICTION VIOLATIONS (paragraph 7.68)

The Proposed Guide requires gains recognized by the fund resulting from investment restriction violations to be disclosed in notes to the financial statements. If the advisor makes a payment to the fund to reimburse for losses resulting from such violations, the Proposed Guide would require it to be reported as a separate line item in the statement of operations. We believe it is inappropriate to highlight items of compliance in shareholder reports. Information currently

required to be filed with the SEC (e.g., Form N-SAR) would identify any material weakness in the fund's system of internal accounting control.

NET REALIZED AND UNREALIZED GAINS OR LOSSES

We believe that mutual funds should record and include in financial statements all gains and losses whether realized or unrealized based on tax cost. As a "pass-through" entity, the more an investment company mirrors tax accounting, the more meaningful and informative the fund's disclosure of financial information is to its shareholders.

We hope our comments are helpful to the AICPA Investment Companies Committee and AcSEC in developing an Audit and Accounting Guide that is comprehensive and useful to mutual fund accountants and auditors. But more importantly, we hope your efforts ultimately serve the interests of our fund shareholders by providing more meaningful financial information in shareholder reports. If you have any questions, please do not hesitate to contact me at (609) 282-7096 or Teresa Westbrook at (609) 282-7086.

Yours truly,

Ronald M. Kloss
Senior Vice President
and Chief Financial Officer

(24)

APPENDIX

COMMENTS ON THE
AICPA AUDIT AND ACCOUNTING GUIDE
AUDITS OF INVESTMENT COMPANIES
File 3170

We have read the Investment Company Institute's Appendix to their comment letter to the AICPA on the Proposed Guide. We agree with items included in their Appendix and have not reiterated any of their points. However, we do have additional comments as follows:

Chapter 1 – Investment Company Industry

Paragraph 1.10 - continuously offered closed-end funds are not mentioned.

Chapter 2 – Investment Accounts

1. We are concerned that the concept of *fair value* as understood from current SEC guidance may differ from the definition of fair value in FAS 107 and this difference causes some confusion. Fair value is defined in FAS 107 as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. FAS 107 states that a quoted market price is the best evidence of fair value and if quoted prices are unavailable, management makes their best *estimate* of fair value. The terms *fair value* and *estimated fair value* should be separate and distinct from *fair value estimated in good faith by the fund's board*, as securities valued by the board may require certain documentation standards (paragraph 2.39, first sentence) and financial statement disclosures (paragraph 7.14). For example, the third sentence of paragraph 2.31 of this chapter implies the use of a mean between two broker quotes is an *estimate* of fair value. Would the documentation and disclosure requirements mentioned above apply to this security? Another example is paragraph 2.37 that implies a matrix-priced security is an *estimate of fair value in good faith*. We don't believe a matrix-priced security falls in the category of securities *valued in good faith*.

2. Paragraph 2.40 - clarify that the "dollar NAV" test for a multiple class money market fund may be performed at the fund, and not the class, level. Calculating this test at the fund level further supports the single NAV concept put forth in our letter.

3. Paragraph 2.49 - change to "investment companies usually follow tax accounting to determine if other noncash dividends are recognized as investment income (recorded at the fair value of the property received) or allocated a prorated portion of the cost basis of the related investment.
4. Paragraph 2.54 - should high yield bond income recognition be addressed?

5. Paragraph 2.70 states "Portfolio securities that are traded primarily on foreign securities exchanges should be valued at the functional currency of the preceding closing values for such securities on their exchanges". We would suggest changing this to state "should be valued at the functional currency of the last sales value on the exchange at the time the fund is valued. This clarifies that last sales values obtained from exchanges that are not yet closed when the NYSE closes, such as Latin America, are not the *closing* sales prices from such exchanges.

6. Paragraph 2.90 - should there be more clarification that certain foreign dividends may not be recorded on the ex-date for reasons iterated and the SEC does not consider this to be an error if best efforts to obtain the information have been performed and the information was not available in the marketplace?

7. Paragraph 2.93 - should guidance be given on the basis on which the capital gains tax accrual is to be made? Is accrual of this tax inconsistent with paragraph 2.94 that states "if the tax rate is not known or estimable, such expense or receivable should be recorded on the date the net amount is received"? Also, the last sentence should be reworded to state "If a receivable for withholding tax reclaims has been recorded, the auditor should review the collectibility of such amount."

Chapter 3 – Financial Instruments

1. Paragraph 3.18, second sentence – this sentence seems to apply to an ARM MBS rather than an ARM.

2. Paragraph 3.27 – should currency and index options be included since they are commonly purchased and written by funds?

3. Paragraph 3.28 - item c. is not available for an index option.

4. Paragraph 3.32 – should index futures be included since they are commonly purchased/sold by funds?

5. Paragraph 3.35, second sentence - eliminate "reducing the carrying cost of the contract" as this may imply the value of the future is recorded in the fund's records.

Chapter 4 – Capital Accounts

Paragraph 4.26, second sentence states that the reinvestment date is typically the day after the ex-dividend date. The reinvestment date is typically the ex-dividend date. In practice, capital share activity is posted on the day after the trade or ex-dividend date using the prior day NAV (ex-date NAV).

Chapter 5 – Complex Capital Structures

1. Paragraph 5.4, third bullet - consider eliminating reference to "1%" as this may not be typical and add "and may have a CDSC" to end of sentence.

2. Paragraph 5.6, reference to offshore funds at end of paragraph - could "certain conditions" be expanded upon?

3. Paragraph 5.11, fifth sentence - consider changing to "Management fees, custodian fees, and so on must be allocated between all classes using an allocation methodology discussed in 5.13".

4. Paragraph 5.13, fourth bullet, last word - replace "claims" with "classes".

5. Paragraph 5.14 - second sentence implies these are the only methods. Perhaps "The" should be replaced with "Examples of some".

6. Paragraph 5.14, second bullet - replace "record date shares" with "settled shares" as this method is used only for daily dividend funds.

7. Paragraph 5.19 - please insert "long term" in front of capital gains distributions in the first sentence. Short-term capital gains distributions are considered ordinary income for tax purposes.

8. Paragraph 5.27 - on what basis should the tax return of capital be allocated to each class?

9. Paragraph 5.28 - we feel the disclosure is excessive and the only incremental disclosure should be the differing distribution fee arrangements for each class.

10. Paragraph 5.30 - should clarification be given on which master financial statements should be included in feeder financial statements if the master and feeder have different year-ends?

11. Paragraph 5.34 - is separate disclosure of types of income allocated from the master necessary? Expenses are shown as one-line item and we would prefer the same treatment for income items. The details of the types of income earned and expenses incurred by the master are reflected in the master's financial statements which are included in the feeder financial statements.

12. Paragraph 5.38, second bullet - will disclosure of the ownership percentage at the reporting period be confusing for shareholders who may expect to correlate the earnings recorded from the master to this percentage as well?

13. Exhibit 5.2, page 76 - eliminate .25% and .75% parenthetical references.
14. Exhibit 5.2, page 76 - example for the Actual Income Available Method is misleading as this method should not be used for periodic distribution funds.

Chapter 6 – Taxes

Our comments were provided previously to the AICPA Investment Companies Tax Committee.

Chapter 7 – Financial Statements of Investment Companies

1. Paragraph 7.15, footnote 12 - does S-X require defaulted securities to be so noted? We do not read this in Rule 12.12.

2. Paragraph 7.18 - why is the cost of foreign currency to be disclosed parenthetically? This information is not required for other foreign currency denominated assets and liabilities.

Chapter 8 – Other Accounts and Considerations

1. Paragraph 8.22, Item 6. Registration Fees - this item is included in offering costs and paragraph 8.25 indicates such costs should be accounted for as a deferred charge and amortized to expense over 12 months on a straight-line basis. We feel appropriate accounting for state and SEC registration fees should be based on the type of fee paid. For example, the annual state registration fee paid regardless of capital share activity should be amortized to expense over 12 months on a straight-line basis. Other state fees, as well as SEC fees paid based on the number of shares issued or net capital share activity, should be accrued prorata.

2. Paragraph 8.36 - address organization cost accounting for the acquired fund.

Chapter 5

COMPLEX CAPITAL STRUCTURES

5.1 Many investment companies adopt complex capital structures to increase flexibility in pricing and access to alternative distribution channels for their shares. Such structures principally are of two kinds: multiple-class funds and master-feeder funds.

5.2 Multiple-class funds issue more than one class of shares. Each class of shares typically has a different kind of sales charge, such as a front-end load, contingent-deferred sales load, 12b-1 fee, or combinations thereof. Multiple-class funds may charge different classes of shares for specific or incremental expenses, such as transfer agent, registration, and printing expenses related to each class.

5.3 In master-feeder structures, the investment management and distribution functions are performed by separate investment companies. Feeder investment companies, each having similar investment objectives but different distribution channels for their shares, invest their assets solely in another investment company, known as the master fund. All investment management functions are conducted by the master fund, whereas distribution, shareholder servicing, and transfer agent functions are conducted by the feeders.

5.4 A commonly used multiple-class structure includes (but is not limited to) the following classes of shares:

- *Class A.* Shares are charged a front-end sales load
- *Class B.* Shares bear a contingent deferred sales charge (CDSC) coupled with a 12b-1 distribution or service fee
- *Class C.* Shares bear a level sales load, typically a 12b-1 distribution or service fee of 1 percent of average net assets per year
- *Class D.* Shares bear no sales load, but a high minimum investment is required. These shares may have a CDSC or redemption charge if they are redeemed within a year of purchase.

5.5 Though no legal requirements exist regarding specific class designations, many in the industry have voluntarily adopted the above nomenclature to avoid shareholder and sales force confusion.

5.6 Master-feeder funds accumulate the assets of feeder funds, which may be sold to different kinds of customers (such as retail or institutional customers), into one master fund. Each feeder fund can be sold through a different distribution channel and will have a product identity (name, sales load structure, and so forth) that is different from the other feeder funds. The master fund is generally organized as a trust, with attributes that qualify it as a partnership for tax purposes, and is registered under the Investment Company Act of 1940 (the 1940 Act). Feeders are generally organized as corporations or trusts, are taxed under the Internal Revenue Code (IRC) as **regulated investment companies (RICs)**, and are registered as investment companies under the 1940 Act and the Securities Act of 1933 (the 1933 Act) (and the Securities Exchange Act of 1934 [the 1934 Act] as appropriate). A feeder fund also can be organized with a multiple-class structure. Under certain conditions, establishing an ***offshore master and feeder***, that is a fund organized outside the United States whose shares are offered solely to foreign investors, may provide the ability to manage pooled assets of both domestic and offshore feeder funds within a single master. In situations where offshore feeders are present, the master fund and its principal office are generally maintained offshore.

OPERATIONAL AND ACCOUNTING ISSUES

Multiple-Class Funds

5.7 Multiple-class funds have unique operational and accounting issues. These issues include the methods and procedures to: allocate income, expenses, and gains or losses to the various classes to determine the net asset value (NAV) per share for each class; calculate dividends and distributions to shareholders for each class; and calculate investment performance for each class (such as total return and Securities and Exchange Commission [SEC] yield).

5.8 Rule 18f-3 under the 1940 Act permits open-end funds to issue multiple classes of shares. Before the adoption of the rule, a fund was required to obtain an exemptive order from the SEC to initiate a multiple-class structure. The rule permits certain differences in expenses between classes and prescribes how income, expenses, and realized and unrealized gains and losses must be allocated among the classes. Funds operating under existing multiple-class orders can elect either to adopt the new rule or to continue to follow all of the terms and conditions set forth in their exemptive order. A fund choosing to follow the new rule may have to modify its existing allocation practices, as the rule requires specific allocation methods that may be different from methods included in exemptive orders previously issued by the SEC.

5.9 Rule 18f-3 specifies that certain expenses, such as distribution and servicing fees, must be treated as class-level expenses and must be charged directly to the individual classes to which they relate. Under that rule other expenses, such as transfer agent and registration fees attributable to individual classes, may be designated as class-level expenses at the discretion of the fund's board of directors. All other expenses are allocated among the classes based on the methodology discussed in paragraph 5.13. Because certain expenses are charged to the classes of shares differently, NAV per share and dividends per share must be calculated separately for each class of shares. Class B shareholders will receive a smaller dividend per share from net investment income than Class A shareholders because of higher distribution and servicing fees and, in some instances, higher transfer agent fees. NAV per share may differ between classes. Funds that declare dividends of all net investment income daily will frequently have NAV per share that are the same for each class, except for differences that may arise from rounding.

5.10 To calculate the NAV per share of each class for multiple-class funds, income, expenses, and realized and unrealized gains or losses must be allocated to each class. Fees and expenses of the fund need to be classified as either fund or class-level expenses. Fund-level expenses, such as investment management fees, apply to all classes. Expenses that can be specifically attributed to a particular class are designated as class-level expenses.

5.11 Each class of shares bears all designated class-specific expenses. The Internal Revenue Service (IRS) currently takes the position that funds with multiple classes have only one class of stock for tax purposes. On September 6, 1996, and effective for distributions on or after that date, the IRS issued Revenue Procedure 96-47 which essentially provides that if a fund pays differential dividends to its various classes of shares pursuant to a capital structure allowed by (or similar to that allowed by) rule 18f-3, the IRS will not consider such dividends to be preferential. This ruling allows differential dividends due to divergent allocations of items such as 12b-1 fees, shareholder servicing fees, and other class-specific expenses such as transfer agency fees. Management fees, custodian fees, and so on must be allocated proportionally between all classes based upon relative NAV. Before issuing the Revenue Procedure, the IRS issued numerous private letter rulings limiting class expenses. One limitation stated that, to avoid a preferential dividend, permitted class expenses (excluding distribution fees) could differ between the classes by no more than a de minimis amount. The IRS viewed class expense differences, other than distribution fees, as de minimis when the class expenses allocated to each share of a class during a year were different from the class expenses allocated to each share of any other class of that fund for that year by less than fifty basis points of the average daily NAV per share of the class of shares with the smallest average NAV.

5.12 Class-specific expenses may be waived or reimbursed at different amounts for individual classes. The amount waived or reimbursed is borne by the class subject to such waiver or reimbursement. In certain instances fund-level expenses may be waived or reimbursed differently among the classes. However, rule 18f-3 requires a fund's board of directors to monitor waivers or reimbursements to guard against cross-subsidization among the classes. Fund management must also ensure that such waivers or reimbursements do not create a preferential dividend to a particular class of shares from a tax perspective. To protect itself from an inadvertent preferential dividend, a rigorous approach to the documentation of class expense differences (including waivers or reimbursements), and also compliance with any private letter rulings, should be carefully followed by multiple-class funds. Revenue Procedure 96-47 does not address the effect of reimbursements on whether class-specific allocations will result in preferential dividends. See paragraphs 6.52 and 6.53 for more specific guidance regarding preferential dividends.

5.13 The methods for allocating income, fund-level expenses, and realized and unrealized gains or losses used in practice are as follows:

- *Fair value of shares outstanding - relative net assets.* Under this method each class of shares participates based on the total net asset value of its shares in proportion to the total net assets of the fund. Under rule 18f-3, this method is required to be used to allocate income, fund-level expenses, and realized and unrealized gains and losses for calculating the net asset value of nondaily dividend funds.

- *Fair value of settled shares outstanding.* Under this method, earnings are allocated based on the fair value of settled shares. It is typically used to achieve consistency between the allocation method and a fund's dividend policy with respect to the shares eligible to receive dividends. For example, most daily dividend funds pay dividends only to settled shares and, therefore, in a fund that requires settlement of its shares on a trade date plus three basis, the appropriate basis of allocation of income and nonclass-specific expenses would be the fair value of settled shares. Rule 18f-3, as amended, permits the use of the "settled-shares method" for daily dividend funds for allocating income and expenses and permits the use of the relative net assets method for daily dividend funds for allocating realized and unrealized gains and losses.

- *Shares outstanding.* This method provides for each share outstanding to participate equally in the nonclass-specific items of income, expense, gains, and losses. Under rule 18f-3, as amended, this method can be used by funds provided (a) that the fund is a daily dividend fund that maintains the same net asset value per share in each class, (b) that the fund has agreements in place for waivers or reimbursements of expenses to ensure that all classes maintain the same per share net asset value, and (c) that payments waived or reimbursed under such agreements may not be carried forward or recouped at a future date.

- *Simultaneous equations.* This method is permitted under rule 18f-3, as amended, and ensures that the annualized rate of return of each class will differ from that of the other classes only by the expense differential among the claims.

Illustrations using the allocation methods discussed above are presented in exhibit 5.1.

Rule 18f-3, as amended, also provides that a fund can use any allocation method not specified in the rule so long as the fund's directors, including a majority of directors who are not interested persons of the fund, determine that the method is fair to each class of shareholders.

5.14 Rule 18f-3 does not include any requirements regarding the distribution methods that a multiple-class fund should use. The methods used to calculate distributions to shareholders from net investment income are as follows:

- *Record-share method.* The sum of net investment income available for all classes after deducting

allocated expenses, but before consideration of class-specific expenses, is divided by the total outstanding shares on the dividend record date for all classes to arrive at a gross dividend rate for all shares. From this gross rate, an amount per share for each class (the amount of incremental expenses accrued during the period divided by the record date shares outstanding for the class) is subtracted. The result is the per share dividend available for each class.

- *Actual income available method.* Actual net investment income that has been allocated to each class (as recorded on the books) is divided by the record date shares for each class to derive the dividend payable per share.
- *Simultaneous equation method.* This method seeks to ensure, by using simultaneous equations, that the distribution rates will differ among the classes by the anticipated differential expense ratios.

5.15 The record-share method is most commonly used by funds that do not pay dividends daily (nondaily dividend funds). It is also used by daily dividend funds that employ policies to manage their dividend payout levels (such as to distribute stable dividend amounts or to compensate for book-tax differences). The dividend payout level can be managed for only one share class; the dividend rates for the other classes will vary because class-level expenses differ between classes. The record-share method is simple to apply, it makes sure that the annualized distribution rate for the class with higher expenses will be lower than that for the class with lower expenses, and it minimizes the likelihood of a preferential dividend being paid. The disadvantage of this method is that the difference between the annualized distribution rates of the classes usually will not equal the precise expense ratio difference between the classes, because the directly related expenses accrued over time on a varying number of shares are reduced to a per share amount on the record date shares. The larger the fluctuation in shares over time, the greater the potential difference.

5.16 The actual income available method is used for funds that declare daily dividends per share equal to the amount of net investment income allocated to each class. This results in the same per share NAV for all classes (except for differences that may result from rounding). The actual income available method is not used for funds that pay dividends on a periodic basis.

5.17 The simultaneous equation method is used for periodic dividend funds and is more complex than other methods. This method ensures that the annualized distribution rates will differ between classes by the approximate amount of the expense ratio difference. Per share NAV will usually converge after the dividend has been recorded.

5.18 Because distribution amounts under both the record share and the simultaneous equation methods are determined independently of the amount of net investment income allocated to each class, situations can result whereby, after recording the dividends, one class has positive undistributed income while the other class is negative. For both financial reporting and tax purposes, a tax return of capital is not determined and retained earnings is not disclosed at the class level, but only determined at the fund level.

5.19 Regardless of the frequency of income dividends or the income distribution method selected, multiple-class funds should declare capital gain distributions at the fund level rather than at the class level, so that all shares receive the same per share gain distribution. This procedure is necessary to avoid paying a preferential dividend for tax purposes.

Illustrations of the above distribution calculation methods are presented in exhibit 5.2.

Master-Feeder Funds

5.20 In a master-feeder arrangement, investment management and distribution functions are separated between two or more entities. Two or more feeder investment companies, each having similar investment objectives but different distribution channels for its shares, invest the proceeds from shares sold in another investment company, known as the master fund. The feeder fund has investment

objectives and policies consistent with those of its related master fund. Portfolio management and related functions (for example, custody) are conducted at the master fund, while distribution, shareholder servicing, and transfer agent functions are carried out by the feeders. Both the master and feeder funds incur administrative and operating expenses, such as directors', legal, and audit fees.

5.21 Master-feeder sponsors usually apply to the IRS for a private letter ruling to ensure that the master will be treated as a partnership for federal income tax purposes and that each feeder will be treated as an owner of its proportionate share of the earnings and profits and net assets of the master. This is to make sure that the feeders maintain their status as regulated investment companies and can afford their shareholders the pass-through tax benefits that result from that status.

5.22 Master-feeder accounting involves allocating the master portfolio's income, expenses, and realized and unrealized gains and losses among its feeder funds. Because most master funds are typically structured as partnerships for tax purposes, the allocation of income, expenses, gains, and losses follows partnership tax allocation rules (partner's distributive share rules as provided for in section 704(b) of the IRC). Each feeder must be allocated its share of gain or loss realized by the master when the master disposes of a particular security lot. The tax allocation process is complicated because the relative interest of the feeder funds in the master portfolio changes, usually daily, as feeder fund shares are sold or redeemed. Before final regulations that apply after December 21, 1993, the IRC required this allocation to follow the literal partnership allocation methodology that implies a "property-by-property" method for investment partnerships. Performing tax allocations under the property-by-property method requires evaluating each feeder's share of the realized gain or loss on the security lot sold. The final regulations allow allocation based on an aggregate method. The regulation allowing an "aggregate method" for allocating gains and losses does not apply to built-in gains and losses from securities contributed by a feeder to a master in a nontaxable event. Performing tax allocation under the aggregate method requires evaluating each feeder's share of the unrealized gains or losses on its entire (that is, aggregate) interest in the master, rather than each feeder's share of the realized gain or loss on the sold security lot alone.

5.23 Master-feeder structures allow the creation of offshore feeder funds that may result in more favorable tax treatment for offshore investors than would be afforded by a direct investment by a foreign investor in a domestic fund. Offshore funds may invest their assets in the same master fund as domestic feeder funds. If a foreign person invests in a domestic fund, dividends (including dividends paid out of interest and short-term capital gains) are subject to U.S. income tax withholding, usually at a 30 percent rate (if no tax treaty exists). If the master's principal office is offshore, and assuming the offshore feeder is organized in a tax haven jurisdiction, a foreign person's investment in an offshore feeder usually will not be subject to U.S. income taxes on the offshore feeder's share of portfolio interest or capital gains (including short-term capital gains) derived from investment and trading activity in the United States. However, U.S. income taxes must be withheld from the offshore feeder's share of dividends received on U.S. portfolio securities of the master. Accordingly, the offshore feeder structure would be less useful for income funds, where the principal source of investment return is dividend income on domestic portfolio securities.

FINANCIAL STATEMENT PRESENTATION

5.24 In addition to the financial statement reporting requirements in chapter 7, management investment companies that have multiple-classes of shares or master-feeder structures follow reporting guidelines discussed below when preparing financial statements, including financial highlights. Illustrations are shown at the end of this chapter.

Multiple-Class Funds

Refer to exhibit 5.3 for examples of each of the three statements listed below.

5.25 <u>*Statement of Assets and Liabilities*</u>. The composition of net assets is reported in total, but net

asset value per share and shares outstanding should be reported for each class. The maximum public offering price per share is often reported for each class.

5.26 *Statement of Operations*. Class-specific expenses are reported for each class. Reporting the amount of fund-level expenses allocated to each class is not required. However, some funds voluntarily disclose fund-level expenses by class in the statement of operations or in notes to the financial statements.

5.27 *Statement of Changes in Net Assets*. Dividends and distributions paid to shareholders and capital share transactions for each class are required to be disclosed. A tax return of capital is determined at the fund level and not at the class level. A tax return of capital distribution should be allocated between the classes and reported for each class.

5.28 *Notes to Financial Statements*. The notes should—

- Describe each class of shares including sales charges, shareholder servicing fees, and distribution fees.
- Disclose the method used to allocate income and expenses, and realized and unrealized capital gains and losses, to each class.
- Describe fee arrangements for class-specific distribution plans and for any other class-level expenses.
- Disclose capital share transactions (if not disclosed separately in the statement of changes in net assets) for each class.
- Disclose total sales charges paid to any affiliates for each class.

5.29 *Financial Highlights*. Financial highlights, including total return, should be presented for each class except for portfolio turnover, which is calculated at the fund level.

Master-Feeder Funds

5.30 Under current SEC policies, the annual and semiannual reports for feeder funds should contain two sets of financial statements, one for the master fund and the other for the specific-feeder fund. (Refer to exhibits 5.4 and 5.5 for illustrative financial statements. Items below correspond to these exhibits).

5.31 *Statement of Assets and Liabilities*. Each *feeder fund's* statement of assets and liabilities shows an investment in the master fund, which is the sole or principal investment of the feeder fund. The total of all feeder investments in the master fund should equal the total net assets of the master fund. A schedule of portfolio investments is not presented at the feeder level. The net asset value per share, total shares outstanding, and the components of net assets should be reported. Should the feeder fund have a multiple-class structure, it would report the multiple-class information specified in this chapter.

5.32 *Master funds* are usually organized as trusts with flow-through accounting treatment to its feeder funds. As such, the statement of assets and liabilities of the master fund usually does not report the components of net assets, shares outstanding, or net asset value per share.

5.33 The *portfolio of investments* is included only in the master fund's financial statements.

5.34 *Statement of Operations*. The statement of operations reports details of the *feeder fund's* allocated share of net investment income from the master fund (that is, separate disclosure of allocated interest, dividends, and expenses). The statement reports the feeder's allocated share of the master fund's realized and unrealized gains and losses. The total of all feeders' income, expense, and realized and unrealized gain or loss components should agree to the corresponding totals of the master fund. Feeder

IRS to make sure that the master fund will be taxed as a partnership rather than a corporation. Failure to be treated as a partnership for tax purposes could result in adverse tax consequences for the master and feeders. In addition, the private letter ruling requests that the feeder funds can look through to the master fund for purposes of the income and diversification requirements necessary for the feeder funds to qualify as regulated investment companies for federal income tax purposes.

5.44 For multiple-class funds electing to continue to operate under the terms of their exemptive orders, the SEC requires an expert's opinion from the fund's auditors regarding the adequacy of the systems and internal controls to achieve the stated objectives included in the exemptive order request. The expert's opinion is required to be included each year in the fund's year-end Form N-SAR filing. The annual expert's opinion is not required for funds operating under rule 18f-3, which permits adoption of a multiple-class structure without an exemptive order, subject to certain parameters.

5.45 Multiple-class funds. In connection with the audit of multiple-class funds, auditors should consider whether—

- Class-level and fund-level expenses have been determined as required by rule 18f-3 or as specified in the fund's SEC exemptive order.
- Income, expenses, and realized and unrealized gains or losses have been allocated among the classes of shares in accordance with the allocation methods in rule 18f-3 or in the fund's SEC exemptive order.
- IRS private letter rulings have been complied with regarding the amount of class-level expense differentials necessary to avoid preferential dividends for income tax purposes.
- Differences between expense and net investment income ratios of various share classes should appear reasonable when compared to the amount or percentage differences in class-level expenses.

5.46 Master-feeder funds. In connection with the audit of master-feeder funds, auditors should consider whether —

- Fees and expenses incurred by the master fund or feeder funds are in accordance with contractual agreements as disclosed in the registration statement. Advisory and custodian fees are incurred only at the master fund, while fees and expenses relating to distribution and shareholder servicing are incurred at the feeder level.
- Controls and procedures are adequate to ensure that investment fair values and related income components are correctly allocated to feeder funds.
- Systems and controls are adequate to record accurately and timely the daily contributions and withdrawals between the feeder funds and the master fund. This is important to determine properly each feeder fund's proportionate ownership interest for purposes of computing daily allocations. All shareholder purchases and redemptions are recorded first at the feeder level. Assuming cash moves on the same day, after the total daily net sales or redemptions is known for each feeder, contributions and withdrawals in the master fund are recorded to reflect changes in the feeders' ownership interests (that is, a net redemption at the feeder level will result in a withdrawal from the master fund). All such transactions at the feeder level affect the investment in the master fund. At the master fund level, the cash movements flow through the partnership equity or net assets account.
- Satisfaction has been obtained as to the accuracy of master fund tax adjustments allocated to the feeder funds.

5.47 A master-feeder structure could consist of a master fund and feeder funds that are not related to each other, except that they are each feeders of the same master fund. Each feeder could have

different auditors that may also differ from the auditor of the master fund.

FUNDS OF FUNDS

5.47 Funds of funds are investment companies that invest in other investment companies. The most typical fund of funds arrangement is the master-feeder structure. Historically, a registered investment company's ability to invest in other investment companies was limited by section 12(d) of the Investment Company Act of 1940. Under section 12(d), an open-end investment company is limited, among other restrictions, to aggregate investments in other investment companies of 10 percent of the acquiring company's total assets. Master-feeder structures, however, are specifically permitted by section 12(d)(l)(E)(ii) of the Act. As a result, except for a limited number of registered funds that received exemptive orders from the SEC, fund of funds structures have been limited to unregistered investment companies. In 1996, section 12(d) was amended to permit registered investment companies to invest in other investment companies provided that both the investor and investee funds were part of the same group of investment companies (affiliated funds). Investments in nonaffiliated funds would continue to be subject to the historical limitations under section 12(d) unless an exemptive order is obtained from the SEC.

5.48 Many multitiered structures are U.S. domiciled, but recent trends include the creation of offshore, domestic, and blended structures. A blended structure might include a fund with significant investments in other investment companies and also investment in individual securities. Participants in such structures include both foreign and domestic investors, individually and through funds, commodity pools, retirement accounts, and other sources.

Valuation

5.49 For publicly-traded investee funds, market quotes are usually available. For those investee funds that are not publicly traded, market quotes may not be readily available. In such instances, the fair value of investments in investee funds, as determined by the investor fund's board of directors or management, should be used to value the investments on the books of the investor fund. Fair value may be determined by reference to the investor fund's interest in the investee fund's net assets. The valuation of an investee fund by the investor should reflect any incentive or performance fee or **incentive allocation** of earnings to the general partner based on the current performance of the investee fund.

Other Considerations for Investments in Nonpublicly Traded Investees

5.50 Proper execution of the fund of funds strategy requires management of the investor fund to exercise significant judgment in selecting and monitoring the performance of the investee funds. Occasionally, management may engage an outside consultant to assist in the performance monitoring and selection process. While this process may include many procedures, a review of prior audited financial results should be included.

5.51 Monitoring the performance is an essential control in the operation of the fund. Fund management should review regular (at least quarterly) investment results and review periodically the trading strategy being followed by the investee company to make sure that it is consistent with the strategy approved at the time of the initial investment. The results of daily monitoring functions established by management of the investee company should also be reviewed periodically. Discussions with each investee company to identify any significant changes or problems with systems, illiquid securities, personnel or trading strategies should be held periodically and documented. Sometimes, such as when there are significant changes in market conditions or a particularly risky strategy, monthly or more frequent discussions may be advisable. Another essential control that management of the investor fund should exercise is comparison of preliminary annual results reported by the investee fund to the investee fund's audited financial statements. The audited financial statements should substantiate the reliability of the investee fund's reporting processes.

5.53 As an additional control over the valuation process, management of the investor funds may wait for receipt of audited financial statements and individual capital account statements from the investee funds to make sure no significant changes in previously reported results have occurred before issuing their audited financial statements. This approach provides key audit evidence and instills discipline into the investor fund's financial reporting system.

Auditing Procedures

5.54 Significant audit risk may exist if management does not use strong procedural controls in selecting and monitoring its investments in investee companies and determining the investments' fair value. The audit approach to an investor fund's investments in investee funds companies should focus on two areas:

- Evaluating the investor and investee fund's control environments

- Substantiating the fair value attributed to investments in investee funds

5.55 *Control Environment*. The primary concern in the control environment relates to the procedures that management of the investor fund uses to monitor its investments in investee funds. Investments in public investee funds may be valued based on reported daily net asset values and the auditor may rely upon the structure established by the 1940 and 1933 Acts to gain comfort that such reported fair values are accurate.

5.56 For investments in nonpublic-investee companies, audit tests may include participation in management site visits or telephone calls to investee funds, or a review of documentation of such visits or calls. Prior experience with the investee fund's management, results of prior year audits or the history of adjustments to unaudited results reported by the investee funds, if any, should be considered in determining the extent to which such participation is necessary. For example, participation in management site visits would be more appropriate if the investee funds represented a significant investment by the investor fund or if serious concerns as to the management controls at the investee fund existed. The auditor should also review the investor fund's reconciliation of the unaudited financial results received from the investee funds to their audited financial statements for the prior year, if the current year's audited financial statements are not available. Any significant variations, their causes, and their impact on the investor fund's financial statements should be identified.

5.57 If significant variations are discovered in the comparison of prior year audited financial statements to financial information obtained from the investee funds, the auditor should consider participating in the management site visit, reviewing the investor fund's audited financial statements, or vouching withdrawals, if any, from the investee fund after year-end, as part of the annual audit tests.

Allocation Methods Of Income, Fund-Level Expenses And Realized And Unrealized Gains (Losses)

	Total	*Class A*	*Class B*
Assumptions:			
Total shares outstanding		2,000,000	3,000,000
Settled shares outstanding		1,990,000	2,900,000
Net asset value per share		$10.52	$10.49
Fair Value Of Shares Outstanding – Relative Net Assets:			
Total shares outstanding	5,000,000	2,000,000	3,000,000
Net asset value per share		$10.52	$10.49
Net asset value	$ 52,510,000	21,040,000	31,470,000
Allocation percentage		40.0686%	59.9314%
Fair Value Of Settled Shares Outstanding:			
Settled shares outstanding	4,890,000	1,990,000	2,900,000
Net asset value per share		$10.52	$10.49
	$ 51,355,800	20,934,800	30,421,000
Allocation percentage		40.7642%	59.2358%
Shares Outstanding:			
Total shares outstanding	5,000,000	2,000,000	3,000,000
Allocation percentage		40.0%	60.0%

Chapter 6

TAXES

OVERVIEW

6.1 This chapter has been divided into two Sections to focus on distinct aspects of taxes for investment companies: "Financial Statements and Other Matters" and "Taxation of Regulated Investment Companies." Due to the extensive interrelationships between taxes and the underlying accounts or products, certain tax matters appear in other chapters, as follows:

Topic	Paragraph reference
Dividends to shareholders and reinvestments	4.45
Characterization of dividends for financial statement purposes	7.~~3~~52
Financial statement disclosures:	
—Status under Subchapter M	7.69
—Capital loss carryforwards and post-October capital and currency loss deferrals	7.69
Multiple classes of shares:	
—Preferential dividends	5.11, 5.15
—Return of capital	5.18
Master-feeder funds:	
—Master tax qualification	5.21
—Master tax earnings allocation	5.22
—Offshore funds	5.23
Tax-free business combinations	8.37
Unit investment trusts	9.13
Variable contracts	10.42-10.56

FINANCIAL STATEMENTS AND OTHER MATTERS

Tax Provision

6.2 A provision for federal income taxes is not required for investment companies that qualify under Subchapter M of the Internal Revenue Code of 1986, as amended (IRC), and that distribute all of their investment company taxable income and taxable realized gains from securities transactions. For investment companies that qualify as regulated investment companies (RICs) under the IRC, federal income taxes payable on security gains that the investment company elects to retain are accrued only on the last day of the tax year.[1] Only shareholders of record ~~at~~ on the last day of the fiscal year are entitled to the credit for income taxes paid by the fund. Information regarding retained gains and taxes paid will be sent to those shareholders, to enable them to report their proportionate share of the gains and taxes paid on their individual returns. Also, no provision for federal excise taxes is required if a fund timely distributes substantially all of its taxable ordinary income calculated on a calendar-year

[1] Securities and Exchange Commission (SEC), *Codification of Financial Reporting Policies*, Section 404.6b.

basis and substantially all of its taxable capital gains calculated generally on the basis of a 12 month period ended October 31st. (see paragraph 6.648). Excise taxes imposed on underdistributed income should be recorded when determinable.

6.3 A provision for income taxes should be recorded on net investment income and realized gains or losses on investments when it is probable that an investment company subject to Subchapter M of the IRC will not so qualify. Some funds also may be required to establish a provision for deferred taxes if it is probable that the company will not qualify for a period longer than one year.

6.4 Some investment companies may be subject to state, local, or foreign taxes on net investment income and realized gains on a recurring basis. State, local, and foreign taxes, if payable, are reported on the accrual basis, including deferred taxes on the unrealized appreciation of investments. A valuation allowance should be established for any deferred tax asset resulting from temporary differences related to unrealized depreciation that could result in deductible amounts in future years when the realization of that benefit cannot be assured due to the uncertainties of the financial markets.

Federal Income Tax Provisions Affecting Investment Accounts

6.5 In establishing investment policies, companies that qualify as RICs under Subchapter M of the IRC should consider the requirements of Subchapter M relating to diversification of assets, sources of income and realized gains, and similar matters. Those requirements are described later in this chapter.

Withholding Taxes

6.6 Whenever income tax is withheld from investment income at the source (typically foreign taxes), the amounts withheld that are not reclaimable should be accrued at the same time as the related income on each income recognition date if the tax rate is fixed and known. If the tax withheld is reclaimable from the local tax authorities, it should be recorded as a receivable and not as an expense. If the tax rate is not known or estimable, such expense or receivable should be recorded on the date the net amount is received.

Financial Statement Presentation

6.7 Taxes in certain foreign jurisdictions may be based on the net investment income and realized gains of the fund within that jurisdiction; the guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, is applicable to such taxes. Provisions for other taxes by investment companies are usually presented under the separate income categories (that is, investment income and realized and unrealized gains) to which they apply. A provision for deferred income taxes, if any, should be presented separately.

Diversification of Assets

6.8 As noted in paragraph 8.41, the diversification requirements appearing in a fund's prospectus and specified in various Securities and Exchange Commission (SEC) rules and interpretations differ from those in Subchapter M, discussed later in this chapter.

General Discussion of the Taxation of RICs

6.9 This chapter discusses in general terms the requirements of the IRC for qualification as ~~an RIC~~a RIC, the tax effects of such status, the excise tax on certain undistributed taxable income, and certain other federal tax matters affecting investment companies under ~~p~~Part 1 of Subchapter M of the IRC.[2] (Although many states and municipalities have adopted provisions similar to Subchapter M, a discussion of state and local taxes is beyond the scope of this chapter, as is discussion of the tax aspects of investment companies formed as partnerships.) In designing the detailed audit program, the auditor should refer to the latest IRC, its regulations, rulings by the Internal Revenue Service (IRS), and applicable state laws to be certain that all requirements for qualification have been covered and to determine the need for accruing income, excise, or other taxes.

6.10 This chapter is intended to be used as guidance to the auditor and should not be considered a detailed explanation of the IRC, its regulations, or the various rulings issued by the IRS as applied to investment companies. In addition, the tax law is complex and changes constantly because of new legislation, regulations, rulings by the IRS, and court decisions. Thus, the auditor should be aware of such developments that occur subsequent~~ly~~ to the publication of this Guide and should apply the information in this chapter in that context.

Taxation of ~~an RIC~~a RIC's Taxable Income and Net Capital Gains

6.11 An investment company organized as a corporation or as a business trust is taxable as a corporation and, as such, would be subject to federal income taxes and certain state and local taxes as would any other domestic corporation. However, if the investment company is registered under the Investment Company Act of 1940 (the 1940 Act), it may elect to qualify for special federal income tax treatment as ~~an RIC~~a RIC under the IRC, which allows it to deduct dividends paid to shareholders[3] and to pass through tax-favored income, such as capital gains and tax-exempt income (see paragraphs 6.32~~1~~ through 6.47~~51~~). A dividend for this purpose is defined as a distribution of current or accumulated earnings and profits (E&P). ~~Qualification as an RIC~~a RIC ~~permits the investment company to avoid federal and most state taxes on the investment income and capital gains it earns and distributes to its shareholders.~~ Thus, an investment company distributing all of its income to its shareholders would have no taxable income and, therefore, no tax liability. If an investment company fails to qualify as ~~an RIC~~a RIC, it will be taxed as a regular corporation.~~,~~ ~~and t~~The deduction for dividends paid by the investment company will not be available, and all distributions out of earnings and profits ("E&P") will be taxed as ordinary income to shareholders. The effects of failure to qualify may extend beyond the income tax consequences, since net asset values may have been improperly stated.

6.12 Certain funds are organized as *series funds*. A series fund includes several portfolios, each of which may have a different investment objective. Series funds are required to treat each portfolio as a separate corporation for tax purposes.[4]

---

[2] Part I of Subchapter M consists of Sections 851 to 855 ~~and 860~~ of the Internal Revenue Code (IRC), as amended by the Revenue Reconciliation Act of 1993~~, as amended by~~ the Taxpayers Relief Act of 1997, and the Internal Revenue Service Restructuring and Reform Act of 1998.

[3] Section 851(a) of the IRC.

[4] Section 851(g~~h~~) of the IRC.

6.13 To determine if ~~an RIC~~a RIC has a federal income tax liability, investment company taxable income and net capital gain must be computed separately. Investment company taxable income begins with regular taxable income and is adjusted as follows:

a. Net capital gain (that is, ~~the~~ net long-term capital gain for the taxable year in excess of ~~the~~ any net short-term **capital loss** for such year) is excluded.[5]
b. Net operating losses are not allowed as a deduction.6
c. The corporate deduction for dividends received is not allowed.[7]
d. The deduction for dividends paid shall be allowed.

6.14 Note that although investment company taxable income excludes net capital gain, it includes net short-term capital gain in excess of net long-term capital loss. A net capital loss may be carried forward by ~~an RIC~~a RIC to eight succeeding taxable years, but it may not be carried back. Capital losses that are carried forward are treated as short-term capital losses in the year to which they are carried and reduce capital gains that arise in such year. ~~An RIC~~A RIC is prohibited from claiming a net operating loss deduction. An investment company, especially a new one, may incur a net investment loss that can be used to reduce net short-term capital gains. If the net investment loss exceeds short-term gains, it cannot be carried forward and deducted as a net operating loss if such investment company~~it~~ elects to be ~~a RIC~~a RIC in succeeding years.

6.15 In order for ~~an RIC~~a RIC to avoid paying any federal income taxes, it must distribute ordinary dividends to shareholders sufficient to offset investment company taxable income and capital gain dividends sufficient to offset net capital gain.

6.16 The RIC's investment company taxable income may be reduced to zero by dividends paid to shareholders from ~~an RIC~~a RIC's ~~earnings and profits (~~E&P~~)~~ other than capital gain dividends and exempt-interest dividends. The RIC's net capital gain may be offset by a ~~**designated**~~ **capital gain** dividend paid by the RIC to its shareholders and designated in a written notice mailed within sixty days of the close of the RIC's taxable year in which such dividend is paid.[8] This notice must specify whether any portion of the dividend is from capital gain transactions of the RIC subject to a 20% or 25% tax rate or transactions which will qualify as section 1202 gain distributions related to small business stock. Any gains not so designated will be treated as subject to a 28% tax rate[9]. ~~An RIC~~A RIC may not reduce its net capital gain by dividends that have not been designated as capital gain dividends. Accordingly, although ~~an RIC~~a RIC may have fully distributed its investment company taxable income and net capital gain, it may be subject to tax on its net capital gain if the dividends have not been properly designated. Distributions to shareholders are discussed in more detail in paragraphs 6.52 through 6.62.

6.17 An investment company that does not meet all of the RIC qualification requirements in a taxable year will be taxed as a regular corporation for that year and must comply with provisions in a subsequent year if it elects to be taxed as ~~an RIC~~a RIC, as follows:

---

[5] Section 852(b)(2)(A) of the IRC.
[6] Section 852(b)(2)(B) of the IRC.
[7] Section 852(b)(2)(C) of the IRC.
[8] Section 852 (b)(3)(C) of the IRC.
[9] IRS Notice 97-64.

a. A regular corporation that elects to qualify as ~~an RIC~~a RIC will be subject to a corporate level tax on its net unrealized gains as if its assets had been sold on the day before the first day of the fiscal year that the corporation qualifies to be taxed as ~~an RIC~~a RIC.[10] This general rule is designed to prevent regular corporations with appreciated assets from qualifying as ~~an RIC~~a RIC, selling the assets at a gain, and avoiding corporate-level tax by distributing all income to the shareholders of the RIC.

b. From the general rule discussed above, it might appear that ~~an RIC~~a RIC disqualified in one taxable year but qualifying the next year would owe a corporate-level tax on its net unrealized gains. However, an exception to the general rule is provided stating that a previously qualifying RIC that fails to meet the requirements of the RIC tax provisions for a single taxable year usually will not be required to recognize net unrealized gain if it "re-qualifies" in the immediately succeeding tax year.[11]

c. A corporation that accumulates E&P in a year in which it is not taxed as ~~an RIC~~a RIC is required to distribute such E&P before the end of its RIC year if it wishes to be taxed as ~~an RIC~~a RIC in such year. This also includes non-RIC E&P acquired in a tax-free reorganization occurring before December 22, 1992.[12]

Taxation of Shareholder Distributions

6.18 A dividend is a distribution from ~~the~~ current year~~'s~~ E&P or E&P accumulated in prior years. E&P is determined by adjusting taxable income for items that constitute economic income or deduction although they do not affect taxable income.[13] Examples of these adjustments include tax-exempt income, amortization of organization costs or federal income taxes. Expenses related to tax-exempt income and capital loss in excess of capital gain arising in a taxable year do not reduce current E&P.[14]

6.19 Distributions from ~~an RIC~~a RIC are reported to shareholders on Form 1099-DIV as—

a. Dividends, to the extent of the RIC's current or accumulated E&P.[15]

b. Nontaxable distributions (that is, return of capital), ~~to the extent that such~~which are distributions paid within a fiscal year that exceed the RIC's current and accumulated E&P.[16]

c. Capital gains, to the extent properly designated in a written notice to shareholders.

6.20 If ~~an RIC~~a RIC has made distributions during a taxable year in excess of its current and accumulated E&P, it is required to answer the question on page 3 of Form 1120-RIC appropriately, file Form 5452 with its Form 1120-RIC, and report the taxable and nontaxable components on Form 1099-DIV.

---

[10] IRS Notice 88-19, 1988-1 C.B. 486.
[11] IRS Notice 88-96, 1988-2 C.B. 420.
[12] Regulation 1.852-12 of the IRC.
[13] Section 312 of the IRC.
[14] Section 852(c) of the IRC.
[15] Sections 301(c)(1) and 316 of the IRC.
[16] Section 301(c)(2) of the IRC.

6.21 A dividend from investment company taxable income may qualify in whole or in part for the dividends received deduction available to corporate shareholders. Only a portion of the dividends paid by the RIC may be eligible for the dividends received deduction if the qualifying dividends received by the RIC are less than the RIC's net income (see appendix C, part II).

a. For domestic equity securities acquired after March 1, 1986, a dividend does not qualify for the dividends received deduction if the stock on which the dividend was paid is held for less than forty-six days ~~(ninety-one days for certain preferred stock~~ during the ninety-day period that begins forty-five days before the stock becomes ex-dividend with respect to the dividend ~~[~~(ninety-one days for certain preferred stock during the 180-day period that begins ninety days before the stock becomes ex-dividend ~~for certain preferred stock]~~). ~~All the holding period suspension provisions in the IRC relating to diminution of risk of loss apply in determining the forty-six day period~~The holding period generally is suspended for this purpose during any time that the RIC has diminished it's risk of loss through hedging.[17]

b. The portion of the dividend qualifying for the dividends received deduction must be designated in a written notice mailed to the shareholders within sixty days after the end of the RIC's tax year in which the dividend was paid.[18]

6.22 If, at the end of ~~an RIC~~a RIC's tax year, at least 50 percent of the fair market value of its assets is invested in stock or securities of foreign corporations, the RIC may elect to "pass through" to its shareholders the foreign income taxes that it has paid during the year and also the foreign source income earned by the fund.[19]

a. ~~An RIC~~A RIC that makes this election is not entitled to a tax deduction for the expense or a foreign tax credit. However, the fund is entitled to treat the foreign taxes passed through to shareholders as a **deemed dividend** (that is, as part of the dividends-paid deduction).

b. Shareholders must report as taxable income the gross income received from the RIC (increased by foreign taxes), and are entitled to either a foreign tax credit (subject to certain limitations) or a deduction (subject to other limitations) for their allowable share of foreign taxes paid by the RIC.[20] To claim or pass through a foreign tax credit, ~~an RIC~~a RIC must hold the stock for sixteen days within the thirty-day period beginning fifteen days before the ex-dividend date (forty-five days within the ninety-day period for certain preferred stock). The holding period generally is suspended for this purpose during any time that the RIC has diminished it's risk of loss through hedging~~. The holding period suspension provisions in the IRC apply in determining the sixteen-day (or forty-five-day) holding period~~. Foreign taxes paid by ~~a RIC~~a RIC, which do not qualify for the foreign tax credit, do not increase the taxable income reported to the shareholders (i.e., the RIC is allowed to deduct such taxes in computing its investment company taxable income).

c. If ~~an RIC~~a RIC does not qualify to pass through the foreign taxes to shareholders, the taxes are deductible by the RIC in determining its investment company taxable income.

d. The source of the income (by country) and foreign taxes must be designated by the fund in a written notice to its shareholders mailed within sixty days after the end of the RIC's tax

[17] Section 246(c) of the IRC.
[18] Section 854(b)(2) of the IRC.
[19] Section 853(a) of the IRC.
[20] Section 853(b)(2) of the IRC.

year in which the dividend was paid.[21] ~~An RIC~~A RIC~~ must notify shareholders of the amount of foreign taxes that would be disallowed for failure to meet the holding period requirement in a written notice mailed to shareholders within sixty days of the end of the RIC's tax year.~~

6.23 ~~An RIC~~A RIC that at the end of each quarter of its taxable year has at least 50 percent of its assets invested in tax-exempt obligations is eligible to distribute exempt-interest dividends to its shareholders. Exempt-interest dividends received by a shareholder are treated as tax-exempt income.[22]

a. The maximum amount identified as exempt-interest dividends cannot exceed the net tax-exempt interest earned by the fund. ~~This requires a reduction of t~~Tax-exempt interest income must be reduced for the amortization of premium on tax-exempt bonds in the portfolio and also for fund expenses attributable to the production of its tax-exempt interest income. ~~An RIC~~A RIC's allowable expenses must be allocated between its taxable and tax-exempt income. (Capital gains are excluded from this calculation.) ~~The only~~ Generally, an acceptable basis for allocation ~~appears to be~~is the ratio of tax-exempt income to gross investment income (tax-exempt plus taxable).[23] The required amortization of premium on tax-exempt bonds must be allocated to the tax-exempt income.[24]

b. If distributions exceed net tax-exempt interest income and taxable income (if any), the excess will be taxable to shareholders as ordinary dividends to the extent of earnings and profits. Because amounts not allowable as deductions do not reduce E&P, the excess payments will be ordinary dividends up to at least these amounts. ~~amounts not allowable as deductions (that is, expenses allocable to exempt-interest income).~~ Any additional distributions may constitute a return of capital.

c. If a fund is not qualified to pay exempt-interest dividends, it may still qualify as ~~an RIC~~a RIC if it meets the other applicable tests. However, its distributions will be fully taxable to its shareholders.

d. Net gain or loss realized on the sale of tax-exempt securities is treated as capital gain or loss, unless the market discount rules apply, in which case a portion of the gain may be ordinary taxable income.

e. An exempt-interest dividend must be designated as such in a written notice mailed to shareholders not later than sixty days after the end of the RIC's tax year in which the dividend was paid.[25]

6.24 A capital gain dividend is any dividend designated as such in a written notice mailed to shareholders not later than sixty days after the end of the RIC's tax year in which the dividend was paid.[26]

---

[21] Section 853(c) of the IRC.
[22] Section 852(b)(5) of the IRC.
[23] Section 265(a)(3) of the IRC.
[24] Section 171(a)(2).
[25] Section 852(b)(5)(A) of the IRC.
[26] Section 852(b)(3)(C) of the IRC.

a. ~~The~~ To the extent that the amount so designated ~~cannot~~ exceeds the excess of the net long-term capital gain over the net short-term capital loss for the year, the excess is treated as a ordinary distribution[27].

b. A capital gain dividend is generally treated as long-term capital gain by the shareholder regardless of the actual holding period of the shareholder's ~~RIC's stock.~~ shares in the RIC.

c. ~~An RIC~~ A RIC may retain all or any portion of its net capital gain and elect to have shareholders include the gain in their taxable income as though a capital gain dividend had been paid. In such a case, the RIC will pay corporate income tax (currently 35 percent) on the undistributed net capital gain within thirty days of its year end and notify shareholders within sixty days of the RIC's tax year end of the allocable retained capital gain and related income tax paid. The gain is treated as long-term capital gain and the tax is treated as a tax payment by the shareholders. Each shareholder is entitled to increase the basis of his or her shares by a percentage (currently 65 percent) of the deemed distribution[28]. Notification must be provided to shareholders through Form 2439.[29]

d. The RIC may also retain all or any portion of the net capital gain and pay the income tax thereon without notifying shareholders. In this situation, the shareholders will not include the capital gain as income nor will they receive a credit for the taxes paid by the fund or an adjustment to the basis of their shares held.

e. For securities acquired by a RIC after December 31, 2000, and held for 5-years, the applicable tax rate on gains on sales is 18% (or 8% for shareholders in the 15% tax bracket). *In addition, a RIC can elect to treat a security held on January 1, 2001, as sold* on that date and repurchased at its closing market price on that date. If such securities are sold more than five years later, they will be subject to the 18% (8%) rate.

6.25 A noncorporate taxpayer can exclude from taxable income 50 percent of capital gains resulting from the sale of qualified small business stock held for more than five years. This provision is applicable to the shareholder of ~~an RIC~~ a RIC since the RIC is considered a pass-through entity and, as such, the RIC shareholder is considered to indirectly own the stock owned by the RIC. To qualify for this exclusion, the stock must be acquired directly by the taxpayer (or indirectly, through the RIC in this case) at its original issuance after August 10, 1993, and held by the RIC for more than five years. Gains eligible for this exclusion are limited to the greater of ten times the investor's basis in the stock or $10 million. Finally, the corporation (a C corporation) must meet certain definitional requirements in order for its stock to be considered qualified small business stock. The requirements for tracking specific shareholder investments that are eligible for the exclusion and nontax issues such as the limits on **restricted securities** may make it difficult for most RICs to take advantage of this provision. This provision is effective for stock issued after August 10, 1993.[30] Effective for sales after August 5, 1997 a taxpayer may elect to rollover capital gain from the sale of qualified small business stock held for more than six months if other small business stock is purchased within sixty days.

---

[27] Section 852(b)(3)(C).

[28] Section 852(b)(3)(D)(iii).

[29] Regulation 1.852-9 of the IRC.

[30] Section 1202 of the IRC.

~~*Variable Contracts*~~

~~6.26 Additional quarterly asset diversification tests are to be met by RICs used as investment vehicles for variable annuity, endowment, and life insurance contracts. These diversification requirements must be met on a calendar year basis without regard to the fiscal year of the fund. In general, a segregated asset account will be considered adequately diversified if—~~

~~a.No more than 55 percent of total assets is represented by any one investment.~~

~~b.No more than 70 percent of total assets is represented by any two investments.~~

~~c.No more than 80 percent of total assets is represented by any three investments.~~

~~d.No more than 90 percent of total assets is represented by any four investments.~~

~~In general, for a separate account to be permitted to "look through" to the assets of an RIC~~a RIC~~, all of the interests in the RIC must be held by one or more insurance company separate accounts.~~

~~6.27 All securities of the same issuer, all interest in the same real property project, and all interests in the same commodity are each treated as a single investment. Each governmental agency or instrumentality is treated as a separate issuer.~~

~~6.28 The regulations provide a safe harbor for segregated asset accounts. The safe harbor test is met if a segregated asset account meetsIn addition to the RIC diversification tests, and the segregated asset account must also haves no more than 55 percent of the fair valuefair market value of its total assets invested in cash, cash items, government securities, and securities of other RICs to meet this safe harbor.~~

~~6.29Special rules apply to a segregated asset account with respect to a variable life insurance contracts.~~

~~6.29 If the diversification test is not met on the last day of a particular quarter, the separate account is allowed a thirty-day grace period after such quarter end to meet the diversification requirements. An exception may is also be available to for certain separate accounts that are in the start-up mode, whereby accounts are considered diversified for the first year of their existence.~~

~~6.30 Failure of the underlying segregated asset accounts (separate accounts) to qualify will adversely affect the tax treatment of the variable annuity, endowment, or life insurance contracts. It will not directly affect the tax status of the RIC. However, asset diversification it should be reviewed by the auditor and, if not passed, the impact on financial statement disclosure must be considered.~~

TAXATION OF REGULATED INVESTMENT COMPANIES

Qualification Tests

~~6.31~~6.26 *Requirements for Qualification*. To qualify as ~~an RIC~~a RIC for tax purposes, an investment company must—

a. Be a domestic corporation (or a business trust taxable as a corporation) registered for the entire taxable year under the 1940 Act.[31] An investment company is registered upon filing its notification of registration on Form N-8A.[32] Income earned before registration will cause a fund to fail to qualify as ~~an RIC~~a RIC.

b. Elect, if it has not previously done so, to be taxed as ~~an RIC~~a RIC.[33] To elect RIC status, an investment company prepares its tax return and computes taxable income in accordance with the provisions of Subchapter M. Once elected, the company's status is unchanged as long as the company continues to qualify under the IRC.

c. Meet the 90 percent gross income test. (See paragraphs 6.34~~3~~ through 6.36~~5~~.)

~~d. For taxable years beginning before August 6, 1997, meet the 30 percent gross income test. (See paragraphs 6.36 through 6.41.)~~

~~e.~~d. Meet certain requirements concerning diversification of its total assets at the end of each quarter of the taxable year. (See paragraphs 6.38~~42~~ through 6.44~~48~~.)

6.26a In order for its distributions to be used to offset taxable income the RIC must distribute at least 90 percent of its investment company taxable income (which includes net short-term capital gains, if any) and net tax-exempt income for the taxable year. (See paragraphs 6.45 through 6.47.)
~~Distribute at least 90 percent of its investment company taxable income (which includes net short-term capital gains, if any) and net tax-exempt income for the taxable year. (See paragraphs 6.459 through 6.4751.)~~

~~6.32~~6.27 ~~An RIC~~A RIC should keep a record of the computations supporting qualification under the foregoing tests. (See appendix C.)

Gross Income Test

~~6.33~~6.28 *90 Percent Gross Income Test (90 Percent Test)*. ~~An RIC~~A RIC must derive at least 90 percent of its gross income from dividends, interest, income from securities on loans, and gains (without including losses) from the sale or other disposition of stocks or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to the RIC's investing in such stock, securities, or currencies.[34]

a. The IRS may issue regulations that would exclude from qualifying income foreign currency gains that are not "directly related" to the RIC's principal business of investing in stock or securities (or options and futures with respect to stock or securities). However, when this provision was originally passed, the standard applied was foreign currency gains not "ancillary to" ~~an RIC~~a RIC's principal business of investing in stock or securities. Apparently the U.S. Treasury believed that this standard was too loose and therefore proposed in 1988 to tighten the standard to directly related. Although no formal guidance

[31] Section 851(a) of the IRC.
[32] Each series of a series fund will be considered a registrant for this purpose.
[33] Section 851(b)(1) of the IRC.
[34] Section 851(b)(2) of the IRC.

currently exists as to the definition of directly related, the standard industry interpretation assumes that the directly related test would be met when foreign currency gains are a result of either an investment in securities or a hedging activity used to reduce the currency risk in such securities.

b. Gross income derived from a partnership (which is generally not what is reported on the partner's K-1 as taxable income and is not cash distributions received by the partner during the year) should be treated by the RIC in the same manner as it would be if it were realized directly by the RIC for purposes of the 90 percent test.[35] Thus, gross income earned by a partnership other than that described in paragraph 6.34 would be treated by ~~an RIC~~a RIC partner as nonqualifying income. Such nonqualifying gross income would include income from real estate rental and oil and gas leasing activities and also income from other trades or businesses. In addition, if ~~an RIC~~a RIC invests in a real estate partnership that earns rental income, the RIC should include its share of the partnership's gross rental income for purposes of this test. ~~An RIC~~A RIC's share of all income earned by a partnership should be included for these purposes, regardless of whether it receives any cash distributions from the partnership during the year.

~~6.34~~6.29 Certain items require special treatment in calculating the 90 percent test. For example, tax-exempt interest on state or local obligations is included in gross income and is considered qualifying income. Gains from the disposition of options and futures contracts on securities and securities indexes are also included as qualifying income.

~~6.35~~6.30 Other income, such as redemption fees, expense reimbursements, and lawsuit settlements, may require special consideration to determine the tax status of those items and their effect on the 90 percent test. The IRS has ruled that if in the normal course of its business ~~an RIC~~a RIC receives a reimbursement of investment advisory fees that was not the result of a transaction entered to artificially inflate the RIC's qualifying gross income, such reimbursement may be considered qualifying income for purposes of the 90 percent test. However, the ruling did not indicate whether income resulting from the reimbursement of expenses other than investment advisory fees would qualify.[36]

~~6.36*30 Percent Gross Income Test (Short-Short Test)*. An RIC must derive less than 30 percent[37] of its gross income from gains (without including losses) on the sale or other disposition of any of the following held for less than three months:~~

~~a. Stocks or securities~~

~~b. Options, futures, or forward contracts~~

~~c. Foreign currencies (or options, futures, or forward contracts on foreign currencies), but only if such currencies are not directly related to the company's principal business of investing in stock or securities. (The IRS has not yet defined directly related for this purpose.)[38]~~

~~6.37 A short sale occurs when an RIC (or other taxpayer) enters a contract to sell (deliver) a particular security. The RIC may or may not own the particular security that is to be delivered~~

[35] Section 851(b) of the IRC.
[36] Revenue Ruling 92-56.
~~[37] Not applicable for years beginning after August 5, 1997.~~
~~[38] Section 851(b)(3) of the IRC.~~

~~at the time the contract is entered. In general, if the security to be delivered has been held for one year or less on the date of the short sale, or was acquired after the contract was entered but before the closing (delivery) date, then any gain on the closing of the short sale is considered a short-term capital gain. In addition, the holding period of any substantially identical stock or securities (in an amount equal to that sold short) owned by the RIC that had not been held for more than one year at the time of entering into the short sale and had not been used to close such short sale will have its holding period forfeited. The holding period is considered to begin on the earlier of either the date of disposition of such property or the date of the closing of the short sale.[39] The purchase of a put option is considered a short sale. The holding period rules discussed here could affect the short-short test.[40]~~

~~6.38 Certain holding period rules are suspended when a **straddle** occurs. (See paragraphs 6.89 through 6.91.) These rules do not apply for purposes of the short-short test, unless short sale rules would otherwise apply.~~

~~6.39 A "designated hedge" election provides for netting of increases and decreases in the fair value of positions that are part of such hedge during the period of the hedge for purposes of the short-short test. The rule is based on the theory that for hedging transactions, both the hedged and the hedging positions are properly considered a single investment. The netting rule applies both in determining the RIC's short-short gain and in computing the RIC's gross income for the numerator and denominator of the short-short test.[41]~~

~~6.40 If an RIC disposes of a Section 1256 contract (see paragraphs 6.107 through 6.111) that it has held for less than three months, then the entire gain is short-short gain (not just 40 percent).[42]~~

~~6.41 If an RIC recognizes gains from marking-to-market Section 1256 contracts at year-end that it has held for less than three months, then such gains should not be considered as short-short gains (see above); however, it is possible that such gains may be included in gross gains (that is, included in the denominator). The law is not clear how to treat **mark-to-market** gains from Section 1256 contracts in a prior year if the contracts are sold after year-end but before they have been held for three months.~~

50 Percent and 25 Percent Asset Diversification Tests

~~6.42~~6.31 *50 Percent Test*. At the end of each quarter of the taxable year, at least 50 percent of the ~~fair value~~fair market value of the RIC's total assets must be represented by cash and cash items, U.S. government securities, securities of other RICs, and other securities.

~~6.43~~6.32 For this purpose, other securities does not include ~~all~~ investments in the securities of any one issuer that represent more than 5 percent of the ~~fair value~~fair market value of the investment company's total assets or more than 10 percent of the issuer's outstanding voting securities.[43]

[39] ~~Section 1233(b)(2) of the IRC.~~

[40] ~~Revenue Ruling 74-434, 1974-2 C.B. 195~~.

[41] ~~Section 851(g) of the IRC.~~

[42] ~~Private Letter Ruling 8823067~~.

[43] Section 851(b)(~~4~~3)(A) of the IRC.

~~6.44~~6.33 *25 Percent Test*. At the end of each quarter of its fiscal year, not more than 25 percent of ~~an RIC~~a RIC's total assets may be invested in the securities of any one issuer, except for the securities of the U.S. government or other RICs. This requirement also prohibits investing more than 25 percent of the RIC's total assets in two or more issuers controlled by the RIC engaged in the same (or similar) or related trades or businesses.[44] For that purpose, the RIC controls the issuers if it has 20 percent or more of the combined voting power.[45]

~~6.45~~6.34 For purposes of the diversification tests, the issuer of an option or futures contract is the corporation or government that issued the underlying security, except for index instruments (options and futures and options on futures based on stock or securities indexes). The IRS has concluded that the issuers of an option on a stock index are the issuers of the stocks or securities underlying the index, in proportion to the weighting of the stocks or securities in the computation of the index, regardless of whether the index is broad-based or narrow-based.[46] For example, futures contracts on GNMAs are considered government securities.[47]

~~6.46~~6.35 While the IRS has not *published* guidance, d~~D~~erivative instruments may be valued under guidelines established by the IRS in *private* rulings, as follows:

a. For naked futures contracts, the amount of the investment is the ~~fair value~~fair market value of the contract, not the amount paid on **margin**, because the holder's liability is virtually unlimited and is related to the ~~fair value~~fair market value of the futures contract.[48] In futures contracts where the RIC holds deliverable securities (covered futures contracts), the securities should be counted only once for purposes of the diversification test.[49]

b. For options, the amount depends on whether the RIC is the writer or the purchaser of the option. A purchaser acquires a right of exercise; a writer assumes an obligation to honor a purchaser's exercise, as follows:

   - If the RIC is the writer of a naked option, its potential loss is also unlimited, and the amount of the investment for the asset diversification tests is the ~~fair value~~fair market value of the security on which the option was written.[50]

   - If the RIC is the writer of a covered call option, the ~~fair value~~fair market value of the written call should not be included in the 50 percent or 25 percent tests. To do so would result in double-counting the ~~fair value~~fair market value of the covered security.[51]

   - If the RIC is the purchaser of an option, its potential loss is limited to the premium paid for the option, and the amount of the investment is the ~~fair value~~fair market value of the option, not the ~~fair value~~fair market value of the underlying security.[52]

---

[44] Section 851(b)(~~4~~3)(B) of the IRC.
[45] Section 851(c)(2).
[46] GCM 39708 (March 4, 1988).
[47] Private Letter Ruling 8529005.
[48] GCM 39316 (December 21, 1984).
[49] See note 45.
[50] See note 45.
[51] GCM 39565 (October 17, 1986).
[52] Private Letter Ruling 8453019; GCM 39316 (December 21, 1984).

~~6.47~~6.36 A ~~n~~ RIC that meets the asset~~investment~~ diversification requirements at the end of its first~~one~~ taxable quarter ~~(other than the first quarter of the first RIC taxable year)~~, will ~~does~~ not lose its status as ~~a RIC~~a RIC if it fails to satisfy those requirements in a later taxable quarter, provided ~~the noncompliance is due neither in whole nor in part to the acquisition of a security or other property. If, because of an acquisition, an RIC~~a RIC ~~fails to meet the diversification requirements, it may~~ it ~~reestablish its status at the beginning of the quarter by~~ eliminat~~es~~ing the discrepancy between the diversification requirements and its holdings within thirty days after the end of the quarter, using the securities' ~~fair value~~fair market values as of the end of the quarter.[53]

~~6.48~~6.37 Special rules apply to an investment company that qualifies as a venture capital investment company.[54]

Variable Contracts

6.38 In addition to the diversification requirements applicable to all RICs (discussed above, special quarterly asset diversification tests are to be met by RICs used as investment vehicles for variable annuity, endowment, and life insurance contracts. These diversification requirements must be met on a calendar year basis without regard to the fiscal year of the fund. In general, a segregated asset account will be considered adequately diversified if—

a. No more than 55 percent of total assets is represented by any one investment.

b. No more than 70 percent of total assets is represented by any two investments.

c. No more than 80 percent of total assets is represented by any three investments.

d. No more than 90 percent of total assets is represented by any four investments.

In general, for a separate account to be permitted to "look through" to the assets of a RIC, all of the interests in the RIC must be held by one or more insurance company separate accounts.

6.39 All securities of the same issuer, all interest in the same real property project, and all interests in the same commodity are each treated as a single investment. Each governmental agency or instrumentality is treated as a separate issuer.

6.40 The regulations provide a safe harbor for segregated asset accounts. The safe harbor test is met if a segregated asset account meets the RIC diversification tests, and the segregated asset account has no more than 55 percent of the value of its total assets invested in cash, cash items, government securities, and securities of other RICs.

6.41 Special rules apply to a segregated asset account with respect to a variable life insurance contracts.

6.42 If the diversification test is not met on the last day of a particular quarter, the separate account is allowed a thirty-day grace period after such quarter-end to meet the diversification

[53] Section 851(d) of the IRC.
[54] Section 851(e) of the IRC.

requirements. An exception is also available for certain separate accounts that are in the start-up mode, whereby accounts are considered diversified for the first year of their existence.

6.43 Failure of the underlying segregated asset accounts (separate accounts) to qualify will adversely affect the tax treatment of the variable annuity, endowment, or life insurance contracts. It will not directly affect the tax status of the RIC. However, asset diversification should be reviewed by the auditor and, if not passed, the impact on financial statement disclosure must be considered.

Distribution Test

~~6.49~~6.44 *90 Percent Distribution Test*. ~~An RIC~~A RIC must pay dividends (exclusive of capital gain dividends) equal to at least 90 percent of its investment company taxable income plus 90 percent of its net tax-exempt income for the year. In addition, a corporation that has E&P from non-RIC years must distribute such E&P by the end of its first RIC year.[55]

~~6.50~~6.45 For purposes of this distribution ~~qualification~~ test, ~~an RIC~~a RIC may elect to treat as paid on the last day of the fiscal year all or part of any dividends declared after the end of its taxable year. Such dividends must be declared before the due date for filing the corporate return, including any extensions. The dividends must be paid within twelve months after the end of the taxable year and not later than the date of payment of the first regular dividend after such declaration.[56]

~~6.51~~6.46 If ~~an RIC~~a RIC does not distribute all of its investment company taxable income, although it meets all of the qualification tests and ~~including~~ the 90 percent distribution test, it must pay corporate income taxes on the undistributed portion. Similarly, if the company fails to distribute its net capital gains, the company is subject to tax on the gains.

~~***Distributions***~~

~~6.52~~6.47 *Preferential Dividends*. A dividends paid deduction is allowed only for ~~payments~~ distributions that are pro rata, with no preference as to any share of stock compared with any other share of the same class of stock~~. If all or a portion of any distribution is preferential, the entire distribution is disallowed as a dividends paid deduction~~.[57]

~~6.53~~6.49 RICs may issue more than one class of stock. The principal tax issue arising with respect to this structure is whether or not the RIC has distributed preferential dividends to any of its shareholders. ~~An RIC~~A RIC must allocate the various kinds of dividends it pays (such as tax-exempt interest, net capital gains, or the dividends-received deduction) proportionately among the classes of stock outstanding if more than one class of stock exists.[58] No deduction for dividends paid will be permitted to the extent that an excess amount has been allocated to any one class~~. However, an RIC~~a RIC ~~may specially allocate a type of income to a specific class of stock if the RIC makes such nonproportionate designation pursuant to a rule described in a registration statement filed with the SEC before June 13, 1989.~~ However, a RIC may specifically allocate certain expenses to a specific class of stock if it has a different

[55] Section 852(a)(1) of the IRC.
[56] Section 855(a) of the IRC.
[57] Section 562(c); Regulation 1.562-2(a).
[58] Revenue Ruling 89-81, 1989-1 C.B. 226.

arrangement for the distribution of shares or for the provision of shareholder services for each class and otherwise meets the requirements of IRC Revenue Procedure 96-47. Advisory fees and other fund-wide expenses must be allocated on a pro-rata basis. The IRS has not published a position on waivers and reimbursements in a multi-class context.

~~6.54~~6.50 *Distributions Made After December 31~~Year-End~~*. Dividends declared in October, November, or December payable to shareholders of record in such months and actually paid during January of the following year must be treated as having been paid on December 31 of the previous year for purposes of a dividend deduction for the RIC and income recognition for the shareholder.[59] This rule applies for both income and excise tax purposes.

~~6.55~~6.51 ~~An RIC~~A RIC may elect to treat as having been paid in the prior fiscal year (spillover~~back~~ or throwback) all or part of any dividends declared after the end of such taxable year. (See paragraph 6.~~50~~46.) This election applies to regular dividends, capital gain dividends, and exempt interest dividends. It affects only the RIC and does not change the year in which distributions are reported by the shareholders. ~~The distribution is deemed paid during the year for regular tax purposes but it must be declared during such year to qualify for excise tax purposes.~~ (See paragraphs 6.~~63~~59 through 6.74~~0~~.)

~~6.56~~6.52 *Deficiency Dividends*. If a determination resulting from an IRS examination or court decision causes an increase in investment company taxable income, net capital gain, or a decrease in the deduction for dividends paid, the RIC may pay a **deficiency dividend** to protect its special status or avoid the payment of federal income tax.[60]

~~6.57~~6.53 Interest and penalties usually are asserted as part of the procedure, which requires a payment within ninety days of the determination and the filing of a claim for deduction within 120 days of the determination.[61]

~~6.58~~6.54 *Equalization Distributions*. An open-end investment company may use equalization accounting to prevent changes in the per share equity in its undistributed net income that may be caused by the continuous issuance and redemption of shares. Gross equalization debits for ~~accounting~~ tax purposes differ substantially because ~~are conceptually similar to the income tax rules. However,~~ the ~~actual~~ calculation ~~for the income tax dividends-paid deduction has several important differences, including~~ ignoresing contributions by purchasing shareholders (gross equalization credits)[62] and treating dividends on a paid rather than payable basis.[63]

a. Under the book equalization accounting method, which was first adopted in the 1930s, a portion of the proceeds a fund receives on the sale of a share is credited to an equalization account instead of paid-in-surplus. The amount credited to the equalization account is determined by dividing the sum of undistributed net investment income and the balance in the equalization account by the number of shares outstanding before issuing the share. The balance in the equalization account is equal to prior equalization credits from sales of fund shares less equalization debits on prior redemption of fund shares. Similarly, upon a redemption of fund shares, a portion of the redemption proceeds is charged, or debited, to

---

[59] Section 852(b)(7) of the IRC.
[60] Section 860(a) of the IRC.
[61] Section 860(c) of the IRC.
[62] Private Letter Ruling 8722108.
[63] Regulation 1.301-1(b).

the equalization account instead of paid-in-surplus. The amount charged to the equalization account also can be determined by dividing the sum of undistributed net investment income and the balance in the equalization account by the number of shares outstanding before redeeming the share.

b. Although equalization credits increase undistributed net investment income for book purposes, they do not increase taxable income. Gain or loss is not recognized by corporations, including funds, on the receipt of money or other property due to the issuance of stock. This would include any amounts received by a fund on the issuance of shares credited to the equalization account for book purposes. As equalization credits are not taxable income, they do not create E&P for a fund. Under federal corporate tax rules, distributions from a corporation are taxable only as dividends to the extent that they are paid out of a corporation's E&P. As funds are subject to the same corporate rules to determine the taxability of their distributions, they need E&P to distribute a taxable dividend. This requirement creates a potential problem for a growing fund. Although a fund can maintain its book undistributed net investment income per share by adopting equalization accounting, it cannot avoid diluting its E&P per share when it issues new shares.

~~6.59~~6.55 ~~An RIC~~A RIC is permitted to claim a dividends-paid deduction for the E&P associated with the redemption of shares (gross equalization debits).[64] Shareholders treat the entire redemption distribution as sales proceeds.

~~6.60~~6.56 While the theory of treating equalization payments as qualifying for the dividends-paid deduction is well established in the income tax rules, the method of calculating the E&P attributable to the redeemed shares is less clear. One should take care to ensure that the most recent IRS pronouncements have been considered if equalization debits are to be used.

~~6.61~~6.57 Equalization debits used as dividends are may be used to satisfy~~applicable to~~ the regular distribution requirements and also the excise tax distribution requirements.

~~6.62~~6.58 *Capital Gain Dividends*. Any net capital loss or net long-term capital loss realized after October 31 is recognized in the next taxable year for purposes of designating capital gain dividends. The RIC may elect the same treatment for computing taxable income and E&P[65]. This deferral for designation purposes may be subject to bifurcation; that is, gains and losses in each capital gain category may be separately netted for the pre- and post October 31 periods. For federal excise tax purposes, all post-October 31 capital gains and losses occur in the following excise tax year~~Any net capital loss or net long-term capital loss realized after October 31 is recognized in the next taxable year for purposes of designating capital gain dividends for federal income and excise tax purposes.~~[66]

Excise Tax on Undistributed Income

[64] Revenue Ruling 55-416, 1955-1 C.B. 416.

[65] IRS Notice 97-64

[66] Regulation 1.852-11.

~~6.63~~6.59 *Introduction*. A nondeductible excise tax on undistributed income is imposed on ~~an RIC~~a RIC to the extent that the RIC does not satisfy certain distribution requirements for a calendar year (as shown below).

~~6.64~~6.60 *Measurement Periods*. To determine the excise tax, ~~an RIC~~a RIC's ordinary income and capital gain net income are measured separately.

~~6.65~~6.61 Ordinary taxable ~~i~~income is defined as all income of the RIC during the calendar year other than gains or losses from the sale of capital assets.

~~6.66~~6.62 Capital gain net income is the net of short-term and long-term gains and losses from sales or exchanges of capital assets generally computed for the one-year period ending on October 31.

~~6.67~~6.63 RICs with fiscal years ending in November or December may elect to determine their capital gain net income as of the end of that fiscal year.[67]

~~6.68~~6.64 *Calculation and Elections*. No excise tax is imposed if the RIC makes sufficient distributions during the calendar year. The required distribution consists of the following:

a. 98 percent of the ordinary income for the calendar year

b. 98 percent of the capital gain net income for the one-year period ending on October 31

c. 100 percent of the ordinary income or capital gain net income of the prior year that was not previously distributed[68]

~~6.69~~6.65 Provided that the RIC distributes in aggregate an amount equal to the sum of the amounts listed above, the excise distribution requirement will be satisfied.

~~6.70~~6.66 Any overdistribution (other than a return of capital) from the prior year may be applied to the required distribution of the current year.[69]

~~6.71~~6.67 If ~~an RIC~~a RIC retains a portion of its taxable income or gains and pays income tax on that amount, the amount will be treated as distributed for excise tax purposes~~ since the shareholders are required to include these retained capital gains in their tax returns for that year~~. If ~~an RIC~~a RIC distributes less than the minimum excise requirement, it must pay a 4 percent excise tax on the deficiency and include the excise tax in the calculation of required distributions in the current year.[70]

~~6.72~~6.68 Ordinary income is equal to investment company taxable income measured on a calendar year basis after excluding net short-term capital gains:

a. Tax exempt interest and allocable expenses are not included in ordinary income.

---

[67] Section 4982(e)(4) of the IRC.
[68] Section 4982(b) of the IRC.
[69] Section 4982(c)(2) of the IRC.
[70] Section 4982(c)(1) of the IRC.

~~b.Market discount, whether realized upon disposition or accreted currently, is treated as ordinary income using the calendar year measurement period.~~

~~c.~~b. Although foreign currency gains and losses are treated as ordinary income or loss, they are measured for this purpose using the October 31 capital gain measurement period, unless the RIC has made the election referred to in 6.63 above.

c. Master-feeder arrangements require ratable inclusion of all items of income, gain, and loss. This should be contrasted with an investment in a partnership outside the master-feeder structure. In the latter case, partnership income is included in the measurement period which includes the year end of the partnership.

~~e.~~d. Mark-to-market income and income from dispositions from RICs holdings of Passive Foreign Investment Companies ("PFICs") is treated as ordinary income, and is measured as of the 12 month period ending on October 31st. See paragraph 6.110, below for a general discussion of PFICs.

~~6.73~~6.69 Capital gain net income includes long-term and short-term capital gains and losses.

a. The mark-to-market rules for Section 1256 contracts, the **wash sale** rules, and the ~~year-end~~ straddle loss deferral rules are applied using October 31 as a year end (or November 30 or December 31 if a fiscal year election is made).[71] Note that mark-to-market of certain foreign currency forward contracts will result in ordinary income, which will be measured using October 31 as a year-end.

b. Capital loss carryovers computed using the excise tax measuring period may be used to reduce capital gain net income for purposes of the excise tax.[72]

c. Short-term capital gain ~~Capital gain net income~~ may be reduced (but not below net short-term capital gain) by the RIC's ordinary loss for the calendar year.[73]

~~6.74~~6.70 *Exemption for Certain RICs*. Excise tax rules do not apply to ~~an RIC~~a RIC if at all times during a calendar year each shareholder was either a qualified pension trust or a segregated asset account of a life insurance company held in connection with variable contracts. Shares owned by the investment advisor attributable to the **seed money** it contributed (up to $250,000) are not counted for this purpose.[74]

~~Other Income Tax Considerations~~Computation of Taxable Income and Gains

~~6.75~~6.71 *Dividends and Interest*. RICs record dividend income on the ex-dividend date for tax and accounting purposes.[75]

~~6.76~~6.72 If a dividend or other distribution received by ~~an RIC~~a RIC represents a return of capital, the basis of the security is reduced for tax purposes. If the distribution exceeds the RIC's tax basis in the security, the excess is treated as capital gain.[76]

---

[71] Tax Reform Act of 1986, H.R. Rep. No. 99-841, 99th Congress, 2d Sess. 243 (19).
[72] Tax Reform Act of 1986, H.R. Rep. No. 99-841, 99th Congress, 2d Sess. 243 (19).
[73] Section 4982(e)(2)(B) of the IRC.
[74] Section 4982(f) of the IRC.
[75] Section 852(b)(9) of the IRC.

~~6.77~~6.73 Interest and original issue discount are accrued on a daily basis for tax and accounting purposes. However, differences in book and tax accounting for interest and original issue discount related to troubled debt securities may exist.

~~6.78~~6.74 *Sales of Securities*. The cost of securities sold or otherwise disposed of may be either identified specifically or determined on a first-in, first-out (FIFO) basis; the average-cost basis is unacceptable for tax purposes. Identification procedures are prescribed in regulations.[77] Use of the last-in, last-out method is also acceptable assuming specific identification procedures are followed.

~~6.79~~6.75 Under the IRC, a wash sale occurs on a sale of securities (including options) if the seller acquires or enters a contract or option to acquire substantially identical securities within a period beginning thirty days before the date of a sale at a loss and ending thirty days after such date (sixty-one day period). A loss resulting from such a transaction is ~~not deductible~~deferred for tax purposes; the amount of the loss increases the tax basis of the new security purchased, and the holding period of the new position includes the holding period of the original position. However, a gain on the same type of transaction is taxable, and the tax basis of the new security is not affected by the sale of the old security.[78] Wash sale rules also apply to short-sale transactions such that the date a short sale is made, rather than the date of close is considered in determining whether a wash sale has occurred[79].

~~6.80~~6.76 *Commissions*. Commissions related to purchases or sales of securities are not deductible but are added to the cost of the securities or offset against the selling price.[80]

~~6.81~~6.77 *Bond Discount and Premium*. The following is a discussion of the general tax rules relating to bond premium and bond discount. Special rules may apply to certain kinds of debt obligations, such as obligations subject to prepayment (for example, Government National Mortgage Association [GNMA] certificates and real estate mortgage investment conduit [REMIC] interests), contingent debt obligations, and obligations denominated in other than the U.S. dollar.

~~6.82~~6.78 Significant rules concerning tax-exempt securities are as follows:

a. Amortization of premium is mandatory. For bonds issued after September 27, 1985, the yield-to-maturity method must be used for this calculation. The tax basis of the security must be reduced by each year's amortization. Special rules apply if the bond is callable.[81]

b. For nonstripped long-term bonds issued after September 3, 1982 and acquired after March 1, 1984, issued with original issue discount (OID), the normal OID accretion rules apply (that is, current amortization is required using the effective interest method), except acquisition premium of a subsequent holder is ignored. Accreted OID constitutes tax-exempt income and is added to the tax basis of the security.[82] Obligations with a

---

[76] Section 301(c) of the IRC.
[77] Regulation 1.1012-1(c)(1).
[78] Section 1091 of the IRC.
[79] Regulation 1.1091-1(g).
[80] Regulation 1.263(a)-2(e).
[81] Section 171 of the IRC.
[82] Section 1288 of the IRC.

maturity of one year or less are treated like short-term taxable securities. (See paragraph 6.83.)

c. For **stripped** bonds or stripped coupons purchased after October 22, 1986, and before June 11, 1987, OID is the amount that produces a yield to maturity equal to the lower of the original coupon rate on the original bond, the yield to maturity at the bond's issuance, or the actual yield to maturity based upon the RIC's purchase price. For bonds acquired after June 10, 1987, OID may be partially taxable where the yield to maturity based upon the purchase price exceeds the original coupon rate and the original yield to maturity.[83]
d. Market discount rules do not apply to tax-exempt securities acquired on or before April 30, 1993. The rules do apply to tax-exempt securities acquired after that date. See the discussion of the market discount rules in paragraph 6.~~83~~79c.

~~6.83~~6.79 Significant rules concerning taxable debt securities are as follows:

a. Amortization of premium is elective. However, once elected, it is applicable to all bonds owned at the beginning of the year of election and to all subsequent acquisitions. For bonds issued after September 27, 1985, the yield-to-maturity method must be used for the calculation. For bonds issued before September 28, 1985, any reasonable method of amortization is permitted. Additionally, for bonds acquired after 1987, the premium amortization is recorded as an offset to interest income, whereas for bonds acquired between October 23, 1986, and January 1, 1988, it is treated as interest expense. Special rules apply to callable and convertible bonds.[84]

b. Accretion of OID on taxable obligations is mandatory and is treated as taxable interest income. OID is the excess of the stated **redemption price** at maturity of an obligation over its issue price. The basis of the obligation is increased to reflect the accrual of the discount.[85] The proper method for computing the accretion of OID on taxable obligations depends on when the obligation was issued. OID on corporate obligations issued after July 1, 1982, must be accreted using the constant-interest method.[86] OID on corporate obligations issued after May 27, 1969, but before July 2, 1982, must be accreted using the straight-line method.[87] Accretion of OID on corporate bonds issued before May 28, 1969, is not recognized currently. However, any gain on the sale of that instrument is recharacterized from capital to ordinary, to the extent of the accrued discount.

   OID on government obligations issued after July 1, 1982, must be accreted using the constant interest method.[88] Accretion of OID on such obligations that are issued before this date is not recognized currently. However, any gain on the sale is recharacterized from capital to ordinary, to the extent of the accrued discount.[89]

   The accrual period with respect to which OID is computed and compounded is usually a one-year period for obligations issued before January 1, 1985, and a six-month period for

---

[83] Section 1286 of the IRC.
[84] Section 171 of the IRC.
[85] Section 1272 of the IRC.
[86] Section 1272(a) of the IRC.
[87] Section 1272(b) of the IRC.
[88] Section 1272(a) of the IRC.
[89] Section 1271(c) of the IRC.

obligations issued after December 31, 1984.[90] The regulations provide for any accrual period which is not in excess of one year. Generally, it should correspond with the terms of the security.

Certain obligations are exempt from the mandatory accretion rules. OID is not required to be accreted on short-term obligations (any debt instrument with a fixed maturity date not more than one year from the date of issue), U.S. savings bonds, and obligations issued by a natural person before March 21, 1984.[91] Taxable~~Additionally,~~ obligations with a de minimis amount of OID are treated as if they were not issued at a discount. De minimis discount is defined as one quarter of 1 percent of the stated redemption price at maturity, multiplied by the number of complete years to maturity. Special rules apply to certain obligations, collection of the principal of which may be subject to acceleration (for example, REMICs and Collateralized Mortgage Obligation (CMOs).[92]

c. A taxable bond issued after July 18, 1984, and acquired on or before April 30, 1993, which is purchased in the secondary market at less than par, has a fixed maturity that exceeds one year from the date of issue, and is neither a tax-exempt bond, a U.S. savings bond, nor an installment obligation, is a market discount bond. All bonds (taxable and tax-exempt) which are purchased in the secondary market at less than par and have a fixed maturity that exceeds one year from the date of issue other than a U.S. savings bond or an installment obligation acquired after April 30, 1993, are market discount bonds. When a bond has no OID, market discount is the difference between the purchase price and par. When OID exists, market discount is the difference between the purchase price and the revised issue price (which includes prior holders' required OID accretion).[93]

The market discount rules are applicable at the disposition of the related security and cause capital gain to be recharacterized as ordinary income to the extent of the accrued market discount at the date of disposition.[94]

Such rules are inapplicable if the bond is sold at a loss. An election can be made to accrete market discount currently. This election is binding for the tax year in which it is made and in all subsequent years on all market discount bonds acquired during that year and all subsequent years. Market discount is ~~can be~~ calculated using the ~~on either a~~ ratable accretion method unless an election is made to use the ~~or~~ constant interest rate method ~~depending upon the RIC's election~~. This is a bond-by-bond election.[95]

Interest expense incurred to purchase or carry market discount bonds is deferred unless discount is accreted currently.[96]

Market discount is deemed to be zero if it is de minimis.

d. RICs must accrete acquisition discount (that is, the excess of the stated redemption price at maturity over the RIC's basis) on taxable short-term U.S. government obligations

[90] Section 1272(a)(5) of the IRC.
[91] Section 1272(a)(2) of the IRC.
[92] Section 1272(a)(6) of the IRC.
[93] Section 1276(b) of the IRC.
[94] Section 1276 (a) of the IRC.
[95] Section 1276 (b) of the IRC.
[96] Section 1277 of the IRC.

(obligations with a fixed maturity at issuance of not more than one year). The discount is accreted using the straight-line method.[97] However, the RIC may make an irrevocable election to use the constant interest rate method.[98]

For nongovernment short-term obligations (including short-term tax exempt obligations), OID must be accreted currently using a straight-line method. An election is available to accrete acquisition discount instead of OID on these obligations.[99]

~~6.84~~6.80 ~~Section~~*Section 1256 Contracts*. Certain financial instruments are subject to the mark-to-market rule (that is, treated as sold on the last day of a taxpayer's taxable year) and to the 60-40 rule (which treats as long-term 60 percent of any capital gain or loss from such deemed sale or an actual sale and treats 40 percent as short-term, regardless of how long the instrument has been held).[100] The termination of a Section 1256 contract will result in a taxable gain or loss. If the RIC terminates a Section 1256 contract by taking delivery of the underlying property, the tax basis of the property received is decreased or increased by the gain or loss recognized. These instruments may also be subject to the straddle rules discussed below. Additionally, foreign currency contracts, options and futures on foreign currency, and options and futures on debt securities denominated in foreign currency may be subject to the rules of Section 988 discussed below.

~~6.85~~6.81 The relevant instruments, which are referred to as Section 1256 contracts, are the following:

a. *Regulated futures contracts (RFCs).* Contracts with respect to which the amount required to be deposited and the amount that may be withdrawn depend on a system of marking-to-market, and are traded on or subject to the rules of a qualified board or exchange.

b. *Foreign currency contracts*. Contracts that require delivery of, or the settlement of which depends on the ~~fair value~~fair market value of, a foreign currency that is a currency in which positions are also traded through RFCs, traded in the interbank market, and have been entered at arm's length at a price determined by reference to the price in the interbank market.

c. *Nonequity options*. Listed options that are not equity options. A listed option is any option (other than the right to acquire stock from the issuer) traded on (or subject to the rules of) a qualified board or exchange. Nonequity options are options traded on or subject to the rules of a qualified board or exchange, except for options to buy or sell stock or options on specific stock indexes. However, options on specific stock groups or stock indexes will be nonequity options if the Commodities Futures Trading Commission (CFTC) has in effect a designation of a contract market for such items, or the U.S. Treasury determines that such options meet the requirements for such a designation. For example, options on RFCs and debt securities are nonequity options.[101]

---

[97] Sections1281 and 1283(b)(1) of the IRC.
[98] Section 1283 (b) (2) of the IRC.
[99] Section 1283 (c) of the IRC.
[100] Section 1256 (a) of the IRC.
[101] Section 1256(g) of the IRC.

~~6.86~~6.82 *Equity Options and Nonlisted and Nonequity Options (Non-Section 1256 Contracts)*. For purchased options, if a put or call is sold or lapses, any gain or loss is long-term or short-term capital gain or loss depending on the holding period of the option. If a call option is exercised, its cost is added to the taxpayer's basis of the securities purchased.[102] If a put option is exercised, its cost reduces the amount of the proceeds received upon sale of the underlying securities.[103] If, however, the put is acquired at a time when the underlying stock has been held for one year or less, then any gain upon termination of the put is short-term capital gain, and the holding period of the underlying stock may be forfeited through the date of termination of the put.[104]

~~6.87~~6.83 For written options, if a put or call is closed out or lapses, any gain or loss is short-term capital gain or loss.[105] If a call is exercised, the premium received is added to the sale proceeds and capital gain or loss is calculated based on the holding period of the stock.[106] If a put is exercised, the premium received decreases the RIC's basis in the stock acquired. The holding period of the stock begins on the date of its purchase, not the date the put was written.[107]

~~6.88~~6.84 Purchased or written options may be subject to the straddle rules discussed below or the wash sale rules discussed in paragraph 6.113.

~~6.89~~6.85 *Tax Straddles*. The term "straddle" describes offsetting positions in personal property in which the ~~fair value~~fair market value of each position is expected to fluctuate inversely to that of the other. The term "position" means an interest (including a futures or forward contract or option) in personal property. An offsetting position occurs whenever risk of loss has been substantially diminished by holding one or more other positions.

~~6.90~~6.86 For example, ~~an RIC~~a RIC could close a loss position in year one (recognizing the tax loss) and close out the offsetting gain position in year two. The straddle rules defer realized losses from any "position" to the extent of unrealized gains from "offsetting positions." Deferred losses are carried forward to the succeeding year and are subject to the deferral rules in that year as well. Losses in excess of the unrealized gains at year end are deductible.[108]

~~6.91~~6.87 Additionally, complex rules exist for continuing to defer losses when offsetting positions are replaced during a year by other similar positions. Complex rules also exist for recharacterizing long-term capital gains as short-term and short-term capital losses as long-term in certain situations.

~~6.92~~6.88 *Stock Issuance Costs*. Stock issuance costs paid by an open-end investment company are deductible for tax purposes except for costs incurred during the initial stock offering period. This also applies to 12b-1 fees.[109] Registration fees and expenses, including accounting procedures, are discussed in further detail in chapter 8.

---

[102] Section 1256(g) of the IRC.
[103] Revenue Ruling 78-182, 1978-1 C.B. 265.
[104] Section 1233(b) of the IRC.
[105] Section 1234(b) of the IRC.
[106] Revenue Ruling 58-234, 1958-1 C.B. 279.
[107] See note 101.
[108] Section 1092 of the IRC.
[109] Rev. Rul. 73-463; Rev. Rul. 94-70.

~~6.93~~6.89 *Stock Redemption Costs*. Stock redemption costs of an open-end investment company are deductible in computing investment company taxable income. Stock redemption costs of a closed-end investment company paid or incurred after February 28, 1986, are not deductible.[110]

~~6.94~~6.90 *Capital Loss Carryforwards*. Capital losses may be carried forward for a period of eight years. However, t~~T~~he capital loss carryforward of ~~an RIC~~a RIC may be limited in the years after a tax-free reorganization where the assets of one RIC are acquired by another RIC. The amount of loss that may be utilized is limited annually to the extent of the ~~fair value~~fair market value of the acquired RIC multiplied by the long-term tax-exempt rate. However, the loss may be further limited in the initial year to the pro rata amount of the acquiring RIC's net capital gain.[111]

~~6.95~~6.91 In certain cases, unrealized built-in gains or losses recognized during the five-year period after the change in an ownership date may adjust the amount of the loss currently utilizable.

Treatment of Certain Foreign Currency Transactions

~~6.96~~6.92 ~~*Section*~~*Section 988 Transactions*. Special rules apply to the treatment of foreign currency gains and losses attributable to "Section 988 transactions" (described below). Foreign currency gains and losses from such transactions are treated as U.S.-source ordinary income or loss.[112]

~~6.97~~6.93 A foreign currency gain or loss will result from a Section 988 transaction described below denominated in a currency other than the RIC's functional currency (nonfunctional currency), or the ~~fair value~~fair market value of which is determined by reference to nonfunctional currency:

a. Acquiring a debt instrument or becoming the obligor under a debt instrument

b. Accruing any item of expense or gross income or receipt that is to be paid or received at a later date

c. Entering or acquiring any forward contract, futures contract, option, or similar financial instrument

d. Disposing of any nonfunctional currency[113]

~~6.98~~6.94 The functional currency is the currency of the economic environment in which the RIC's operations are predominantly conducted and the currency used in keeping its books and records.[114]

~~6.99~~6.95 For domestic RICs, the functional currency is the U.S. dollar. However, ~~an RIC~~a RIC that maintains a significant portion of its operations in a foreign jurisdiction may establish a

[110] Section 162(k) of the IRC.
[111] Section 382 of the IRC.
[112] Section 988(a) of the IRC.
[113] Section 988(c)(1) of the IRC.
[114] Section 985(b) of the IRC.

qualified business unit (QBU). A QBU is a separate and distinguishable trade or business that maintains separate books and records. Accordingly, ~~an RIC~~a RIC that establishes a QBU may elect to use that country's currency as its functional currency. The election is binding for the year the election is made and for all subsequent years unless it is revoked with the permission of the Commissioner of the IRS. Once the election is made, the QBU would not recognize foreign exchange gain or loss with respect to transactions denominated in the foreign currency. However, foreign currency gain or loss would be recognized when the fund remits the foreign currency (the functional currency) to the United States to pay dividends to shareholders.

~~6.100~~6.96 Interest income or expense (including OID and discount on certain short-term obligations) on a nonfunctional currency debt instrument is determined in units of nonfunctional currency and translated into functional currency at the average exchange rate for the accrual period for accrual-basis RICs. ~~An RIC~~A RIC may elect to use the spot rate on the last day of the accrual period (or partial accrual period ending on the last day of its year) for translating interest income and expense. If ~~an RIC~~a RIC makes this election, it may also elect to translate interest income and expense at the spot rate on the date of receipt or payment (if such date is within five business days of the end of the accrual period) and potentially eliminate any exchange gain or loss attributable to such interest income and expense.

~~6.101~~6.97 Foreign currency gain realized in a Section 988 transaction will be recognized for tax purposes and treated as U.S.-source ordinary income to the extent of the lesser of the foreign currency gain or the overall gain realized. Similarly, if a foreign currency loss is realized in a Section 988 transaction, it will be recognized for tax purposes and treated as a U.S.-source ordinary loss to the extent of the lesser of foreign currency loss or the overall loss realized.[115]

~~6.102~~6.98 The acquisition of nonfunctional currency is treated as an acquisition of property[116] with a functional currency tax basis determined with reference to the spot contract exchange rate (spot rate). A spot contract is a contract to buy or sell nonfunctional currency on or before two business days following the date of the execution of the contract.[117] The disposition or other use of nonfunctional currency will result in a Section 988 transaction if it is exchanged for another nonfunctional currency or for functional currency.[118] Foreign currency gain or loss on a disposition or use of nonfunctional currency is calculated using the spot rate (or a spot rate convention) for purposes of determining the amount realized.

a. Units of nonfunctional currency exchanged for different units of the same nonfunctional currency do not result in the recognition of exchange gain or loss.[119]

b. In addition, the deposit, withdrawal, or receipt of nonfunctional currency from the maturing of a demand or time deposit issued by a financial institution does not result in the recognition of exchange gain or loss.[120] As deposits of the same nonfunctional currency may have different per-unit tax bases, ~~an RIC~~a RIC may use any reasonable method that is consistently applied to determine the tax bases of nonfunctional currency withdrawn from an account.[121]

---

[115] Section 988(b) of the IRC.
[116] Regulation 1.988-1(a).
[117] Regulation 1.988-1(b).
[118] Regulation 1.988-2(a).
[119] Regulation 1.988-2(a)(1).
[120] Regulation 1.988-2(a)(1).
[121] See note 115.

~~6.103~~6.99 Although Section 988 does not apply to transactions involving equity securities, any fluctuation in the exchange rate between the trade date and the settlement date will result in a foreign currency gain or loss because the payment of the settlement liability constitutes a Section 988 transaction.[122] ~~However, c~~Cash-basis taxpayers ~~RICs~~ are required to determine the tax basis and the amount realized upon sale of stock or securities traded on an established securities market using the settlement date spot rate. Accrual-basis taxpayers, including RICs may elect this treatment as well.

~~6.104~~6.100 The sale, closing, or settlement (including by taking or making delivery of currency) of any forward contract, futures contract, option, or other similar financial instrument denominated in (or the ~~fair value~~fair market value of which is determined by reference to) a nonfunctional currency results in ordinary income or loss unless the contract is a futures or listed option contract traded on a qualified board or exchange.[123] However, certain elections are available for these kinds of financial instruments that permit income or gain to be differently characterized.

~~6.105~~6.101 Special timing rules apply to forward contracts, futures contracts, options, and currency contracts closed through **offset**. If these contracts are not subject to Section 1256 and are not traded on certain exchanges that follow the practice of terminating offsetting contracts, mere offset does not cause realization of exchange gain or loss. However, gain must be realized upon offset if an "economic benefit" has been derived.[124]

~~6.106~~6.102 The IRS has provided special rules for certain "Section 988(d) hedging transactions." Current regulations cover certain debt instruments the currency risk (or a portion thereof) of which is entirely eliminated through a "qualified hedge," "executory contracts" that are hedged, and hedges of trade to settlement date receivables and payables arising due to the sale or purchase of stocks or securities traded on an established securities market. These regulations provide "integrated treatment" for "Section 988(d) hedging transactions." The IRS may also issue rulings to taxpayers regarding net hedging and anticipatory hedging methods.[125] Given the fact that hedging generally refers to transactions conducted in the ordinary course of a trade or business, which does not include investing, Section 988(d) hedging rules most likely will not apply to RICs.

~~6.107~~6.103 *Gain or Loss Recognition Timing*. The timing of the recognition of gain or loss from contracts subject to both Sections 988 and 1256 is governed by the rules of Section 1256.[126] Such contracts, therefore, are marked-to-market at fiscal year end. The character of such gain or loss may be either ordinary or capital depending upon the type of contract and whether certain elections are made.

~~6.108~~6.104 Gain or loss on regulated futures contracts and non-equity options related to foreign currency or debt securities denominated in a nonfunctional currency traded on a qualified board or exchange should be treated as 60 percent long-term and 40 percent short-term capital gain or loss and marked-to-market if held at year end.[127]

[122] Regulation 1.988-2(a)(2).
[123] Regulation 1.988-2(a).
[124] Regulation 1.988-2(d).
[125] Regulation 1.988-5.
[126] Regulation 1.988-2(d).
[127] Section 1256(a) of the IRC.

~~6.109~~6.105 ~~An RIC~~A RIC may elect, however, to treat such contracts as Section 988 transactions. The election is effective for the taxable year made and all future years unless the IRS consents to its revocation. If such an election is made, any gain or loss on such futures and options is ordinary, and the contract is still subject to the mark-to-market rule.

~~6.110~~6.106 Unlike regulated futures contracts and non-equity options, foreign currency contracts are considered Section 988 transactions. Therefore, such contracts generate ordinary gain or loss. If the contract is also a 1256 contract, it is subject to the mark-to-market rule.

~~6.111~~6.107 Under certain circumstances, an election may be made to characterize gains or losses from foreign currency contracts as capital if they are not part of a straddle.

~~6.112~~6.108 *Qualification Tests and Foreign Currency Transactions*. For a discussion of the impact of foreign currency transactions on the RIC qualification tests, see paragraphs 6.31 through 6.51.

~~6.113~~6.109 *Wash Sale Rules*. If ~~an RIC~~a RIC sells a debt instrument at a loss and reacquires a substantially identical security within thirty days before or after the date of the sale, the loss will be deferred based on the wash sale rules of the IRC. Accordingly, neither the foreign currency component nor the overall loss will be taken into account for tax purposes. The overall loss is deferred and included in the basis of the new investment.

Passive Foreign Investment Companies

~~6.114~~6.110 The Tax Reform Act of 1986 enacted a series of provisions regarding **passive foreign investment companies (PFICs)** that impose a tax and interest charge on certain PFIC distributions and on any gain on the sale of the PFIC stock.[128] As RICs are not exempt from the PFIC provisions, ~~an RIC~~a RIC that invests in PFIC stock can incur a corporate level tax and interest charge on its investment in a PFIC.

~~6.115~~6.111 *Definition*. A PFIC is a foreign corporation that meets either an income test or an asset test for a particular tax year. Once classified as a PFIC, the corporation will retain that status for the entire period of ownership.[129]

~~6.116~~6.112 The income test provides that a foreign corporation will be deemed to be a PFIC if 75 percent or more of the corporation's gross income is "passive income."[130] Passive income includes dividends, interest, royalties, rents, annuities, and net gains from the sale of securities, foreign currency, and certain commodities transactions that are not received from an active trade or business.

~~6.117~~6.113 The asset test provides that if 50 percent or more of the average percentage ~~(as determined under SectionSection 1297 (e))~~ of the foreign corporation's assets produce passive income, the corporation will be deemed to be a PFIC.[131] Property used in a trade or business, and the related trade accounts receivable, are not passive assets. Examples of passive assets

[128] Section 1291 of the IRC.
[129] Section 1298 of the IRC.
[130] Section 1297(a) of the IRC.
[131] Sections 1297 (a) and (e) of the IRC.

include cash (even if maintained for working capital requirements), stocks, bonds and other securities.

~~6.118~~6.114 Corporations that own 25 percent or more of another entity, and corporations that are either starting operations or changing their business are subject to special provisions. In addition, special rules may specifically exempt foreign banks and insurance companies from the income and asset tests.[132]

~~6.119~~6.115 *Excess Distributions*. The IRC applies the tax and interest charge to excess distributions as follows:

a. A dividend is characterized as an excess distribution to the extent that it exceeds 125 percent of the average distributions made to ~~an RIC~~a RIC shareholder during the prior three years (or fewer, if the RIC held an interest in the PFIC for less than three years).[133] The excess distribution is then allocated ratably to each day that the RIC held the PFIC interest.[134] A federal income tax liability is imposed at the highest marginal tax rate for the portion of the excess distribution allocated to each year after 1986, excluding the portion allocated to the current year.[135] In addition, interest is charged based on the tax liability allocated to each year.[136]

b. Gain on the sale of a PFIC interest is treated as though the entire amount of the gain were an excess distribution taxed as ordinary income.[137] Accordingly, if ~~an RIC~~a RIC sells its interest in a PFIC at a gain, it would incur a tax and interest charge on the gain allocable to the post-1986 years (excluding the current year). The gain allocable to the pre-1986 years and to the current year would be converted to ordinary income and would be included in investment company taxable income.

~~6.120~~6.116 *Elections*. ~~An RIC~~A RIC can potentially avoid the imposition of the tax by making a qualified electing fund (QEF) election for the year in which the PFIC interest is acquired. If this election is made, the RIC will be required to include in income its share of the PFIC's ordinary income and capital gain for the year the election is made and all subsequent years.[138] The RIC would then have to distribute this "phantom income" to its shareholders to obtain the benefit of the deduction for dividends paid.

~~6.121~~6.117 The QEF election may not be available to RICs that do not "control" the PFIC[139] because the PFIC itself must provide an information statement to electing shareholders each year that reports the shareholder's prorata share of PFIC ordinary earnings and net capital gain (on a U.S. tax basis), as well as a statement that the PFIC will permit the shareholder to inspect and copy the PFICs books and records.—

~~a.Designate a U.S. agent.~~

[132] Section 1297~~6~~(b~~e~~) and (c) of the IRC.
[133] Section 1291(b) of the IRC.
[134] Section 1291(a) of the IRC.
[135] Section 1291(c) of the IRC.
[136] See note 130.
[137] Section 1291(a) of the IRC.
[138] Section 1293(a) of the IRC.
[139] Regulation 1.1295-1T.

b.Maintain certain books, records, and documents in the U.S. that are available for IRS inspection.

c.Comply with annual shareholder certification requirements.

d. Report specific information to the IRS each year.

6.118 The Taxpayers Relief Act of 1997 (TRA) permits an RICa RIC to make mark-to-market election for PFIC stock. This election, which can be made for years beginning after 1997, allows an eligible RIC to mark-to-market on the last day of each year each marketable PFIC it owns, recognizing income to the extent that stock has appreciated in value, and ordinary loss to the extent of previously included mark-to-market income. The RIC's basis in the PFIC shares held is increased by the income recognized and decreased by deductions allowed. Under proposed Regulations, tThe holding period of PFIC shares held by an electing RIC is deemed to begin again on the first day of the following year.[140] Income recognized under the mark-to-market election and gain on the sale of PFIC stock is treated as ordinary income. Deductions allowed under the election and loss on the sale of PFIC stock is treated as ordinary loss to the extent of net mark-to-market income previously recognized. The source of income or loss is determined as if the amount were gain or loss from the sale of PFIC stock. Any loss resulting from PFICs that occurs after October 31st of a taxable year is not considered in determining taxable income, or E&P.
6.122

6.1236.119 If the Mark-to-MarketQEF election is made in a year after acquiring the PFIC interest, it would be marked-to-market as of the first year in which the election applies and any gain (but not loss) would be recognized. The gain would be treated as an excess distribution subject to the rules previously discussed. A RIC would be subject to a nondeductible interest charge on the gain recognized.

Offshore Funds

6.1246.120 In recent years the number of funds that are organized offshore (offshore funds) has increased substantially. This has occurred as U.S. fund advisors sought to globalize their customer base, and as foreign institutions increased their investments in U.S. securities.

6.1256.121 A myriad of U.S. and foreign tax issues are associated with offshore funds. These funds are typically structured in a way so that they are not considered "engaged in a U.S. trade or business" for U.S. tax purposes. They are organized in the form that is most suitable for the expected owners. Further, they are located in the jurisdiction that provides the most beneficial taxation and regulation of the entity, taxation of owners, and withholding tax treatment for income earned and distributions made.

6.1266.122 Due to their complex nature, U.S. and local country tax and regulatory considerations must be thoroughly examined for each offshore fund. An offshore fund subject to U.S. tax cannot elect to be treated as an RICa RIC.

[140] Proposed Regulation 1.1291-8(b). While this Proposed Regulation has expired, industry practice has been to treat holding periods as starting on the day after a PFIC stock is marked-to-market.

Small Business Investment Companies

~~6.127~~6.123 A small business investment company (SBIC) operating under the Small Business Investment Act of 1958 (the 1958 Act) receives special tax treatment. It is allowed certain exclusions or additional deductions without the limitations prescribed for other corporations.

~~6.128~~6.124 An SBIC operating under the 1958 Act is allowed a 100 percent deduction for dividends received which qualify for the dividend received deduction under the IRC unless the SBIC elects to be taxed as a~~n~~ RI~~R~~C.[141] To claim that deduction, the company must file with its return a statement that it was a federal licensee under the 1958 Act at the time the dividends were received.

~~6.129~~6.125 If the stock issued by an SBIC is sold, exchanged, or becomes worthless, an ordinary loss, instead of a capital loss, can be recognized pursuant to the conversion privilege of convertible debentures.[142] Capital losses on other investments receive no special treatment. The company must submit with its tax return a statement that it is a federal licensee under the 1958 Act and also must report the following:

a. The name and address of the small business concern on whose securities the loss was sustained

b. The number of shares of stock

c. The basis and selling price

d. The dates the securities were bought and sold or the approximate date on which they became worthless and the reason[143]

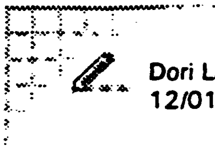
~~6.130~~6.126 An SBIC may be excluded from the definition of a **personal holding company.**[144]

~~6.131~~6.127 A shareholder in an SBIC may treat a loss on its stock as an ordinary loss. In computing the net operating loss deduction, such a loss is treated as a loss from a trade or business.[145]

---

[141] Section 243(a)(2) of the IRC.
[142] Section 1243 of the IRC.
[143] Regulation 1.1243-1(b) of the IRC.
[144] Section 172(b)(1)(F) and 542(c)(8) of the IRC.
[145] Section 1242 of the IRC.

Comments - Chapter 7



Dori Laskin@VGINOTES
12/01/98 02:45 PM

To: Arlene Sakatos@PRICE WATERHOUSE-US
cc:
Subject: AICPA Audit Guide

I generally agree with comments provided by others related to Chapter 6 and have no items that have not already been discussed. With respect to the tax sections in Chapter 7, note that section 7.69 should be updated for FASB Statement No. 133 (Accounting for Derivative Instruments and Hedging Activities) which, I believe, supercedes Statements 105 and 119. I think our accounting colleagues should be responsible for this section related to GAAP updates.

Subject to tax limitations

BUSINESS COMBINATIONS

8.32 Investment companies usually combine in tax-free reorganizations. In such reorganizations, shares of one company are exchanged for substantially all the shares or assets of another company. The primary purpose of such combinations is to reduce operating costs and improve performance by minimizing certain fixed costs over a large asset base. The composition of the acquired investment company's portfolio is usually less important to the acquiror than the overall size of the acquired pool of assets. Following a combination, portfolios of investment companies are often realigned to fit the objectives, strategies, and goals of the surviving company. Adjusting the carrying values of assets and liabilities or determining exchange formulas is usually unnecessary, because a significant portion of the net assets of investment companies (that is, investments) are stated at fair value and liabilities are generally short-term.

8.33 Only one of the combining companies can be the legal survivor. In certain instances, it may not be clear which of two funds constitutes the surviving entity for financial reporting purposes. Although the legal survivor would normally be considered the accounting survivor of the merger, continuity in one or more of the following might lead to a determination that the fund legally dissolved should be considered the accounting survivor:

? Portfolio management

? Portfolio composition

? Investment objectives, policies, and restrictions

? Expense structures and expense ratios

? Asset size

8.34 A registration statement on Form N-14 is filed in connection with a fund merger. Form N-14 is a proxy statement, in that it solicits a vote from the acquired fund's shareholders to approve the transaction, and a prospectus, in that it registers the acquiring fund?s shares that will be issued in the transaction. Form N-14 requires the inclusion of pro forma financial statements reflecting the impact of the merger.

8.35 Merger-related expenses (mainly legal, audit, proxy solicitation, and mailing costs) are addressed in the plan of reorganization and ~~may be borne by the funds, sponsor organizations, or others~~. Such costs are charged to expense currently.

INSERT: are generally paid by the fund incurring the expense, although the Advisor may waive or reimburse certain merger-related expenses, subject to SEC limits.

8.36 In a reorganization, the deferred organization costs,(superscript: 1) if any, of the accounting survivor, not the legal survivor, are carried over to the merged company. The costs would continue to be amortized over the remaining amortization period.

8.37 Tax-free business combinations of investment companies are accounted for by a method that most closely approximates the accounting followed for tax purposes. Companies combined in a nontaxable exchange of shares should carry forward the historical cost basis of investment securities to the

Comments on the Investment Company Audit Guide
Proposed by: Sam Beardsley
December 1, 1998

Insert 1 to Chapter 8 (after about par. 8.34)

8.34 a. Tax considerations must be carefully considered and monitored in the planning, execution and post-merger stages of a business combination. The tax rules that must be considered include the determination that the transaction is tax-free to the funds involved and their shareholders (Superscript 2), the qualification tests affecting RICs (Superscript 3), and the accounting for tax attributes of specific accounts such as E & P (Superscript 4), capital loss carryforwards and methods of tax accounting (Superscript 5). A private letter ruling from the IRS or an opinion of counsel on the tax-free treatment should be obtained. There are important differences in the tax rules between business combinations of RIC's and non-RIC investment companies.

2=368(a) & Notice 88-19
3=851
4=1.852-12(b)
5=381

Chapter 9

UNIT INVESTMENT TRUSTS

9.1 A unit investment trust (UIT) is an investment company organized under a trust agreement and indenture or a similar instrument between the sponsor and trustee. It does not have a board of directors, and issues only redeemable units of undivided interest or shares of beneficial interest, each representing a fractional undivided interest in the trust's portfolio of investment securities. Units remain outstanding until a unit holder tenders them to the trustee for redemption or resale by the sponsor on the secondary market, or until the trust is terminated. Trust agreements usually require periodic distribution of earnings~~dividends~~ pro rata to the unit holders in the amount of the trust's entire net investment income and net realized capital gains, if any, and distribution of the proceeds of calls~~redemptions~~, maturities, or sales of securities~~obligations~~ in the trust, unless the proceeds are used to pay for units to be redeemed. A distinguishing feature of UITs is that the portfolio is intended to be static; neither the sponsor nor the trustee has power to manage the portfolio. In general, securities may only be sold to generate proceeds to pay a redeeming unit holder.

9.2 A UIT is one of the three basic kinds of investment companies defined by the Investment Company Act of 1940 (the 1940 Act). The unit investment trust form is used primarily as an investment vehicle to hold (a) a portfolio of tax-exempt bonds, money market instruments, corporate bonds, government bonds, and common or preferred stocks or other kinds of securities, or (b) the shares of a particular management investment company being accumulated under a contractual plan. (See chapter 10 for a discussion of unit trusts as a funding medium for variable annuity contracts.) The form and content of financial statements of publicly held UITs are prescribed by article 6 of Regulation S-X, and for financial schedules, by rules 6-10(d) and 12-12 of Regulation S-X.

9.3 The discussion in this chapter covers fixed-income and equity unit investment trusts ~~and contractual plans~~ because the majority of unit investment trusts ~~and contractual plans~~ are of those kind. The accounting and auditing procedures for unit trusts are similar to those for other investment companies described in this Guide. (See chapter 8 for a discussion of accounting for offering costs of UITs.)

FIXED-INCOME AND EQUITY UNIT INVESTMENT TRUSTS

9.4 Units~~Shares~~ in unit investment trusts representing self-liquidating pools of tax-exempt or taxable bonds or other taxable fixed income securities held in custody by a corporate trustee were first offered to the investing public in the early 1960s. Trusts investing entirely or in part in equity securities have ~~are~~ become~~ing~~ increasingly common in the 1990s.

9.5 The principal objectives of most fixed-income UITs are to generate a consistent income stream that may be taxable or tax-exempt and to preserve principal by investing in a diversified portfolio of securities. The principal objectives of most equity UITs are to generate dividend income and potential for capital appreciation through investment in a fixed portfolio of stocks.

9.6 A sponsoring organization, such as an investment banking firm or a broker-dealer, initiates a unit investment trust by accumulating a group of securities of a kind specified in the

trust indenture. Portfolios may range in fair value from a few million dollars to $100 million or more and may consist of many individual issues. A tax-exempt bond portfolio may be diversified by economic activity (such as education, health care, and housing) or geographic area, or it may be concentrated in a particular state to provide investors with income exempt from federal, state, or local income taxes. The portfolio may be accumulated by the sponsor over a period ranging from a few days to several weeks or longer. At the deposit date, the portfolio of securities or contracts to purchase securities is conveyed to a corporate trustee at prices defined in the trust agreement. For fixed-income UITs, these prices are usually based on offering prices, rather than bid prices, as determined by an independent evaluator retained by the sponsor. For equity UITs, these prices are usually based on the trustee's or evaluator's evaluation of the fair value of the securities in the portfolio. An irrevocable letter of credit is issued by a commercial bank and delivered to the corporate trustee to cover the cost and accrued interest to settlement dates or expected dates of delivery of portfolio securities. Securities offered on a when-issued basis, delayed deliveries, or the normal settlement process may cause delayed deposits. An audit of a UIT is usually performed as of the opening of business on the initial date of deposit.

9.7 The sponsoring company, underwriters and other participants sell units of undivided interest at their public offering price, which is equal to the fair value of the underlying securities owned by the trust, including accrued interest, and other assets, if any, divided by the number of units outstanding, plus a sales charge. The sales charge is a percentage of net asset value of the trust unit, excluding accrued interest, and may be reduced on a graduated scale for sales to quantity purchasers. Upon the formation of the trust, the sponsor may realize a profit or loss on the sale of the portfolio to the trust equal to the difference between the aggregate cost of the portfolio to the sponsor and the aggregate valuation on the date of deposit. A footnote to the initial schedule of investments should disclose the aggregate cost of the securities to the trust and the related net gain or loss to the sponsor.

9.8 A UIT may be expandable. At the initial date of deposit, a limited amount of securities is placed in the trust and a limited number of units is issued. The trust agreement makes provisions for "expanding" the trust in size and number of units through additional deposits of securities in the trust, usually for a period of up to 60 to 90 days~~over a six month or twelve month period~~. The additional securities deposited must be identical to the original securities and the original proportionate relationship among each security must be maintained. The auditor may be requested to perform certain agreed-upon procedures at the subsequent deposit dates.

9.9 A UIT does not offer units of participation continuously. However, the sponsor usually maintains a secondary market by repurchasing units from unit holders at prices based on the aggregate bid price of the underlying securities, and by re-offering them at prices based on the aggregate bid or offering prices of the underlying securities plus a sales charge. If the sponsor does not maintain a secondary market, or does not choose to purchase the units, a unit holder can redeem his or her units at a price which is usually based on the aggregate bid price of the underlying securities. Some UITs allow unit holders to "exchange" units of the trust for other kinds of UITs offered by the sponsors based on relative net asset values, and at a reduced sales charge.

9.10 After the initial syndication by the sponsoring entity, all accounting, recordkeeping, and income and principal -distribution services are performed by the trustee. The trustee distributes the accumulated income to unit holders periodically, usually monthly~~annually~~ or quarterly~~semiannually~~, but sometimes semiannually~~quarterly~~ or annually~~monthly~~. Usually, as

securities are calledredeemed or as they mature, the proceeds are distributed to unit holders. Investors may have the option of reinvesting the proceeds from income or principalcapital gains distributions into additional units of the trust or other investment vehicles of the sponsor.

9.11 The trustee generally reports to unit holders periodically on the fair values of the underlying securities and on certain other financial information relating to the trust, as required by the trust agreement. The valuation policies are similar to those used by other investment companies. Audited financial statements are usually not distributed to unit holders; however, unaudited year-end distribution information is supplied by the sponsor or trustee. The trust agreement specifies the reporting of tax and other information.

9.12 Some or all of the debt securities owned by certain trusts are covered by insurance obtained by the issuer or the trust to guarantee principal and interest payments when due. The valuation of securities in an insured portfolio is discussed in chapter 3.

TAXES

9.13 SomeMany UITs that invest principally in taxable bonds qualify as regulated investment companies (RICs) under subchapter M of the IRC by complying with the applicable requirements (See Chapter Six). They usually distribute all their taxable income and gains from sales of securities and are therefore not subject to federal income or excise taxes. Most UITs which invest principally in tax-exempt bonds and equity securities are organized as grantor trusts. The tax requirements for a grantor trust structure are different from an RIC. A grantor trust is formed to facilitate the direct investment of its assets. If multiple classes of ownership exist, they must be incidental to the purpose of easing direct ownership (that is, senior or subordinated rights) and beneficial ownership of the trust represents proportional participation in the undivided interests of the whole. The trustee candoes not have the power to vary investments. Unlike an RIC, a grantor trust does not have income and asset qualification tests. Also, the taxable income flows through to the participant as it is earned by the trust; income recognition to the grantor or beneficiary does not depend on distributions fromby the trust. UITs structured as grantor trusts pass through principal and interest payments to the grantor or beneficiary, but, the cash flows may not fully correlate with the taxable income reported.

9.14 For a UIT that is an RIC, if more than 50 percent of the UIT's total assets consist of securities on which interest is exempt from federal income taxes under existing law when received by a trust, the tax-exempt character of the interest is retained when distributed (net of the trust's expenses) to unit holders. Amounts realized from capital gains and paid to unit holders by the trust are taxable to the unit holder. (Chapter 6 discusses taxes in more detail.)

ILLUSTRATIVE FINANCIAL STATEMENTS

9.15 The financial statements of UITs are similar to those of management investment companies. When a trust is formed, the financial statements filed with the Securities and Exchange Commission (SEC) on Form S-6[1] include a statement of assets and liabilities and a schedule of investments. Subsequently, if the sponsor repurchases and re-offers trust units in the secondary market, a posteffective amendment to Form S-6 must be filed periodically with the SEC. The financial statements included in the posteffective amendment, which are

[1] See chapter 1, note 10.

prepared in accordance with Regulation S-X, include a statement of assets and liabilities, a schedule of investments, statements of operations, and statements of changes in net assets (see illustrative statements in paragraphs 9.17 through 9.21). Audited financial statements are provided to prospective investors in the prospectus. Form S-6 requires that both the statement of operations and statement of changes in net assets cover a three-year period.

9.16 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the illustrative financial statements that follow because they are not otherwise required by generally accepted accounting principles. Such compliance disclosures include—

a. The aggregate cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 (note 8) of Regulation S-X.

b. The gross unrealized appreciation or depreciation for all securities, on a tax basis, according to rule 12-12 (note 8) of Regulation S-X.

9.17

Anytown Income Trust
First Intermediate Series
Statement of Assets and Liabilities
August 31, 19X4

Trust Property

Assets	
Investment in securities, at fair value	
(cost $14,591,035) (Note 1 and Schedule 1)	$13,878,788
Interest receivable	339,174
Cash	166,489
Total assets	14,384,451

Liabilities and Net Assets

Liabilities	
Trustee and evaluator fees payable	47
Accrued other expenses payable	475
Total liabilities	522
Net assets	
Balance applicable to 15,500 units of fractional Undivided interest outstanding (Notes 1 and 3)	
Cost to original investors	15,475,560
Less initial underwriting commission	(619,022)
	14,856,538
Accumulated deficit	(232,610)
Principal distributions to unitholders of proceeds from investment transactions	(239,999)
Net assets	$14,383,929
Net asset value per unit (15,500 units)	$928

The accompanying notes are an integral part of these financial statements.

Schedule 1
Anytown Income Trust
First Intermediate Series
Portfolio of Corporate Securities
August 31, 19X4

Name of issuer and title of issue	*Coupon rate (%)*	*Date of maturity or final sinking fund payment*	*Principal Amount or par value*	*Fair value*	
Corporate debt obligations:					
Air transport					
Flying Tiger Lines Incorporated equipment trust certificates	9.000	10/01/X1	$ 931,000	$ 912,380	
Total air transport (Percentage of net asset value)			931,000	912,380	(6.3%)
Banking					
Dominion Bankshares notes	9.500	4/01/X3	1,000,000	1,022,500	
First Maryland Bancorp notes	9.750	11/01/X3	250,000	252,500	
Southeast Banking Corporation notes	10.000	5/01/X3	218,000	224,267	
Total banking (percentage of net asset value)			1,468,000	1,499,267	(10.4[illegible]
Utilities					
Utah Power & Light Company first-mortgage bonds	4.500	6/01/X2	12,100,000	11,467,141	
Total utilities (percentage of net asset value)			12,100,000	11,467,141	(79.7%)
Total debt obligations (percentage of net asset value)			$14,499,000	$13,878,788	(96.5%)

The accompanying notes are an integral part of these financial statements.

Anytown Income Trust
First Intermediate Series
Statements of Operations

	For the year ended August 31, 19X4	*From March 23, 19X3 (date of deposit) through August 31, 19X3*
Investment income		
Interest income	$1,258,975	$554,509
Expenses (Note 1)		
Trustee's fee	14,063	5,411
Evaluator's fee	1,350	375
Other	1,083	351
Total expenses	16,496	6,137
Net investment income	1,242,479	548,372
Realized and unrealized gain (loss) on investments (Note 1)		
Net realized losses from investment transactions	(12,738)	(12,765)
Net change in unrealized appreciation (depreciation) of investments	(738,828)	26,581
Net gain (loss) on investments	(751,566)	13,816
Net increase in net assets resulting from operations	$ 490,913	$ 562,188

The accompanying notes are an integral part of these financial statements.

9.20

Anytown Income Trust
First Intermediate Series
Statements of Changes in Net Assets

	For the year ended August 31, 19X4	*From March 23, 19X3 (date of deposit) through August 31, 19X3*
Increase (decrease) in net assets resulting from Operations		
Net investment income	$1,242,479	$548,372
Net realized losses on investment transactions	(12,738)	(12,765)
Net change in unrealized appreciation (depreciation) of investments	(738,828)	26,581
Net increase in net assets resulting from Operations	490,913	562,188
Distributions to unit holders (Note 2)		
Accrued income as of the date of deposit	5,182	360,787
Net investment income	1,231,408	54,303
Proceeds from investment transactions	129,000	110,999
Total distributions	1,365,590	526,089
Increase (decrease) in net assets	(874,677)	36,099
Net assets		
Beginning of period	15,258,606	15,222,507
End of period	$14,383,929	$15,258,606

The accompanying notes are an integral part of these financial statements.

Anytown Income Trust
First Intermediate Series
Notes to Financial Statements

1. Summary of Significant Accounting Policies

The Trust was organized on March 23, 19X3, under the laws of the Commonwealth of Massachusetts by a Trust Indenture and Agreement, and is registered under the Investment Company Act of 1940. The significant accounting policies of the Trust include the following:

Basis of presentation. The financial statements are presented on the accrual basis of accounting.

Investment in marketable securities. Security transactions are recorded on a trade date basis. Investments owned are carried at fair value, which is the closing bid price on the last day of trading during the period, except that fair value on the date of deposit (March 23, 19X3) represents the cost to the Trust based on offering prices for investments at that date. The difference between cost and fair value is reflected as unrealized appreciation (depreciation) of investments. Realized gains (losses) from securities transactions are determined for federal income tax and for financial reporting purposes on the identified cost basis.

Income taxes. No provision for federal income taxes has been made in the accompanying financial statements because the Trust has elected and intends to continue to qualify for the tax treatment applicable to regulated investment companies under the Internal Revenue Code. Under existing law, if the Trust so qualifies, it will not be subject to federal income tax on net investment income and capital gains distributed to unit holders. Distributions to unit holders of the Trust's net investment income will be taxable as ordinary income to unit holders. Capital gains distributions will be taxable as capital gains to unit holders.

Investment expenses. The Trust pays a fee for trustee services to XYZ Bank that is based on $0.75 per $1,000 of outstanding investment principal. In addition, a fixed fee of $35 is paid to a service bureau for portfolio valuation at least weekly and more often at the discretion of the trustee.

2. Distributions of Income and Redemption of Units

The Trust Agreement requires that the net investment income and net realized capital gains (if any) of the Trust, and also the proceeds from the sale, redemption, or maturity of securities (to the extent that the proceeds are not used to redeem units), be distributed to unit holders monthly.

The Agreement also requires the Trust to redeem units tendered for redemption, to the extent that such units are not purchased by the sponsor, at a price determined based on bid prices of the securities of the Trust.

As of August 31, 19X4, the accumulated deficit on a tax basis was as follows:

Undistributed net investment income	$ 505,140
Unrealized depreciation of investments	(712,247)
Accumulated net realized loss from investment transactions	(25,503)
	$(232,610)

3. Original Cost to Unit Holders

The original cost to investors[2] represents the aggregate initial offering price as of the date of deposit exclusive of accrued interest. The initial underwriting commission and investors' original cost of units, as shown on the statement of assets and liabilities, are based upon the assumption that the maximum sales commission was charged for each initial purchase of units.

4. Financial Highlights

	8/31/94	*8/31/93*
Per Share Operating Performance:		
Net asset value, beginning of period	$ 984.43	$982.10
Income from investment operations		
Net investment income	80.16	35.38
Net realized and unrealized gain (loss) on investment transactions	(48.49)	0.89
Total from investment operations	31.67	36.27
Less distributions	(88.10)	(33.94)
Net asset value, end of period	$928.00	$984.43
Total Return:	3.22%	3.51%
Ratio To Average Net Assets:		
Expenses	.11%	.09%
Net investment income	8.38%	8.21%

[2] This information is required by Regulation S-X and is not otherwise required by generally accepted accounting principles.

communications with the fund auditor are appropriate and, in general, should consider wh other steps are appropriate to rely on the work of another auditor or perform other procedures

10.40 If the underlying fund has a yearend that is different from the separate accour questions may arise regarding auditing investment valuation. The auditor of the separa account achieves audit satisfaction with respect to the value of the investment in the fur through the separate audit of the fund. When the fund is not audited at the separate accou year-end date, the auditor should consider what other audit procedures might be appropriate substantiate the separate account's valuation, including confirmation of the price with th fund's transfer agent, inquiry of the transfer agent and others as to any adjustments made t the year-end price, discussion with the fund's controller or treasurer as to circumstances arisir since the audit, and analytical review of price changes since the audit date.

10.41 The auditor's report is typically addressed to the board of directors of the sponsorin insurance company and the contractholders of the separate account.

TAXATION OF VARIABLE CONTRACTS

10.42 Variable annuity contracts are designed for use primarily by individuals for persona savings or retirement plans, which, under the provisions of the Internal Revenue Code (IRC may be qualified or nonqualified plans. Variable life contracts are designed for individuals t provide market sensitive cash surrender values and death benefits. The ultimate effect c federal income taxes on the contract value, annuity payments, cash values, death benefits, an economic benefit to the contract owner, annuitant, or beneficiary depends on the separat account's tax status, the purpose for which the contract is purchased, and the individual's ta and employment status. The discussion in this section is general and is not intended to be a all-inclusive and comprehensive treatise on the current tax status of variable annuities.

10.43 If the annuity contract qualifies as such under the IRC, a contract holder is generally no taxed on increases in the value of a contract until he or she receives payment in a lump sum o as an annuity under the settlement option elected, nor is he or she taxed upon the investmen build up in cash values. Although the assets and liabilities of the separate account are segregated from the sponsoring life insurance company's regular business, it is not considerec a separate taxable entity. The tax treatment of the separate account depends upon the character of the contracts held by the separate account. If the contracts qualify as "variable contracts" that are "adequately diversified" (see paragraph 10.49 below), then section 817 o the IRC dictates the taxation of the separate account. If the contracts do not qualify as variable or are not adequately diversified, then the activity of the separate account will be governed by the tax rules applicable to life insurance companies under subchapter L of the IRC. The separate account is not subject to the tax rules applicable to regulated investment companies (RICs) under subchapter M of the IRC.

10.44 Under section 817 of the IRC, reinvested investment income is applied to increase insurance company reserves under the contracts, and the increase in reserves is deductible from income. Usually a provision for federal income taxes on investment income or gains is not required; therefore, a provision is not made in the variable annuity separate account financial statements.

10.45 Section 817(g) of the IRC provides that a variable annuity contract will be taxed in the same manner as a traditional or fixed annuity if the payments under the variable contract are computed based on recognized mortality tables and the investment return of the individual segregated account.

10.46 When the UIT approach was developed using mutual funds as the underlying investment, insurers relied on several tax rulings as the basis for treating mutual fund wraparounds similarly to traditional variable annuities.

10.47 However, in April 1977, the IRS issued Revenue Ruling 77-85, which concluded that because contract holders have control over the assets and investments, they own the underlying assets and are liable for tax on their earnings. Despite Revenue Ruling 77-85, the IRS issued favorable letter rulings on wraparound annuities between 1977 and 1980. In Revenue Ruling 80-274, however, the IRS picked up the language of Revenue Ruling 77-85 and concluded that the position of a contract holder of an annuity wrapped around a savings account is as if the investment had been maintained or established directly with a savings and loan association. Thus, the contract holder is taxed on a current basis on the separate account income.

10.48 On September 25, 1981, the IRS issued Revenue Ruling 81-225, which held that, for federal income tax purposes, the insurance company and not the contract holder will be considered the owner of mutual fund shares underlying investments for an annuity contract, provided that such shares are unavailable to the public. Accordingly, under that ruling, if the mutual fund shares are not available to the public, the contract holder is not treated as the owner of the shares, and dividends applicable to such shares are not currently includable in the contract holder's gross income.

10.49 Many argue that Congress intended to resolve the "investor control" issue with the enactment of the diversification requirements (described below in paragraph 10.50) and that the aforementioned rulings no longer apply. However, the IRS appears to continue to exercise authority in this area and has not conceded that the diversification requirements were intended to resolve this issue.

10.50 Section 817(h) of the IRC and the regulations thereunder require the investments of a separate account (or the underlying mutual fund, if the separate account is a UIT) to be "adequately diversified" to qualify as an annuity contract under section 72 of the IRC (qualification under section 72 is necessary to avoid current taxation of both current and "built-up" earnings of the contract). In order for the separate account to be adequately diversified, the fair value of the largest holding may not exceed 55 percent of the fair value of total assets, the two largest holdings may not exceed 70 percent, the three largest holdings may not exceed 80 percent and the four largest holdings may not exceed 90 percent. Regulation 1.817-5(b)(1) further describes what assets must be included in the calculation and what assets may be excluded.

10.51 U.S. government securities are subject to the 817(h) diversification rules. The treatment of U.S. government securities for purposes of determining separate account diversification is different from that applied to RICs. Under section 817(h), each government agency or instrumentality is treated as a separate issuer for purposes of diversification testing.

10.52 As an alternative to the general diversification standards described above, IRC sectio 817(h)(2) provides "safe harbor" diversification standards that are similar to those required fc RICs and are often easier to administer. However, the "safe harbor" diversification rules diffe from those of RICs in that the total assets of the separate account represented by cash, cas items (including receivables), U.S. government securities, or securities of other RICs may nc exceed 55 percent of the value of total assets in the account.

10.53 Section 72(s) of the IRC provides that a contract should not be treated as an annuit for tax purposes unless it provides for certain required distributions in the event of the contrac holder's death.

10.54 Section 72(q) of the IRC imposes certain penalties on early withdrawals from annuit contracts.

10.55 The federal excise tax rules governing the timing and amounts of distributions do no apply to insurance-related mutual funds if no taxable investors are present. Further, ir organizing the separate account, the sponsoring insurance company can invest taxable seec money of up to $250,000 without subjecting the fund to the excise tax rules (IRC 4982(f)).

10.56 Dividends and distributions from the fund to the separate account are usuall reinvested. As a result, some "insurance funds" do not actually pay any dividends o distributions. Rather, they satisfy their fund level tax qualification tests by using a procedure known as "consent dividends" (IRC 565). Under this procedure, with annual written consen from each investor (that is, the separate accounts), distributions are deemed to be passec through from the fund to the investors. This is operationally manageable because, in practice few separate accounts tend to invest in a fund.

ILLUSTRATIVE FINANCIAL STATEMENTS

10.57 The financial statements illustrated in this chapter are for variable annuity separate accounts registered as UITs. For separate accounts with multiple subaccounts the financial position and results of operations should be presented separately for each subaccount. This kind of arrangement is presented with individual columns for each subaccount. The total information for the separate account as a whole is not meaningful. Accordingly, similar to a series mutual fund, the subaccount is the reporting entity and the auditor's report should be modified to cover the individual subaccounts (see paragraph 11.7). The financial statements of a subaccount may also be presented as if the subaccount were a separate entity. Variable annuity separate accounts registered as management investment companies would prepare financial statements that conform to those presented in chapter 7, although certain financial statement notes that follow would also apply. Variable life separate accounts registered as UITs would follow the form of the exhibit. Also, certain contract charges, for example, cost of insurance, would be shown on the statement of changes in net assets, similar to the presentation of annuity contract charges.

10.58 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the following illustrative financial statements because they are not otherwise required by generally accepted accounting principles. In addition, certain disclosures are impractical due to the characteristics of the separate account. These disclosures include the following:

- The total cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 of Regulation S-X

- The components of net assets presented as a separate schedule or in the notes to the financial statements according to rule 6-05.5 of Regulation S-X. However, the unit value and net assets are to be provided for the most recent five years and the prior period-end tax unit value (equating to beginning and ending unit value for five years).

AICPA Exposure Draft
Audits of Investment Companies
Comments on Appendix B

Table 1: Delete @ footnote. It is not needed and, as written, it is not an accurate definition of Accrual Period (see Reg. Sec. 1.1272-1(b)(ii)).

Table 2: Delete N/A to the right of "*Tax-exempt obligations*" in the Method of Amortization column. This is a title and the field should be blank. Also, third line from the bottom, the effective date should read "Acquired after 4/30/93".

Appendix B

COMPUTATION OF TAX AMORTIZATION OF ORIGINAL ISSUE DISCOUNT, MARKET DISCOUNT, AND PREMIUM

Table 1
Amortization of Original Issue Discount (OID)

		Reporting of Amortization		*Characterization of Amortization*	
	Method of Amortization	*On a Daily Basis*	*At Disposition*	*Capital Gain*	*Interest Income*
Taxable obligations:					
Short-term corporate obligations *	YTM#	X			X
Long-term corporate obligations					
Issued before 5/28/69	SL		X		X
Issued 5/28/69 – 7/1/82	SL	X			X
Issued after 7/1/82	YTM	X@			X
Short-term government obligations*	SL†	X			X
Long-term government obligations					
Issued before 7/2/82	SL		X		X
Issued after 7/1/82	YTM	X@			X
Tax-exempt obligations:					
Short-term obligations*	SL†	X			X^
Long-term obligations					
Issued prior to 9/4/82 *and* acquired prior to 3/2/84	SL	X			X^
All other acquisitions	YTM	X			X^

SL = Straight-line (ratable); YTM = yield to maturity.

* Short-term is defined as having a maturity of not more than one year after the date of issue.

@ Accrual period with respect to which OID is computed and compounded is a one-year period for obligations issued before 1/1/85 and is a six-month period for obligations issued after 12/31/84.

^ Amortization is characterized as tax-exempt interest.

† An election may be made to use the yield-to-maturity method.

\# An election may be made to use the straight-line method.

Table 3
Amortization of Premium

	Method of Amortization	Reporting of Amortization: On a Daily Basis	Reporting of Amortization: At Disposition	Characterization of Amortization: Capital Gain	Characterization of Amortization: Interest Income
Taxable obligations:					
Obligations issued after 9/27/85	YTM	†	X		X*
Obligations issued before 9/28/85	@	†	X		X*
Tax-exempt obligations:					
Obligations issued after 9/27/85	YTM#	X		X	
Obligations issued before 9/28/85	@	X		X	

YTM = Yield to maturity.

† An election may be made to report amortization currently. If the election is made, it will apply to all bonds held by the taxpayer at the beginning of the taxable year and to all bonds thereafter acquired by the taxpayer.

@ Any reasonable method of amortization may be used.

\# The amortization should be computed taking into account call dates and call prices.

* For bonds acquired between 10/23/86 and 1/1/88, premium amortization is treated as interest expense.

Appendix C

INTERNAL REVENUE CODE WORKSHEETS

I. Internal Revenue Code (IRC) section 851 requirements:

Assets (as of close of each quarter):

A.	Cash, receivables, securities, and total other assets (total assets)		$______
B-1.	Cash, receivables, government securities, and securities of other regulated investment companies (RICs)	______	
B-2.	Other securities not including either (a) securities of any one issuer having a value in excess of 5 percent of line A or (b) securities representing more than 10 percent of the outstanding voting securities of any one issuer. (Exclude entire amount of investments that exceed either limitation.)	______	
B-3.	(Lines B-1 plus B-2)		$______
C.	25 percent of line A Line B-3 must be at least 50 percent of line A		$______

No one issue (other than government securities or securities of other RICs) can exceed line C.

Income (for the taxable year to date[1]):

1.	Gross gains (tax basis, excluding all losses) on:	
	a. Stock or securities sold	$______
	b. Options, futures, and forwards	______
	c. Foreign currencies	______
2.	Interest and dividends from investments	______
3.	Income from securities on loan	______
4.	Other income	______
D.	Total (sum of lines 1 through 4)	$______
E.	10 percent of line D	$______
F.	30 percent of line D[2]	$______

Other income not derived with respect to the fund's business of investing in stock, securities or currencies cannot exceed line E. (Note that the secretary may by regulations exclude from qualifying income foreign currency gains that are not directly related to the RIC's principal

[1] This computation should be done by the RIC as least monthly so that failure to meet the requirements can be determined and corrected on a current basis.

[2] Not applicable for years beginning after August 5, 1997.

12. Gross equalization debits (optional) ~~(see section II.D. for possible limitations)~~
13. Total
14. Subchapter M net income (loss) (item 7 less item 13)
15. 10% of net investment income (item 7)
16. Excess of 14 over 15 (excess means a disqualification)

Securities profits (or losses)-tax basis

17. Net long-term gain (loss)
18. Net short-term gain (loss)
19. Cash dividends treated as gains
20. Reclassification of foreign currency gain or loss
21. Deferral of current year post-October losses deferred ( )
22. Reversal of prior year post-October losses deferred
23. Other
24. Total

Deduct—

25. Carryforward loss of fund
26. Carryforward loss acquired by merger (subject to limitations)
27. Total
28. Net gain (loss)

Deduct—

Distributions paid in-

29. Current year, total
30. Current year, related back to prior year ( )
31. Subsequent year, to be related back to current year (IRC section 855(a))
32. January of subsequent year, to be related back to current year (IRC section 852(b)(7)) for calendar year funds only
33. Net short-term gains included in ordinary income
34. Total
35. Remainder of taxable gains

Appendix E

19X4. The acquisition was accomplished by a tax-free exchange of 1,000,000 shares of Fund A (valued at $10 million) for the 1,000,000 shares of Fund B outstanding on December 31, 19X4. Fund B?s net assets at that date ($10 million), including $1 million of unrealized appreciation,** If appropriate, significant amounts of undistributed income and undistributed realized net gains or losses from investment transactions should be similarly disclosed. were combined with those of Fund A. The aggregate net assets of Funds A and B immediately before the acquisition were $20,000,000 and $10,000,000, respectively. If the acquisition is completed at other than the fiscal-year end, disclosure of the combined net assets immediately after the acquisition is appropriate.

Note 7 ? Capital Share Transactions