**MEMO# 24561**

September 24, 2010

# ICI Comments on FASB Accounting for Financial Instruments Proposal

[24561]

September 24, 2010

TO: ACCOUNTING/TREASURERS MEMBERS No. 29-10
CLOSED-END INVESTMENT COMPANY MEMBERS No. 48-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 44-10 RE: ICI COMMENTS ON FASB ACCOUNTING FOR FINANCIAL INSTRUMENTS PROPOSAL

As you know, earlier this year the Financial Accounting Standards Board issued an exposure draft of a proposed accounting standards update relating to financial instruments. [1] The FASB proposal would affect investment company financial reporting. In particular, the proposal would require: 1) transaction costs on portfolio trades to be expensed and included in the expense ratio; 2) money market funds to report their holdings at fair value (in lieu of amortized cost) in their financial statements; and 3) liabilities to be measured at fair value, with changes in value reflected in the net increase/decrease in net assets in the fund's statement of operations. The Institute recently filed the attached comment letter, which is briefly summarized below.

## Transaction Costs

The Institute's letter strongly opposes recognizing transaction costs on portfolio trades as an expense in funds' financial statements. The letter indicates that such change will cause transaction costs to be included in the expense ratio, diminishing its utility as a measure of recurring operating costs, to the detriment of fund investors. The letter notes that the level of portfolio trading and related transaction costs change over time and as a result, the proposal would introduce volatility into the expense ratio, further diminishing its utility. The letter points out that total return, which is based on the change in net asset value per share over the reporting period, is net of all fees and costs, including transaction costs.

The letter notes that the proposal would require brokerage commissions on equity trades to be treated as expense.  The proposal, however, provides no specific guidance for measuring transaction costs on fixed-income transactions and other securities that trade on a bid-ask spread basis.  Absent specific guidance for measuring transaction costs on such securities, the letter notes that the proposal would cause funds to apply their own methods of measuring these costs, introducing significant comparability concerns.

The letter indicates that if the proposal were to apply only to explicit costs in the form of brokerage commissions, it would artificially cause equity funds to appear more expensive than fixed-income funds.  The letter also indicates that there is no single agreed-upon measure of transaction costs.

The Institute's letter also describes the SEC's prior consideration of this issue through its 2003 concept release requesting comment on issues relating to measurement and disclosure of mutual fund transaction costs.  The letter recommends that the Board retain current fund accounting for transaction costs and affirm that such accounting effectively recognizes these costs as expense by requiring that they reduce reported gain (or increase reported loss) on the fund's investment portfolio.

## Money Market Funds

The Institute's letter acknowledges that fair value based financial reporting best serves investment company shareholders.  The letter argues that there would be little practical benefit with the Board's proposal, however, because Rule 2a-7's risk limiting conditions provide assurance that under normal circumstances the amortized cost value of the fund's securities will not deviate materially from their fair value.  The letter also describes recently adopted Rule 30b1-7 and new Form N-MFP, which will require money market funds to disclose the fair value of their portfolio securities monthly beginning in 2011.  The letter recommends that in lieu of requiring money market funds to measure their investments at fair value in their financial statements, the Board require these funds to disclose the fair value of the investment portfolio in the notes to the financial statements.

## Liabilities at Fair Value

The Institute's letter notes that changes in the fair value of liabilities that can be realized give rise to economic gains (losses) that accrue to the benefit (detriment) of common shareholders and that such liabilities should be reflected at their fair value to properly present a fund's results of operations and financial position.  Where changes in the fair value of a liability cannot be realized or are highly unlikely to be realized, however, the letter indicates that measurement of the liability at its amortized cost best reflects a fund's results of operations and financial position.  The letter recommends that the Board require liabilities to be measured at fair value with the change in value reflected in earnings, if the change in value is probable of being realized. Other liabilities, for which the likelihood of realization of the change in value is remote, should be measured at their amortized cost.  The letter recommends that the fair value of such liabilities be disclosed in the notes to the financial statements.

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

Attachment

**endnotes**

[1] See ICI memorandum to Accounting/Treasurers Member No. 18-10, Closed-end Investment Company Members No. 31-10, and Money Market Funds Advisory Committee No. 25-10, dated June 15, 2010 [24366].

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