INVESTMENT COMPANY INSTITUTE

MEMO# 24366

June 15, 2010

FASB Issues Exposure Draft On Accounting for Financial Instruments

[24366]

June 15, 2010

TO: ACCOUNTING/TREASURERS MEMBERS No. 18-10
CLOSED-END INVESTMENT COMPANY MEMBERS No. 31-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 25-10 RE: FASB ISSUES EXPOSURE DRAFT ON ACCOUNTING FOR FINANCIAL INSTRUMENTS

The Financial Accounting Standards Board recently issued a proposed Accounting Standards Update that sets forth a comprehensive approach to financial instrument classification and measurement, impairment, and revisions to hedge accounting. [1] Under the Proposal, most financial instruments, including loans held by banks and held-to-maturity securities, would be measured at fair value with changes in value recognized in net income, unless an instrument qualifies and the reporting entity elects to recognize the changes in value in other comprehensive income. The Proposal continues the FASB's move from amortized cost-based reporting to fair value-based reporting. The Proposal would also affect investment company financial reporting as described below. Comments on the Proposal are due to the FASB by September 30, 2010. We understand that the Proposal, if adopted, would be effective no earlier than January 1, 2013.

Transaction Costs to be Expensed and Included in Expense Ratio

Currently investment companies include transaction fees and costs in the cost of securities purchased and deduct them from the proceeds of securities sold. Accordingly, these fees reduce gain or increase loss on portfolio transactions. The Proposal would require transaction fees and costs incurred to purchase or sell financial instruments to be characterized as expense and deducted from net income in the period incurred. This proposed change would cause transaction fees and costs to be included in the fund's expense ratio, which, per Item 13 of SEC Form N-1A, is based on the fund's expenses reported in its statement of operations.

The FASB accounting standards codification indicates transaction costs represent the incremental direct costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. The Proposal makes clear that brokerage commissions on equity trades are transaction costs. We understand that the FASB intends for the bid-ask spread on fixed-income trades to be captured as transaction costs. However, the Proposal provides no specific guidance for measuring transaction costs on fixed-income trades.

The Proposal indicates that the FASB decided that transaction costs and fees relating to financial instruments should be recognized as an expense in net income when incurred because such costs do not directly relate to the financial instrument's fair value, consistent with FASB's fair value measurement guidance.

Amortized Cost

The Proposal would require money market funds that comply with Rule 2a-7 of the Investment Company Act of 1940 to measure their investments at fair value rather than amortized cost. The Proposal indicates that amortized cost reflects a historical transaction price that is not relevant for current investment decisions. For example, amortized cost does not reflect current market conditions such as interest rate changes and market prices.

The Proposal requests comment on whether the proposed change would provide investors with decision-useful information. If yes, the Proposal requests comment on how the fair value information provided will influence investors' analysis of the fund. If no, the Proposal requests comment on why amortized cost is more relevant.

The Proposal would not change Rule 2a-7 and we anticipate that money market funds would continue to use amortized cost for purposes of calculating daily net asset value per share. Accordingly, we believe the proposed change, if adopted, would affect only the fund's reporting of its investments in Form N-CSR and Form N-Q.

Liabilities to be Measured at Fair Value

The Proposal would require investment companies to report financial liabilities at fair value and include all changes in fair value in the net increase (decrease) in net assets in the statement of operations for the reporting period. The Proposal indicates that neither the option to report changes in the fair value of an asset or liability in other comprehensive income nor the amortized cost option for qualifying financial liabilities is available to an investment company. The Proposal would affect, for example, closed-end funds that issue debt or preferred shares that mature on a specified date.

The Proposal indicates that the FASB believes that recognizing all financial assets and financial liabilities at fair value with changes in value included in the net increase (decrease) in net assets resulting from operations would provide the most relevant information to investors. The Proposal requests comment on whether the effect of the proposed change will provide investors with decision-useful information.

The Proposal would require investment companies with financial liabilities (e.g., closed-end funds with outstanding debt securities) to report both the fair value and the amortized cost value of the debt on the balance sheet. Fair value would be used to calculate net assets. In addition, the Proposal would require such funds to report separately in the statement of operations the change in fair value attributable to: 1) changes in the fund's credit standing, and 2) changes in the price of credit. The Proposal, at Appendix B, describes possible methods to measure changes in an entity's credit standing.

Statement of Comprehensive Income

The FASB concurrently released a separate proposal requiring a new primary financial statement, referred to as the statement of comprehensive income, which would replace the income statement. [2] The new statement would contain subtotals for net income and "other comprehensive income" within a single continuous statement. The components of net income and other comprehensive income would not change as part of this proposal.

Investment companies are included within the scope of this proposal. However, because investment companies typically do not have any items of other comprehensive income, this proposal would not affect them.

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

endnotes

[1] The proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities is available on the FASB website ("Proposal").

[2] The proposed Accounting Standards Update, Statement of Comprehensive Income is available on the FASB website.
