

MEMO# 24461

August 2, 2010

ICI Draft Comment Letter on FASB Accounting for Financial Instruments Proposal

[24461]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 8-10
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 14-10
FIXED-INCOME ADVISORY COMMITTEE No. 13-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 32-10 RE: ICI DRAFT COMMENT LETTER
ON FASB ACCOUNTING FOR FINANCIAL INSTRUMENTS PROPOSAL

As you know, the FASB 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 ASU, most financial instruments, including loans held by banks and held-to-maturity securities, would be measured at their fair value with changes in value reflected in net income, unless an instrument qualifies and the reporting entity elects to recognize the changes in value in other comprehensive income. The ASU continues FASB's move from amortized cost-based reporting to fair value-based reporting.

The ASU would also affect investment company financial reporting. In particular, the ASU would require: 1) transaction costs on portfolio trades to be expensed; 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 has prepared the attached draft comment letter on the ASU.

Transaction Costs

The Institute's draft letter strongly opposes recognizing transaction costs on purchases and sales of portfolio securities as an explicit expense in the statement of operations. The draft letter indicates that such change would diminish the utility of the expense ratio as a

measure of the recurring costs of operating a fund. The letter notes that the ASU cannot reasonably be applied to fixed-income securities, which generally trade on a bid-ask spread basis. The letter indicates that the SEC in 2003 considered requiring funds to recognize transaction costs as an expense in their financial statements and declined to do so.

The draft letter supports existing GAAP, which requires transaction costs incurred to be included in the cost basis of securities purchased, and deducted from proceeds of sales. Current GAAP appropriately offsets transaction costs against the fund's portfolio, decreasing reported gain (or increasing loss). The draft letter recommends alternative measures to improve shareholder understanding of transaction costs, including financial highlights disclosure of 1) brokerage commissions paid as a percentage of net assets, and 2) brokerage commissions paid as a percentage of the principal amount of portfolio transactions.

Money Market Funds

The draft letter opposes requiring money market funds to measure their holdings at fair value, rather than amortized cost, in their financial statements. The letter notes that, under normal circumstances, due to the risk limiting conditions in rule 2a-7, amortized cost does not differ materially from fair value. The draft letter also describes recently adopted SEC rules which will cause the fair value of money market funds' holdings to be disclosed on a monthly basis beginning on or about February 1, 2011. The letter argues that, given the risk-limiting conditions in rule 2a-7 and the recent adoption of rules that will result in monthly disclosure of fair values, there is little practical benefit associated with the Board's proposal.

Liabilities to be Measured at Fair Value

The draft 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. Such liabilities (e.g., short sales) should be measured at their fair value to properly present a fund's financial position and results of operations. In contrast, where changes in the fair value of liabilities cannot be realized, or are highly unlikely to be realized, the draft letter argues amortized cost best reflects the fund's financial position and results of operations. The draft letter recommends that where the likelihood of realization of the change in fair value is remote, that funds measure the liability at amortized cost and disclose the fair value in the notes to the financial statements.

Comments on the ASU are due to the FASB by September 30, 2010. If you have any comments on the Institute's draft letter, please contact the undersigned at 202/326-5851 or smith@ici.org by August 20.

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

[Attachment](#)

endnotes

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

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