

MEMO# 5933

May 31, 1994

RECOMMENDATIONS OF AICPA SUBCOMMITTEE ON SEPARATE REPORTING OF REALIZED AND UNREALIZED FOREIGN CURRENCY GAINS AND LOSSES

May 31, 1994 TO: ACCOUNTING/TREASURERS COMMITTEE NO. 26-94 SEC RULES
COMMITTEE NO. 58-94 RE: RECOMMENDATIONS OF AICPA SUBCOMMITTEE ON SEPARATE
REPORTING OF REALIZED AND UNREALIZED FOREIGN CURRENCY GAINS AND LOSSES

The AICPA Investment Companies Committee (ICC) is considering recommending changes to the Management's Discussion of Fund Performance requirements that were adopted last year by the SEC (See Institute Memorandum to Accounting/Treasurers Members No. 11- 93, SEC Rules Members No. 35-93, April 8, 1993). The proposed changes, described in the attached report, are intended to illustrate the effects of changes in foreign currency exchange rates on the performance of international and global funds. The proposal would require a table indicating the fund's country or regional asset allocation and the resulting foreign currency exposure, and a line graph depicting the performance of a relevant basket of foreign currencies be included in management's discussion of fund performance. Background Statement of Financial Accounting Standards No. 52 Foreign Currency Translation, (FAS 52) which applies to all entities that prepare financial statements in accordance with generally accepted accounting principles, requires the aggregate foreign currency transaction gain or loss to be disclosed in the financial statements. Investment companies typically have not complied with this requirement in reliance on an exception for "specialized industry practice." Thus, investment companies generally do not disclose separately the portion of realized or unrealized gain or loss that results from foreign currency rate changes. AICPA Statement of Position 93-4 Foreign Currency Accounting and Financial Statement Presentation for Investment Companies (SOP 93-4) permits, but does not require, the foreign currency rate change component of realized and unrealized gains and losses from 1 During the SOP's public comment period, the Institute and others expressed strong opposition to separate reporting of foreign currency gains and losses (bifurcation). In its comment letter the Institute noted that bifurcation would place undue emphasis on a single risk associated with investments denominated in foreign currencies. Separate reporting may imply that currency risk is the only risk or the most important risk associated with investment in foreign securities. In addition, the Institute's letter noted that bifurcation may be detrimental to recent efforts to facilitate cross-border sales of mutual fund shares. The information provided by bifurcation would only be meaningful from the perspective of a U.S.

based shareholder. (See Accounting/Treasurers Committee No. 37-92, August 24, 1992.) investments in foreign securities to be reported separately.¹ The SOP amended the Audit and Accounting Guide Audits of Investment Companies, which investment companies must follow in preparation of their financial statements. The SOP was approved by the Financial Accounting Standards Board (FASB) in April 1993 and is effective for financial statements relating to fiscal years beginning after December 15, 1993. At the adoption of the SOP, the FASB expressed concern that the SOP did not require separate reporting of realized and unrealized gains and losses resulting from changes in foreign currency exchange rates, consistent with the requirements of FAS 52. The FASB approved the adoption of the SOP contingent upon a commitment of the ICC to form a task force to evaluate the relevance of the information that would be provided by separate reporting of realized and unrealized foreign currency gains and losses, to explore alternate approaches to reporting foreign currency effects, and to report their conclusions and recommendations back to the FASB. The task force was formed with nine members: one CPA in public practice, two representatives of accounting system service provider organizations which had developed multi-currency systems, one representative of a major Wall Street securities firm, the president of Lipper Analytical Services and four representatives of ICI member investment company complexes. The task force specifically considered (1) the relevance of the information provided by bifurcation, (2) the cost of accounting system enhancements that would be required, and (3) alternative methods of presenting the effects of changes in foreign currency exchange rates.

Task Force Recommendations The task force concluded that the SOP should not be modified and that the practice of bifurcating foreign currency gains and losses in the financial statements of investment companies should remain voluntary. The task force did, however, recognize the need for additional disclosure, discussion and analysis concerning the magnitude and allocation of a fund's foreign investments, any associated hedging strategies, and the resulting impact on the risk profile and performance of the fund. The task force concluded that the requirements for management's discussion of fund performance should be expanded for funds whose investment in portfolio securities denominated in foreign currencies has a material impact on the performance of the fund. In particular, the task force recommended that management's discussion of fund performance should include a table indicating the fund's country or regional asset allocation and resulting foreign currency exposure, both including and excluding the effects of any foreign currency hedging activities as of the balance sheet date. Also, the task force recommended that the line graph component of management's discussion be expanded to include an additional line graph that would depict the performance of a relevant basket of foreign currencies over the same time horizon as the line graphs that are currently required. The ICC is currently considering recommending these changes to the SEC. At a recent meeting of the ICC, an SEC representative requested that any such recommendation include a summary of industry comment on the recommendations and some measure of the level of industry support for the recommendations. Accounting staff in the Division of Investment Management have consistently suggested the need for separate reporting of realized and unrealized foreign currency gains and losses on foreign securities. We believe that absent changes of the type proposed by the ICC, the FASB and/or Commission staff may take action to require separate reporting of the effects of foreign currency exchange rates in the financial statements.

Comments Requested The Institute has offered to assist the ICC by circulating the recommendations to ICI member firms. Please forward your comments on the attached report to the undersigned no later than July 1. A summary of the comments received will be provided to the ICC and the SEC. If you have any questions on the task force recommendations please call Jim Muller of McGladrey & Pullen at 212/697-0606 or Greg Smith at 202/326-5851. Gregory M. Smith Director - Operations/ Compliance and Fund

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