

COMMENT LETTER

November 13, 2007

ICI Comment Letter On SEC Concept Release on Financial Statements Prepared Under IFRS (pdf)

/14/200711/14/200711/14/2007 VIA ELECTRONIC MAIL November 13, 2007 Ms. Nancy M. Morris Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, DC 20549-1090 Re: Commission Request for Comments on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with IFRS; File Number S7-20-07 Dear Ms. Morris: The Investment Company Institute¹ appreciates the opportunity to comment on the Securities and Exchange Commission's concept release on allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board ("IFRS").² Our comments are limited to financial statements issued by registered investment companies, which are currently prepared in accordance with generally accepted accounting principles as used in the United States ("GAAP"). As a general matter, the Institute supports convergence of accounting principles and reporting requirements as a means to improve comparability and efficiency of financial reporting across global capital markets. Currently, however, there are significant differences between IFRS as applied to investment companies and investment company GAAP. We are concerned that these differences would limit the comparability of financial statements prepared under the differing regimes. Further, we have strong concerns that investment company financial statements prepared under IFRS are less meaningful and less transparent than those prepared under investment company GAAP. We note that other associations around the world representing funds have also expressed concerns regarding the 1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter. 2 SEC Release Nos. 33-8831; 34-56217; and IC-27924 (August 7, 2007), 72 Fed. Reg 45559 (August 14, 2007) ("Concept Release"). Ms. Nancy M. Morris November 13, 2007 Page 2 of 9 application of IFRS to funds. We recommend that the Commission ensure that there is substantial convergence relating specifically to investment company financial reporting before it provides investment companies with the option to prepare their financial statements under IFRS, and urge that the standards converge toward investment company GAAP, which we believe better serves the interests of fund shareholders. We elaborate on our concerns and recommendations below. Investment Company GAAP vs. IFRS GAAP for investment companies is an industry-specific reporting model that reflects the unique characteristics of pooled investment vehicles.³ Funds invest in a portfolio of investment securities with the objective of earning a return through both income and capital growth. GAAP for investment companies effectively illustrates the fund's financial position and

results of operations by requiring disclosure of the fund's portfolio holdings, investment income, the change in value of its holdings, as well as key measures, such as the fund's total return, the income ratio, the expense ratio and the portfolio turnover rate. In contrast, IFRS does not provide accounting standards or guidance specific to the investment company industry. Accordingly, investment companies would follow the same financial reporting standards followed by general corporate enterprises and their financial statements would appear very similar to those prepared by corporate entities. As a result, fund financial statements prepared under IFRS would not reflect the nature of the fund's investing activities and thus would be far less meaningful to shareholders relative to those prepared under investment company GAAP. Certain disclosures required under investment company GAAP are not required by IFRS. The absence of these disclosures, we believe, results in financial statements that are less informative to shareholders. Equally problematic, IFRS requires certain disclosures that are not required by investment company GAAP. In most instances, these additional disclosure requirements, while relevant to general corporate enterprises, are not germane to pooled investment vehicles and serve only to obfuscate more important information. We describe certain differences below to illustrate why we believe there should be substantial convergence before the Commission provides investment companies with the option to file IFRS financial statements.

- **Schedule of Investments** – IFRS does not require a schedule of investments. In contrast, investment company GAAP requires at least a summary schedule of investments listing each holding that constitutes more than 1 percent of net assets and at a minimum, the 50 largest investments. Investments must be categorized by type (e.g., common stock, preferred stock, bonds, 3 GAAP provides industry specific accounting standards and guidance, in addition to the general authoritative accounting pronouncements. The AICPA Audit and Accounting Guide – Investment Companies describes fund industry specific guidance and standards and represents investment company GAAP. Ms. Nancy M. Morris November 13, 2007 Page 3 of 9 etc.) and by industry or country. In practice, most registered investment companies provide a full schedule of investments, listing separately each investment held by the fund. The schedule of investments provides investors with a valuable insight into the fund's holdings and the implementation of its investment objective and strategies.
- **Financial Highlights** – IFRS does not require disclosure of financial highlights. In contrast, GAAP for investment companies requires disclosure of financial highlights for each share class. The financial highlights provide, on a per share basis: beginning net asset value, net investment income/loss, realized and unrealized gain/loss, total from investment operations, distributions, and net asset value at the end of the period. The financial highlights also provide several important measures that shareholders frequently rely upon to evaluate funds, such as: total return, income ratio, expense ratio and portfolio turnover. These measures, calculated based on prescribed methodologies, enable fund shareholders to compare fund performance, the recurring income generated by the fund's portfolio, fund operating expenses, and the frequency of portfolio trades.
- **Income Statement** – IFRS permits combining interest and dividend income with gains/losses on securities to determine net income. In contrast, investment company GAAP requires separate presentation of investment income (i.e., dividends and interest) and gains/losses on investment securities. This separate presentation permits display of the fund's net investment income (i.e., dividends and interest less expenses). Net investment income represents the recurring income generated by the investment portfolio and forms the basis for the income ratio included in the financial highlights. Further, investment company GAAP requires separate reporting of realized gain/loss on investment securities and the net increase/decrease in unrealized gain/loss on investments.
- **Statement of Cash Flows** – The primary purpose of a statement of cash flows is to provide relevant information about cash receipts and cash payments over the period. The information included in a statement of

cash flows enables an investor to: i) assess the enterprise's ability to generate positive cash flows, ii) assess the enterprise's ability to meet its obligations, its ability to pay dividends and the need for external financing, iii) assess the differences between net income and associated cash receipts/payments and iv) assess the effects of investing and financing transactions during the period. In 1989 the Financial Accounting Standards Board ("FASB") exempted investment companies from the requirement to provide a statement of cash flows, so long as they meet certain criteria.⁴ The FASB exemption recognized that the statement of cash flows provides little benefit where funds invest in highly liquid securities and have little or no debt. FASB concluded that the other 4 Financial Accounting Standard No. 102, Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (February, 1989). Ms. Nancy M. Morris November 13, 2007 Page 4 of 9 financial statements in a fund's shareholder report would provide sufficient information for shareholders to assess liquidity, financial flexibility, profitability and risk. IFRS requires investment companies to provide a statement of cash flows, even though it provides little benefit to investment company shareholders. We believe the requirement to include a statement of cash flows may divert shareholder attention from more important information contained elsewhere in the financial statements. We recommend that the Commission ensure that IFRS provides an exemption from the requirement to provide a statement of cash flows, similar to that provided in GAAP before providing funds with the option to file IFRS financial statements.

- **Comparatives Information** – IFRS requires two years' balance sheets, income statements, statements of changes in equity, and cash flow statements. In contrast, investment company GAAP requires only presentation of the most recently completed period. For general corporate enterprises, analysis of changes in revenues, earnings and cash flows relative to the prior period is appropriate. However, for investment companies, it is more appropriate to focus on total return and total return relative to a benchmark index over various periods. The requirement to include prior period financial statements may divert shareholder attention from more important information contained elsewhere in the financial statements.
- **Differences in Accounting Policy** In addition to the financial statement presentation differences described above, IFRS differs from investment company GAAP on certain matters of accounting policy. We believe these differences would limit the comparability of financial statements prepared under the differing regimes. Further, we believe that the IFRS prescribed policy must be tailored to reflect the structural differences between investment companies and operating companies. Without such refinement, we are deeply concerned that the application of IFRS to funds would result in financial statement presentations that are less meaningful from the investment company shareholder perspective.
- **Classification of Fund Shares** – IFRS provides that any financial instrument that gives the holder the right to put it back to the issuer for cash is a liability, regardless of whether the amount of cash is determined by reference to an index or has potential to increase or decrease in value. IFRS specifically cites shares issued by open-end funds as a puttable instrument. Accordingly, mutual fund shares are deemed to be liabilities under IFRS. Classification of fund shares as liabilities results in funds having no equity or net assets.⁵ Further, under IFRS, distributions paid to fund shareholders are reflected as "financing costs" in the income statement (as though distributions

⁵ Classification of fund shares as liabilities gives rise to other non-financial statement related concerns. In particular, many investment policies and fee calculations are based on "net assets." It is unclear how these policies and fee calculations would be applied if the fund were deemed to have no equity. Ms. Nancy M. Morris November 13, 2007 Page 5 of 9 paid are similar in nature to interest expense on borrowings). In 2006 the IASB issued proposed amendments to IFRS that would allow fund shares to be classified as equity, under certain conditions.⁶ While we appreciate the IASB's efforts to address this classification issue, we are concerned that the proposed

amendments do not address multiple class share arrangements where classes bear different levels of fees and expenses.⁷ Fund shares are treated as equity under investment company GAAP. Further, distributions paid are characterized as such in the Statement of Changes in Net Assets. We believe any characterization of fund shares as liabilities grossly misrepresents the nature of the shareholder's investment in the fund and could cause substantial shareholder confusion and potential industry disruption.

- **Brokerage Commissions** – IFRS does not explicitly require disclosure of brokerage commissions incurred on acquisition and disposition of investment securities. However, we have been advised by several accounting firms that in their view, under IFRS, commissions paid should be recognized as expense in the income statement and that a separate line item in the income statement may be required if commissions paid are material. Brokerage commissions paid on purchase of portfolio securities are included in the cost basis of the holding under investment company GAAP. Brokerage commissions paid on sale of portfolio securities are deducted from the proceeds in determining realized gain/loss. Brokerage commissions paid reduce gains (or increase losses) on the fund's portfolio transactions and are reflected within the realized and unrealized gain/loss accounts in the income statement. We believe the current treatment of brokerage commissions paid under investment company GAAP is theoretically sound. In its concept release requesting comments on improving disclosure 6 Exposure Draft of Proposed Amendments to IAS 32 and IAS 1: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation. The exposure draft requires the puttable shares to meet certain conditions intended to ensure that they are equivalent to ordinary common shares in all respects. One of these conditions requires that the puttable shares be in the most subordinated class of instruments with a claim on the entity's net assets. If the exposure draft is adopted (and fund shares are classified as equity), IAS 33 may require funds to calculate earnings per share. FAS 128, adopted by the FASB in February 1997, exempts investment companies from the requirement to calculate and disclose earnings per share. This exemption recognizes that the per-share information disclosed in the Financial Highlights is more appropriate for investment companies.

⁷ In particular, funds often issue several different classes of shares, each bearing different sales charges and fee rates. These share classes provide shareholders the option to pay sales charges at initial investment (i.e., a front-end sales load) or over time (i.e., a contingent deferred sales load). Additional classes with no sales charges may be offered, for example, through qualified retirement plans. Because these share classes bear expenses at differing fee rates, they may receive differing dividend distributions per share and have differing share prices. It is unclear whether such multiple class share arrangements would qualify as a "financial instrument that entitles the holder to a pro rata share of the net assets of the entity" under the proposed amendments to IAS 32. Ms. Nancy M. Morris November 13, 2007 Page 6 of 9 of mutual fund transaction costs the Commission indicated, "The component of commissions that represent execution and clearing costs are the equivalent of acquisition or disposition costs incurred on physical assets and current accounting principles dictate that they be included in the cost basis of securities purchased or in the net proceeds from securities sold."⁸ Differences in the treatment of brokerage commissions paid would likely impede comparison of fund expenses and expense ratios.

- **Valuation of Investment Securities** – IFRS requires investment securities traded in active markets to be valued at the bid price. Funds have traditionally used the last sale price to value actively- traded exchange-listed investment securities.⁹ The methods for valuing investment securities must be described in the fund's offering documents.¹⁰ Such methods are used to process purchase and redemption orders in fund shares. The IFRS requirement to value at bid creates a conflict between valuation of securities for purposes of financial statements and valuation of securities for purposes of processing fund share transactions. IFRS enables funds to include an adjusting line item in

their financial statements that reconciles the value of the portfolio at bid prices to value at last sale prices. Nevertheless, we believe these differing methods would be extremely confusing to shareholders.¹¹ Investment company GAAP requires actively-traded securities that are exchange-listed to be valued at the last traded price for financial reporting purposes. Investment company GAAP is consistent with SEC rules, which require actively-traded securities that are exchange-listed to be valued at the last traded price for both financial reporting purposes and for purposes of daily net asset value calculations used to process fund share transactions.

- Consolidation – IFRS requires funds to consolidate all investments in which they have control. Control is defined as the power to govern the financial and operating policies of an entity so as to obtain control. Control is presumed to exist if the fund owns more than half of the voting power of another entity and may also exist under other circumstances. As a result, a feeder fund in a master/feeder structure would be required to consolidate the master fund if it owns a majority of the master fund's voting shares. Such consolidation would, of course, distort the results and financial position of the feeder fund because it does not have ownership of the minority portion of 8 See Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, SEC Release Nos. 33-8319, 34-48952, IC-26313 (December 19, 2003). 9 See Section 2(a)(41) of the Investment Company Act of 1940 and Accounting Series Release No. 118, Investment Company Release No. 6295, (December 23, 1970). 10 See SEC Form N-1A, Item 6. 11 It is unclear what affect the IFRS requirement to value at bid would have on money market fund financial reporting. SEC registered money market funds typically value their investments at amortized cost for financial reporting purposes and disclose that amortized cost approximates market value. Ms. Nancy M. Morris November 13, 2007 Page 7 of 9 the master fund. Feeder funds do not consolidate master funds under investment company GAAP, even where they own a majority of the master fund's voting shares. SEC registered feeder funds typically provide the master fund's financial statements with the feeder fund's financial statements so as to ensure that the feeder fund's shareholders understand the master/feeder structure. An investment fund may also be required to consolidate an investee company under IFRS even where it does not exercise voting control. This may be the case where the investee company is deemed to be a "special purpose entity." Special purpose entities are referred to as "variable interest entities" under U.S. GAAP. FASB Interpretation No. 46 exempts registered investment companies from consolidating variable interest entities.

Strong Concerns in Other Jurisdictions on the Application of IFRS to Funds We are not alone in our concern about the application of IFRS to investment companies and similar pooled investment products. The European Funds and Asset Management Association¹² recently released a paper discussing the application of IFRS to investment funds.¹³ According to EFAMA, most European jurisdictions do not apply IFRS to investment funds. Instead, in most cases, existing national laws require the use of local GAAPs that apply specifically to UCITS and there is no special obligation for investment funds to prepare financial statements based on IFRS. The EFAMA Paper describes a number of significant issues in IFRS that must be addressed before IFRS can be meaningfully applied to investment funds. These include, for example: IAS 1 – Comparatives, IAS 7 – Cash Flow Statements, IAS 27 – Consolidation of Subsidiaries, IAS 32 – Classification of Puttable Instruments, IAS 33 – Earnings per Share, and IAS 39 – The Use of Bid Price for Quoted Securities. The EFAMA Paper indicates that IFRS ignores the open-ended nature of investment funds and the fact that financial reporting does not affect the share price. The EFAMA Paper indicates "EFAMA is of the clear view that under the current conditions IFRS cannot constitute the nucleus of a comprehensive and common accountancy framework for investment funds in the European Single 12 EFAMA is a non-profit association organized to represent European collective investment funds and asset managers. EFAMA's members include national associations representing investment funds

from more than twenty European nations. 13 IFRS Application to Investment Funds – EFAMA Discussion Paper (June, 2007) (“EFAMA Paper”). The EFAMA Paper is available on EFAMA’s website at <http://www.efama.org/Plone>. Ms. Nancy M. Morris November 13, 2007 Page 8 of 9 Market and it is its intention to bring forward this position to the European Commission and the Committee of European Securities Regulators.” The International Investment Funds Association¹⁴ recently completed their 21st annual meeting, which was attended by 76 delegates representing 35 investment fund associations from markets with \$24.3 trillion in assets under management. Conference delegates resolved to support the development of a consistent worldwide regime for investment fund financial reporting that provides meaningful information to investors. In this context IIFA members agreed that IFRS do not presently provide a satisfactory basis for investment fund financial reporting. Further, the conference delegates expressed the view that some of the provisions in IFRS are contrary to sound and long-standing practices for meaningful investment fund reporting. Conference delegates agreed that investment fund financial reporting should be focused on the needs of investors and improving their ability to make informed investment decisions, and that in order to achieve this objective, financial reporting standards need to take into account and reflect the unique characteristics of pooled investment funds.¹⁵ Convergence of IFRS and U.S. GAAP The Concept Release solicits comment on the effectiveness of the process for convergence and the progress to date. As described above, we believe there are numerous, significant differences between IFRS as applied to investment companies and investment company GAAP. IFRS applies a general corporate reporting model to investment funds. In contrast, GAAP for investment companies is an industry-specific model that recognizes the unique characteristics of pooled investment vehicles. We believe fund financial statements prepared under investment company GAAP provide greater transparency and are more meaningful to shareholders. Accordingly, we recommend that the Commission ensure that there is substantial convergence relating specifically to investment company financial reporting before it provides investment companies with the option to prepare their financial statements under IFRS. The convergence process should recognize that an industry specific accounting model that reflects the unique characteristics of pooled investment vehicles better serves the interests of fund shareholders. ***** 14 IIFA is an international association of national associations representing fund sponsors around the world. IIFA seeks to promote the protection of investment fund investors, to facilitate the growth of the investment funds industry internationally, to act as a medium for the advancement of understanding of the investment fund business around the world, and to encourage adherence to high ethical standards by all participants in the industry. 15 The IIFA conference statement is available at http://www.ifsa.com.au/documents/2007_1102_FINAL%20COMMUNIQUE.pdf. Ms. Nancy M. Morris November 13, 2007 Page 9 of 9 We appreciate the opportunity to comment on the Concept Release. If you have any questions about our comments or would like additional information please contact the undersigned at 202/326- 5851. Sincerely, /s/ Gregory M. Smith Director – Operations/ Compliance & Fund Accounting cc: Conrad W. Hewitt, Chief Accountant Office of the Chief Accountant Andrew J. Donohue, Director Division of Investment Management Richard F. Sennett, Chief Accountant Division of Investment Management About the Investment Company Institute The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.5 trillion and serve almost 90 million shareholders.

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