VIA ELECTRONIC MAIL

March 31, 2008

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090


Dear Ms. Morris:

The Investment Company Institute\(^1\) appreciates the opportunity to comment on the Progress Report of the SEC Advisory Committee on Improvements to Financial Reporting.\(^2\) We understand the Committee was established in July of 2007 with the objective of examining the U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to investors, creditors and other users of financial reporting, while reducing the complexity of the financial reporting system to investors, companies, and auditors. As investors in more than $5.9 trillion of domestic corporate equity and fixed-income securities, we strongly support the Commission’s efforts to ensure that the U.S. financial reporting system provides equity and fixed-income investors with decision useful information that fairly presents the financial position and results of operations of companies accessing our capital markets.

We commend the Advisory Committee on its issuance of the Progress Report and look forward to the issuance of its final report later this year. We are pleased to see that several of the Advisory Committee’s recommendations emphasize the “investor perspective” in the financial reporting system. The Progress Report notes that the financial reporting system has sometimes been more responsive to the needs of preparers and auditors than the needs of investor groups. We support the Advisory Committee’s efforts to ensure that the financial reporting system gives pre-eminence to the needs of investors, while not ignoring the interests of other relevant parties.

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\(^1\) 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.

Our comments below address developed proposal 1.1 from the perspective of investment companies as issuers of financial statements. Developed proposal 1.1 recommends that GAAP should be based on business activities, rather than industries and that existing industry-specific guidance should be eliminated. We believe elimination of industry specific guidance applicable to investment companies would diminish the meaningfulness of fund financial reporting and be detrimental to the interests of funds and their shareholders. In keeping with the overarching objective of serving the best interests of investors, we strongly recommend that the Advisory Committee’s final report recognize that industry-specific guidance is appropriate where the operating activities and relevant financial information of a particular industry, such as investment companies, are legitimately different than other industries. The Committee Report indicates that the Committee plans to address global convergence of accounting standards later in 2008. Our comments below also address our concerns with the application of International Financial Reporting Standards to investment companies.

**Complexity in Financial Reporting**

One of the Advisory Committee’s stated objectives is to reduce the complexity of the financial reporting system. The Advisory Committee defines complexity as the state of being difficult to understand and apply. According to the Committee’s report, complexity in financial reporting refers primarily to the difficulty for:

1. Investors to understand the economic substance of a transaction or event and the overall financial position and results of a company;
2. Preparers to properly apply GAAP and communicate the economic substance of a transaction or event and the overall financial position and results of a company; and
3. Other constituents to audit, analyze, and regulate a company’s financial reporting.

The Committee Report identifies various causes of complexity in financial reporting, including exceptions to general principles and the existence of industry-specific guidance. Exceptions to general principles and industry-specific guidance make comparisons across issuers and industries difficult and the Committee Report recommends that they be eliminated as a means to reduce complexity.

We respectfully suggest that investment company financial statements are not complex. Indeed, when compared to operating company financial statements, we believe they are relatively simple and are more readily understood by investors. Further, we believe investment company GAAP, much of which originates in the SEC’s financial reporting requirements, can be readily applied by preparers and communicates well the economic substance of a fund’s investing activities, financial position and results of operations. Moreover, the PCAOB has

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3 The terms “investment company” or “fund” as used throughout this comment letter refer to SEC registered investment companies, including open-end mutual funds, closed-end investment companies, exchange-traded-funds and unit investment trusts.

4 See Article 6 of Regulation S-X, Item 22 of SEC Form N-1A, and Item 28 of SEC Form N-2.
formally acknowledged that investment companies are less complex to audit than operating companies.\(^5\)

We agree that exceptions to general principles and industry-specific guidance may limit comparability of issuers in differing industries. However, we believe that comparisons of investment companies to issuers in other industries are not particularly relevant and should not serve as a basis to eliminate exceptions and industry-specific guidance applicable to investment companies. For example, while investors in operating companies may focus on growth in revenues, earnings or cash flows, investors in investment companies focus on entirely different reporting measures specific to funds such as total return, yield, expense ratios and portfolio turnover. Further, while the value of an operating company may be based on the expected future earnings or cash flows, the value of an investment company is the fair value of its net assets.

The Commission, which closely regulates the investment company industry, has articulated an industry-specific reporting model for funds through Article 6 of Regulation S-X. This industry-specific reporting model is also required under investment company GAAP, as described in the *AICPA Audit and Accounting Guide: Investment Companies* (“Audit Guide”). The FASB has, in certain instances, recognized differences between operating companies and investment companies by providing investment companies with exceptions to its general standards. For example, funds do not calculate or disclose earnings per share.\(^6\) In lieu of earnings per share, funds calculate and disclose SEC-mandated “financial highlights,” which reconciles beginning and ending net asset value per share and provides the performance measures noted above. Funds generally do not provide a statement of cash flows.\(^7\) An investment company statement of cash flows would effectively duplicate the statement of changes in net assets in instances where the fund invests in highly liquid securities and does not finance purchase of investment securities through issuance of debt.\(^8\)

Many of the most complex accounting issues facing operating companies do not affect investment companies, because their activities are generally limited to investing in securities for the purpose of realizing income and/or gains. For example, funds do not issue incentive stock options, offer pension plans, lease real estate, or employ “hedge accounting.” The Committee

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\(^5\) The PCAOB charges an accounting support fee to all public companies based on their market capitalization to fund its operations, as authorized by Section 109 of the Sarbanes-Oxley Act of 2002. The accounting support fee charged to investment companies is 10% of the fee rate charged to operating companies. The PCAOB’s release adopting accounting support fees indicates, “In recognition of the structure of investment companies, and the relatively less-complex nature of investment company audits (as compared to operating company audits) investment companies would be assessed at a lower rate.” *See* PCAOB Release No. 2003-003 (April 18, 2003).


\(^7\) 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). FAS No. 102 exempted investment companies from the requirement to provide a statement of cash flows, so long as they meet certain criteria.

\(^8\) In such circumstances, FASB concluded that the other financial statements in a fund’s shareholder report would provide sufficient information to assess liquidity, financial flexibility, profitability and risk. Also, that the cost of providing a statement of cash flows would exceed the benefits.
Report identifies the “mixed attribute” model (i.e., valuation of certain assets at historical cost and other assets at fair value) as one of the primary causes of complexity in financial reporting. Investment companies value all of their investment securities at their fair value and reflect changes in value in earnings, avoiding entirely the complexities attributable to use of the mixed attribute model.

Industry-Specific Guidance

Developed proposal 1.1 recommends that GAAP move from industry-specific guidance to activity-based guidance (e.g., from banking as an industry to lending as an activity by any company). The Committee Report calls for the SEC to recommend that any new projects undertaken by the FASB be scoped on the basis of business activities rather than industries. Further, any new projects should include the elimination of existing industry-specific guidance in relevant areas as a specific objective of those projects, unless, in rare circumstances, retaining industry guidance can be justified.

Industry-specific guidance refers to: 1) exceptions to general accounting standards for certain industries, 2) industry-specific guidance created in the absence of a single underlying standard or principle, and 3) industry practices not specifically addressed or based in GAAP. Industry-specific guidance has been developed over time for different reasons. These include, according to the Committee Report, multiple standards-setters issuing guidance without consistently coordinating their efforts, a desire to enhance uniformity throughout an industry, and efforts to customize accounting standards for allegedly special transactions or investor needs.

Many of the industry-specific financial reporting practices followed by investment companies are required by SEC regulations or forms and are specially tailored to the unique characteristics of funds. These requirements are intended to ensure disclosure of the fund’s portfolio securities, as well as the income and gains (both realized and unrealized) on the portfolio. These requirements are typically also mandated by the Audit Guide.

For example, funds provide a schedule of investments detailing securities held at the reporting date. The schedule of investments details each security holding, the shares or principal amount, and the current fair value. The schedule of investments must be classified by security type (e.g., stock, preferred stock, debt, etc.) and by industry (e.g., energy, financials, health care, etc.). In addition, funds must identify those securities that: 1) are non-income producing, 2) have restrictions on resale, or 3) are “affiliated” (i.e., the fund owns five percent or more of the outstanding voting shares).9 The schedule of investments provides investors with valuable insight into the fund’s holdings and the implementation of its investment objectives and strategies.

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9 Funds may provide a summary schedule of investments in lieu of a complete schedule of investments in their shareholder reports. A summary schedule of investments must list the top 50 holdings and securities that exceed one percent of the fund’s net assets at the reporting date. A fund that elects to provide a summary schedule of investments in its shareholder report must file the complete schedule of investments with the SEC and provide it to shareholders upon request. See Regulation S-X, Rule 12-12(c).
Funds provide a statement of operations that separately displays investment income on the portfolio, gains realized during the period, and the change in unrealized appreciation/depreciation during the period. The format of the statement of operations enables the reader to discern the portion of the fund’s earnings that are attributable to net investment income (interest and dividends on portfolio holdings less expenses), realized gain/loss on securities sold, and the change in unrealized appreciation/depreciation during the reporting period. This presentation enables the reader to distinguish recurring income from changes in value of securities holdings.

Another fund industry-specific practice relates to consolidation. Investment companies are precluded from consolidating companies in which they invest by Regulation S-X and other investment company GAAP.\(^\text{10}\) This exception to general consolidation principles is well founded. Consolidation of a portfolio company would cause the fund to misstate its net assets, net asset value per share, and total returns.

Certain investment company structures invoke consolidation principles. Often a feeder fund in a master/feeder arrangement or a fund of funds will own a significant portion of the investee fund’s outstanding shares. In such circumstances, in lieu of consolidation, the feeder fund or fund of funds may include in its shareholder report mailing a copy of the investee fund’s financial statements. This industry-specific practice enables shareholders to better understand the nature of their investment.

We believe the industry-specific reporting practices described above are well supported and result in financial reporting that is more meaningful and informative to fund shareholders. Certain industry-specific guidance, such as the Audit Guide, assists fund industry preparers and auditors to interpret and apply GAAP to investment companies. We encourage the Advisory Committee to conclude that industry-specific guidance is appropriate where the operating activities and relevant financial information of a particular industry, such as investment companies, are legitimately different than other industries.

**Global Convergence**

The Committee Report notes that publicly-traded companies in foreign countries increasingly are following IFRS as adopted by the International Accounting Standards Board. The Report further notes that the Committee supports the long-term goal of converging GAAP with IFRS in order to reduce accounting costs to investors and others in an increasingly global business environment. Later in 2008 the Committee plans to identify and analyze some of the

\(^{10}\) See Regulation S-X, Rule 6-03(c), Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and the Audit Guide. Similarly, funds are not required to consolidate variable interest entities under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (December 2003).
issues to be resolved in the move toward global convergence of accounting standards.

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. In many instances IFRS does not provide for the industry-specific reporting practices described above. We are concerned that these differences 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 encourage the Committee to analyze convergence in the context of investment companies and recommend that it acknowledge that the industry-specific reporting practices in U.S. GAAP are appropriate. We elaborate on our concerns and recommendations below.

**Investment Company GAAP vs. IFRS**

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.

- **Schedule of Investments** – IFRS does not require a schedule of investments. As described above, the schedule of investments provides investors with a snapshot of the fund’s portfolio securities and their attributes at the reporting date.

- **Financial Highlights** – IFRS does not require disclosure of financial highlights. As described above, the financial highlights reconciles beginning and ending net asset value per share and provides important measures that shareholders frequently rely upon to evaluate and compare funds, such as total returns and expense ratios.

- **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** – In 1989 the FASB exempted investment companies from the requirement to provide a statement of cash flows, so long as they meet certain criteria.\(^\text{11}\) IFRS contains no such exemption.

- **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, both for financial reporting purposes and for calculating daily the net asset value per share used to issue and redeem shares.\(^\text{12}\) 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. We believe these differing methods would be extremely confusing to shareholders.

- **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 the master fund or any interest in the portion of the master fund’s investment securities underlying the minority interest. 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.” As noted above, SEC Regulation S-X precludes consolidation and GAAP provides funds with an exemption to consolidation principles.

**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. In 2007, the European Funds and Asset Management

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\(^{11}\) See supra note 7.

Association\textsuperscript{13} released a paper discussing the application of IFRS to investment funds.\textsuperscript{14} 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.

We appreciate the opportunity to comment on the Committee Report. If you have any questions about our comments or would like additional information please contact Don Boteler at 202/326-5845 or Greg Smith at 202/326-5851.

Sincerely,

/s/  
Donald J. Boteler  
Vice President - Operations  
Investment Company Institute Committee

/s/  
Richard J. Thomas  
Chairman  
ICI Accounting/Treasurers

cc:  Robert C. Pozen, Chairman  
Advisory Committee on Improvements to Financial Reporting

Robert H. Herz, Chairman  
Financial Accounting Standards Board

Conrad W. Hewitt, Chief Accountant  
Office of the Chief Accountant

Richard F. Sennett, Chief Accountant  
Division of Investment Management

\textsuperscript{13} 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.

\textsuperscript{14} IFRS Application to Investment Funds – EFAMA Discussion Paper (June, 2007). The EFAMA Paper is available on EFAMA’s website at http://www.efama.org/Plone.
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 $12.33 trillion and serve almost 90 million shareholders.