



DIVISION OF  
INVESTMENT MANAGEMENT

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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position on these matters.

November 1, 1996

Dear Chief Financial Officer:

The accounting staff of the Division of Investment Management (the "Division") has prepared this letter to assist investment company registrants and their independent public accountants in addressing certain accounting-related matters. These comments represent the views of the staff of the Division and are not necessarily those of the Securities and Exchange Commission (the "Commission"). The comments addressed in this letter apply to filings, including reports to shareholders, made by registered investment companies. This letter should be read in conjunction with similar letters previously issued by the Division's Chief Accountant as well as letters issued by the Division's Office of Insurance Products and Office of Disclosure and Review.

**IM-DCFO 1996-01 Undertaking to File Financial Statements** **This position has been rescinded.**

Item 32(b) of Form N-1A requires a registrant to undertake to file a post-effective amendment within the four to six month period after the effective date of its registration. The purpose of the undertaking is to provide financial statements of the registrant reflecting an initial period of operations that is considered representative of the operations of the new registrant.<sup>1</sup>

Recently, the Division addressed the need for this undertaking in the case of a merger of an operating investment company into a non-operating registrant, that is, a "shell" entity. The operating investment company was to be the accounting survivor; therefore, its financial statements became those of the continuing new registrant. We agreed that the registration statement containing the financial statements of the operating company need not include the four to six month period undertaking pursuant to Item 32(b). This position was based on our view that the financial statements of the new registrant were those of the pre-merger operating investment company and were considered representative of the operations of the new registrant. In other merger situations, when the operating investment company is a relatively new registrant (i.e., having fewer than four to six months of operations), undertaking to file financial statements within four to six months following the merger is not necessary if the financial statements included in the initial registration statement of the new registrant are considered representative of its operations.

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<sup>1</sup> The Division has previously provided limited relief from this requirement. See Letter to Registrants from Carolyn B. Lewis dated February 25, 1994, Item V, "Financial Statements" (limited relief granted when the initiation of operations is deferred and the end of the four to sixth month period is near the date of the end of the annual or semi-annual period).

## **IM-DCFO 1996-02 Accounting for Foreign Corporate Actions**

In recent years, the number of investment companies investing in foreign securities has increased dramatically.<sup>2</sup> In many cases, information relating to corporate actions (e.g., dividends, stock splits, rights offerings, interest payments) by foreign issuers is difficult for investment companies or their agents to obtain and verify on a timely basis. Generally accepted accounting principles ("GAAP") require an investment company to record corporate actions affecting portfolio securities on the dates when they become effective<sup>3</sup> (e.g., ex-dividend date, payment date) in order for the investment company's net asset value to be correctly stated.

The Division understands that some investment companies do not record foreign corporate actions until they receive formal notification from a third party such as the investment company's custodian or other service provider and are able to verify that the corporate action has occurred. Generally, it is not appropriate under applicable accounting rules for an investment company to delay the recording of foreign corporate actions if the investment company knew or, in the exercise of reasonable diligence, should have known that the corporate action had occurred. Delayed recording of foreign corporate actions may be appropriate, however, if the investment company, exercising reasonable diligence, did not know that the corporate action had occurred.<sup>4</sup> In this event, the investment company should record such action promptly after receipt of the information. Reasonable diligence would generally require an investment company to adopt appropriate procedures to obtain timely notification and verification of the effective date of the foreign corporate action.<sup>5</sup>

## **IM-DCFO 1996-03 Financial Highlights in Multi-Class Reorganizations**

In the past, we have addressed the issue of determining which investment company in a business combination is deemed the survivor and which historical financial highlights are used by the new surviving investment company.<sup>6</sup> Several registrants have inquired about accounting for a multi-class reorganization in which several investment companies merge into one fund, and, contemporaneously, the acquiring fund implements a multi-class structure. Each of the predecessor funds becomes a different class of the acquiring

<sup>2</sup> The number of registered investment companies with international portfolios has more than doubled over the past four years. Investment Company Institute, "Trends in Mutual Fund Activity," Table 6A, July, 1996.

<sup>3</sup> Financial Accounting Standards Board Statement of Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," December, 1984.

<sup>4</sup> In addition, an investment company may have conflicting information about the date of a corporate action which it is unable to confirm with reasonable diligence.

<sup>5</sup> In some cases, failure to record a foreign corporate action on a timely basis will cause an investment company later to adjust its financial statements. Accounting for a correction of a material error is discussed in the Division's letter to Chief Financial Officers dated November 2, 1995, in which we concluded that immediate recognition of the entire amount of any error should be reflected in the statement of operations and, if appropriate, the footnotes, regardless of the effect on net asset value.

<sup>6</sup> North American Security Trust (pub. avail. August 5, 1994) ("NAST Letter").

successor fund. Only the successor class (i.e., the existing fund) represents the continuing entity whose operating history is reflected in the historical financial highlights. The financial highlights of the other predecessors (classes) are not carried forward, and each new class generates an operating history on a post-reorganization basis.<sup>7</sup>

**IM-DCFO 1996-04      Accounting for Liquidation Expenses**

Several investment company registrants have inquired as to the proper treatment of expenses in connection with a liquidation. In some cases, the estimation of expenses and the approval of the plan of liquidation may not occur at the same time. We believe that it is prudent to record the liquidation expenses promptly to ensure that investors who remain shareholders of the liquidating company do not pay a disproportionate share of the liquidation expenses. GAAP require liabilities to be recorded when it is probable that a liability has been incurred and the amount can be estimated.<sup>8</sup> We believe the liquidation expenses should be reflected on the books and records of the registrant as soon as determinable under GAAP.<sup>9</sup>

**IM-DCFO 1996-05      Accounting Treatment for Indirect Expenses**

The Division recently reviewed a filing of a closed-end investment company organized as a term trust (the "Trust") that raised issues regarding the accounting treatment for indirect expenses. The Trust's assets consisted of government securities and a forward purchase contract between the Trust and an independent third party (the "seller") who owned common stock of an unaffiliated company. The forward purchase contract provided that each of the Trust's unitholders would receive a certain number of shares of common stock of the unaffiliated company at the expiration of the Trust. The seller agreed to pay all underwriting, organizational and ongoing operational expenses of the Trust either directly or indirectly through the underwriter.

In the initial registration filing, the Trust included a table pursuant to Item 3 of Form N-2 (Fee Table and Synopsis) that presented its total annual expenses as zero because the seller had agreed to pay these Trust expenses. We concluded that the presentation of zero expenses was not appropriate because the cost of the forward purchase contract included these expenses. Further, we concluded that the Trust should record these costs as an expense or prepaid asset with a corresponding reduction to the cost of the contract purchased. The prepaid asset is to be reduced ratably over the life of the Trust by a charge to Trust expenses. Under the circumstances, these charges, whether

<sup>7</sup> Operating history contained in the financial highlights is different from historical performance which may contain information prior to reorganization. (See, e.g., NAST Letter; IDS Financial Corp. (pub. avail. December 19, 1994.))

<sup>8</sup> Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," March 1975, Par. 8.

<sup>9</sup> See Letter to Registrants from Carolyn B. Lewis and Barry D. Miller dated February 15, 1996, Item IV.C., "De-Registering Funds" (reminding registrants to File Form N-8F to notify the Commission that the investment company has ceased operations).

paid directly or indirectly by the Trust, were included as part of the Trust's total annual expenses in the table required by Item 3 of Form N-2.

**IM-DCFO 1996-06 Average Commission Rate Considerations This position has been rescinded.**

In July 1995, the Commission revised certain line items in the financial highlights table in Forms N-1A, N-2 and N-3, including the "average commission rate paid" (the "ACRP").<sup>10</sup> Since that time, the Division has responded to a number of questions regarding an ACRP that includes both domestic and foreign commission rates. According to registrants, blending both commission rates presents a concern because of the significant difference between the dollar amount of commissions paid for domestic securities and the dollar amount (after translation) of commissions paid for foreign securities.

In adopting revisions to the financial highlights table, the Commission considered the effects of requiring a blended commission rate and indicated that such a rate is appropriate. In particular, the Commission stated that "disclosure of average commission rates [in a blended manner] can improve investors' ability to evaluate and compare investment company brokerage costs . . . and that a comparison of average commission rates among investment companies will be a useful bench-mark for investors . . ." <sup>11</sup> An average commission rate should be based on actual commissions paid, translated into U.S. dollar equivalents, as required by the instruction to the financial highlights table.<sup>12</sup> The registrant may, at its option, add an explanatory note to the financial highlights table with respect to the components of the ACRP including domestic, foreign or country-specific average commission rates.

**IM-DCFO 1996-07 Dating of Financial Statements**

The Division has addressed questions regarding the proper dating of financial statements when the reporting period ends on a non-business day.<sup>13</sup> When the reporting period ends on a weekend, the investment company has the option to choose either the calendar day or the last business day as the date of the balance sheet. If the investment company chooses to use the last business day, the financial statements should reflect that date and include the appropriate accruals to that date. If the investment company chooses to define the fiscal period based on the calendar date, the financial statements should reflect the calendar date and include the appropriate accruals to the calendar date.

<sup>10</sup> Investment Company Act Rel. No. IC-21221 (July 28, 1995).

<sup>11</sup> *Id.*, Item II.E.

<sup>12</sup> An instruction to the item provides that the registrant should "[c]onvert commissions paid in foreign currency into U.S. dollars and cents per share using consistently either the prevailing exchange rate on the date of the transaction or average exchange rate over such period as related transactions took place."

<sup>13</sup> For example, the calendar end may be a Sunday, but the last business day would be the preceding Friday.

This letter contains information of importance to the company's independent public accountants; therefore, we encourage you to discuss these items with them. Any questions about the contents of this letter or related matters can be addressed to John S. Capone or Paul T. Kraft, Assistant Chief Accountants, or me, at (202) 942-0590.

Very truly yours,

A handwritten signature in cursive script that reads "Lawrence A. Friend". The signature is written in dark ink and is positioned above the printed name and title.

Lawrence A. Friend  
Chief Accountant