



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

DIVISION OF
INVESTMENT MANAGEMENT

November 1, 1994

Please consult the Accounting Matters Bibliography available at <https://www.sec.gov/investment/accounting-matters-bibliography> for the staff's current position on these matters.

File No.	ICA-40
Section	30
Rule	
Public Availability	11/1/94

Dear Chief Financial Officer:

The accounting staff of the Division of Investment Management 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 of Investment Management and are not necessarily those of the Securities and Exchange Commission (the "Commission"). The comments addressed in this letter apply to filings made by registered investment companies, including reports to shareholders. This letter should be read in conjunction with similar letters issued by the Division's Office of Disclosure and Review and Office of Insurance Products.

IM-DCFO 1994-01

Accounting For Certain Transactions with Affiliates

Increasingly during the past year, affiliates¹ have compensated funds for losses on certain of their investment holdings. The contributions generally take one of two forms - a direct contribution by the affiliate to the fund to offset the effect of a realized loss on a portfolio investment ("direct contribution") or the purchase by the affiliate of securities from the fund at prices in excess of the securities' current market value ("affiliated purchase"). In both cases, the accounting for the loss on the investment and the resulting payment should be reflected in a fund's financial statements as a realized loss and a corresponding contribution to capital.

Cash (or other assets) received from an affiliate as a direct contribution should be reflected by the fund in its financial statements in the statement of changes in net assets immediately after the capital share transactions section and in the financial highlights table immediately following the "distributions" section. Notes to the financial statements and financial highlights table should describe these contributions. In addition, footnotes to the total return disclosure in the table should quantify the effect of the capital contribution in a manner similar to disclosure for the effect of voluntary waivers of fees and expenses.²

¹ The term "affiliate" as used in this context is as defined by the Commission's Regulation S-X Item 6-02(a) (17 CFR §210.6-02(a)). This comment does not address situations involving non-affiliates. The accounting for such non-affiliated transactions should be reviewed on a case-by-case basis.

² In addition to the general guidance in Statement of Financial Accounting Standards No. 57, *Related Party Disclosure*, specific requirements are set forth in Paragraph 5.29 of the *Audit and Accounting Guide, Audits of Investment Companies*, AICPA, 1993.

Affiliated purchases at a price in excess of the current market value³ do not reduce the loss that would otherwise have occurred if the investment had been sold to an unaffiliated person. The amount by which the payment exceeds the current market value of the investments purchased is considered a contribution to capital, and the accounting should be the same as that for direct contributions.

Funds should consider the non-financial statement disclosure implications surrounding the contribution and the related accounting treatment, including the *Management's Discussion of Fund Performance* required by Item 5A of Form N-1A. The narrative disclosure should be consistent with the related financial statement disclosure referred to above.

IM-DCFO 1994-02

Valuation of Certain Portfolio Investments

In recent years, investment companies have made increasing use of certain instruments that, under some market conditions, may require valuation by the companies' boards of directors. The Commission's *Accounting Series Releases (ASRs) 113 and 118* provide guidance in the valuation, accounting and auditing of these investments. This guidance requires clearly defined policies and procedures to be established by an investment company's board of directors and any deviation from these policies and procedures to be disclosed in the financial statements or notes thereto. These policies and procedures should encompass all appropriate factors relevant to the valuation of investments for which market quotations are not readily available.

In determining whether market quotations are readily available, Section 404.03.b.iii of the Codification of Financial Reporting Policies reiterates the guidance in ASR 118, which states that "quotations for a security should be obtained from more than one broker-dealer....If the validity of the quotations appears to be questionable, or if the number of quotations indicates that there is a thin market in the security, further consideration should be given to whether market quotations are readily available." Where it is determined that market quotations are readily available, the certifying accountant should independently verify all the quotations used by the company at the balance sheet date. With respect to valuation of non-exchange-traded investments by a certifying accountant, independent verification should be interpreted as reliance on quotations received from a source independent of the source used by the client.

The guidance in ASRs 113 and 118 also applies to investments for which there are few market makers or broker-dealers⁴ providing market quotations. The staff believes, where there are few market makers or broker-dealers providing market quotations (as in the case of structured notes), the independent verification guidance set forth above requires the independent public accountant to seek verification from a market maker or broker-dealer different from that used by the company. In the case of only one market maker or broker-dealer providing a market quotation, the independent public accountant should employ alternative valuation procedures that provide an accurate and reasonable valuation.

³ Unless facts indicate otherwise, the staff views purchases of fund investments by affiliates under the circumstances described in this letter as being at a price in excess of market value. This letter is not intended to express any views on the implications of any transactions described under section 17 of the Investment Company Act of 1940.

⁴ The terms "market maker" and "broker-dealer" as used in this context have the same meaning as those in ASRs 113 and 118.

Audited Balance Sheet for New Series

Although the staff has interpreted Section 14(a)(2) of the Investment Company Act of 1940 (the "Act") generally to permit a new series of a fund to make a public offering of securities without having at least \$100,000 of net worth, a fund registering a new series may sell one or more shares of the series to a single shareholder, usually affiliated with the fund. In such cases, regardless of the amount invested by the initial shareholder or shareholders prior to the effectiveness of the registration, an audited balance sheet is required in the registration statement in accordance with Item 25, Schedule A of the Securities Act of 1933. This requirement also applies to those companies distributing insurance products which are allowed an exemption under Rules 6e-2(b)(6), 6e-3(T)(b)(6) and 14a-2 under the Act which, despite the exemption, decide to seed the insurance products' company with initial capital.

Securities With Zero Value

Schedule 12-12 of Regulation S-X contemplates the listing of each security a fund owns in the schedule of investments. A fund that owns securities considered to be worthless should continue to list those securities in its schedule of investments indicating a zero value. Only after the fund has classified the security as a worthless security for federal income tax purposes should any security be removed from the listing. Omitting securities from the schedule prior to the determination of worthlessness for tax purposes may be misleading to investors interested in evaluating the fund's investments.

This letter contains information of importance to the company's independent public accountant; therefore, we encourage these items to be discussed with them. Any questions on the contents of this letter or related matters can be addressed to me, Anthony S. Evangelista or James F. Volk, Assistant Chief Accountants, at (202) 942-0590.

Very truly yours,



Lawrence A. Friend
Chief Accountant