THE POSITIONS EXPRESSED IN THIS LETTER MAY HAVE BEEN MODIFIED OR RESCINDED

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

DIVISION OF
INVESTMENT MANAGEMENT

ACT ICA-40
SECTION 8
RULE
PUBLIC AVAILABILITY 11/2/95

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

November 2, 1995

Dear Chief Financial Officer:

The accounting staff of the Division of Investment Management (the "Division") has prepared this letter to respond to questions raised by investment company registrants and their independent public accountants with regard to 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 made by registered investment companies, including reports to shareholders. This letter should be read in conjunction with similar letters previously and subsequently issued by the Division's accounting staff, Office of Disclosure and Review and Office of Insurance Products.

IM-DCFO 1995-06

**Transactions With Affiliates in a Master/Feeder Structure**

In a letter addressed to Chief Financial Officers dated November 1, 1994 (the "November 1 Letter"), the Division expressed the position that funds that are compensated by affiliates for losses on certain of their investment holdings should account for such transactions as contributions to capital. The staff has subsequently become aware of instances when the master fund in a "master/feeder" structure received a capital contribution, but the effect of the transaction was not disclosed at the feeder level. Although a feeder fund includes the financial statements of its master fund in its annual and semi-annual reports to shareholders, the feeder fund's financial statements should also reflect these capital contributions.

If the master fund is organized as a partnership, generally accepted accounting principles ("GAAP") require the financial statements of the feeder to reflect its pro rata portion of every master fund transaction. Income received by the master fund partnership is considered to be received, pro rata, by the feeder fund contemporaneously with the receipt by the master fund. The distribution policy of the master fund does not dictate the feeder fund's accounting for income. The feeder fund's financial statements should contain the same presentation and disclosure suggested by the November 1 Letter with respect to the feeder fund's pro rata benefit received from the master fund's receipt of a capital contribution.

If the master fund is organized as a corporation, classification of the master fund's income in the feeder fund's financial statements depends upon the distribution policies of the master fund. Until it is distributed, income received by the master fund is recorded by a feeder fund as unrealized appreciation. When distributions are made by the master fund, it must differentiate distributions from capital gains and other sources from distributions of net investment income. The master fund's determination of the source of its distributions dictates the accounting by the feeder. A capital contribution to a master fund corporation will not be automatically recorded by a feeder fund as such. Rather, as noted above, the feeder fund will account for it as it would any other increase in the master fund's overall net asset value. Notes to the feeder fund's financial statements should refer to the circumstances surrounding the capital contribution received by the master fund either specifically or by cross-reference to the corresponding note to the financial statements of the master fund and should indicate the feeder fund's benefit received.

IM-DCFO 1995-07

## Accounting For Organization and Other Deferred Costs

This position has been rescinded.

In a letter dated May 9, 1995, the Division stated that the Investment Company Act of 1940 (the "1940 Act") does not prohibit unit investment trusts ("UITs") from bearing certain organizational and offering expenses.[1] Since then, the Division has received a number of questions regarding the accounting for such expenses and the appropriate period of amortization.

In accordance with GAAP, costs qualifying as organization expenses should be amortized over the period of benefit, not to exceed sixty months. Organization expenses generally consist of expenses incurred to establish a company and legally equip it to engage in business.[2] Such costs may be deferred and amortized by all registered investment companies. For accounting purposes, **offering costs**, including the costs of registering securities with the Commission and the states, do not qualify as organization costs and, accordingly, require different accounting treatment. Offering costs are distinguishable from organization expenses because they represent costs associated with the sale of a fund's securities. Open-end funds may defer charging offering costs to expense for a period not to exceed one year. Closed-end funds and UITs should charge offering costs to paid-in-capital. In accordance with industry practice, closed-end funds and UITs may capitalize offering costs until the offering period commences. For closed-end funds, the costs should then be charged to paid-in-capital immediately. For UITs, such costs should be charged to paid-in capital no later than the close of the period during which units of the trust are first sold to the public, which generally does not exceed thirty days.

Since many UITs have predetermined termination dates, organization expenses should be amortized over the shorter of the life of the trust or sixty months from the date of commencement of operations. UITs with trust indentures that contain provisions for mandatory termination of the trust if assets fall below a specified level should accelerate the amortization of any remaining organization costs when it appears probable that the trust will terminate before the sixty month or shorter period has elapsed. In such instances, the reduction of the amortization period should be considered a change in accounting estimate in accordance with Accounting Principles Board Opinion No. 20 - *Accounting Changes* ("APB 20").[3]

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1 Letter to Pierre de St. Phalle, Re: Unit Investment Trust Organizational Expenses, publicly available May 9, 1995. Specifically, the letter addresses whether a UIT can "bear the cost of preparing its registration statement, trust indenture and other documents, registering its securities with the Commission and the states, and the initial audit of the trust." Although these expenses were referred to in the letter as "organizational" expenses, the letter was not intended to address the accounting treatment of these types of expenses.

2 See paragraph 8.09 of the Audit and Accounting Guide - *Audits of Investment Companies*, issued by the American Institute of Certified Public Accountants, with conforming changes as of May 1, 1994.

3 Issued by the American Institute of Certified Public Accountants, July 1971.

IM-DCFO 1995-08

## Financial Statements of Depositors Required by Forms N-8B-2 and S-6

In many cases, the financial statements of the depositor may not be critical to evaluating and understanding a UIT offering. As a result, the staff has not objected if, under certain circumstances, a registrant omits the depositor financial statements required by Item 59 of Form N-8B-2 and Instruction 1(c) (as to the prospectus) of Form S-6.

Registrants have requested clarification of the circumstances under which the financial statements of the depositor may be omitted from Form N-8B-2 and Form S-6. In addition, registrants that include financial statements have asked whether they are required to be audited.

Registrants using Forms N-8B-2 or S-6 generally may omit depositor financial statements unless the depositor meets **any** of the following conditions:

- The depositor has liabilities pursuant to Section 27 of the 1940 Act (associated with a periodic payment plan). Periodic payment plan certificates and some insurance products are subject to refund requirements under Section 27. The depositor's financial statements are important in determining the ability of the depositor to refund the required amounts.

- The depositor is considered the issuer of the securities whose reserves will be relied upon to ensure payments. Insurance companies issuing variable products charge fees for mortality and expense risks which, in part, are credited to reserves required by state insurance statutes. The financial statements reflect the size of the reserves available to cover these and other risks.

- The depositor has a legal obligation to maintain a secondary market for the securities. To prevent trusts from diminishing in size during a specified period, some depositors agree to maintain a secondary market for the orderly transfer of ownership of trust units.[4] The ability of the depositor to continue to maintain that market is reflected in its financial statements.

- The depositor must continuously function as the issuer because of the nature of the offering. For example, equity ownership units in some trusts have been sold with the ability to split the units into separate financial instruments. The separate instruments are separately traded and have differing market values attributable to their unique economic characteristics based on their differing demands on the assets of the issuer. Trading of the separate instruments usually requires the depositor's continuation in business. In addition, the depositor must remain continuously involved when additional equity ownership units are issued or the separate instruments are reconstituted for the purpose of a redemption.

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[4] More often, the depositor agrees only to attempt to maintain such a market but makes no legal commitment. This is not considered a legal obligation to maintain a secondary market.

If the depositor meets any of the above conditions so that financial statements are required, the following procedures should be noted:

> **Form N-8B-2**, the 1940 Act registration form used by UITs that are currently issuing securities, requires audited financial statements of the depositor. The financial statements must include a balance sheet, statement of income (profit and loss) and a statement of surplus for the depositor's most recently completed fiscal year [5] as of the date of filing.
>
> **Form S-6** is used to register under the Securities Act of 1933 securities of UITs registered on Form N-8B-2 and also requires financial statements of the depositor. The form requires the financial statements to contain a balance sheet as of a date within ninety days of the date of the filing. This requirement is modified by Rule 3-01(a) of S-X [17 CFR §210.3-01(a)] which permits the balance sheet to be as of a date within 135 days of the date of filing. The Commission, therefore, will accept balance sheets as of a date within 135 days of the date of filing. If the balance sheet is unaudited, an audited balance sheet as of a date within one year of the date of the filing must also be provided. The financial statements must also include an income (profit and loss) statement for the most recently completed fiscal year and for any subsequent period up through the date of the latest balance sheet provided. The income statements must be audited through the date of the latest audited balance sheet.[6]

When financial statements are required in accordance with the policy set forth above, the Office of the Chief Accountant of the Division will still consider informal written requests for omission or substitution of financial statements pursuant to Rule 3-13 of S-X [17 CFR §210.3-13].

IM-DCFO 1995-09

## Financial Statement Presentation of Fee Waivers

This position has been modified.

There have been varying interpretations of the requirement to disclose fee waivers in a fund's statement of operations. The varying interpretations may result from current discrepancies between the Audit and Accounting Guide - *Audits of Investment Companies* [7] (which is considered to encompass GAAP) and Rule 6-07 of S-X.[8] Although the audit guide states that voluntary waivers need to be disclosed, it does not require voluntary waivers to be stated separately in the statement of operations. Rule 6-07.2 of S-X requires fee reductions or reimbursements by any entity **to be shown separately** in the statement of operations as a negative amount or as a reduction of total expenses. The rule makes no distinction between voluntary and involuntary waivers and requires a note to the financial statements to include the amounts and a brief description of such arrangements. When there is an apparent conflict, registrants should follow the requirements of S-X in filings with the Commission.

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5 The financial statements of the depositor are required to be prepared in accordance with Regulation S-X ("S-X"). Rule 3-02 of S-X [17 CFR §210.3-02] requires a statement of cash flows to be filed as part of the financial statements.

6 Id. The statement of cash flows must also be audited through the date of the latest audited balance sheet.

7 Issued by the American Institute of Certified Public Accountants, with conforming changes as of May 1, 1994.

8 17 CFR §210.6-07

IM-DCFO 1995-10

## Compliance with Rule 18f-3

Rule 18f-3 [17 CFR §270.18f-3] - *Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans* was adopted on February 23, 1995.[9] The rule, among other things, prescribes how income and expenses must be allocated among classes. The allocation methods selected by the fund, however, must be applied consistently from period to period. Paragraph (c)(2) of the rule allows income, realized and unrealized capital gains and losses, and expenses not otherwise allocated to a particular class to be allocated on a settled share basis (as defined in the rule) for companies operating under Rule 2a-7 of the 1940 Act and for companies declaring distributions of net investment income daily, provided those companies maintain the same net asset value per share for each class.

Some registrants have interpreted the rule to require funds electing to use the settled share method to apply consistently such method to all components of operations (including realized and unrealized gains and losses). We believe use of the same method to allocate all components of operations may result in a divergence of net asset value among classes when certain levels of subscriptions are received by a fund. The staff, therefore, will not object if funds relying on Rule 18f-3 consistently use a dual allocation method where such method would reduce the likelihood of net asset values diverging among classes. The dual allocation method would permit the use of the relative net assets method for allocating realized and unrealized gains and losses and the settled share method for allocating investment income and expenses.

IM-DCFO 1995-11

## Pro Forma Financial Information for Business Combinations

Form N-14, the registration statement used to register securities to be issued in a business combination, requires pro forma financial statements to be included if the transaction meets the criteria set forth in Item 14(a)(2) of the form. Recently, the Division did not object to the exclusion of certain financial information by registrants when the registration statements filed on Form N-14 solicited approval of the shareholders of two or more funds for proposals whereby the funds to be acquired (the "target funds") were to be combined with and into another fund (the "acquiring fund").[10]

The transactions typically are structured so the combination will include any and all funds that obtain shareholder approval; however, approval by every target fund is not necessary for the merger to take place. As a result, multiple pro forma presentation alternatives are required, depending on the number of target funds.

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9 Investment Company Act Release No. 20915 (February 23, 1995) [60 FR 11876 (March 2, 1995)].

10 E.g., Jaffray Funds, Inc., Form N-14 (File No. 33-58849). The pro forma combined schedule of total returns and expense ratios provided in this filing contained information for four years prior to the period covered by the pro forma combining financial statements, which exceeded the current requirement to provide the information for the two prior years, as noted below.

Article 11 of S-X governs the form and content of pro forma financial statements. Rule 11-02(b)(8) of S-X [17 CFR §210.11-02(b)(8)] states "if the transaction is structured in such a manner that significantly different results may occur, additional pro forma presentations shall be made which give effect to the range of possible results." A strict interpretation of this requirement would produce full pro forma financial statements for each possible combination.

The staff believes that including full pro forma financial statements for each potential combination could be burdensome to the registrant and confusing to shareholders. In situations where the acquiring fund will combine with only target funds that receive shareholder approval, the staff will not object if, in lieu of providing pro forma financial statements for all possible combinations of the eventual combined entity, registrants provide the following:

- pro forma combining financial statements reflecting the combination of all funds that are involved in the proposed combinations, prepared in accordance with the requirements of Rule 11-02 (b) and (c) of S-X [17 CFR §210.11-02(b) and (c)] based on the assumption that the shareholders of all target funds will approve the transaction; and

- a schedule reflecting pro forma combined expense ratios and total returns for every possible combination involving the target funds and the acquiring fund. The schedule should present the information for all periods covered by the pro forma financial statements referred to above and for each of the two fiscal years prior to the earliest pro forma financial statements presented. Appropriate adjustments should be made where funds have different fiscal years, different dividend payout rates, or other relevant differences in order to provide a consistent presentation based on the actual results of the accounting survivor in each scenario. The expense ratio should be calculated in the manner set forth in Item 2 of Form N-1A, and total return should be calculated in the manner set forth in Item 22 of Form N-1A. In addition, a headnote to the schedule should explain the reason for presentation of the abbreviated pro forma information and briefly describe, if relevant, any assumptions that were made to conform the information of the various target funds to that of the acquiring fund.

IM-DCFO 1995-12

## Correction of Errors

Certain funds are not immediately recording the correction of errors in their books and records. In cases where the correction would have an immediate effect on net asset value, some funds have capitalized the loss and amortized it over some arbitrary period. APB 20 prescribes the accounting treatment for adjustments resulting from the correction of errors. In pertinent part, APB 20 requires the correction of errors to be recorded when identified. The staff believes that immediate recognition of the entire amount of the error should be reflected in the statement of operations and, if appropriate, the footnotes, regardless of the effect on net asset value. Capitalization and subsequent amortization of error amounts are not acceptable under GAAP.

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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 Anthony S. Evangelista, James F. Volk, Assistant Chief Accountants, or me at (202) 942-0590.

Very truly yours,

Lawrence A. Friend

Lawrence A. Friend
Chief Accountant