

AICPA Investment Companies Expert Panel

Meeting Highlights

October 15, 2003

The Panel held its initial meeting. The issues discussed include the following:

Organization

- Mission of the Expert Panel and Protocol. The panel was briefed on the AICPA's goals with respect to the Expert Panels.
- The panel reviewed its mission and developed the Panel's Action Plan.
 - Monitor current technical activities and advise standard setters.
 - Identify and discuss emerging practice issues with the objective of providing recommendations to the AICPA on whether action is required in developing positions.
 - Monitor emerging significant regulation and industry practices by liaising with key regulatory and related industry groups. The Panel's key liaison activity is with SEC Division of Investment Management and the Investment Company Institute. However, the Panel may also liaise, on an issue-by-issue basis, with certain other organizations, such as the CFTC, Private Equity Industry Guidelines Group, National Venture Capital Association.
 - The Panel may also liaise with the AICPA Stockbrokerage and Investment Banking Expert Panel.
 - The Panel will advise and assist in the development of AICPA industry related products.

Practice Issues

- **Late Trading and Market Timing Issues** – Given the recent investigations by state and federal regulators of late trading of fund shares, and trading in funds by market timers in a manner inconsistent with market timing policies described in fund prospectuses the Panel discussed the possible effects such investigation and whether recommend whether any action should be taken by the AICPA. The Panel observed that the effect of any adjustments to funds due to either late trading or market timing issue will have potential reporting and auditing implications. The Panel decided to discuss at their meeting

those implications. Please visit the SEC Web site to obtain additional updated information regarding SEC actions related to market timing and late trading.

- **Stable Value Funds** - It was observed that the SEC has raised questions regarding the valuation of wrap contracts in stable value mutual funds. The SEC has questioned whether that the accounting of wrap contracts by stable value mutual funds should be accounted for as derivatives under the provisions of Financial Accounting Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Panel also notes that the effect of the SEC concerns potentially could also affect funds other than stable value funds, for example funds that analogized to SOP 94 -4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Plans*.
- **Panel's Views on SEC Proposed Rule - Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies** (Proposed Rule). The Panel focused on the summary schedule of investments contained in the Proposed Rule. The Panel was concerned that the rule as currently drafted appears to attempt to supercede GAAP because the Proposed Rule is less rigorous and conflicts with current GAAP requirement. The Panel will discuss a draft comment letter at their next meeting. For the full text of the SEC proposed rule please visit at <http://www.sec.gov/rules/proposed/ic-25870.htm>

AICPA Investment Companies Expert Panel

Meeting Highlights

December 2, 2003

The Panel held its meeting at the AICPA Washington, DC. The issues discussed include the following:

Practice Issues

- **Late Trading and Market Timing Issues** –The Panel observed that the effect of any adjustments to funds due to either late trading or market timing issue will have potential reporting and auditing implications. The EP observed the following potential issues should be considered:
 - Appropriate accounting for any cash reimbursed from advisers or others, and whether the accounting would change at all if the dollars related to market timing vs. late trading. Should funds view this as an errors or a gain contingency? Relative to a hedge fund, if a GP or adviser is required to pay a huge fine, a penalty or both is it a liability or obligation of the hedge fund or only of the GP?
 - Disclosure of any regulatory action, even if amounts of reimbursement have not been finally determined.
 - Auditors overall responsibilities related to compliance
 - Issuance of Material Weakness letters (including N-SAR)
 - Fair Value Pricing - whether a change in pricing service vendor would be a change in estimate or a changing in accounting method
 - Procedures that Auditors will employ regarding the use of one of the two pricing services that clients use.

Please visit the SEC Web site at www.sec.gov to obtain additional updated information regarding SEC actions related to market timing and late trading.

- **Panel's Views on SEC Proposed Rule - *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*** (Proposed Rule). The Panel in conjunction with AcSEC PSC issued a comment letter that focused on the summary schedule of investments contained in the Proposed Rule. The Panel views are that the rule as currently drafted appears to attempt to supercede GAAP because the Proposed Rule is less rigorous and conflicts with current GAAP requirement. The Panel believes that the

information currently required by GAAP provides meaningful information for readers of fund financial statements. Therefore, the Guide's required summarized schedule of investments should not be modified or eliminated unless the usefulness of the disclosures required by the schedule has diminished. Accordingly, the Panel believes that a uniform presentation, based on the Guide's required summarized schedule of investments, would be in the best interest of financial statement preparers and users. For the full text of the AICPA comment letter to the SEC please visit <http://www.sec.gov/rules/proposed/s75102/aicpa121203.htm>.

- **Accounting of General Partner Look Back Obligation** – The Panel discussed that industry practice seems to be diverse in accounting for look-back obligation. Some account for look-back as a receivable. Others account for look-back as a negative capital account balance for the general partner. Various views were expressed, however, the EP concluded that the accounting would depend on facts and circumstances.

Regulatory Issues

- The SEC staff briefed the Panel on the SEC's position of Reclassification of realized gains and losses to another line item. The SEC staff indicated that the changes in fair value of financially settled derivatives (economic hedges that do not qualify as hedges under Statement 133), are classified in a single line item on the income statement. However some registrants have reclassified realized gains and losses, represented by the periodic or final cash settlements from those economic hedges into revenue or expense lines associated with the related exposure. The SEC does not believe that the presentation of unrealized gains and losses in one income statement line with reclassification of realized gains and losses to another line is appropriate. The SEC believes that reclassifying realized gains and losses, as described, essentially presents hedge accounting-like results for some captions, without a registrant necessarily applying the rigors of hedge accounting. The Staff suggest the EP provide input to the Division of Investment Management as to whether that view should apply to the investment companies.

For further information please visit the SEC website at <http://www.sec.gov/news/speech/spch121103gaf.htm>

AICPA Investment Companies Expert Panel

Conference Call Highlights

January 15, 2004

The following issue was discussed:

- **Presentation of Derivates in the Condensed Schedule of Investments – SOP 03-4 Implementation Issues**
 - If the underlying is not a security how should it be disclosed in accordance with paragraph 7.12 (a) of the Audit and Accounting Guide, *Audits of Investment Companies*. Some panel members expressed that based on the guidance on paragraph 7.12 it would appear that when the underlying is not a security it would be categorize by broad category of underlying. For example, S&P 500 swap (2%) and Russell 2000 Swap (4%), disclose Equity Swaps 6%. Others observed that the guidance did not explicitly require such treatment. Preparers in making their decision should look to the spirit of the condensed schedule of investments, which is to disclose concentration of risk to users of the financial statements.
 - If the underlying is a security how to present in accordance to paragraph 7.12 (d and e). For example, Company Stock (4%) and Swap ((2%) Company stock or bond is underlying security). Some might conclude, as a best practice, to disclose 6% of Company position. Others might conclude not to combine the position. Preparers in making their decision should look to the spirit of the condensed schedule of investments, which is to disclose concentration of risk to users of the financial statements.
 - If the underlying is a basket of individual securities how to establish the determinant for the 5 % test, for disclosure, in accordance to paragraph 7.12. Current guidance does not require that, an index on a basket of securities be reviewed to determine if the exposure to any individual security within the basket would need to be combined with other investments held by the fund to determine the 5% threshold. Some EP members views are that, as a best practice, to the extent the basket is created such that the exposure to one security within the basket is significant (as example a basket of 2 securities where one security represents 90% of the value of the basket) one might look through the basket to determined the fund's true exposure to the security, consistent with the spirit of the guide. Those EP members

observe that in most typical situations it would appear that when the underlying is a basket of individual securities one need not look through to underlying securities. Additionally, if the value of the overall basket is greater than 5% one might consider the benefits to describe the content of the basket if one considers that information to be meaningful to the readers of the financial statements. Other EP member's view is that preparers need not look through the basket to determine the fund's true exposure to the security. Preparers, in making their decision should look to the spirit of the condensed schedule of investments, which is to disclose concentration of risk to users of the financial statements.

AICPA Investment Companies Expert Panel

Meeting Highlights

March 10, 2004

The Panel held its meeting at the AICPA Washington, DC. The issues discussed include the following:

Practice Issues

- **Accounting Treatment of Insurance Contracts – Principal Protected Funds**—The Panel discussed whether principal protected funds could be considered to be derivative contracts. Currently principal protected funds are considered as insurance contracts and are not fair valued. Some EP members believe that the value of those contracts is zero, if the prospectus states that the shareholders leaving early will not receive any protection. Therefore the only valuation event occurs at the end of the stated life of the product. Other EP members believe that those contracts could be considered to be derivative contracts that do have a value and that insurance companies are likely to be able to value the contracts.
- **Presentation of Returns for Registered Hedge Funds**—The Panel discussed whether a registered fund that allows an incentive fee to be allocated to the GP could present gross and net presentation of incentive fee, as required by SOP 03-4. The Panel observed that historically the registered fund only reported a “net of allocation” total return in accordance with the SEC rules. Some believe that to continue to report only a net of allocation total return would result in unregistered products being required to disclose more information than similar registered products. The EP noted that the SOP 03-4 only applies to non-registered funds and therefore registered funds are not subject to the requirements of SOP 03-4. However, the Panel observed that registered funds are not precluded to the presentation of gross fees, if they so choose to. *Note: The SEC Staff indicated that in their S-O reviews of financial statements they have been requesting registrants to include both gross and net incentive fees.*
- **Condensed Schedule of Investment (SOI) for Comparative F/S of Investment Partnerships**—The Panel discussed whether an investment company should present SOIs as of the end of both periods, or only the most recent date when comparative financial statements are presented (particularly common for venture capital firms). The Panel observes that comparative financial statements are not required for investment companies under GAAP. However, the CFTC requires comparative financial statements for its registrants. The Panel observes that paragraph 7.01 of the AICPA Audit and

Accounting Guide, *Audits of Investment Companies*, says that “at a minimum, a condensed schedule of investments (as discussed in paragraphs 7.12 and 7.13) should be provided for each statement of assets and liabilities.” However, SOP 95-2 seems to indicate that only the most recent period must be shown. Currently, industry practice varies. Some present comparative financial statements and only present a SOI for the most recent period. Others provide a SOI for each statement of assets and liabilities. The EP observes that the audit guide is more recent than SOP 95-2 and therefore it would appear that the Guide supercedes guidance in SOP 95-2. Accordingly, it would appear that comparative SOIs would be required to be presented when comparative balance sheets are shown.

- **Management Assertion Report – Irish Withholding Taxes for Investment Companies**—Fund groups can prevent the imposition of withholding taxes by filing a certification form with the Irish Tax Authority which is required to be signed by the funds auditors. Most audit firms issued management assertion reports in lieu of signing the form. The Irish Tax Authority has drafted a recommended version of a report for auditors to complete. However, the current draft report requires assurance for certain items than the auditors might not be able to assert to. Currently, the Irish offices of the big audit firms will work with Irish Institute of tax to develop a letter that will bridge the gaps between what the Irish Tax Authority wants and what the audit firms are able to provide. An inquiry will be made of the Irish Tax Authorities as to the status of reports being filed prior to the resolution of this issue.
- **Willingness of Brokers to Sign Pricing Confirmations in Connection with Audits**— The EP discussed that, in connection with the audits of investment funds, audit firms are experiencing that some brokers are refusing to sign pricing confirmations. Given that in the past the SEC has indicated it prefers that audit firms verify a price with a different source than that used by the fund, the SEC has been asked to consider whether auditors could independently confirm the same source used by the fund, provided that they perform testing or gather other evidence that controls at pricing services are operating properly. It was observed, however, that pricing services/brokers have not been receptive to having SAS 70 audits. SEC indicated that it would consider the request.
- **Audits of Separate Accounts**— The Panel discussed whether the auditors’ report should make mention to the audit of financial highlights. The EP observes that financial highlights are generally contained in the notes to the financial statements. Therefore the Auditors’ report would not need to specifically mention the audit of financial highlights. However, one might consider referring to the financial highlights in situations where more periods are presented

within the financial highlights than the periods presented for the financial statements.

Regulatory Update

The SEC staff briefed the Panel on the following:

- **Presentation of Interest Rate Swaps Contracts-Income Statement Treatment**—Currently, investment companies report receipts/payments from interest rate swap contracts as an adjustment to investment income and mark to market adjustments for valuation are presented as a change in unrealized appreciation/depreciation. The SEC believes that for investment companies, interest rate swaps contracts, generally do not qualify for hedge accounting under FAS 133. Therefore effective for all periods ending after March 15, 2004 the SEC will require the following:
 - a. All fair value adjustments should be reflected in unrealized appreciation/depreciation and realized gains and losses upon a realization event.
 - b. If an investment company has not previously followed this treatment, it must reclassify amounts retroactively in statement of changes and financial highlights for all applicable periods.
 - Footnote describing reclassification may be appropriate.
 - When the Staff was asked whether all periods must be restated, they replied that registrants should consider all applicable guidance (including SAB 99) when assessing the impact of the reclassification.
 - c. The Staff believes that similar accounting treatment would apply to other derivative contracts.
- **Accounting for the securitization of 12b-1 and load payments by Investment Advisers**—The SEC staff indicated that in most cases sale accounting is not appropriate when an investment advisor or distributor securitizes its interest in a future stream of 12b-1 payments. The lack of ability for sales treatment would especially be true if the securitization agreement included provisions that would allow the advisor or distributor to participate in some of the future cash flows under certain circumstances (participation) or included provisions that caused the advisor or sponsor to indemnify the other parties in the securitization agreement for certain events. Therefore an adviser should consult with the Staff if it feels under their specific facts and circumstances that sales-accounting is appropriate.
- **Portfolio Disclosure**—On February 27, 2004 the SEC adopted the rule, *Shareholder Reports and Quarterly Portfolio Disclosure of*

Registered Management Investment Companies, the rule requires, among things, the following:

- a. **Expense Tables** should be presented for 6 month periods at each semi-annual date (thus, year end report will only contain the last six months of data) as follows:
 1. Cost associated with investment of \$1,000, assuming actual expenses and actual returns over the period.
 2. Cost associated with investment of \$1,000, assuming actual expenses and 5% return.

Registered investment companies must explain in a note to the table any additional charges, such as account maintenance fees or low balance fees, that a shareholder might face and how to factor those charges into the calculation.

- b. **Summary Schedule of Investment (SOI) Rule** is effective for all July 31, 2004 year ends and forward. All non-money market funds are permitted to present a summary SOI in the shareholder report containing the 50 largest issues (aggregate those securities from a common issuer). All money market funds are permitted to exclude the SOI from the shareholder report. The rule currently mirrors the Guide's requirements for non-money market funds. However the conflicts with the Guide (GAAP) requirements for money market funds. Mutual funds would be in violation of GAAP for money market funds if they followed the SEC rule at this time. This issue also affects the unaudited semi-annual report because the CEO/CFO certification would be based on GAAP. Some expert panel members were concerned with eliminating the disclosure of the top 50 securities for a money market fund because they believe it is necessary to properly present concentration of risk. However, the EP will consider the appropriateness of amending the Guide and propose its views to AcSEC. Additionally, the EP members raised the reporting issue for a situation where the registrant elects to provide the summary schedule in the audited shareholder report and is also requested to provide an audited full SOI (at the annual date) to anyone who asks for the full SOI. One possibility would be for the audit firm to issue two audit opinions, one audit opinion for the financial statements and one the full SOI. The EP will discuss the issue at its next meeting.

To view the complete the Rule please visit the SEC website at <http://www.sec.gov/rules/final/33-8393.htm>

- **Status of SEC’s Review of F/S as mandated under Sarbanes-Oxley**— The panel was briefed on the status of the SEC’s financial statement review process. The SEC focused on largest funds, especially those with international operations. Approximately 2,200 reviews of the funds have been completed. The SEC indicated that if they have no comments, the fund will not be contacted. The SEC will communicate general themes of the findings to the industry probably via a Dear CFO letter or in a Q&A format. Examples of comments:
 - a. Dividends paid on outstanding short sales
 - 1. Should be included in the primary expense ratios, not just in footnote or excluded completely.
 - 1. Should be included as an expense in prospectus as well
 - b. Affiliate payments—In situations where an affiliated entity has reimbursed the fund for an investment violation (as described in paragraphs 7.49 to 7.51 of the Investment Company Audit Guide) amounts are being properly reported on the income statement and statement of changes but the impact of the reimbursement is not being identified in the financial highlights. At a minimum the financial highlights should show impact of the reimbursement on total return.
 - c. Securities lending-
 - 1. Report investments made with cash collateral on SOI.
 - 2. Note which securities are on loan.
 - 3. Reflect the value of the collateral to be returned to the counterparty as a liability on the statement of assets and liabilities.
 - 4. Include parenthetically in the investments line item on the statement of assets and liabilities the value of the securities on loan.
 - d. Investments in Affiliated Funds (including investments in affiliated money market funds which may be utilized as a cash sweep vehicle)
 - 1. Separate presentation required in SOI and Statement of Assets and Liabilities as an affiliated issuer.
 - 2. Separate presentation of income required in Statement of Operations as required for affiliated issuers.
 - e. MDFP – Lack disclosure of past fund’s performance. For example, more explanation on deviation of fund’s performance from benchmark.
 - f. Funds Fair Value Policy, in particular International Funds – disclosure of fair value in notes to the financial statements
 - 1. Current one sentence disclosure used by many funds is inadequate.
 - 2. Disclosure should discuss—Time lag between close of foreign markets and time NAV is struck and the possibility of a significant event occurring and the fund’s use of benchmark indicators to monitor pricing. Funds should

- implement fair value procedures when appropriate and provide an explanation.
- g. Closed-end Funds
 - 1. Those that pay a stable dividend should describe in the interim financial statements the possibility that a return of capital may occur, and a reasonable estimate of the expected return of capital and other tax characteristics of distribution, unless the fund is certain that such will not occur.
 - 2. If dividend rate is being advertised, should disclose the estimated components of the distribution yield, including return of capital, as well as, other performance calculations that indicate the true investment return being distributed
 - h. Fees paid outside fund by shareholders
 - 1. Evaluate whether S-X Rule 6.07 is applicable. Several examples have come to the staff's attention which appear that Rule 6.07 does apply.
 - 2. Example -TA receives fee, such as a small account fee, outside of the account. The transfer agent expense on the statement of operations should be grossed up to reflect the fees, with the offset shown below the gross of fees line.
 - i. 144A securities listed on SOI
 - 1. Just need to be noted as such on SOI.
 - 2. Generally, 144A securities are not viewed as illiquid, however, the board or management need to make the determination to consider whether ASR 113 and related S-X disclosures apply.

Other Industry Update

PEIGG Issues Reporting Standards for Venture Capital—
The EP was briefed on the status of PEIGG reporting status. In December 2003 PEIGG issued standards to correspond to GAAP and GIPS rules issued by AIMR. Standards were introduced to provide assistance to Venture Capitals Funds, not to require certain procedures, methodologies, or processes. However, the National Venture Capital Association did not provide full endorsement of standards. The issue is fair value estimation. Venture capital funds generally, write down securities. However, when should venture capital funds write-up an investment? Historically, venture capital funds only have written-up after a true event occurs. The EP observes that Investment Company Audit Guide requires holdings to be valued at fair value at all times, which would mean VCs should be evaluating whether or not a write-up is appropriate, even if a significant event has not occurred.

AICPA Investment Companies Expert Panel

Meeting Highlights

June 16, 2004

The Panel held its meeting at the AICPA Washington, DC. The issues discussed include the following:

Practice Issues

- **Bank Loan Commitment Fund**-The EP discussed how funds present unfunded loan commitments. Some may report a net presentation of unfunded loan commitments within the financial statements whereas others report a gross presentation (separate asset and liability presented in the balance sheet). Those that present a gross presentation indicate that a liability would be required under FASB Statement No. 5, if the commitment meets the standards criteria 5 relative to the probability. Those that report a net presentation indicate that such presentation is appropriate when as of the balance sheet date it is not known whether or not the loan will be required to be funded. The EP also discussed how any rebates fees received on settlement date of the loan are currently recorded. Some EP members indicated that in practice rebate received on settlement dates were recorded as a reduction of cost and then amortize over the life of the security.
- **Financial Highlights for Offshore Partnerships** – The EP discussed how financial highlights are currently presented when the functional currency used in preparing the financial statements is U.S. dollars but the fund includes one class of shares that are denominated in a currency other than U.S. dollars. The discussion evidenced that diversity in practice exists. Some EP members indicated that others present highlights in the specific non-U.S. dollar currency, as opposed to in U.S. dollars, because it would appear to be more meaningful to investors of that specific class. However, some EP members noted that some present the financial highlights in U.S. dollars when the financial statements are in U.S. dollars. Other EP members indicated that financial highlights are also presented both in U.S. dollars and in the foreign currency.
- **Audit Procedures for Swap Valuation** – The EP discussed varying practices used by auditors to test swap contracts.

Testing for Existence - The EP observes that the SEC guidance is not specific relating to whether or not swap contracts effectively constituted a "security" for purposes of 17f-2 counts and for purposes of fulfilling the registered investment company rule which requires an

auditor to confirm with the custodian or brokers all “securities” held by the fund. Nonetheless, Some EP members indicated that currently auditors generally verify the existence of swap contracts with the counterparty.

Testing for Valuation – Investment companies generally either value swap contracts using either a price provided by the counterparty or a price developed internally. As required by GAAP if using the price provided by the counterparty, an investment company should consider using procedures to determine the reasonableness of the valuation. The discussion evidenced that auditors currently use a variety of methods to audit swap valuations, ranging from confirmation with the counterparty alone, confirmation with the counterparty for all contracts along with obtaining an independent valuation from another source (using Bloomberg functionality, a valuation specialist within the audit firm, confirmation with an independent pricing service or broker, or other means) for some of the contracts, or 100% independent valuation. The SEC staff noted that an auditor should independently value all securities held by a registered investment company. Some EP members question whether such swap contracts are to be considered securities. Other EP members indicated that given the level of risk involving swap contracts, auditors generally confirm all prices with the counterparty and, if the investment company is strictly using the counterparty’s pricing, should obtain independent prices for at least a sample of the swap contracts. As a best practice the sample selected might be structured such that at least one swap contract for each of counterparties involved be included. Additionally, the other auditors choose to perform a 100% valuation.

- **PCAOB Auditing Standard No.1** – indicates that the SEC expects to see references to “independent auditor’s report,” “generally accepted auditing standards,” and “attestation standards of the American Institute of Certified Public Accountants” conform to the language required in PCAOB Auditing Standard NO. 1 (PCAOB AS No. 1) References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board. **In general, if a report must be issued by a firm that is registered with the PCAOB, all language in the report must conform to PCAOB AS No. 1. Thus, audit reports, N-SAR internal control letters, consents, and rule 17f-2 letters must conform.** Reports relating to rule 206(4)-2 counts and 17 Ad-13 examinations should not conform because an accounting firm not registered with the PCAOB is permitted to perform these types of engagements and therefore issue these reports.

It was noted that the definition of material weakness included in the N-SAR internal control letter may need to change to conform to the language in PCAOB Auditing Standard No. 2, *An audit of Internal Control over Financial Reporting Performed in Conjunction with an*

Audit of Financial Statement. The EP will bring the issue to the attention of the ASB.

- **Rule 38a-1** – The EP discussed the appropriateness of performing a SAS 70 type audit for service providers on their compliance function. The panel discussed that SAS 70s were designed as a financial statement concept and not a compliance concept and that SAS 70s were not designed to be a marketing tool for service providers. The EP will follow-up with the AICPA to determine whether the IC EP should suggest the development of a report to comply with requirements of rule 38a-1 to the AICPA or PCAOB.
- **Irish Tax Withholding** - The EP discussed proposed revisions to the Irish tax withholding letter were discussed. The EP agreed to provide comments to PwC, which is leading the effort. Such a version would have to be approved by the Auditing Standards Board before being used. The group also noted that the Irish tax authority may be accepting self-certifications by fund groups as an alternative to the issuance of letters by the auditing firms. For background on this issue please view the EP's previous meeting highlights which could be viewed at the following link:
http://www.aicpa.org/members/div/acctstd/expertpanel_investco_highlights.asp
- **Effect of SEC Rule on Money Market Fund SOIs** - The Expert Panel discussed whether or not to recommend that the audit guide should be amended to conform to the SEC rule which permits an investment company to exclude the SOI for a money market fund from shareholder reports. The audit guide currently does not permit that practice. Consistent with the EP views expressed in the comment letter issued by the AcSEC's PSC and the EP continues to believe that a change would not be appropriate at this time, especially considering that the industry has not shown strong interest in eliminating the SOI for money market funds.
- **Deferred Compensation Arrangements for Offshore Funds** – The EP discussed whether deferred compensation amounts should be included as capital which would increase the net asset basis upon which the disclosure of securities in excess of 5% on net assets would be determined. Some EP members indicated that some do not include such amount because it seem inappropriate to include amounts attributable to such arrangements as a component of capital given that deferred compensation is clearly not an equity interest and, in liquidation, would be paid out prior to the interest of the partners. Other EP members indicated that deferred compensation amounts were subject to the performance of the fund in the same manner as an equity holder therefore such amount should be included.

- **Investments in Other Investment Company** – The EP discussed current practice of private funds which invests in other investment companies (such as a fund of funds situation) for the purposes of determining whether or not 5% ownership in any one issuer exists (when presenting a condensed schedule of investments). Some EP member indicated that some private funds look through (to the extent practicable) to the underlying investments of the investee investment company for purposes of determining whether or not 5% ownership in any one issuer exists.

Regulatory Update

The SEC staff briefed the Panel on the following:

- **Derivatives Guidance** – The SEC’s interpretation that investment companies must present, under FAS 133, all derivative receipts/payments (from instruments like swaps) as realized gains/losses (as opposed to the common practice of reporting such receipts/payments as an adjustment to investment income) will be communicated through the posting of the AICPA IC Expert Panel minutes and not through any communications from the SEC.
- **SOP 03-4** – Although the SOP only applies to nonregistered partnerships, the SEC believes that the structures of registered and unregistered partnerships are comparable. Therefore if the presentation of the gross and net incentive allocation is useful for non-registered hedge fund investors, then they are equally as important for registered investors. The SEC has been requesting this disclosure as part of their Sarbanes/Oxley review of financial statements.
- **Valuation Testing by Auditors** – The SEC affirmed that it still expects audit firms to adhere to the 1994 Dear CFO letter requiring auditors to obtain a price from a reliable independent source (differing from the source used by the client). If there is only one market maker available, audit firms should employ alternative valuation procedures to determine the appropriateness/reasonableness of the price. . The SEC indicated that auditors should consider comparing the actual market prices on recent transactions to the fund’s price, determining the dispersion between the price used by the fund and the market price on dates when transactions actually occurred (if there are no recent transactions around the audit date), discuss valuation and liquidity of the security with portfolio managers and market makers and verifying the computation of valuation using the same methodology the fund used after verifying the reasonableness of the methodology.
- **Financial Statement Review Process** – The SEC provided a summary of some additional comments arising from their on-going review of RIC financial statements:
 - Tax- Funds should be disclosing distributions on a tax basis as required. In addition Funds are required to disclose not only the total of the capital loss carryovers as of the end of the year but also the capital loss carryforward by year of expiration date.
 - Master-Feeder - Registered master funds, as independent entities must file separate Form N-CSRs even though the master’s financial statements are included in the Form N-CSRs of the feeders.

- Line Graph- The SEC has noted instances in which the sales charge has not been used or the wrong sales charge has been presented in the required line graph presentation.
- Related Parties- Affiliated securities should be presented separately both in the SOI and in the Statement of Assets and Liabilities, and any related income should be presented separately in the Statement of Operations. Additionally, the terms of any related party expense waivers and the expiration date should be disclosed in the related party note to the financial statements.
- Valuation Methodology - Valuation procedures for all securities and investments, including short-term securities, should be included in the notes to the financial statements or SOI. The registrant should denote in the SOI any restricted securities that have been valued by the Board. With respect to restricted securities that are valued by the Board in good faith disclosure should be expanded to explain in general terms the types of items that the board or its delegates review in determining fair value.
- General Comments-
 - Since the last EP meeting, the SEC has required more funds to restate their financial statements due to gross errors/oversight. Reasons for such include the omission of required financial statements, filing the wrong type of financial statements, and having the financials audited by a firm that is not registered with the PCAOB.
 - As part of the financial statement review, the SEC has broadened the review to include certain parts of the prospectus. The objective of reviewing the prospectus disclosure is to identify any inconsistencies between the financial statements and prospectus.
- **Filing Extension** - Form 12b-25 permits a fund to extend the filing date of its financials on Form N-CSR with the SEC if the Registrant states in reasonable detail the reasons why Form N-CSR could not be filed within the prescribed time period. If the delay is due to the audit firm's inability to furnish the required opinion, the Registrant is required to attach a letter filed as an exhibit signed by the auditor with an explanation of the reason why the opinion could not be furnished. However, the shareholder report still must be mailed to shareholders within the 60 day requirement regardless of the extension. The SEC has been reviewing all 12B-25 filings and notifying Registrants if the Form is not filled out properly.
- **Reporting Expenses in the SOI -**

- **Other Expenses Charged to Shareholders** – A fund’s financial statements must include all fund expenses, even those paid by parties other than the fund. For example, even if the fund technically has no expenses (such as may be the case for some wrap products), it still must gross up the relevant expense line items in the statement of operations and report the amount paid by the external party as a reduction of expenses in a separate line below the gross expenses line (and above net expenses). In certain circumstances, the fund expenses might include fees that might be considered to be shareholder expenses. An example of an expense that normally would not be considered a fund expense that in certain situations may be considered to be a fund expense would be a small account fee. Although this type of expense is normally considered a shareholder fee that would not be considered a fund expense, if such a fee is charged to almost every shareholder within the fund it might be viewed as a fund expense. If a fee, such as a small account fee, charged to shareholders is ultimately determined to be a fund expense, such fees should be included in the statement of operations by grossing up, in this situation, the transfer agent expense line and inserting a corresponding credit below the gross expenses line.
- **Market Timing** – If the fund board engages a consultant to look into potential market timing activity and the bill is paid by the investment adviser, the amount paid should be presented by the fund as a fund expense (gross) and as a reimbursement from the adviser. Allocations of this type of expense to multiple funds in the complex should be done based on some meaningful manner.
- **Side Arrangements** – SEC indicated that any side arrangements in which a service provider, such as a transfer agent, compensates an investment advisor as an incentive to appoint the transfer agent for a fund would normally be deemed to be inappropriate unless such an arrangement was made known to and approved by all parties impacted by the arrangement. All arrangements in which fees are shared should be approved by the fund’s board of directors. The statement of operations should be correctly classified. For example, if the Adviser fees are 40 bp and the TA fees are 15 bp, but the TA gives 2 bp of its fee to the adviser, the total Adviser fee presented should represent 42 bp and the TA fees should represent 13 bp. Such arrangements should also be presented in the related party note to the financial statements.
- **BDCs** - The SEC confirmed that Business Development Companies are subject to Section 404 of the Sarbanes Act. Registrants are encouraged to contact the SEC with implementation questions.
- **144a disclosure in SOI-** If the board has determined that the 144a security is not restricted and is liquid, the fund must still flag the security in the SOI as being a 144a liquid security but does not need to include any of the required restricted security language.

- **Blockage discounts** - The SEC does not feel that a blockage discount should be applied to a security with a readily available market value. In circumstances in which a readily available value does not exist, an investment company may consider a blockage discount as one of the factors in determining the fair value of the security.
- **12b-1 Fees Sales Treatment-** SEC re-emphasized that in most cases sale accounting is not appropriate when an investment adviser or distributor securitizes its interest in a future stream of 12b-1 payments. The SEC has indicated that it would be interested in learning how many broker-dealers would violate net capital requirements if they had accounted for the transaction as a financing.
- **Directors-** SEC will continue to scrutinize the activities of directors to ensure they are fulfilling their fiduciary duties as required under section 36 of the Investment Company Act.
- **Opinions for Complete SOI Schedule** – The SEC’s rule permitting a summary SOI to be presented in the shareholder report still requires that a complete SOI be included elsewhere in Form N-CSR. This schedule must be audited, leaving audit firms to decide how its audit reports should look (issuance of two separate opinions, references to audit of financial statements, etc.) and whether or not they would require a fund group to send a full set of financial statements to anyone requesting the complete SOI. The SEC indicated that the decision on how to proceed is left up to the auditors, but it suggested that the auditors could look to the current 10-K filing practice involving two opinions as an example. None of the audit firms present at the meeting had reached a conclusion as to the approach they will take. The EP also noted that it does not appear that many fund groups will elect to show a summary SOI.
- **N-Q Filing** - The SEC acknowledged that there are some implementation questions that exist relating to the N-Q filing and indicated that it would be glad to assist in answering such questions. In general, the N-Q filing should include everything that is required by S-X Rules 12-12 through 12-14 and anything else necessary to prevent the schedule from being misleading. In the SEC’s opinion, Registrants should consider whether certain notes traditionally included in the notes to the financial statements in the semi-annual and annual reports should be included, in the N-Q filing. For example, the SEC pointed to the valuation footnote as an example of an item that the registrant could discuss in the N-Q filing. Additionally, derivative contracts, which are often presented in the notes to the financial statements, must be included in the N-Q filing as they are included under Rule 12-13. In summary, the presentation between the contents of Form N-Q and the SOIs shown in the shareholder reports may differ.

- **Redemption fee accounting** – The SEC is interested in hearing from the industry regarding issues arising from redemption fee accounting due to reliance on information from intermediaries.

Other Industry Update

- **Commodity Futures Trading Commission Filers** - National Futures Association (NFA) will now grant an extra 30 day extension. The fund must apply for such extension each year.
- **Private Equity** – The Private Equity Industry Guidelines Group (PEIGG) is working through valuation concerns. The Group's intention is for its standards to be in conformity with GAAP.
- **Investment Company Scope SOP** – The EP was briefed on the status of the Scope SOP, which was cleared (with revisions) by the FASB on June 15, 2004. For those investments that previously were accounted for in conformity with the Investment Company Guide, but for which the investor no longer meets the criteria to apply the Investment Company Guide, the carrying amount of the investment should not be adjusted, but rather the investment should be prospectively accounted for under other generally accepted accounting principles, using fair value at the date of the change. For detailed information regarding the Investment Scope SOP please visit the AICPA's accounting standards team webpage at http://www.aicpa.org/members/div/acctstd/projects/scope_clarification.asp
- **Technical Practice Aids (TPAs)** – The Expert Panel discussed the unique nature of investment company accounting and the benefits to provide some guidance to those in the industry. Although, TPAs do not represent authoritative guidance they are helpful in providing guidance where diversity might exist. The Expert Panel will discuss in the near future whether it may be beneficial to suggest that a TPA address some of the issues discussed by the expert panel.

**AICPA Investment Company Expert Panel
October 1, 2004 Meeting Highlights**

PRACTICE ISSUES

Reports for Use by Chief Compliance Officers

In order to monitor the compliance of an investment company's service providers, it is expected that CCOs will seek to receive reports from an independent party to receive some assurances regarding the service providers' control environment relating to compliance. A CCO may directly engage an independent firm to conduct certain procedures; this would likely take the route of an agreed-upon procedures engagement and would be a restricted-use report that only the investment company could use. Although that may work in some cases, a service provider may find it intrusive to have several firms conducting similar engagements, possibly at the same time. Thus, it is believed that many service providers will seek a SAS 70 type report over compliance controls that could be distributed to any user. However, SAS 70s were designed to be used for financial statement purposes, not compliance, and there are no similar provisions for a compliance audit within the professional auditing standards. The EP decided that the representatives from the industry, working with the EP, will meet and determine the format of the report and related guidance. The EP will then present the proposal to the Auditing Standards Board. It was noted that, although the Public Company Accounting Oversight Board (PCAOB) may be consulted, the proposed report does not relate directly to an issuer and would likely not be subject to PCAOB approval prior to issuance.

On a related note, some audit firms have been approached to provide reports relating to their compliance programs; however, audit firms are not specifically referenced as a service provider within Rule 38a-1, and providing such a report would not be appropriate in most cases.

Partnership Auditing

- **Capital Accounts** – Some partnership agreements require audits of partnership capital accounts at certain points in time during the life of the partnership. The accounting firms noted a preference to perform auditing procedures relating to supplemental information on capital accounts attached at the end of the financial statements as opposed to directly auditing partner capital activity. Reasons cited included the potential need for each limited partner to sign engagement letters relating to the audit and the extent of detailed work necessary in order to issue a report at the individual partner level as opposed to the partnership level, at which the materiality limits would likely be much higher.
- **Since Inception IRR** – Members of the EP discussed the issues relating to auditing the since-inception internal rate of return (IRR). One factor is a possible flaw in one of the Microsoft Excel functions (XIRR) used by some firms to calculate the IRR that

occasionally may produce inaccurate results, especially in periods of net capital inflows to the partnership. Management of the funds and auditors should pay close attention to situations in which the IRR calculation seems nonsensical. Additionally, when auditing the IRR, audit firms must subject the entire period since inception to testing. Most auditors have not retained sufficient documentation detailing the dates of specific external cash flows, so they are unable to recalculate the IRR presented by the fund without doing more audit procedures. In some cases, it appears that partnerships have experienced difficulty in locating older records, and it was noted that even cash flows occurring in the first year of the partnership could have a significant effect on the IRR calculation. The EP concluded that audit firms would either need to confirm this information with the individual LPs or examine historical records maintained by the partnerships. This issue will generally be a problem only during the first year that the IRR is presented, but if a change in auditors occurs, the new firm may decide to subject some of the older periods to additional audit procedures.

- **Auditing the Control Environment at Prime Brokers** – SAS 70s exist for most RIC service providers, but such is not the case for prime brokers which serve as recordkeepers for private investment funds. Although some interest in the control environment of prime brokers may exist from fund of fund investors, the hedge fund community and auditors have not expressed a strong interest overall. Site visits of lesser known prime brokers may occur, but they are not a common occurrence. Additionally, most audit firms tend to take a substantive approach, not a control reliance approach, when auditing private investment funds.

17f-2 Counts for Fund of Funds when an Affiliated Transfer Agent Exists

When an affiliated transfer agent is used, one may come to the conclusion that the fund is a self custodian as defined under the Investment Company Act of 1940 and, therefore, would be subject to having the auditor perform rule 17f-2 security counts. The EP discussed this, and the auditors indicated that performing Rule 17f-2 security counts would not seem to be practical, because Rule 17f-2 requires confirmation of the first level of nonaffiliation (such as the Depository Trust Company or the Federal Book Entry System) and because there would be no unaffiliated party with which to confirm the positions, other than the shareholders themselves. It is unlikely that all of the individual shareholders would return all of the confirmations, so it would be difficult to confirm 100% of all positions as suggested by rule 17f-2. The performance of 17f-2 counts in such situations does not appear to be widespread.

FIN 45

FIN 45 requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee and that appropriate disclosure be included within the financial statements or notes to the financial statements. Many service provider contracts contain a general indemnification relating to nonperformance. The EP discussed whether such indemnifications were within the scope

of FIN 45, especially because FIN 45 technically applies only to those situations in which the guarantor must make payments based on changes in an underlying and there is no explicit underlying in most service providers' contracts. The EP decided that valuation (although such valuation would likely be zero) and disclosure would be best practice, although not required. The EP also felt that auditors should be looking more closely at contracts.

For venture capital funds, a guarantee of a portfolio company's debt would likely fall within the scope of FIN 45, because it would increase the value of the investment in the company but also create a corresponding liability. A commitment to make an equity investment in the next closing round would likely create a disclosure item under FIN 45, but the value of such guarantees would likely be zero.

Long-Term Reverse Repurchase Agreements

Some questions have arisen as to whether or not such agreements should be valued at cost or fair value. The EP expressed the view that because such agreements represent a fixed, determinable obligation of the investment company (basically constituting debt) and because investment companies must present other debt obligations at cost, it would be most appropriate for such contracts to also be presented at cost.

Negative Capital Accounts in Partnerships

In preparing financial statements, private investment funds should determine if the partnership agreements allow a capital account to become negative. If that is not allowed, it is strongly recommended that the financial statements contain disclosure of the provision in the agreement, the dollar amounts that the general partner would have to pay back under the clawback provision, and the general partner's ability to repay such amounts.

SAS 99

Historically, it has been difficult for auditors to obtain downloads of general ledger activity for investment company audits that are necessary in order to perform the computer-assisted auditing techniques suggested by SAS No. 99 relating to manual journal entries and closing entries, but audit firms are working towards this to create consistency among the practices. It was noted that the PCAOB has scrutinized the audit firms' procedures relating to journal entries during its ongoing examinations.

Other PCAOB Comments

The PCAOB has examined the tone at the top of the audit firms and has selected a number of engagements for testing. It has provided a number of comments during its examinations, including:

- Investment company auditors should perform some procedures to ensure that brokers sending back pricing confirmations are not biased.
- Gaining control reliance relating to dividend income would require testing controls at the entity providing the dividend information, such as FT Interactive.
- Auditors are required to conduct fraud discussions under SAS No. 99 and should ensure that all team members participate in such discussions.
- Auditors must fully document their work in order to prove that it was actually performed.
- Auditors may need to perform additional procedures when a SAS 70 report being used by the audit team does not cover the entire audit period.

REGULATORY ISSUES PRESENTED BY THE SEC'S DIVISION OF INVESTMENT MANAGEMENT

Financial Statement Review Process

The SEC believes that it is on track to meet the requirement to review the financial statements of every registrant within a three-year period.

The SEC spoke in particular about responses it has received from registrants. It indicated that it has received comments suggesting that the SEC is trying to “rule-write” by issuing comments during the review process. It indicated that that is not the case and encouraged registrants to contact the Division of Investment Management if they feel that there is a problem in the process. The SEC expressed disappointment, however, that some registrants have automatically defaulted to “show me specifically where we have to do this” after being provided a comment by the SEC, because the comments are designed to improve disclosures for the benefit of investors.

The SEC also commented on violations of Rule 19a and 19b of the Investment Company Act of 1940 by business development companies (BDCs) relating to the disclosure of capital gain distributions. Those rules require disclosure of the amount of the unrealized loss (when one exists) if the investment company distributes capital gains. Additionally, the SEC indicated that BDCs have often incorrectly calculated performance fees in violation of SEC rules. The performance fee percentage should be multiplied against realized gains and losses and unrealized losses, but unrealized gains must be excluded. In many cases unrealized gains have been included, resulting in an overpayment of fees. The SEC acknowledged that there are a couple of acceptable calculation methodologies that would permit the registrant to perform the calculations based on year-end balance totals or on the change in individual positions held during the year. Generally speaking, BDCs should review their calculations for compliance.

Dear CFO Letter

The SEC hopes to issue a Dear CFO Letter to the industry prior to year-end. Among the topics that will likely be addressed are the following:

- BDC issues described in the preceding section
- Components of net assets - Must be shown, even though the audit guide does not require this practice.
- Significant investment – If a fund’s assets include a significant investment (such as often is the case for fund of funds), financial information (such as financial statements or other information) for the investment should be presented in the fund’s shareholder report. The SEC does not expect to issue thresholds for determining when only financial information would be required and when financial statements would be required, other than that a 25% position would trigger the additional reporting requirement.
- PCAOB registrations – Firms auditing registrants must register with the PCAOB. Some examples of firms not doing so have been noted.
- Registered partnerships – Should be following SOP guidance for unregistered funds regarding the presentation of financial highlights.
- Affiliates – Current disclosure requirements, even for affiliated money market funds, should be followed.
- Fair value disclosures
- Change in accountant – SEC to discuss disclosure relating to a change in auditors.

OTHER MATTERS

Private Equity

The Private Equity Industry Guidelines Group (PEIGG) is working through valuation concerns. Being “conservative” in valuing investments is no longer acceptable, but much of the industry has been reluctant to write-up an investment until an IPO or some other specific event actually occurs, and market forces have not been asking for more accurate write-ups. Despite the issuance of PEIGG’s standards late last year, no change in the valuation process is expected at 12/31/04.

**AICPA Investment Company Expert Panel
December 1, 2004 Meeting Highlights**

PRACTICE ISSUES

Auditing Limited Partnership Capital Accounts

As a follow-up to the discussion held at the October meeting, it was again noted that some partnership agreements contain a provision requiring audits of partnership capital accounts at certain points during the life of the partnership. The accounting firms confirmed that, although audits of individual capital accounts could be performed under AICPA literature related to special purpose reports, the preference of many of the larger firms is to perform auditing procedures relating to supplemental information on capital accounts attached at the end of the financial statements as opposed to directly auditing partner capital activity. All of the accounting firms agreed that the extent of detailed work necessary in order to issue a report at the individual partner level (as opposed to the partnership level) would require the establishment of a materiality threshold based on the individual partner's capital account being reported on.

Schedule of Investments for Partnerships

The Expert Panel indicated that a private investment fund holding international securities may elect to categorize its holdings first by industry sector and secondarily by geographic region despite the fact that paragraphs 7.12 and 7.90 of the AICPA audit guide might suggest otherwise. Such would be true regardless of whether the fund was electing to present a full or a condensed schedule of investments. The key is to identify and disclose the most significant concentration risks. Ideally, they would be presented directly in the schedule of investments, but could also be include in the notes.

XRBL

The taxonomy for investment companies is due to be released for public comment on December 7. The SEC has issued proposed rule amendments (along with a companion concept release) that allow registrants, including investment companies, to submit tagged financial information using the XBRL format in certain filings with the SEC. Users will be able to sort information in any way they like based on certain "attributes" (e.g., financial statement line items or maturity dates of bonds) included in the taxonomy. Although the creators attempted to select all relevant items, the Expert Panel discussed the need for registrants to comment on the taxonomy to try to ensure that all possible attributes were identified. Although only publicly available information is included in the taxonomy, it will eventually become more granular and include data at the general-ledger detail level.

The audit firms are still trying to determine where their audit responsibility starts and ends relating to the tagged information and whether they may need to provide any

additional assurances. The AICPA's interpretation to Section 101 of the Statements on Standards for Attestation Engagements titled, "Attest Engagements on Financial Information Included in XBRL Instance Documents" contains relevant guidance for audit firms.

REGULATORY ISSUES PRESENTED BY THE SEC'S DIVISION OF INVESTMENT MANAGEMENT - BRIAN BULLARD

XRBL

The SEC is interested in understanding how many groups are planning to voluntarily file their financial statements under the XRBL format. The Expert Panel members indicated that some larger firms may be considering it, but that interest does not appear to be widespread at this point.

The SEC is considering whether or not registrants will need to re-certify their financial statements if they elect to amend filed N-CSR data with the XRBL format at a later date.

Financial Statement Review Process

The SEC acknowledged that it is currently conducting targeted reviews of certain entities (such as business development companies) to determine their compliance with reporting requirements and will likely conduct targeted reviews of certain types of funds sometime in the future.

Dear CFO Letter

The SEC is still working on a "Dear CFO" letter to the industry. The timing of its issuance is unknown.

19a Notices

If a distribution represents a return of capital, Rule 19a of the Investment Company Act of 1940, requires that a fund provide a notice to shareholders informing them of that. The SEC has noted a number of violations in this area, particularly among funds that pay stable dividends, like closed-end funds, and its Enforcement Division is involved. Brian Bullard indicated that groups should make an assessment at the time they make each distribution to determine whether a return of capital is being made. Such assessment should be made on a book basis, not a tax basis. Thus, if a fund has distributed more income than it has reported as being earned as of the date of distribution, it has a return of capital and must send a 19A notice, even if the distribution is not a return of capital from a tax perspective (generally referred to as a "distribution in excess" within the financial statements). For example, if a fund paid out a distribution on the 15th of the month based on earnings to date plus estimated earnings for the rest of the month, it would clearly have distributed more than it had earned as of the date of distribution and must send a

19A notice. Funds are permitted to disclose the circumstances surrounding any return of capital and to clarify that they do not believe the distribution will result in a tax return of capital.

Auditor Independence

The SEC has noted a number of independence problems relating to audit firms. Although audit firms have a responsibility to monitor their own independence, the SEC wants to remind fund boards that they are equally responsible. When a firm conducts an audit when it is not independent, the financial statements must be reaudited and reissued, creating additional business costs. One recent violation noted resulted from board members entering into joint ventures with affiliates of the audit firm. Another violation occurred when a former partner of the fund's audit firm served on the board of the fund while continuing to receive a pension from the audit firm. The recent examples involve situations that fund boards, fund management, and fund counsel should have detected. The SEC encourages groups to consult on independence matters directly with them.

The SEC requested that representatives from the various audit firms meet with the SEC to discuss the difficulties in applying the auditor independence rules in an investment company context. The Expert Panel members commented that most groups and firms would prefer to present situations on a no-names basis. Brian Bullard did not see this as a problem, as long as such situations are real and not hypothetical. The audit firms in the room agreed to consider meeting with the SEC as a collective group to present potential issues, which would help protect anonymity.

Some chief compliance officers (CCOs) have requested that audit firms confirm the procedures they have in place to ensure independence and to ensure that they keep client information confidential. Brian Bullard indicated that, while such requests were not required, he did not feel that they were unreasonable. The auditors who serve on the Expert Panel indicated that the audit professional standards are very detailed relating to the professional requirements that must be followed by each firm, and that most CCOs have been satisfied when the audit firm representatives just provide references to the professional standards.

AICPA Investment Company Expert Panel February 4, 2005 Meeting Highlights

AICPA EP Annual Meeting

The chairs of the various EPs attended the annual meeting and shared the current issues being discussed at each of their panels. When a consensus regarding an issue has been reached by an EP, the chairs determined that the most efficient way to release guidance to the public would be through a Technical Practice Aid (TPA), which represents the lowest level of GAAP. AcSEC has expressed its support for the release of TPAs for this purpose. The process will call for the respective EPs to document their conclusions and then to send them to AcSEC's Planning Subcommittee. Once a TPA is approved, an official release will be issued, and the EP's meeting minutes on the AICPA's website will then be updated to reflect the conclusion reached. TPAs are not subject to a comment period.

Real Estate

The National Council of Real Estate Investment Fiduciaries (NCREIF) is seeking specific guidance for those real estate entities now treated as investment companies under the audit guide. AcSEC's Real Estate Funds Project Task Force, which is chaired by Alan Latshaw, has met and is working through how to define an investment for a real estate entity. For example, should an entity consider property and a nonrecourse mortgage attached to it as one investment that should be valued as a whole? The EP noted that any conclusions reached by the task force may have implications for other investment types.

Audit Confirmations – Broker Signatures

The EP noted that a number of brokers have been refusing to sign auditor confirmations relating to derivative contracts. A similar issue was also discussed in 2004 relating to pricing confirmations. In addition, even when brokers do sign confirmations, the confirmation often contains a disclaimer relating to the accuracy of the information. In other instances, brokers are directing the auditors to a website where they can obtain information, such as prices, in lieu of sending signed confirmations, and those websites often contain similar disclaimers.

Some EP members also questioned the reliability of the confirmation in situations in which someone from the trading desk completed the confirmation as opposed to an internal audit group, because the trading desk might be motivated to provide a price more favorable to the fund.

As a best practice, audit firms should determine the appropriateness and reasonableness of the information on the confirmation reply. If an auditor receives a price confirmation

from a broker that it is not familiar with or from a broker that does not make a market in that financial instrument, it should evaluate the qualifications of the broker, determine if it is pricing the issue frequently, and assess whether or not it will be able to produce a reliable price.

N-SAR Internal Control Letter for RICs

The EP discussed the wording of the internal control letters that auditors of registered investment companies must issue and that investment companies include in Form N-SAR, as required by the SEC. The example letter contained in the audit guide currently includes a reference to the AICPA's definition of material weakness, not the PCAOB's definition, which is slightly different. The EP decided that the 2004 audit guide should not be updated for the new PCAOB wording, but that the 2005 conforming changes to the audit guide should include the new wording. The EP decided that in March 2005 it would begin to look at the necessary changes, agree on the revisions, and then discuss them with the AICPA and SEC. Two of the big four accounting firms reported that they had already made the changes in their own internal guidance; the other two have not.

There was also discussion as to whether or not the restricted use wording, which appears in the final paragraph of the letter, should continue, especially since the letter is publicly available on the SEC's website. The EP noted that removing the wording would make it a general use document and might imply that the audit firms are providing some level of assurance. Such is not the intended purpose of the letter, and removing the wording might expose the audit firms to more risk. It was also noted that the AICPA professional standards include a discussion of the appropriateness of restricted use wording in similar situations.

Necessity of CF Statement for Preferred Stock Issued by a RIC

Investment companies are exempt under FASB Statement No. 102 from presenting a cash flow statement, as long as they meet certain criteria, including holding very little debt. Mandatorily redeemable preferred stock issued by an investment company is generally classified on the statement of assets and liabilities between the liabilities and equity sections based on guidance provided by EITF D-98, "Classification and Measurement of Redeemable Securities." The EP members indicated that they did not feel that such preferred stock would constitute a debt obligation that would trigger a requirement for a cash flow statement. It was noted that this stance is consistent with a SEC position noted a few years previously. The EP did comment that, if a RIC violated one of its preferred stock covenants and was forced to redeem some of its stock, the RIC would need to reclassify the affected preferred stock as a liability under FASB Statement No. 150.

FSP 78-9a and EITF Issue 04-5

The EP discussed a draft comment letter, prepared by AcSEC's FSP SOP 78-9-a Task Force, on the FASB's proposed FSP SOP 78-9-a, *Interaction of AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures, and EITF Issue No.*

04-5, “Investor’s Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights.” The Task Force requested a broader conclusion as to how to apply the SOP to other partnership entities, such as hedge funds and venture capital funds. Although certain points were still worthy of a comment in the letter, they were deemphasized. Such comments include those that questioned the usefulness of general-partner consolidated financial statements to end users (particularly when the general partner has a nominal interest) and those that noted the link between the FSP/EITF Issue to FIN 46R.

The Task Force noted that it may be appropriate to treat large funds differently than small funds in determining whether or not the general partner would be deemed not to control the partnership if the investors (other than the general partner or any of the general partner’s related parties) in the limited partnership interests have the right to remove the general partner. For small funds, perhaps 100% of the limited partners should have to vote for removal in order for the GP to not have control; in larger funds, a majority may be acceptable. Thus, instead of requiring a “simple majority” as a standard, a “reasonable vote” may be more applicable.

The Task Force also noted that it is seeking clarification as to what constitutes “removal rights.” For example, if the LPs can force a partnership to liquidate significant positions, is that evidence of such rights?

Other issues of clarification that the Task Force has requested include (1) whether or not the exemption in the EITF for general partners that carry substantially all assets at fair value was intended to apply only to investment companies or whether it was intended to apply also to certain other entities like broker-dealers and (2) whether or not the level of “economic interest” described in the EITF would include all financial interests, including management fees and carried interests.

AcSEC’s letter to the FASB will be sent on February 17, and the Task Force does not anticipate any further communication with AcSEC prior to that.

Independence Standards

Any engagement letter relating to nonattest services should be included in the auditor’s working papers as evidence of the auditor’s independence under the AICPA standards (01-3). If an engagement letter is not issued, other documentation should be included within the audit file.

Valuing Private Equity Funds Trading on a Secondary Market

The EP discussed how to account for an interest in a private equity fund when an interest in the fund can be purchased on a secondary market for a price (often a discount) that is less than or greater than the NAV of the fund. For example, if a fund buys a PE fund for a 20% discount of the NAV of the PE fund, the fund should not automatically value the interest at the NAV on the next valuation date. In general, the EP concluded that funds should consider whether or not there is other existing information (such as a market price

from a recent transaction) that would indicate that a fund's fair value is more or less than the NAV of the fund. However, one would need to consider the facts and circumstances in each instance, understand why the deviation from the NAV exists (such as if the price represented a "fire sale" price, which would not be appropriate for valuation purposes), and then determine what the fair value truly should be, which may or may not be the NAV.

Interfund transactions

When a fund sells or buys holdings from a related-party fund, the FASB Statement No. 57 disclosures apply. EP members felt that such transactions (for example, 17a-7 transactions for RICs) should be disclosed in the aggregate in the notes to the financial statements.

CCO Reporting

As a follow-up to the October 1, 2004 meeting, the audit firms discussed progress made on the format and related guidance for a SAS 70 type report relating to compliance controls. The EP had previously determined that service providers might want to obtain such a report to provide to CCOs. Representatives of each firm have met and are drafting the wording and format of the report, as well as related guidance. Once completed, the EP will then present its proposal to the Auditing Standards Board (ASB). The EP hopes to have the information ready for the ASB's April meeting.

**AICPA Investment Company Expert Panel
March 22, 2005 Meeting Highlights**

PRACTICE ISSUES

FCM, IB, CPO Practice Aid

A task force consisting of members of the Broker-Dealer Expert Panel recently met to begin work on a practice aid for commodity pools. The task force recognizes that the audit guide for investment companies already provides general guidance for commodity pools, and, thus, has currently decided that the aid should focus on accounting and financial statement presentation matters for commodity pools that are not specifically addressed in the audit guide. The aid would likely include example financial statements as well. The task force will provide the Investment Company Expert Panel (EP) with a draft of the aid after its next meeting (scheduled for May 11), but welcomes any suggestions regarding the aid's content in the interim. The task force hopes to release it before December 31, 2005.

Technical Practice Aids

In July 2004, the EP discussed whether to develop technical practice aids (TPAs) to clarify several investment company accounting and financial statement presentation issues. The EP decided that the items discussed at that meeting were worth further consideration for a TPA. The EP members once again discussed the process at the March meeting and scheduled a conference call for April 11 to discuss the TPAs. The EP members will start with the original list of matters from the July 2004 meeting, consult with their own firms regarding the appropriate accounting treatment, and report back to the group at the April 11 meeting. Additionally, the EP members will suggest any additional TPA topics. Once potential TPAs have been agreed upon, they will be sent to AcSEC's Planning Subcommittee for review.

As previously noted at other EP meetings, any additional changes to the audit guide will not be considered authoritative GAAP, since the only standard setters that have the responsibility to create GAAP are the FASB and, for issuers, the SEC. Newer versions of the guide will be coded to reflect the fact that the old material contained in the audit guide is considered "level b" GAAP and the new material is nonauthoritative.

The EP decided that TPAs represent the best opportunity for it to share its views and provide some level of guidance, even though TPAs are nonauthoritative guidance. Each TPA may cover several topics (for example, several investment partnership questions and answers may be included in one TPA). However, a TPA could address just one question if the EP determines that to be purposeful.

To the extent that the EP has a desire to provide potential auditing guidance, a similar process could be undertaken with the Accounting Standards Board (ASB) for nonpublic

company issues. Auditing guidance for SEC registrants would need to be coordinated with the PCAOB in conjunction with the AICPA.

Broker Confirmations

The audit firms noted several disconcerting trends relating to confirmations, including the following:

- Brokers place a disclaimer on the confirmation response stating that they make no assurances that the information being provided is reliable.
- Brokers refuse to sign the confirmation response.

Both of these scenarios weaken the value of the confirmation. Auditors reported that such responses are fairly common for pricing confirmations, especially when the auditor attempts to confirm the price of an investment with a broker that does not price the investment for the fund. However, the SEC requires auditors of registered investment companies to re-value all securities using an independent price, so auditors need to obtain the confirmation. Of late, private fund auditors have also noted that prime brokers are inserting the same disclaimer on confirmations relating to custody. If the prime broker is not willing to confirm that it holds the assets, it seems unlikely that the auditor can rely on the confirmation for the potential error of existence.

To some extent, disclaimers are not new. The pricing services generally have some form of disclaimer. However, it seems that the disclaimers are becoming broader in terms of the items being disclaimed and that brokers are using them with more frequency. One member of the EP noted that Loan Pricing Corporation (also known as LPC) is an independent service that receives loan price “indications” from brokers and makes those prices available to its customers. Potentially, the use of a similar clearinghouse for the pricing of various security types could be helpful.

The EP discussed the issue with Brian Bullard, Chief Accountant of the Division of Investment Management of the SEC. Brian Bullard indicated he will discuss the issue with Gene Gohlke (Associate Director, Office of Compliance Inspections and Exams) and asked EP members to send him examples of the disclaimers. He questioned whether or not brokers are providing similar disclaimers to fund companies when providing them with a price quote. Although the EP did not believe so, it agreed to check. In a number of instances, the EP believes that brokers may provide fund groups with a quote over the phone or via e-mail.

Valuation of Financial Instruments

In order to value financial instruments, such as swaps, each brokerage firm generally develops one model internally that undergoes a serious review process by internal personnel prior to its use. In completing valuations for clients or in completing confirmations, individuals are expected to follow the model, but errors may occur and go undetected. Additionally, if the broker serves as the counterparty, the swap price

represents, in theory, the price the broker would use to unwind a transaction. However, in practice, the price used to unwind a deal may differ substantially depending on circumstances. Therefore, users cannot view the counterparty's price as being consistent with a price used to unwind the transaction.

Auditors noted that they often use internal specialists to help them assess the reasonableness of the assumptions used by the fund's management or counterparty to price the instrument. Although some brokers have benchmarked themselves against the G30 standards (best practice standards for valuing financial instruments that were developed by the Group of 30), auditors are not able to simply rely on the broker's claim that it complied with those standards, because the G30 standards are more focused on controls and governance and the auditor needs to substantiate each price separately.

Fair Value Exposure Draft (FV ED)

The FV ED would require firms to fair value liabilities associated with derivative contracts and would require the firm valuing the instrument to consider the creditworthiness of the issuer (similar to Concepts Statement 7). The EP discussed concerns that factoring the creditworthiness into the price may yield a valuation that entities may not be able to realize. It was noted that, if the broker were to assign the derivative to another party, consideration of the credit worthiness of the issuer would be irrelevant. The EP members agreed to discuss the issue of realization with their national offices.

Private Equity Valuation

In auditing the investments held within a private equity fund, auditors look at the general partner's process of valuing the investments, but do not form a conclusion that the price is actually correct. Generally, private equity firm do not write up the valuation of an investment without the presence of some external event (round of financing). Although the standards released by the Private Equity Investment Guideline Group (PEIGG) imply that write-ups may be necessary regardless of the occurrence of an event, most venture capital firms are reluctant to do that, given the uncertainty and subjective nature of the valuation. None of the audit firms reported noticing an increase in the number of investments involving valuation write-ups during the period under audit.

The emergence of a secondary market for private equity fund of funds may help establish a value for the underlying funds that are below their NAV, but the EP noted that many of these situations involve a distressed seller, which would not be representative of a price between a willing buyer and seller.

EITF 04-5

Although a final conclusion will probably not be released until June, it appears that the control model discussed in the most recent draft of EITF 04-5 will be retained and that general partners (GPs) will have to consolidate the limited partners (LPs) interest in

certain circumstances, even if the GP's financial investment in the partnership is very small relative to the interest of the limited partners. The EP noted that the GP's financial statements may be less meaningful after consolidation, and that some GPs of private equity funds have requested that lenders accept non-GAAP financial statements. Additionally, some general partners are planning to provide the limited partners with kick-out rights so that the general partners no longer "control" the partnership.

Investment Company Scope SOP

The revisions to the Investment Company Scope SOP have not been completed yet. An estimated date for finalization has not been determined. No changes from the conclusions reached in June 2004 are expected.

Total Return Calculations

Recording security purchases and sales on a trade date + 1 basis is an acceptable industry practice for registered investment companies. In order to comply with the 1940 Investment Company Act rules, registered investment companies record security purchases and sales on trade date for reporting purposes. Often, the fund accounting agent still records the transactions occurring on the reporting date on a trade date +1 basis, and the NAV used to execute shareholder transactions does not reflect any security trades occurring on the reporting date. Occasionally, when the fund accounting agent records the trades on trade date for reporting purposes only, the resulting NAV differs slightly from that used to execute shareholder trades. The EP decided that, in calculating the total return of the fund, the NAV used for reporting purposes (and presented on the statement of assets and liabilities and financial highlights) should be the same one used to calculate the total return percentage shown in the financial highlights. If a firm elects to use the initial NAV, auditors should assess the materiality of the difference. If there were no distributions during the period, the reader of the financial statements would be able to calculate the total return of the fund based on the NAVs shown in the financial highlights table. Thus, in such circumstances, the NAV used for reporting purposes should be used for the calculation of total return regardless of materiality.

Investment Partnership Accounting/Disclosure Questions

Offering Costs – The audit guide specifies the following treatment for offering costs:

8.24 Offering costs of closed-end funds and investment partnerships should be charged to paid-in capital upon sale of the shares or units. Offering costs of open-end investment companies and of closed-end funds with a continuous offering period should be accounted for as a deferred charge until operations begin and thereafter amortized to expense over twelve months on a straight-line basis.

Although the guide does not specifically permit a partnership to amortize offering costs over twelve months, many partnerships that continually offer interests have adopted this

treatment. The EP discussed the initial drafting of this paragraph and determined that the initial intent was that funds should be able to amortize the costs over the offering period (not to exceed 12 months). Thus, investment partnerships that continuously offer their interests should be permitted to amortize the offering costs. For funds that do not continuously offer their interests, the offering period ends immediately with no amortization permitted. Brian Bullard also noted that this is consistent with a conclusion reached on a similar issue a couple of years ago.

Presentation of U.S. Government and Agency Securities – SOP 03-4 requires funds to present all issues of an issuer in the schedule of investments (SOI) if the total position for the issuer exceeds 5% of net assets. A question arose as to how one should present U.S. Government or Agency securities. For example, if more than 5% of a fund consisted of U.S. Government Treasury securities, would the fund need to list each individual security, or could it just show the applicable ranges of maturities and coupon rates? The EP indicated that many practices exist, including full disclosure of each issue as well as disclosure of the top 50 issues and all of those greater than 5% of net assets (similar to the requirements in the SEC’s summary SOI rule released in 2004). However, the EP decided that presentation of the ranges would be acceptable in most cases. Additionally, Brian Bullard indicated that, although the S-X rules do not technically permit funds to present a range of maturities and coupon rates in the full SOI (except for short-term securities held by non-money market funds), the SEC would not object to registrants presenting such securities in that manner.

Presenting of Commissions Expense – General partners of commodity pools sometimes charge the pools a fixed fee or fee percentage designed to cover any commission charge that might be incurred, as well as other operating expenses or selling costs. Some commodity pools include this charge in trading gains (losses), while others include it in the operating expenses and in the expense ratios. Neither the audit guide nor SOP 03-4 prescribes the proper treatment. Although the EP members did not have much practical experience with the issue, the EP agreed that the following treatment seemed most logical:

- If the cost is transaction-based (the GPs charge to the pool was equal to the amount incurred for each transaction), then it should be presented as part of gains/losses.
- If the cost is not transaction-based, the entire amount of the charge (including the amounts relating to commissions) should be presented as an expense.

If the GP is receiving excessive amounts, a different categorization may be required.

Disclosure of Realized Gains – Tax elections, including an IRC Section 475 election for mark-market accounting, should not alter the presentation of realized gains/losses in the financial statements. Even if an unrealized gain/loss is considered “realized” from a tax perspective, it may not be presented along with “realized gains/losses” in GAAP-based financial statements.

UPDATE ON CURRENT PROJECTS

SEC UPDATE

XRBL

Unless a major flaw is noted during the pilot program, the SEC believes the XRBL will be the next technology used to file data on EDGAR. The SEC recognizes that the XRBL taxonomy for investment companies has not been completed yet and that fund groups have been focused on dealing with many regulatory issues. Still, it would like the fund industry to soon focus on the impact of XRBL and would like representatives to serve as volunteers for the pilot program in order to detect any potential flaws that may affect investment management. Any questions can be directed to Brian Bullard or Toai Cheng.

Insurance Company Depositors

The SEC recently issued a letter to address concerns raised by nonpublic insurance companies that are required to include audited financial statements in filings made in connection with the offering of variable insurance products that are registered with the SEC. The letter indicates that “certain insurance company depositor or sponsor financial statements included in the registration statements of variable annuity and variable life insurance contracts” may be “audited in accordance with either the auditing standards of the Public Company Accounting Oversight Board or generally accepted auditing standards issued by the American Institute of Certified Public Accountants Auditing Standards Board,” while the SEC is considering whether or not the depositor constitutes an issuer under the Sarbanes Oxley Act.

Financial Statement Review Process

The SEC has been providing oral comments on its reviews of financial statements to registrants. Brian Bullard indicated that formalizing comments in writing would require an extensive review internally at the SEC prior to the release of the comment(s). Thus, the SEC’s current policy is to put its comments in writing only if it plans to require a restatement of the financial statements. If a reviewer makes a comment, and the registrant does not agree with the staff, the registrant may raise a question to Brian Bullard’s office, which will appoint an assistant chief accountant to assist.

The SEC continues to note deficiencies in business development company reporting.

The SEC is focused on excess expense plans. It has been questioning groups on why they have not recorded a liability for the reimbursement of excess expenses payable to the fund adviser. Brian Bullard indicated that groups need to consider FASB Statement No. 5 and demonstrate why the fund does not need to record a liability. In some cases, the period of recapture is fairly short (such as eighteen months) and it is unlikely that the

fund will have to pay the adviser. However, the SEC has noted circumstances (including those with recapture periods of three years) in which it has questioned the decision not to record a liability.

Other Reporting Issues

The SEC has not noted a number of issues/concerns with the new expense tables or N-Q filings, but would not rule out the issuance of an FAQ if necessary. A couple of comments that the SEC has provided:

- a. *Expense Example* - If the fund or class has been in existence less than 6 months, the actual return example should present expenses for the abbreviated period, whereas the hypothetical return example should present expenses for the entire six month period to make it comparable to other funds.
- b. *N-Q* – A feeder fund must include a presentation of the master fund’s holdings. For example, if the feeder has a 12/31 year-end, its first quarter N-Q must include the holdings of the master fund as of 3/31.

OTHER

N-SAR Letter

The EP decided that it will begin drafting a model form N-SAR letter to be included in the next audit guide. The new model will include the PCAOB’s definition of material weakness.

**AICPA Investment Company Expert Panel
May 5, 2005 Meeting Highlights**

PRACTICE ISSUES

Audit Reports

Form N-SAR Internal Control Letter – The Expert Panel (“EP”) decided that the illustrative example of the Form N-SAR internal control letter in the AICPA Audit and Accounting Guide, *Audits of Investment Companies* needed to be revised in order to update it for PCAOB-related references and for the PCAOB’s definition of material weakness, contained within PCAOB Auditing Standard No. 2, which differs from the AICPA definition. The auditors on the EP discussed a draft version that had been created by one of the Big Four accounting firms. Once the firms have agreed on the revised wording, the firms will need to meet with the SEC and the PCAOB to gain approval prior to inclusion in the Guide.

Audit Opinion – Contained within AU Section 9508 (Auditing Interpretations 17 and 18) of the AICPA Professional Standards is example wording that an auditor may elect to include in his or her audit report when an auditor is not expressing an opinion on the effectiveness of internal control over financial reporting. The AICPA’s Center for Public Company Audit Firms has also provided draft wording. The auditors on the EP discussed a draft version incorporating the optional wording that had been created by one of the Big Four accounting firms. The accounting firms decided to include the optional wording in italics, parenthesis, or via footnote disclosure in the illustrative example contained within the audit guide.

Irish DWT Report

In 2004, the EP discussed a draft version of a letter that independent auditors could prepare and provide to a fund for submission to the Irish tax authority relating to the residency of a fund’s shareholders for purposes of obtaining an exemption from the Irish withholding tax on dividend income. The EP noted that the Irish tax authority is now accepting self-certifications from funds as an alternative to the issuance of letters by the auditing firms. For this reason, the EP does not believe it is necessary to include a version of the report in the audit guide. One member of the EP noted that auditing firms were still being asked to provide a similar report for U.S. manufacturing companies with subsidiaries in Ireland, because the same self-certification mechanism does not exist.

ACCOUNTING GUIDANCE

Technical Practice Aids

The EP continued its discussion of potential TPA topics.

The May 5 discussion was a follow-up to an April 11 conference call in which the EP voted to proceed with 2 TPA topics and delayed a vote on two others. The topics, all of which pertain to nonregistered investment companies, included—

- Disclosure of an underlying that is a security in a condensed SOI
- Establishing the determinant for the 5% test, for disclosure, when an underlying is a basket of individual securities or funds
- Comparative SOIs
- Accounting for general partner clawback obligations
- Disclosure of soft dollar arrangements
- Netting of payables and receivables
- Treatment of deferred fees
- Presentation of purchases and sales of investments in the statement of cash flows
- General partner carried interest
- Boxed positions in the schedule of investments
- Offering costs
- Reverse repurchase agreements

**AICPA Investment Company Expert Panel
July 15, 2005 Meeting Highlights**

PRACTICE ISSUES

Independence – The public accounting industry, represented by the Big Four accounting firms and two other accounting firms, met with representatives of the SEC on July 13 to discuss independence issues relating to the definition of the investment company complex. Those members of the Expert Panel (EP) who attended the session described the session as being interactive. The SEC seemed very interested in pursuing the subject further and indicated that they would like to meet with representatives from the investment company industry and, potentially, audit committee representatives, in order to better assess the issue. The SEC also noted that it may consider combining the issue with similar concerns raised by the accounting firms relative to private equity funds.

Audit Reports

Form N-SAR Internal Control Letter – The EP continued its discussion on updating the Model Form N-SAR internal control letter in the AICPA Audit and Accounting Guide *Audits of Investment Companies*. The firms agreed to finalize the current draft by Friday, July 22 and then to send it to the SEC for its review. Brian Bullard, Chief Accountant of the Division of Investment Management, noted that the PCAOB should review the letter and that he would consult internally within the SEC to determine who at the PCAOB should review it.

The EP noted that a 10-day lag currently exists between the filing date for Form N-SAR (60 days after fiscal year-end) and Form N-CSR (10 days after the annual report is transmitted to shareholders). Form N-CSR requires management to disclose its conclusions regarding the effectiveness of its internal controls and to disclose any material weaknesses to the independent auditors. The EP noted that there is a chance that:

- a. The auditor's N-SAR letter may not disclose a material weakness (because management did not disclose one to the auditor), but Form N-CSR does.
- b. The auditor's N-SAR letter discloses a material weakness, but Form N-CSR does not.

It was noted that auditors should be reviewing Form N-CSR prior to its filing (because the audit report is included within Form N-CSR). If *a* occurs, auditors may elect to re-issue their letter. If *b* occurs, auditors should mention the inconsistency to fund management during their review. Regardless, the EP decided that the next audit guide update should explain that auditors should be reading Form N-CSR prior to its release.

The EP noted that the SEC is considering eliminating Form N-SAR and potentially moving any pertinent items to Form N-CSR.

Audit Opinion –AU Section 9508 (Auditing Interpretations 17 and 18) of the AICPA Professional Standards contains illustrative wording that an auditor may elect to include in his or her audit report when an auditor is not expressing an opinion on the effectiveness of internal control over financial reporting. It was noted that two of the big four firms are currently using the wording (or wording derived) from the Interpretations. The EP discussed two proposed examples (one for registered investment companies and one for nonregistered investment companies) that have been drafted for potential inclusion in the next update of the audit guide. The EP agreed to finalize the audit opinions, which would be included as additional examples in the audit guide for those auditors interested in using the internal control wording, by the same July 22 deadline.

The EP was not aware of the timing of the next audit guide update, but did plan to confer with AICPA representatives.

ACCOUNTING GUIDANCE

Technical Practice Aids – The EP continued its discussion of potential TPA topics from the previous meeting and the following new issues:

- Reverse repurchase
- Financial highlights for funds issuing series
- Recognizing premiums/discounts on fixed income positions sold short

The following five TPAs were sent to AcSEC's Planning Subcommittee in May:

- Disclosure of long-short positions in a condensed SOI
- Disclosure of an underlying that is a security in a condensed SOI
- Boxed positions in the condensed schedule of investments
- Comparative SOIs
- Presentation of purchases and sales of investments in the statement of cash flows

SEC UPDATE

Brian Bullard and Toai Cheng of the SEC provided the following updates:

SEC Personnel Changes

Recent personnel changes (Chairman Donaldson and Paul Roye) will likely result in a slowdown in regulatory action at the SEC.

XBRL

The XBRL taxonomy for investment companies has been finalized and is available at the following web site: <http://xbrl.org/us/fr/gaap/im/2005-06-28/us-gaap-im%20Summary%20Page.htm>. The SEC will be attempting to upload the taxonomy into EDGAR, with the hope that it will be available for public use in the next month or so. Filers from any industry may voluntarily file using XBRL, but do not have to announce in advance to the SEC that they plan to use XBRL.

XBRL is widely used internationally, but the differences in financial statements from one industry to another (and even within the same industry) make the use of XBRL here in the U.S. difficult. The SEC is aware of only a few voluntary filers (including Bowne and RR Donnelly). Despite the lack of strong interest from any industry (including investment companies) and although this was an initiative pushed by former Chairman Donaldson, support still exists within the SEC for XBRL. The SEC will evaluate the benefits of the XBRL format over a period (unofficially estimated to be at least two years) and make a decision on its continuance at that point.

The SEC noted that the PCAOB recently issued an FAQ on XBRL: http://www.pcaobus.org/standards/staff_questions_and_answers/xbrl%20financial%20reporting_2005-05-25%20.pdf.

Depositor Financial Statements

The SEC has noted instances in which an insurance separate account depositor has a guarantee or support arrangement with an affiliated entity but has inappropriately failed to include the affiliated entity's financial statements. Similarly, the SEC has noted instances in which the depositor's financial statements do not disclose a credit enhancement that an internal or external party may be providing. The purpose behind these disclosures is simply to allow the financial statement user to determine whether the depositor will be able to fulfill its obligations.

Audit Confirmations from Brokers

Often brokers fail to sign audit confirmations or explicitly disclaim responsibility for their confirmation responses. The EP discussed this issue previously with the SEC, and Brian Bullard indicated that the SEC will consider whether there is anything it can do to assist the audit firms.

SEC Financial Statement Review Process

- *Performance Fees* – Errors have been noted in the calculations of performance fees. Also, the SEC indicated that it expects the following financial statement disclosures relating to performance fees:
 - Description of how the fee is calculated
 - Identification of the benchmark
 - Frequency of accrual and payment

— Use of breakpoints

Additionally, the registration statement should contain examples of the calculation.

- *19a Notices* – Financial statement notes should disclose the need for a 19a notice (due to a potential return of capital situation), if applicable.
- *Fair Value Disclosures* – The SEC is looking for a less boilerplate description of how the investment company calculates fair value, but confirmed it does not expect to see information on the specific triggers being used or anything else that might provide information that an arbitrageur could use to market time the fund. Instead, the SEC expects a more general description of the factors the valuation committee is using to fair value each type of security held.
- *Comments* – If registrants believe the comments from a reviewer are unfair, registrants have the right to request a discussion with the Chief Accountants' office to review the matter.

Predecessor Auditor Reports – N-1A filings should either contain or incorporate by reference the audit reports of a predecessor auditor for at least as long as financial statements audited by the predecessor firm are included in the annual report. Practically speaking, because the statement of changes includes two years, as long as the statement of changes audited by the predecessor firm is included in the annual report being included in the N-1A filing, the predecessor auditor's report and consent should be incorporated/included in the N-1A filing.

Brian Bullard noted that, although the SEC accepts this practice, the true requirement would imply that the respective audit reports and consents should be included for each year of financial highlights included in the report, which registrants generally are not doing.

FCM, IB, CPO Practice Aid

Recently, a task force consisting of members of the Broker-Dealer Expert Panel met to begin work on a practice aid for commodity pools. One member of the EP who serves on that task force indicated that the first draft of the practice aid will likely be finished during the week of July 18. The aid will focus on accounting and financial statement presentation matters for commodity pools that are not specifically addressed in the audit guide for investment companies, including fund of fund-related issues.

Funds of Funds

The EP noted that available accounting and SEC sources of guidance do not significantly address the presentation and accounting issues currently faced by funds of funds. The EP

decided to form a subcommittee to draft guidance relating to funds of funds and to present such guidance to the SEC for its consideration. Brian Bullard indicated that the SEC would be willing to review any such drafts.

**AICPA Investment Company Expert Panel
September 1, 2005 Meeting Highlights**

PRACTICE ISSUES

Independence

As a follow-up to a meeting between the audit firms and the SEC relating to the definition of the investment company complex (ICC), the SEC has expressed an interest in holding a follow-up meeting with representatives from investment companies and potentially their audit committees to gain their perspectives on the definition of the ICC and the need for any clarifications or revisions.

Form N-SAR Letter

The Form N-SAR letter draft that the EP has been revising was recently sent to the SEC for its comments. The SEC provided the name of a PCAOB contact who could facilitate the PCAOB's review, as the PCAOB will also need to review the letter. Members of the EP expressed concern that those audit firms that are not represented on the EP may not receive a copy of the letter in a timely fashion. Normally, such guidance appears in the audit guide, but as the PCAOB AS2 requirements necessitating the changes are effective for all funds with years ending on or after July 15, 2005, and since a draft of the revised audit guide will not be available for a few months, as firms will not be able to obtain a copy used by everyone else. The AICPA agreed to consider ways to distribute the Form N-SAR letter, once finalized, to the accounting firms not represented on the EP.

The SEC indicated that, unlike an audit opinion, an investment company's registration and ability to sell shares would not be affected if an auditor failed to issue a properly worded internal control letter for Form N-SAR. However, the SEC commented that its examiners do review the internal control reports included in the Form N-SAR filing.

ACCOUNTING GUIDANCE

Technical Practice Aids – The Chair reported that AcSEC's Planning Subcommittee approved the following TPAs in July:

- Disclosure of long-short positions in a condensed SOI
- Disclosure of an underlying that is a security in a condensed SOI
- Boxed positions in the condensed schedule of investments
- Comparative SOIs
- Presentation of purchases and sales of investments in the statement of cash flows

The EP also continued its discussion of other proposed TPAs.

SEC UPDATE

SEC Personnel Changes

The SEC commented that the new Chairman, Christopher Cox, is focused on making the rules more straightforward and promoting “plain English” disclosures. The SEC also noted that there has been no movement on appointing a successor to Paul Roye.

SEC’s Risk Management Assessment

The SEC has held meetings with investment management firms to see how they assess risk. The SEC would like to talk with several accounting firms about how they assess their own business risk and the procedures/tools they use in that process (client acceptance practices, etc.).

Performance Fees

The SEC reiterated its commentary from the last meeting. Registrants need to clearly disclose how a performance fee arrangement works, which includes identifying the specific benchmarks and describing the measurement period and frequency of payment. The SEC asked registrants to consider FASB Statement No. 57, as it is relevant to related party disclosures.

Commission Recapture

The SEC indicated, as it has previously, that if a registrant receives cash as part of a commission recapture program, that cash should be presented as an adjustment of basis or as a gain. If the broker pays one of the fund’s expenses instead of providing cash, then the registrant should gross-up the related expense line item and present the payment below the gross expenses line on the statement of operations.

Business Development Companies

The SEC noted a number of reporting errors it has observed in BDC filings:

- a. Some BDCs are not following Article 6 of Rule S-X and are not presenting the typical investment company financial statements. Instead, they are incorrectly filing normal operating company financial statements. The same is true for public commodity trading pools. Some EP members noted that the Division of Corporate Finance (Corp Fin) did not permit certain commodity pools to follow investment company accounting in recent filings. The commodity pools will clearly fall within the scope of the audit guide once the SOP clarifying the scope of the investment companies Guide is issued. Corp Fin will need to be made aware of the finalization of the SOP.

- b. Some BDCs are not properly preparing financial highlights in accordance with the audit guide and Form N-2.
- c. Some BDCs are not properly accruing and disclosing performance fees.

Distributions

The SEC continues to scrutinize closed-end funds that advertise a level dividend but end up returning capital. The SEC reminds registrants that they must send a 19a notice per the 1940 Act rules describing that the distribution contains more than just income. Additionally, semi-annual financial statements should indicate that the distributions the registrant has paid year to date might be characterized differently at the end of the year. The SEC noted that the 19a rules are based on “good accounting.” The SEC’s view is that this means accounting based on GAAP and not on tax rules (as commonly believed), but its prime focus is on egregious violations of the rule.

Timely Submission of Financial Statements

The SEC noted that there have been a number of late filings of financial statements by registrants. The SEC reemphasized the following:

- a. Proper officer certifications must be included in all filings.
- b. When appropriate, an affirmation from the auditor must accompany a late submission.
- c. Registrants have a requirement to mail their reports on time to their shareholders even if the filing will be late.

Comments on New Filings

- a. N-Qs – Most N-Qs have been in good shape. The SEC commented that some registrants had failed to include derivative positions, which is a requirement. The SEC is also looking for more complete disclosures.
- b. Graphical Holdings Requirement – Securities purchased with cash collateral should be included in the graphical holdings section. Some registrants have been excluding such securities.
- c. Expense Tables - Some registrants have been presenting annual amounts instead of semiannual amounts.

Financial Highlights for Nonregistered Funds

If the financial highlights for a nonregistered fund are included in the notes to the financial statements and are not included as a separate schedule, the EP concluded that a reference to the financial highlights would not be required.

Back Taxes on UK Tax Issue

Earlier this year, many funds with UK investments realized that they had made a Section 853 election and incorrectly accounted for dividends using the pre-April 30, 2004 method. The EP noted that the advisers of most registrants facing this issue have paid for associated costs (such as settlement costs with the IRS), as opposed to charging the funds for the related expense.

**AICPA Investment Company Expert Panel
November 2, 2005 Meeting Highlights**

Form N-SAR

The PCAOB and SEC have approved the Form N-SAR letter version prepared by the EP. The AICPA will be publishing the version of the N-SAR letter on its website so that all public accounting firms have access to it.

It was also noted that the definition of material weakness for purposes of the 302 certification may differ from that which appears in PCAOB Auditing Standard 2.

17ad-13 Examination Letter

One EP member noted that the 17ad-13 examination report example contained in the AICPA Accounting and Audit Guide *Investment Companies* is based on guidance provided by AT 501, which has been superseded by PCAOB Auditing Standard No. 2. The EP member will suggest updates to the report example and provide it to the EP at a later date for review.

Partner's Capital Reports

For many reasons, audit firms prefer not to issue audit reports on specific partners' capital balances. It was noted, however, that the Independent Capital Partners Association (ICPA) has issued guidelines requiring partner capital reports. Some large pension funds also require audited partners' capital statements.

Fair Value Exposure Draft

The EP discussed a few relevant issues relating to the FASB's exposure draft on fair values. The FASB published in October a working draft that incorporated all of the Board's deliberations to date.

- a. Hedge Funds – The ED indicates that securities that are not publicly traded should be valued at a discount. The EP discussed whether or not this would be applicable for hedge funds, since they are not publicly traded. In most circumstances, a discount would not seem to be appropriate.
- b. Private Equity – The ED indicates that discounts may be based only on legal restrictions. The EP discussed what may constitute a legal restriction, but did not conclude.

SEC UPDATE

Representatives of the Chief Accountants Office – Division of Investment Management joined the EP meeting and provided commentary on a variety of topics.

Taxes

The SEC shared its views related to the proposed Interpretation of FASB Statement No. 109 and taxable RICs.

- **Aggressive Uncertain Tax Positions** - The SEC noted that it believes that some uncertain tax positions should be disclosed in the notes to the financial statements. For example, a small number of funds may take aggressive tax positions relating to income recognition for the gross income test under Subchapter M or may borrow large sums of money at the end of a quarter in an attempt to achieve the diversification required under Subchapter M, even though the fund is not properly diversified in reality. If asked, the IRS may not support these practices. The SEC believes that disclosure of these types of aggressive tax positions is required in order to meet the standards established in SOP 94-6 relating to uncertainties (similar to what might be disclosed in the prospectus) and is looking for this during its examinations and reviews.
- **Taxable RICs** – A growing number of RICs, especially master limited partnerships, are electing to be treated as taxable entities (instead of seeking qualification under Subchapter M of the IRC). The SEC indicated its preference for such entities to present separate expense ratios in the financial highlights that illustrate the expense ratio before taxes and after taxes and to disclose the effect of taxes on the total return. The SEC noted that taxes on capital gains and unrealized appreciation should be included in the after-tax ratios, although it acknowledged that Form N-1A and N-2 do not require that and that such taxes are not included as expenses on the statement of operations. The SEC believes that including those taxes is necessary to illustrate the total taxes incurred by these taxable funds. The SEC does not believe that such is necessary for funds electing to qualify under Subchapter M.

Settlements with the Attorney General

Some funds have entered into settlements with the Attorney General (AG) that require reductions in fees or require funds to subsidize expenses over a period. Some of the settlements require the presentation of a fee table that might differ from the table required to appear in the prospectus. In such cases, the registrant may need to present two tables and explain why the table requested by the AG has been included. The registrant should not exclude or modify the table required by the SEC.

An EP member inquired as to whether or not the SEC had noted any instances in which the registrant had failed to include all of the disclosures required by the settlement order.

The SEC indicated that it has not noticed any missing disclosures, but acknowledged that it has not specifically looked for this during its reviews.

XBRL

Chairman Cox is a supporter of XBRL. Although the SEC may not elect to go with XBRL after the current pilot program ends, RICs should consider voluntary filing using XBRL so that the industry can provide some feedback to the SEC on any problem areas relating to the application of XBRL to investment companies. The SEC also noted that one or two fund service providers are considering using it or adding it to their platforms.

OTHER ACCOUNTING/REPORTING CONSIDERATIONS

Technical Practice Aids

The EP discussed revised versions of proposed technical practice aids on deferred fees and clawbacks.

Consolidation of a RIC by its Adviser

An adviser that has a controlling interest in a RIC that it manages generally needs to consolidate that RIC for GAAP purposes. Such a controlling interest may occur at any point during the life of the fund, but is especially common in the early stages of a fund, for example, if the adviser has seeded the product and no other parties have invested.

The EP discussed whether or not an adviser would be required to consolidate a portfolio within a series company if the adviser held a controlling interest in the portfolio but did not have a controlling interest in the series company as a whole. Although the series company (and not each portfolio) is the registrant, the EP noted that each portfolio has its own shareholders and is essentially a separate entity. For that reason, it would seem appropriate to consolidate the portfolio company even if the adviser does not have a controlling interest in the series company as a whole.

CURRENT PROJECTS

Fund of Funds Project

In the fall, the EP submitted to the AICPA a list of considerations relating to the financial reporting and auditing difficulties associated with a fund of funds with the hope that AcSEC might sponsor a project to develop fund of funds guidance. Due to restructuring within the AICPA, there have been no developments relating to this project.

**AICPA INVESTMENT COMPANY EXPERT PANEL
DECEMBER 1, 2005 MEETING HIGHLIGHTS**

PUBLIC ACCOUNTING FIRM ISSUES

17ad-13 Examination Letter

At the November 2 meeting, one EP member noted that the 17ad-13 examination report example contained in the AICPA Accounting and Audit Guide is based on guidance provided in AT 501, which has been superseded by PCAOB Auditing Standard No. 2 (AS2). The EP noted at the December 1 meeting that it could consider rewriting the 17ad-13 report using AS2 or it could request relief from the PCAOB, especially since the 17ad-13 report does not relate to financial statements. The EP also noted that, since a public accounting firm does not need to be registered with the PCAOB in order to issue a 17ad-13 report, auditors may not need to follow the report wording in AS2. The EP decided to discuss this further at future meetings.

Audit Opinion

The EP voted to add to the audit guide an illustrative report for those auditors electing to highlight in their audit reports that they did not audit the internal control of a registered investment company.

ACCOUNTING/FINANCIAL REPORTING ISSUES

Return of Capital

At the request of the Real Estate Investments Task Force, the EP renewed its discussion of how an entity (such as a real estate fund) should determine if a distribution it receives from an investment (such as a property or a fund) is a return of capital for financial reporting purposes. The EP noted previously that essentially all entities would make that determination on a tax basis; quite commonly, they receive only tax basis distribution

information from the investee entity. However, the Real Estate Investments Task Force indicated that it had identified some investment companies that were making such determinations on a book basis and asked the EP to clarify which position was correct.

The Real Estate Investments Task Force noted that some real estate funds make the determination based solely on operating cash flows, which essentially represents a book basis without depreciation. The EP concluded that this is not a preferable method for determining return of capital.

At the November 2 meeting, the EP drew a parallel to the recording of distributions made by REITs. When a fund holds a REIT, it typically reviews the capital gain and income distributions it receives and determines, based on current and historical tax information, what percentage of those distributions represent a tax (not GAAP-based) return of capital. Funds then generally reclassify such amounts as a reduction in cost in GAAP-based financial statements. The EP noted that the tax basis may make more economic sense and may be the only information available. However, one participant at the December 1 meeting noted that public information relating to REIT distributions is available on a book basis within 10-Ks and 10-Qs, since REITs are registered with the SEC, although such information may not be available as frequently as a fund needs it.

Since the financial statements are prepared on a GAAP basis, one might naturally conclude that return of capital distributions should be determined on a book basis as well. The audit guide does not provide clear guidance, although it does indicate that the statement of changes should separately report a return of capital distribution determined on a tax basis for investment companies that have *distributed* a tax return of capital. Drawing a similar parallel might imply that an investment company should use the tax basis to determine whether or not distributions it *receives* represent returns of capital. However, EP members involved in drafting the audit guide in the 1990s believed that making the determination on a tax basis was the intention.

The EP concluded that making the determination on a tax basis is more appropriate and that it would draft a proposed TPA to support that position.

Financial Highlights when Side Pocket Investments Exist

Many funds provide certain investors with the rights to income and gains from a specific investment at the date an investment is made (“side-pocket investments”). This is often done for private equity investments. In accordance with SOP 03-4, most domestic partnerships present financial highlights for the limited partner class as a whole and do not present financial highlights for investors with rights to the same side-pocket investments as if they were a separate class. The EP concluded that that was appropriate, but that supplemental ratios could be permitted if a fund wanted to present them.

It was noted that many offshore funds actually establish a legal class for those investors with rights to the same side-pocket investments, and that funds do provide separate financial highlights for each such class as opposed to presenting financial highlights for the nonmanaging investors as a whole.

SFAS 150 Issues

- *Small Business Investment Companies (SBICs)*. A number of SBICs have issued what is called a "participating preferred" security to the SBA. It is a type of mandatorily redeemable preferred interest that pays a fixed coupon rate plus a participation in the profits (if any) of the SBIC. The shares are all held by the SBA directly, which can detach the preferred stock from the profit participation and sell the preferred stock. Current practice has been to disclose the participation amount contingently payable to the SBA in the notes to the financial statements. A question has arisen as to how to classify these participating preferred securities when implementing SFAS 150 in SBIC financial statements under GAAP.

Most of the EP members had no experiences with the product, but some have considered it a liability under SFAS 150 because of the mandatory redemption feature. The EP did not conclude whether or not the participating feature could be considered an embedded derivative that should be bifurcated from the preferred security and valued at fair value.

- *Hedge Funds.* Footnote 1 of FSP 150-3 provides for differing deferral dates for SEC registrants and non-SEC registrants. The FSP defines SEC registrants as entities, or entities that are controlled by entities, (a) that have issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (b) that are required to file financial statements with the SEC, or (c) that provide financial statements for the purpose of issuing any class of securities in a public market. The EP considered three situations in which one may question whether or not a hedge fund is considered a registrant:
 1. A hedge fund that is registered on a stock exchange solely for the purposes of meeting investor eligibility requirements but does actually trade would not be considered an “SEC registrant” for purposes of the FSP 150-3 definition. The FSP 150-3 definition refers to entities “that have issued or will issue debt or equity securities that are traded in a public market.” A listing without any expectation of trading, and in which no trading actually occurs, would be inconsistent with that definition.
 2. If a general partner of a hedge fund is an SEC registrant and is not required to consolidate the nonregistered hedge fund under either EITF 04-5 or FIN 46, then it may be presumed not to “control” the partnership. Because the fund itself is not an SEC registrant, and is not “controlled” by a registrant, the fund similarly would not meet the definition of an “SEC registrant.”

3. If a general partner of the hedge fund is an SEC registrant (or wholly owned subsidiary thereof) and consolidates the nonregistered fund under EITF 04-5, FIN 46, or another standard, it is unclear whether or not the fund itself would be considered a registrant. One theory is that the general partner may be presumed to “control” the partnership. Because the partnership is controlled by an “SEC registrant,” the partnership is not eligible for the deferral provided under FSP 150-3. This could lead to inconsistency in the industry, as some funds may be following SFAS 150 reporting because they are considered registrants, whereas other funds would not be. This inconsistency would potentially hurt an investor’s ability to compare financial statements.

The EP did not conclude, but acknowledged that IFRS will require partnership interests to be presented as liabilities, which will affect the comparability of financial statements with those prepared under GAAP. The EP will continue to consider the issue and will determine whether or not to approach the FASB on this issue.

529 Plans with Stable Value Options

The EP discussed the valuation of stable value plans subject to GASB (not FASB) standards. GASB 31 requires entities to report investment contracts with redemption values tied to market rates at fair value; those not tied to market rates should be recorded at contract value. Members of the EP were of the view that plans with stable value options using traditional GICs should use contract value accounting and that those with synthetic GICs should state them at fair value.

It was noted that GASB is planning to commence work on a derivatives project and that stable value plans may be part of that project.

Consolidation of a RIC by its Adviser

An adviser that has a controlling interest in a RIC that it manages generally needs to consolidate that RIC for GAAP purposes. Such a controlling interest may occur at any point during the life of the fund, but is especially common in the early stages of a fund that the adviser has seeded and in which no other parties have invested.

Revisiting an issue covered at the November 1 meeting, the EP discussed whether an adviser would be required to consolidate a portfolio within a series company if the adviser held a controlling interest in the portfolio but did not have a controlling interest for the series company as a whole. One may argue that the series company (and not each portfolio) is the registrant and the trust (and not each portfolio) has a board of directors and that these reasons might support an entity's decision not to consolidate such an entity. However, the EP noted again that each portfolio has its own shareholders that have voting rights specific to that portfolio and the portfolio is treated as a separate company for tax purposes. For these reasons, the EP believes that consolidation of the portfolio company would be appropriate even if the adviser does not have a controlling interest in the series company as a whole.

The EP noted that an unaffiliated corporate entity owning an investment in an institutional series may not know whether it has a controlling interest, since significant ownership percentages are published in the SAI only once a year. For that reason, an unaffiliated corporate entity would not have the necessary information to determine whether to consolidate, and, therefore, could not consolidate.

FIN 46(R) para. 16(d)1

In determining whether or not a general partner (GP) should consolidate a nonregistered partnership under FIN 46(R) or EITF 04-5, the GP should first determine if the partnership is a variable interest entity as defined by FIN 46. One may conclude that the partnership is a VIE if the GP's interest in the fund is zero or very small. For example,

one member of the EP suggested that any interest less than 1% would be considered very small. If the interest exceeds 1%, one might conclude that the entity is not a VIE, in which case EITF 04-5 (and not FIN 46) would be applicable. However, the EP noted that the use of 1% is a subjective judgment and that others may have a different way of determining whether the GP is truly a holder of the equity investment at risk.

Assuming that FIN 46(R) applies, the EP discussed FIN 46(R) para. 16(d)1, which states that parties that cannot sell, transfer, or encumber their interests in an entity without prior approval of an enterprise are considered to be de facto agents of the enterprise and, therefore, related parties. The EP discussed but did not conclude on how to apply this to private investment funds. It was suggested that one may conclude, under certain circumstances, that limited partners would be considered related parties for purposes of determining whether the GP is the primary beneficiary of the VIE under FIN 46(R).

Classification of Short-Term Gain Distributions

Paragraph 5.50 of the audit guide states that long-term gain distributions should be presented on the statement of operations under “realized gains,” as opposed to under “investment income.”

5.50 When investing in registered investment companies, distributions received from long-term capital gains should be reported as realized gains together with gains realized on disposition of shares of investee companies.

The EP discussed whether short-term gains from RICs should also be reported as realized gains, since the guide is silent to that fact. The classification decision affects the per share unit rollforward in the financial highlights and the net investment income ratio. The EP made the following comments:

- S-X 6-07 7(b) indicates that “*distributions of realized gains by other investment companies shall be shown separately under this caption [Realized and unrealized*

gain (loss) on investments—net].” This implies that short-term gain distributions and long-term gains are treated no differently and should be reported under realized gains on the statement of operations.

- Paragraph 5.49 of the audit guide indicates that “dividends” from investment companies should be presented as investment income:

5.49 Income reflected on the statement of operations should represent the net earnings received from investee funds. For example, if the investee funds are all registered investment companies (as in the example in the exhibit), then the income would represent the dividends received from such investee funds.

Considering that capital gains are paid to shareholders in the form of “distributions” and that net investment income is paid to shareholders in the form of a “dividend,” one might conclude that paragraph 5.49 relates only to net investment income and not to short-term capital gains.

- The statement of operations should be presented on a book basis. Although a short-term capital gain distribution might be reported as ordinary income for tax purposes, book accounting would consider such amount as a capital gain.

Based on the above, the EP concluded that the audit guide should be conformed to Regulation S-X and that the words “long-term” should be removed in the next draft of the audit guide.

The EP did acknowledge that, if an investment company received a Form 1099 and was unable to determine if an ordinary income distribution consisted of short-term capital gains, the investment company could probably conclude that the entire distribution was an income distribution.

Fair Value Exposure Draft

The EP discussed a few issues relating to the FASB's fair value exposure draft (ED). The FASB published in October a working draft that incorporated all of the Board's deliberations to date.

- *Audits.* Although many PE/VC funds periodically recognize impairments, they are less apt to write up an investment's value unless a specific transaction or event (e.g., an IPO or an acquisition) has occurred that can justify the increase. However, the ED implies that PE/VC funds should periodically assess the valuation of their investments and should increase or decrease the valuation even in the absence of a market transaction or other event that might suggest that the current valuation is no longer accurate. The PE/VC community is concerned that the new FASB Statement will cause auditors to more carefully scrutinize the valuations and to request independent appraisals in order to validate the valuation assigned to each investment by the general partner. Not only are appraisals costly, but they may not be as reliable as valuations determined by the general partner, since the general partner often sits on the board of the portfolio company and has a deep understanding of the portfolio company's activities.

The audit firms on the EP responded that they do not believe the FASB Statement will affect their audit procedures and do not expect to require independent appraisals. PE/VC firms should always have had a process in place to periodically reassess the valuation of their investments. Such process should result in the fund increasing or decreasing the valuation when appropriate, not just when a market transaction or event occurs. Likewise, the auditor's responsibilities relating to estimates will not change as a result of the FASB Statement. Auditors have always been required to understand a fund's valuation methodology, assess the reasonableness of that methodology and its assumptions, and determine if the general partner has followed the methodology in valuing the respective investments. Auditors are not expected to serve as appraisers of the valuation, as stated clearly in the AICPA Accounting and Audit Guide.

The EP did not conclude on these questions, but agreed to develop TPAs on (a) reporting and implementation and (b) auditing guidance when the FASB's Statement on fair value is finalized.

- *Block Discounts.* The ED prohibits the use of block discounts and would require an entity that previously used block discounts to apply the change retrospectively by presenting the cumulative effect of the change as of the beginning of the first period presented and making an adjustment to the beginning investments balance. The EP discussed how a hedge fund would handle this, since investors may have bought or sold into the fund during times when block discounts were used (prior to the effective date of the FASB Statement). Therefore, in the year of adoption, the beginning investment value used to calculate the change in unrealized appreciation/depreciation per the financial statements might differ from the value used at the end of the prior year when partners invested in or redeemed out of the fund. The EP determined that this was not an accounting issue, but rather a legal issue, and that the partnership could probably continue using block discounts for determining partnership interests if it wanted to do so and if the partnership agreement permitted it.
- *Restricted Securities.* The ED defines restricted securities as those for which a sale is “legally restricted by governmental or contractual requirement for a specified period.” The ED suggests that the discount should be based on the amount of discount that a marketplace participant would request in order to assume the risk associated with the inability to access the public market due to the restriction. However, in some instances, the restriction exists on the seller's side and not on the buyer's. An example is when affiliated parties cannot sell a security during a blackout period or when the holder can sell only a percentage of its ownership interest. The EP determined that, if those situations involve a legal restriction, applying a discount would be appropriate. For example, if an entity owns 10 million shares and is permitted to sell only 9 million shares, the entity

should use the unrestricted price for the 9 million shares and should then apply a discount to that price for the remaining 1 million shares, since a legal restriction related to those 1 million shares exists.

Technical Practice Aids

The EP discussed revised versions of proposed technical practice aids on deferred fees and clawbacks.

SEC UPDATE

Representatives of the Chief Accountant's Office – Division of Investment Management joined the EP meeting and provided commentary on a variety of topics.

Independence

The SEC commented on its discussions with the public accounting firms on several independence issues and on its continued interest in reviewing the need for amendments to or interpretations of the existing auditor independence rules.

Fair Value Exposure Draft

The SEC indicated that it made some comments to the FASB on the ED through its Office of the Chief Accountant. The SEC's general view is that, although some of the disclosures in the ED may be slightly excessive, many of the concepts in the ED make sense and are appropriate. The EP noted that it was considering drafting some example disclosures for RICs that would comply with the finalized FASB Statement, and the SEC indicated that it would be willing to review those disclosures.

Financial Statement Reviews

The SEC noted that it has not identified any new comments during its financial statement reviews, but did reemphasize to the EP its focus on performance fee disclosures and the presentation of both net and gross expense ratios when expense offsets exist.

Taxes

The SEC shared its views related to taxable RICs. At the November 2 meeting, the SEC indicated that a growing number of RICs were electing to be treated as taxable entities (instead of seeking qualification under Subchapter M of the IRC) and its belief that such entities should present separate expense ratios in the financial highlights illustrating (1) the expense ratio before taxes and (2) the expense ratio after taxes and should disclose in the notes to the financial highlights the impact of taxes on the total return. The SEC also stated that taxes on capital gains and unrealized appreciation should be included in the expense ratio after taxes and in the disclosure of the impact of taxes on the fund's total return.

At the December 1 meeting, the SEC reemphasized these points. The EP questioned the appropriateness of these points, given that neither Form N-1A nor N-2 explicitly require this presentation and that taxes on capital gains and unrealized appreciation are not included in the expenses section on the statement of operations (in accordance with

Regulation S-X, Rule 6-07). The EP also noted that the expense ratio is really a measure of operational efficiency, not a measure of investment returns. Including taxes associated with investments would bring in an investment return component and make the ratio less meaningful.

The SEC indicated that the instructions in Form N-1A and Form N-2 state that the expenses shown in the statement of operations (not the “expenses related to net investment income”) should be included in the expense ratio and that taxes on unrealized appreciation/depreciation and on capital gains are a type of expense. The EP asked the SEC to reconsider its position.

N-Q Filings

The SEC noted that it has not identified significant issues with the periodic N-Q filings. It has noted instances in which the disclosures related to restricted securities and to non-income producing securities have not been presented properly.

SEC’s Publication of Letters issued by SEC Staff and by Registrants

The following link (<http://www.sec.gov/answers/edgarletters.htm>) may be used to view comment letters issued by SEC staff as well as letters submitted by registrants as Edgar correspondence in response to SEC staff comments. When accessing the attached link, the search results do not distinguish between IM and Corp Fin registrants or between legal comments issued in connection with a registration statement review and accounting comments issued in connection with a Sarbanes-Oxley review. The SEC has assigned responsibility for posting these letters to a newly developed group, but the overall process is still being worked out and there is currently a backlog. Specific instructions on how to obtain comment letters are shown below:

1. Cut and paste the link in the web browser

2. Click on Item 1 - Historical Archive Search
3. In the Edgar search String box input the following:
 - a. "type=upload" to access comment letters issued and uploaded by the SEC staff into the Edgar database; or
 - b. "type=corresp" to access registrants responses to SEC staff comment letters. These letters are filed by registrants as Edgar correspondence.
4. Click on the desired entity

The SEC indicated that registrants may request confidential treatment of a portion of a letter. Although some have requested confidential treatment of the entire letter, registrants should understand that it is easier for the SEC to provide confidential treatment for just a portion of the letter.

CURRENT PROJECTS

CCO Reporting

The subcommittee has nearly finalized its project to provide guidance to the public accounting profession on conducting and reporting on the policies and procedures at a service providers, which is expected to be used by chief compliance officers of funds in evaluating a fund's policies and procedures. The next step will be to submit an interpretation of AT 601 to the AICPA Auditing Standards Team. If it is deemed to represent new guidance, it must be submitted to the Audit Issues Task Force. Although the interpretation will cover only examination reports, the subcommittee believes that an agreed-upon procedures report could still be issued.

CPO Practice Aid

A draft of the practice aid will be sent to the EP after the practice aid task force holds its meeting on December 8. The practice aid will focus on providing report examples of financial statements for commodity pools.

**AICPA INVESTMENT COMPANIES EXPERT PANEL
JANUARY 10, 2006 MEETING MINUTES**

PUBLIC ACCOUNTING FIRM ISSUES

Fund Mergers and a Change in Accountants

The EP discussed the following situation with the SEC:

- a. Fund A is audited by Firm X.
- b. Fund B is audited by Firm Y.
(It does not matter whether Funds A and B are affiliated or unaffiliated—they could be either.)
- c. Fund A and Fund B merge. Fund A is the accounting survivor; Fund B is the legal survivor.
- d. Fund B continues to use Firm Y as the auditor—no formal reappointment of Firm Y or dismissal of Firm X occurs.

The SEC indicated that such scenario represents a reportable change in accountants under Item 77k of Form N-SAR, which is consistent with guidance on corporate mergers issued by the SEC in 2003. The SEC noted that, anytime the legal survivor differs from the accounting survivor, a reportable change in accountants has occurred. That includes situations in which Firm X remains as the auditor. However, if the accounting and legal survivor are the same, no change in accountants disclosure is necessary if the accountant for that entity continues.

Form N-1A contains a shareholder reporting requirement relative to a change in accountants. For mergers, a member of the EP suggested that disclosure in the N-14, instead of the next semiannual or annual report, might be sufficient because the N-14 is distributed to all shareholders. The SEC indicated that that might be a permissible position.

Audit firms are required to file a cessation letter with the SEC within 5 days after they cease as the auditor. Relative to the merger situation described above (accounting survivor differs from the legal survivor), the audit firms were uncertain whether or not such a letter would be required. The SEC indicated that it would consider the issue and report back to the EP.

Audit Confirmations

The EP discussed the ongoing problems that auditors face in confirming certain items with brokers (especially values for securities and financial instruments). Many brokers are reluctant to confirm anything, or, if they do return a confirmation response, may refuse to sign it or may attach a disclaimer indicating that the value confirmed may not be accurate. These limitations make it difficult for auditors to conclude that the confirmation represents substantial audit evidence that can stand on its own. The EP discussed these problems with Brian Bullard, Chief Accountant of the SEC's Division of

Investment Management, who agreed to explore ways the SEC could encourage brokers to provide more definitive confirmation responses.

ACCOUNTING/REPORTING MATTERS

Partnership Redemptions: Application of FAS 150

FSP FAS 150-3 (paragraph 3) defers the effective date of FASB Statement No. 150 for mandatorily redeemable financial instruments issued by nonpublic entities that are not SEC registrants, as follows:

- a. For instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index, the classification, measurement, and disclosure provisions of Statement 150 shall be effective for fiscal periods beginning after December 15, 2004.
- b. For all other financial instruments that are mandatorily redeemable, the classification, measurement, and disclosure provisions of Statement 150 are deferred indefinitely pending further Board action.

There has been diversity in practice in applying paragraph 3(a) for redemptions from nonregistered investment companies. In some circumstances, funds have reclassified the unsettled redemptions as liabilities; in other circumstances, funds have continued to include the amount of the redemption within partners' capital. The EP noted that the application of FAS Statement No. 150 has significant effects on the financial reporting of the partnership, because the presentation of investments in a condensed schedule of investments and the net investment income and expense ratios are based on the net assets of the fund. In order to clarify the views of the EP members, the following scenarios (assuming a year-end of December 31) were discussed:

- *On December 1, an investor requests a redemption, and the redemption is effective as of January 1.* The EP concluded that the redemption amount and date are fixed as of December 31, and, therefore, the redemption amount should be classified as a liability instead of remaining in partners' capital.
- *On December 1, an investor requests a redemption, and the redemption will be paid to the investor based on the investor's interest as of January 31 of the following year. The general partner or adviser may refuse to grant the redemption request at any time prior to January 31.* The EP concluded that the redemption amount and date are not fixed as of December 31 because the general partner or adviser may refuse the redemption request, and, therefore, the redemption amount should remain in partners' capital.
- *On December 1, an investor requests a redemption, and the redemption will be paid to the investor based on the investor's interest as of January 31 of the*

following year. The general partner or adviser may not refuse the redemption; however, the investor may withdraw its redemption request. The Fund is unitized. The EP tentatively concluded that the redemption amount and date are not fixed as of December 31 because the investor may withdraw its redemption request, and, therefore, the redemption amount should, in most circumstances, remain in partners' capital.

- *On December 1, an investor requests a redemption, and the redemption will be paid to the investor based on the investor's interest as of January 31 of the following year. The general partner or adviser may not refuse the redemption, and the investor may not withdraw its redemption request. The Fund is unitized.* The EP did not conclude on whether a liability should be recorded in this scenario. The following items were considered:

- Is the date of the redemption fixed and the amount of the redemption fixed or determinable?

One view is that the amount of the redemption is not fixed or determinable because the Fund's NAV per unit/share as of January 31 is not known as of December 31 and the fund does not know exactly how many shares/units will be liquidated. Additionally, if the fund decreased significantly in value between December 31 and January 31, the fund might not be able to fully meet the redemption request. Supporters of this view would say that a liability should not be recorded, although the fund should disclose the redemption amount in the notes to the financial statements.

A differing view revolves around the fact that the fund clearly has an obligation at December 31 and knows that a certain amount will be owed as of January 31. If the investor redeems a specific dollar amount of the interest, and that amount represents only a small fraction of the fund's net assets, it is unlikely that the investor will receive any amount less than the requested redemption amount even if the fund's net assets decline significantly. If the investor redeems an amount that represents a significant percentage of the fund's net assets, then one might conclude that only a certain percentage of the redemption may be fixed and only that percentage should be classified as a liability.

Whether or not the fund is unitized may influence the decision. One EP member noted that, if the fund is not unitized, the uncertainty surrounding the number of shares/units issued would be removed.

- Equity interest remains. The investor is still entitled to receive its share of the fund's profits/losses as of December 31 because its interest will not be redeemed until January 31. Classifying the portion of the investor's interest subject to the redemption request as a liability would incorrectly

depict that the investor is not entitled to the profits/losses. Although the EP members noted that this economic argument seemed logical, it is possible that GAAP may still require reclassification. Additionally, the EP noted that international accounting standards require all partnership requests that are mandatorily redeemable to be reclassified as a liability.

Upfront Payments on Swap Contracts

Normally, when an investment company enters into a swap agreement, neither it nor the counterparty makes an upfront payment because the yield to maturity set at the inception of the contract makes both parties whole. However, in certain instances, such as when a fund assumes an existing swap contract, market inequities might exist, and one party may make a payment to the other. Most commonly, funds amortize the upfront payment over the remaining life of the contract, as it is essentially an adjustment of the yield. Another practice is to defer the payment and recognize it as a gain/loss at the conclusion of the swap, which might be permissible. The EP believes, however, that recognizing the entire payment as a gain or loss at the inception of the contract would not be appropriate.

Swap-like Contracts involving Payment of the Full Principal at Inception

The EP discussed products that seem to have elements of both a fixed-income security and a swap contract. The forms of the agreement have been different. In some cases, there is a swap with a related note/deposit. In other cases, there is an integrated swap with "Party A" agreeing to pay the principal amount up front and "Party B" agreeing to return it (with interest or some other return) on termination. But some sort of interest on the cash is agreed together with an adjustment for return. In some instances, the product may resemble a structured note; in other instances, it may seem more like a swap contract with a deposit of collateral. The EP agreed that investment companies and auditors should look at each specific agreement to determine the appropriate accounting treatment.

529 Plans with Stable Value Options

The EP discussed the valuation of stable value plans subject to GASB (not FASB) and re-emphasized several of the conclusions it reached at the December 2005 meeting. The EP noted that GASB Statement No. 31 requires entities to report investment contracts with redemption values tied to market rates at fair value; those not tied to market rates should be recorded at contract value because they are considered to be nonparticipating contracts (per GASB 31 Q&A 44 and 45). Members of the EP were of the view that stable value options using traditional GICs should use contract value accounting and that those with synthetic GICs should state them at fair value.

The EP noted that some 529 plans follow the FASB requirements instead of GASB at the request of the state, although individual municipalities may require adherence to GASB.

The EP also noted the following relating to FSP AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies*

Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans.

- Even if the stable value fund is required under the FSP to report at fair value, the defined contribution plan could still use contract value.
- 529 plans are not addressed in the FSP. Thus, there is no ability to use grandfathering exemptions similar to those included for defined benefit plans.
- Under the FSP, a stable value fund may still use contract value accounting even if a portion of its net assets are attributable to non- DC plan money. However, the amount of non-DC money cannot increase after January 15, 2006, except as the result of reinvestments of income earned. Although unclear in the FSP, if an investor withdraws part of its interest from the stable value fund after January 15, 2006, the investor cannot re-contribute the amount or a portion of the amount withdrawn if the stable value fund still wishes to use contract value accounting.

Presentation of Mortgage-Backed Securities in SOI

The S-X rules permit a non-money market fund to group short-term securities issued by the same issuer in the schedule of investments by presenting a range of rates and maturities: “Short-term debt instruments (i.e., debt instruments whose maturities or expiration dates at the time of acquisition are one year or less) of the same issuer may be aggregated, in which case the range of interest rates and maturity dates shall be indicated.”

However, a RIC is not specifically permitted to do this for long-term securities held by the same issuer. The EP commented that presenting each mortgage-backed security separately in the SOI may encompass several pages and may actually provide financial statement users with less intelligible information than if summarized positions had been presented. The EP determined that it would be appropriate for a RIC to combine those securities for which the risk is deemed the same, and, therefore, the price is the same. The EP discussed its conclusions with Brian Bullard, and, although he felt that the SEC would probably support that position, he agreed to look into it further.

PROPOSED TECHNICAL PRACTICE AIDS

Release of Five TPAs

The EP noted that five TPAs generated by the EP have been released and are available at: http://www.aicpa.org/download/acctstd/IC_TPAs.pdf

Deferred Fees

The EP reviewed an updated draft of the deferred fees TPA. No new conclusions were reached; however, many EP members had questions relating to the wording of the TPA. The EP agreed to continue to work on the TPA.

Clawbacks

An updated version of this TPA was not available for review. However, the EP noted that, if the clawback does not represent a legally enforceable right, it might not be appropriate to record or to disclose the clawback amount that would be due assuming immediate liquidation of the partnership. The EP reaffirmed that recording/disclosing would be proper if the clawback represents a legally enforceable right, which is the premise behind the TPA.

SEC UPDATE

Financial Statement Review Comments

The SEC noted the following two items that it had detected during its financial statement reviews conducted in accordance with the Sarbanes-Oxley requirements:

- *Senior loans* – Certain registered investment companies (RICs) invest in senior bank loans as part of their investment strategy. In making such investments, the RIC might make commitments to provide funding for a loan prior to it being issued or commit to additional amounts beyond the existing funded portion. Such unfunded commitments might create a value to the RIC different from the underlying commitment, which would create unrealized appreciation or depreciation. For each unfunded commitment, the RIC should disclose the amount and extended value of the unfunded commitment as of the date of the reporting period. The RIC may provide this disclosure by including a listing of unfunded commitments by senior loan in a separate schedule located within the schedule of investments or within the notes to the schedule of investments or notes to the financial statements. Alternatively, the RIC may state the amount and extended value of the unfunded commitment within a footnote attached to each senior loan.

The EP noted that the effect of such valuation changes should be recognized in determining the net asset value of the RIC even in situations in which the entire unfunded commitment itself is not reflected as a liability because it does meet the FASB Statement No. 5 requirements.

- *Organization costs in seed financial statements for a closed-end fund* - The SEC has noted that, in certain arrangements, the sponsor or another party agrees to pay for and assume only those organization and offering costs incurred by a closed-end fund that exceed a specified ceiling expressed as a per share amount. For example, an arrangement might state that the adviser will reimburse the fund for organization expenses and offering costs in excess of \$0.03 per share. Although

the actual amount of the organization costs that will be borne by the fund will not be known until the initial offering has been completed, SOP 98-5, *Reporting on the Costs of Start-Up Activities*, requires organization costs to be expensed as incurred. Therefore, a fund must either expense such amount if the sponsor contributes additional capital to ensure the net assets do not fall below \$100,000, or the sponsor can waive the organization expenses and reimburse the fund at a future date.

“Zero Expense” Funds

The SEC noted that some funds, especially those in that serve as option in a wrap fee program, claim to have zero expenses. In reality, such funds have expenses that are paid by the adviser. The SEC requires that actual expenses be presented. There are two ways this is generally accomplished:

- One way involves the inclusion of a unitary fee structure in which the advisory fee agreement specifies that the adviser will pay certain expenses directly from the fee it receives. A fund with a unitary fee structure does not separately list the individual expenses of the fund in the statement of operations, because the fund is only responsible to pay the management fee and any other selected expenses. To the extent that the adviser has decided to “waive” certain expenses, it may just establish a management fee that is lower than what would be required to compensate it for its services and pay the other expenses of the fund.
- The other way, which the SEC prefers, calls for the fund to populate the individual line items in the statement of operations with an assumed amount of expense and then present fee waivers and subsidies separately on the statement of operations below gross expenses. However, determining what expenses would have existed if the adviser had not paid them is difficult, because expenses involving an agreement would have been subject to board approval and it is possible that the agreement negotiated by the board would have differed from that negotiated by the investment company. The SEC requested that the EP consider how such amounts would be determined, and how funds would disclose the relationship in accordance with FASB Statement No. 57.

**AICPA INVESTMENT COMPANIES EXPERT PANEL
FEBRUARY 10, 2006 MEETING HIGHLIGHTS**

PROPOSED TECHNICAL PRACTICE AIDS

Return of Capital

The EP reviewed a second draft of a TPA that suggested the following:

- If an investment company receives a distribution from one of its investments, such as another investment company or a trust, it should determine for financial reporting purposes whether or not all or a portion of the distribution represents a return of capital.

- If an investment company presents its financial statements on a GAAP basis, it should calculate the return of capital on a GAAP basis. However, calculation on a tax basis would be acceptable if it were the only means available or provided a reasonably close approximation of the return of capital determined on a GAAP basis.

The EP again agreed with the first point, citing a passage in chapter 2 of the audit guide that supports the determination of the return of capital: “Distributions that represent returns of capital are credited to investment cost rather than to investment income.”

The EP noted that private equity funds typically determine return of capital distributions on a tax basis, as do RICs relative to distributions received from REITs. Although determining amounts on a GAAP basis may sound from a conceptual perspective, the ability of funds to operationally determine return of capital information on a GAAP basis may be very difficult. Additionally, for RICs, the use of GAAP basis would likely create a permanent book-to-tax difference that would require reclassification on the statement of assets and liabilities under the audit and accounting guide’s ROCSOP provisions. Accordingly, the EP saw no compelling reason to issue a TPA on this subject and determined to terminate its efforts on the TPA.

ACCOUNTING/REPORTING MATTERS

Consolidation Issues Related to Affiliated BDC and CDO

The EP discussed a scenario in which a business development company (BDC) owned—

- 70% of the preferred stock of a CDO (but less than 5% of its common equity).
- 80% of an asset manager that provides advisory services to the CDO.

Under FIN 46, registered investment companies may consolidate only other registered investment companies that are variable interest entities. The EP noted that, if the CDO qualifies as VIE, the BDC may be required to consolidate the CDO. If that occurred, one

might also conclude that the asset manager, because it provides services to the CDO, would also have to be consolidated in accordance with paragraph 7.05 of the audit guide, even if the BDC purchased an interest in the asset manager solely as one of its portfolio company holdings and not so that it could provide services to the CDO. If either of these entities are not consolidated, the ownership by the BDC would likely be disclosed in the BDC in accordance with FIN 46.

One of the EP members agreed to draft a white paper summarizing the issues associated with this scenario and formulating some preliminary conclusions. The other EP members agreed to consider the issue and discuss their conclusions at the next meeting.

It was noted that the SEC requests that all RICs gain approval from the SEC prior to consolidating an operating company. As BDCs are registered with the SEC, the EP noted that the white paper would likely need to be reviewed at some point by representatives of the SEC.

CURRENT PROJECTS

CCO Reporting

The subcommittee presented its proposed auditor reports/letters associated with engagements related to 38a-1 to the Big Four representatives on the Audit Issues Task Force (AITF). The representatives agreed with the concepts in the drafts, but also made some suggestions that the subcommittee will revisit. The EP noted that, as currently drafted, the accountant's report on management assertions will be accompanied by a list of control objectives and activities in the back, similar to a SAS 70 report, although no testing of those objectives and activities will be included.

**AICPA INVESTMENT COMPANIES EXPERT PANEL
MARCH 30, 2006 MEETING HIGHLIGHTS**

PUBLIC ACCOUNTING FIRM ISSUES

CCO Reporting

The subcommittee working on a report example for issuing “SAS 70-like” reports related to Rule 38a-1 of the Investment Company Act of 1940 indicated that it would be submitting a revised version to the Audit Issues Task Force (AITF) to incorporate some comments it had received from certain representative of the AITF. The EP noted that, as currently drafted, the accountant’s report on management assertions will be accompanied by a list of control objectives and activities in the back of the report, similar to a SAS 70 report, although no testing of those objectives and activities will be included. The EP acknowledged that some users might want to see the testing.

After the AITF accepts the document, it will be converted into a SOP. The goal is for the SOP to be released this summer.

SOP 06-1

The EP noted that SOP 06-1 had been released to replace SOP 01-4 for engagements to examine compliance with the Global Investment Performance Standards (GIPS).

FINANCIAL ACCOUNTING/REPORTING ISSUES

Legal Settlements

When a fund incurs legal costs relating to a lawsuit and then receives a payment or reimbursement in a subsequent year, the SEC has indicated that the payment should be presented separately, in accordance with paragraph 8.26 of the Audit and Accounting Guide *Investment Companies*, and that any legal expenses incurred in the current year should be presented in the expense section of the statement of operations. The SEC did not support net presentation of the income and expenses. Presentation of an additional expense ratio to highlight the impact of the income receipt may be an option.

Consolidation Issues Related to Affiliated BDC and CDO

The EP revisited a scenario in which a business development company (BDC) owned—

- 70% of the preferred stock of a CDO (but less than 5% of its common equity).
- 80% of an asset manager that provides advisory services to the CDO.

Under FIN 46, registered investment companies may consolidate only other registered investment companies that are variable interest entities. The EP noted that, if the CDO qualifies as VIE, the BDC may be required to consolidate the CDO. If that occurred, one

might also conclude that the asset manager, because it provides services to the CDO, would also have to be consolidated in accordance with paragraph 7.05 of the Guide, even if the BDC purchased an interest in the asset manager solely as one of its portfolio company holdings and not so that it could provide services to the CDO.

The EP discussed whether preferred stock ownership should be considered "equity." If so, consolidation of the CDO may be appropriate. The EP acknowledged that most would consider the preferred stock ownership to be equivalent to equity, but the EP did not conclude on the matter.

The EP agreed to consider other relevant factors at a future meeting.

Agreements to Offset Placement Fees Against Management Fees: VC/PE

Several venture capital-type funds, as part of their offering materials or management agreements have indicated that, to the extent placement fees are paid by the partnership for the offering of units, the manager will reimburse the fund over time by reductions in the fund's management fee. Some (not all) of the agreements have also stated that, if the partnership terminates prematurely, the general partner/manager will refund any unrecovered amounts in cash upon termination.

The EP believes that an arrangement to reduce the management fee over time is similar to the brokerage/service arrangement described in Chapter 7 of the Guide and that the appropriate accounting treatment would likely involve debiting capital for the full amount of the placement fees at the time of the charge. Over time, management fee expense should be presented gross and a contra-expense should be provided to illustrate the reduction of the management fee. One suggestion for the description of the line item was "fees paid indirectly." Footnote disclosure should be made of the arrangement and the cumulative amount of fees that has not yet been recovered.

The EP noted that, if the agreement provides for cash recovery at the termination of the fund, the fund should still record a debit to capital. However, the EP believes the fund has a viable receivable (assuming that it is deemed collectible) and that, accordingly, a receivable account should be debited with an offsetting credit to capital. The receivable would be reduced over time as management fee expense is debited.

One EP member noted that a related issue arose where an investment adviser to a private equity fund received "deal fees" for being the intermediary in a refinancing transaction, during which the fund acquired an equity interest in one of its investees. Under the partnership agreement, the adviser ceded 80% of the "deal fees" to the partnership, either through future fee reductions or (upon an earlier termination of the partnership) in cash. (Other unaffiliated investors purchased equity interests for cash at the same price as the fund.) The EP member concluded to treat this situation as described in the preceding paragraph, except that the "deal fees" were recorded as a contra-expense instead of a contribution to capital. The EP member considered whether the "deal fees" should be considered a reduction of the purchase price of the equity interest, but concluded that

they should not be as other investors had paid the same amount in cash for their interests, suggesting that the "deal fees" represented a separate service rather than a purchase price discount.

The EP agreed to revisit these preliminary conclusions at a future date and decide whether a TPA related to the subject should be created.

SEC UPDATE

Carryovers from Previous Meeting

The SEC began its session by addressing questions related to previous meetings:

- a. In situations in which the accounting survivor differs from the legal survivor, should an audit firm file an auditor cessation letter? Answer: Yes, an auditor cessation letter should be filed as soon as the auditor is notified (not necessarily the day of the merger).
- b. Would the SEC be able to encourage brokers to provide more definitive confirmation responses (especially related to pricing)? Answer: The SEC is aware that brokers are often reluctant to provide and sign confirmations relating to the valuation of certain fund investments, but is not taking any action currently.
- c. For portfolios with mortgage-backed securities of the same issuer, would the SEC support grouping similar issues on the Schedule of Investments when the risk (and, therefore, pricing) is essentially the same? Answer: Yes, only in this situation. The range of maturity dates and interest rates must be presented.
- d. Has the SEC formed any additional conclusions on the accounting/reporting of senior loans? Answer: The SEC is still considering the issue. It believes that its comments made at the January meeting still represent relevant considerations, but would acknowledge that the SEC staff has not fully considered the issue.

XBRL

Old Mutual has announced that its funds will file using XBRL sometime in the future. The SEC will hold a series of roundtables relating to interactive data in June.

Section 19 of the Investment Company Act of 1940

Funds are not permitted to make more than one long-term capital gain distribution in a year. If a fund decides it needs to make a second distribution, it may request exemptive relief under Rule 19b-1e, but must do it ahead of time – before the distribution is made. The SEC does not have the statutory ability to provide relief after the fact. This includes situations in which a fund group attempts to recharacterize a distribution at year-end.

The SEC is contemplating revisions to Section 19 and the rules thereunder. It recognizes that it is difficult to estimate the portion of the payment that is from net investment income, as required under Rule 19a-1, although the SEC noted that the estimates can be revised (as addressed under Rule 19a-1e). The SEC is also considering whether the determination should be made on a GAAP basis (currently the SEC's interpretation) or a tax basis, given that Section 19 is unclear when it states that the determination should be made "in accordance with good accounting practice."

The SEC acknowledged that many closed-end funds have submitted requests for managed distribution plans that have not yet been granted by the SEC. The SEC has been reviewing its policies and is interested in codifying some of the exemptive relief that it has been provided to date.

Uncertain Tax Positions

The SEC believes that there are currently no serious NAV concerns relating to the FASB's proposed amendment to SFAS 109 since the FASB lowered the recognition threshold from "probable" to "more likely than not."

Deemed Distribution

A deemed distribution occurs when a RIC retains all or any portion of its net capital gain and elects to have shareholders include the gain in their taxable income as though a capital gain dividend had been paid. The gain is treated as long-term capital gain, and the tax is treated as a tax payment by the shareholders. The SEC indicated that because the fund actually pays the tax, it should make a provision for the tax in the statement of operations, consistent with Article 6 of Regulation S-X and ASR 114. It was suggested that EITF 95-9 might imply that a statement of changes presentation is more appropriate, but the SEC was not persuaded by this suggestion, indicating that EITF 95-9 represented a lower level of GAAP than SEC guidance.

Taxable Funds

The SEC still considers it best practice for those funds that elect to be taxed (e.g., BDCs, funds investing in master limited partnerships) to present expense ratios that are pre- and post-tax expenses.

Funds in Wrap Programs

Following up from its comments at the January meeting, the SEC noted that some funds, especially those that serve as option in a wrap fee program, claim to have zero expenses, when, in fact, those expenses have been paid by the adviser. The adviser is paid by the program sponsor, which collects the wrap fee from the investor (outside of the fund). The SEC reiterated that it believed that the fund incurs certain expenses and that those expenses should be presented on the statement of operations. The SEC asked the EP to

consider whether certain expenses should be imputed and how the statement of operations should be presented.

**AICPA Investment Companies Expert Panel
May 24, 2006 Meeting Highlights**

FINANCIAL ACCOUNTING/REPORTING ISSUES

Money Market Fund SOI Presentation

The SEC's shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments (SOI) for a money market fund from the semiannual or annual shareholder report provided that a full schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform a shareholder as how the shareholder may obtain a complete schedule of investments. The Audit and Accounting Guide *Investment Companies* currently does not permit the exclusion of the SOI, but does permit the presentation of a condensed schedule of investments (paragraph 7.11, footnote 10). The EP had previously discussed whether the GAAP requirement to present a full SOI should be eliminated and decided not to proceed with such an undertaking. However, at the May 24 meeting, one EP member suggested that fund families would find significant printing cost reductions if they were permitted to exclude the SOI. The EP discussed two options:

1. Change the GAAP requirement.
2. Create an audit report that would reference the full SOI, which would be available on an electronic website

The EP considered Option 1, but concluded that it held certain challenges, largely stemming from the requirement to put the initiative in front of the FASB. The process would be time consuming and would probably expose the issue to public comment. Advisers of other kinds of investment companies, such as private equity and hedge funds, may read the exposure draft and request similar relief. Because the money market exclusion is viewed as a narrow exemption for a low risk product, the EP felt that Option 1 could be problematic.

Option 2 was viewed as an easier solution to administer. If the EP creates a proposal, the EP may submit it to a group such as the Auditing Standards Board or the Audit Issues Task Force (AITF) for its consideration.

The EP determined that there is a real business reason to provide relief for money market funds and that it would pursue Option 2 by creating a proposal and submitting it to one of those two audit groups. The EP will determine which group should see the proposal first.

529 Plans with Stable Value Options

Revisiting a previously discussed subject, the EP discussed the valuation of stable value plans subject to GASB and FASB requirements. The Stable Value FSP, which was released at the end of 2005, permitted contract value for stable value funds that had received money from defined contribution plans (DC). Those funds whose net assets

included some non-DC money were permitted to use contract value accounting provided that no additional non-DC money was received by the fund after January 15, 2006.

The FSP did not address 529 plans and their ability to use contract value accounting. Nonetheless, many 529 plans have adopted contract value accounting. The financial statements of 529 plans with a public official serving on the board of directors generally roll-up into the financial statements of the respective municipality and must follow GAAP established by GASB, not by FASB. The relevant guidance is GASB 31, which requires entities to report investment contracts with redemption values tied to market rates at fair value; those not tied to market rates should be recorded at contract value because they are considered to be nonparticipating contracts (per GASB 31 Q&A 44 and 45). Members of the EP reaffirmed their conclusion that 529 plans with stable value funds using traditional GICs should use contract value accounting, but should report stable value funds with synthetic GICs at fair value.

Part of the confusion in the industry may relate to a lack of significant guidance from GASB, although GASB has suggested that synthetic GICs will be addressed in the second phase of a current derivatives project. A stable value industry group is attempting to persuade GASB to address the issue. The EP determined that it might be helpful if it discussed the issue with the AICPA's Government and Not-for-Profit Organizations Expert Panels to see if, collectively, they could discuss the issue with GASB.

Stable Value Funds: Fair Value of Wrapper Contracts

The Stable Value Investment Association (SVIA) has expressed concern that auditors may reject the methodology used by stable value funds to value wrapper contracts at fair value (if fair value, and not contract value, must be used) and has started an initiative to try to develop a white paper that would define one specific methodology that the audit firms would universally accept. Methods discussed as possible options include the discounted cash flow method, the Black-Scholes model, and the Monte Carlo method, with the first option seen as the most viable, assuming that changes in interest rates and changes in the credit quality of the insurance provider are factored into the calculation.

Venture Capital and FASB's Fair Value Measurements Exposure Draft

The Exposure Draft is expected to be issued in June 2006; reportedly, a fatal flaw version has been released. The EP discussed the potential impact of the Exposure Draft on venture capital funds. First and foremost, such funds need to have written policies and procedures in place relative to the valuation.

VC funds may struggle with determining whether an investment should be classified as a Level 2 or Level 3 investment because, although venture capital transactions are principal to principal transactions (which are defined in the Exposure Draft as being Level 2), there is often a significant amount of time between transactions, suggesting that such investments would most often be classified as Level 3 investments.

Occasionally, a sales transaction for a venture capital holding is in progress but not finalized at a reporting date. In some instances, the sales price may be higher than the current value assigned in the financial records, but that price may be contingent on an event likely to take place but not guaranteed to occur in the future (e.g., FDA approval of a drug). The EP noted that the VC fund should consider the current negotiated sales price in its reporting date valuation, but should factor in the uncertainty associated with the transaction (which will likely result in a discount to the negotiated price being applied to result in the valuation used at the reporting date). It should not retroactively adjust the value as of the reporting date once the transaction has been finalized, because entities should not base their valuation on subsequent events.

Another challenge for VC funds is that the Exposure Draft requires an entity to value holdings based only on information available to a marketplace participant (paragraph 30 of working draft on the exposure draft). If a VC firm sits on the board of one of the fund's holdings and has access to insider information to which a marketplace participant would not have access, the VC firm may not use that information to determine the value of the holding.

The EP noted that investments in venture capital funds (investee fund) should be classified as Level 3 even if the investee fund has classified certain investments as Level 1. The reason behind this is that the investor holds an interest only in the investee fund, not the underlying investments, so it could dispose of only the investee fund and must determine the exit price of the investee fund in determining its value for financial reporting purposes. As that value would naturally be based on unobservable market inputs, the investee fund should be classified as a Level 3 investment.

The VC community will be accumulating its concerns and discussing them with FASB. There is some hope that a specific chapter in the investment companies Guide can be devoted to venture capital funds.

Tax Settlements

The following two situations were discussed:

1. A number of international equity mutual funds had incorrectly claimed and passed through credits for income taxes withheld in the United Kingdom and Singapore. Some fund complexes have negotiated closing agreements with the Internal Revenue Service that were based on the estimated amounts of tax benefits obtained by individual shareholders through the incorrectly claimed credits. The form of the settlements is between the affected funds and the IRS, but typically the adviser is paying the settlement amount.
2. Some tax-exempt bond funds have been approached by the IRS to settle claims that bonds owned by the funds were not eligible for tax-exempt status. The IRS had found that the issuers of the bonds did not qualify for tax exemption, but the

issuers themselves were not in a position to make a financial settlement, so in some cases the IRS has moved against the holders.

The issue is often that the fund sent out incorrect 1099s to its shareholders. The settlements are often made so that the fund is not assessed any penalties and so that the fund does not have to send out amended 1099s, as doing so may damage the reputation of the fund group and may cause the fund to pay additional printing and resource costs. Payments are often made by the adviser so that the fund does not incur any direct costs. In some instances, the settlement may be larger than the maximum IRS penalty that could be assessed to the fund.

The EP discussed how, if at all, a fund should reflect such settlements in its financial statements. One view was that the settlement relates to an expense that the shareholder would normally bear—income tax expense—and that the fund would not bear because it qualifies under Subchapter M of the Internal Revenue Code. This view might support not recording or disclosing the settlement in the financial statements. However, the EP noted that the settlement agreement is often made directly with the fund, which means that the fund is required to pay it. Even if another party plans to actually make the payment, it may go out of business or decide not to make the payment. For this reason, the EP decided that theoretically it is the fund's expense and that the fund should reflect it as such in its financial statements, although it should also present the reimbursement from the adviser. The financial highlights could be notated to clarify why the expense ratio is not comparable to other years, or an additional gross expense ratio (excluding settlement costs) could be presented. However, the EP noted that the accounting treatment may vary depending on the facts and circumstances. In some cases, disclosure may be necessary; in other cases, disclosure may not be necessary.

“Due to and Due From Broker” on a Hedge Fund’s Financial Statements

Many hedge funds present a due to and/or due from broker line item on their financial statements. Such amounts may include trade receivables and payables, interest receivables and payables, and various cash balances. A significant number of funds currently report the cash at broker on a net by broker basis on the balance sheet and report the interest income earned on the credit cash balance and interest expense paid on the debit cash balance for the same broker gross on the income statement. The interest receivable/payable accounts on the balance sheet typically follow the treatment of the interest income/expense accounts on the income statement, i.e., gross or net.

The EP previously discussed this issue relative to a potential TPA and did not conclude on what the proper accounting treatment might be. The EP noted that the principles in FIN 39 would need to be met in order to net the balances on the statement of assets and liabilities. For example, the EP noted that a fund may be able to net restricted cash for certain items because that cash would be netted with the ultimate position with which it is associated, but would probably not be able to do so for short sales. The EP noted that FIN 39 should be applied on a facts and circumstances basis and that the EP would be

unable to create a TPA that covered all scenarios. For this reason, the efforts on the TPA were discontinued.

SEC UPDATE

New Division of Investment Management Director

Buddy Donohue recently assumed the leadership position vacated by Paul Roye in 2005. Brian Bullard suggested that the appointment of Buddy Donohue to the post finally provides the division with permanent leadership, which may help expedite outstanding industry issues such as auditor independence issues associated with 206(4)-2, with the investment company complex, and with private equity investments. Brian indicated that the new director has been briefed on these issues.

XBRL

The SEC has devoted a section of its website to XBRL and is holding a series of roundtables relating to interactive data. Two of the morning sessions in the roundtable will include discussions relevant to mutual funds. Susan Nash of the SEC will be coordinating. The Allegiant Advantage Fund recently became the first mutual fund filer to use XBRL in connection with its N-Q filing (<http://www.sec.gov/Archives/edgar/data/908823/000119312506095211/0001193125-06-095211-index.htm>). Old Mutual had previously announced that its funds will file using XBRL sometime in the future.

IFRS Financial Statements: Audit Exemption of 206(4) –2 Security Count Requirement

A question was asked of the SEC regarding a situation in which a newly registered (with the SEC) offshore adviser had prepared its prior financial statements under IFRS and had them audited under IAS. In order to utilize the audit exemption and avoid the security count requirements, the custody rules and the related Q&A require:

- A reconciliation of the IFRS financial statements to US GAAP.
- An audit of financial statements under US GAAS.

Q: To use the "audit approach" under the amended custody rule, must the financial statements be prepared in accordance with U.S. GAAP?

A: Yes, with one exception. Pooled vehicles organized outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, may have their financial statements prepared in accordance with accounting standards other than U.S. GAAP so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences are reconciled. Both U.S. and non-U.S. pooled investment vehicles must be audited in accordance with U.S. Generally Accepted Auditing Standards and, in particular with Article I, Section 2(d) of Regulation S-X (governing independence standards) (footnote 41 of the Adopting Release).

The question was whether or not the prior year financial statements would need to be reconciled to US GAAP or presented on a US GAAP basis, since IFRS statements must be presented on a comparative basis. The SEC staff indicated that it would accept a reconciliation of only the current period financial statements.

Restricted Securities

The SEC noted that funds should periodically re-evaluate the discounts they use and should follow ASR 113.

Valuation Guidance

The EP asked the SEC about when it might release additional valuation guidance, which the SEC has been working on for more than a year. Brian Bullard acknowledged that draft guidance exists, but was uncertain if there is a timetable for issuance.

Consolidation by Investment Companies

Rule 6.03 of Regulation S-X provides the following guidance relating to consolidation by registered investment companies.

(c) Consolidated and combined statements.

- (1) Consolidated and combined statements filed for registered investment companies shall be prepared in accordance with §§ 210.3A-01 to 210.3A-05 (Article 3A), except that (i) statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies; (ii) a consolidated statement of the registrant and any of its investment company subsidiaries shall not be filed unless accompanied by, a consolidating statement which sets forth the individual statements of each significant subsidiary included in the consolidated statement: Provided, however; That a consolidating statement need not be filed if all included subsidiaries are totally held; and (iii) consolidated or combined statements filed for subsidiaries not consolidated with the registrant shall not include any investment companies unless accompanied by consolidating or combining statements which set forth the individual statements of each included investment company which is a significant subsidiary.*
- (2) If consolidating or combining statements are filed, the amounts included under each caption in which financial data pertaining to affiliates is required to be furnished shall be subdivided to show separately the amounts (i) eliminated in consolidation and (ii) not eliminated in consolidation.*

Brian Bullard stated that the SEC staff interprets this Rule to require RICs to consolidate other RICs when consolidation is required under GAAP and to not permit consolidation of any other entities because, unlike RICs, other entities are creating for operating (as opposed to investment) purposes. The SEC has granted exemptions for certain

consolidations of nonregistered investment companies or operating companies falling under paragraph 7.05 of the Guide in certain instances.

On a related issue, the EP discussed with the SEC certain instances in which a BDC may invest in a CDO or CLO. Although the SEC did not have direct experience with the issue as yet, the SEC noted that a BDC is not permitted to set up a CDO or CLO for the purpose of leveraging itself in a manner that the BDC by itself would be unable to do under the SEC's rules, as such an action would violate Section 48 of the Investment Company Act of 1940.

Material Weaknesses Letters

The SEC is currently compiling a list of auditor letters included in Form N-SAR that note the existence of material weaknesses and will be comparing those against the requirements of the PCAOB's Auditing Standard 2 to understand any differences that might exist.

Other Reporting Matter

The SEC was asked if it had noted any inappropriate reporting items relating to BDCs, ETFs, registered fund of hedge funds that it could share with the EP. The SEC indicated that it did not have any items to share. In response to another question, the SEC was not aware of any deficiencies with N-Q filings.

**AICPA Investment Companies Expert Panel
July 12, 2006 Meeting Highlights**

Financial Accounting/Reporting Issues

- I. Regulatory Settlements** – Some mutual funds have recently received a check from an intermediary organization to compensate for losses incurred by the funds from market timing permitted by the intermediary. In certain instances, the funds may not have had knowledge of the market timing or may have known about it but objected to it. Apparently, regulators conducted an examination of the intermediary and, as part of a settlement, required the payment to be sent to the funds (but not directly to any shareholders). The mutual funds do not know specifically how the amount was calculated, as they did not make any prior claim on the intermediary for compensation and the regulators have told the funds that the payment amount was correct and that they did not need to review any of the underlying analysis.

The EP considered how the receipt should be recorded in the financial records of the funds. One challenge is that the RICs do not know how the payment amounts were determined. One view is to present the amount on the statement of operations, such as a gain (under FASB Statement No. 5), other income, or a contra expense if the were designed to compensate the RICs for extra expenses incurred as a result of the market timing. However, the EP noted that receipts such as these are normally presented on the statement of operations only when they relate to amounts previously posted on the statement of operations. In this instance, the funds do not know how the payments were determined. Due to this uncertainty, the EP members believe that the amounts should be treated as an increase in capital and should be reported on a separate line item in the statement of changes and in the per share section of the financial highlights if material.

The EP was unsure if the book and tax treatment would be the same.

The EP noted that a fund should not record any settlements until it is certain that it will receive the payment. A fund may be tempted to record a receivable when a fund receives notification of a settlement, but the EP cautioned that such amount might be reversed and that the fund may truly not be certain on notification date that it will receive the payment.

- II. Money Market Fund SOI Presentation** – The SEC’s shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments (SOI) for a money market fund from the semi-annual or annual shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform a shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the Audit and Accounting Guide *Investment Companies* do not currently permit a fund to exclude the

SOI from the financial statements. As auditors have been unable to provide an unqualified opinion to a money market fund excluding the SOI, money market funds have been unable to take advantage of the option. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal. At the May 24 meeting, the EP noted that changing GAAP would be a time-consuming and arduous process, so the EP considered a previously unexplored option: the issuance of an unqualified report referencing the full SOI maintained in an external document (Item 6 of Form N-CSR).

The EP briefly discussed a draft of such a report at the July 12 meeting, noting that no clear example of a similar report exists in the professional standards. The EP agreed to consider the contents of the draft prior to the next EP meeting.

The EP noted that in order for a firm to issue an unqualified report that references Form N-CSR, Form N-CSR must be filed concurrently with the delivery of the shareholder report. If such did not occur, the auditor would be referencing a document (Form N-CSR) that did not exist.

The EP noted that the Auditing Standards Board and Audit Issues Task Force (AITF) should be the first to review the report draft, and, if they approve, the EP would forward the draft to the PCAOB. Some fear that if the opinion were to be accepted, non-registered funds may suggest that they do not need to include SOIs for their funds in the financial statements, because the auditors could just reference in their reports where the SOI can be located. The accounting community as a whole feels strongly that such funds should include at least a condensed schedule of investments with the financial statements, and there is little interest to resume this debate that was prevalent during the drafting of SOP 03-4.

- III. Blocker Entities in a Master-Feeder Structure** – In many master-feeder relationships, a blocker entity (fund, not holding company) is set up in between the top tier and lower tier funds. The EP believes that the Scope SOP would permit the top tier fund to consolidate the blocker even if the top tier fund does not own 100% of the blocker. It would, however, need to own a controlling interest of the blocker.

- IV. FIN 46(R) and EITF 04-5** – The EP discussed general adviser issues relating to FIN 46(R) and EITF 04-5. Footnote 7 of FIN 46(R) notes that if a holder of an investment does not have an ownership interest but essentially has a controlling financial interest through another means, an entity may be a variable interest entity (VIE). For a private fund, the EP theorized that an adviser may obtain decision-making authority through a service contract instead of ownership and the fund may be, therefore, a VIE.

The EP noted that most would view the adviser and an affiliated general partner (GP) to represent the same entity for purposes of considering FIN 46(R) and EITF 04-5.

The EP also re-affirmed a previous conclusion that in determining whether or not a GP should consolidate a non-registered partnership under FIN 46 or EITF 04-5, the GP should first determine if the partnership is a variable interest entity as defined by FIN 46(R). When the GP's interest in the fund is zero or very small, one may conclude that the partnership is a VIE and would not need to apply EITF 04-5. Therefore, even if a fund would have been consolidated under EITF 04-5, it may not be consolidated under FIN 46(R).

- V. Partnership Redemptions** – The EP acknowledged that non-registered investment companies which are consolidated by a public entity or entity that files financial statements with the SEC are considered SEC registrants, are subject to FASB Statement No. 150, and are not permitted to use the deferral in FSP 150-3. Paragraph 3 of the FSP clearly states that SEC registrants may not use the deferral and defines SEC registrants as follows:

“For purposes of this FSP, SEC registrants are entities, or entities that are controlled by entities, (a) that have issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (b) that are required to file financial statements with the SEC, or (c) that provide financial statements for the purpose of issuing any class of securities in a public market.”

For non-SEC registrants, the EP also noted that if an investor in a non-registered fund provides notice of an intent to redeem and such intent is accepted by the fund (if acceptance is required), the fund should generally proceed as follows relative to the redemption when preparing financial statements as of December 31:

- a. *Redemption paid on or prior to December 31: Capital should be appropriately reduced for the 12/31 financial statements.*
- b. *Redemption outstanding on December 31, and amount to be paid will be based on the partner's holdings as of December 31 or a date prior to December 31: Record a liability as of 12/31 and reduce the capital balance for an amount equivalent to the redemption.*
- c. *Redemption outstanding on December 31, and the amount to be paid will not be based on the partner's holdings as of December 31, but rather for a later date: Do not record a liability as of 12/31 and do not remove the amount of the redemption out of capital.*

- VI. 529 Plans with Stable Value Options** – At previous meetings, the EP discussed whether contract value accounting was appropriate for stable value options of a 529 Plan subject to GASB, especially those synthetic GICs. The EP noted that GASB’s current project relating to accounting for derivatives will likely address synthetic GICs. The EP prepared an education document to provide to the government EP to assist in working with GASB on synthetic GICs.

The EP noted that if the securities underlying the synthetic GIC cannot be sold by the 529 plan, GASB 31 may not require fair value accounting because the securities are not transferable. However, the EP did not conclude that this was the intention of GASB 31.

The EP also noted that state treasury pools that are consolidated into a municipality would be subject to standards established by GASB.

SEC Update

- VII. 206(4)-2 No-Action Letter** – The SEC staff indicated that it is working on the no-action relief requested by the audit firms relative to newly registered investment advisers and their ability to use the audit exception in Rule 206 and avoid the security count requirement when the auditor of the related hedge fund product(s) managed by the adviser was not independent under SEC rules (but was independent under AICPA rules). Once the staff is comfortable with the language, it will send it to the Commissioners for their review. However, if the Office of the Chief Accountant or General Counsel’s office requests revisions of the no-action letter, the letter will need to be made by the audit firms prior to distribution to the Commissioners.

Currently, the SEC still believes that when an adviser wants to use the no-action relief, it should disclose in the notes to the financial statements of the funds that the auditor is not independent under SEC rules. The SEC staff believes that other changes it has suggested to the no-action letter draft may provide more flexibility to advisers.

- VIII. Fund of Funds Rule** – The SEC highlighted that the recently released fund of funds rule codifies some exemptive orders that were previously released. The SEC also briefly discussed other aspects of the rule.

Under the newly adopted rule, the shareholder expense table must contain a line item which shows the percentage of total expenses of the underlying funds indirectly incurred by the fund, or, if not material, such percentage may be included in the “other” line item within the expense table. The SEC commented that any fund investing in another fund, not just those labeled as being “fund of funds” must include this disclosure, including funds that may

just hold an ETF or a money market fund. The expense example in the prospectus needs to reflect the expenses of the underlying funds, but the expense example in the shareholder report containing the financial statements and the expense ratio in the financial statements will not contain this extra percentage. Funds are permitted to explain the difference between the expense ratio in the expense table vs. the expense ratio in the financial highlights via a footnote to the expense table.

The SEC also noted that registered hedge funds are subject to this rule and may want to pay close attention to the provisions relating to incentive fees.

- IX. XBRL** – The SEC noted that it is still seeking volunteers to file using XBRL and noted that a fund could elect to file just one series of a Trust using XBRL if it wanted to do so. The Interactive Data Spotlight section on the SEC’s website contains information on the XBRL process.
- X. FIN 48** – The Chief Accountant’s Office, Division of Investment Management, is interested in identifying any situations in which RICs that intend to qualify under Subchapter M believe they may have to record a tax liability for financial reporting purposes in order to comply with FIN 48. The SEC expressed a strong preference for the NAV for financial reporting purposes to be the same as that used to execute transactions under Rule 22c-1, but it is possible that the SEC may grant the use of different NAV for Rule 22c-1 purposes under special circumstances.
- XI. Consolidation by Investment Companies** – As discussed at the previous EP meeting, the SEC interprets Rule 6.03 of Regulation S-X to require RICs to consolidate other RICs it controls and to preclude a RIC from consolidating an operating company unless the SEC pre-approves it. At the July 12 meeting, the SEC noted that it may actually conclude that a RIC should consolidate a 100%-owned non-RIC under certain circumstances. The SEC noted that it does not generally believe that consolidation needs to occur when a master-feeder or typical fund of funds structure exists.

The SEC is considering consolidation as it reviews the registration statements of potential new registrants, especially BDCs. The SEC stated that while it may be okay for a BDC to consolidate an entity that provides services to the BDC, it would not be appropriate to consolidate an entity that only spends 30-40% of its time providing services to the BDC and the remaining time providing services to others. In this example, the SEC’s views the service provider as being more of a portfolio company of the fund and believes that the fund should generally not be consolidated. The SEC indicated, however, that a bright line test does not exist. The SEC expressed concern with current practices of certain BDCs and requested that BDCs consult with the SEC on consolidation prior to doing so.

For those entities that are currently presenting consolidated financial statements but should not be, the SEC has not determined the appropriate way to report a change to de-consolidate the entity, although it would probably represent a change in the reporting entity.

- XII. Change in Auditors:** The SEC noted that a predecessor auditor should provide consent in each filing which contains or incorporates its audit report or contains financial statements or financial highlights audited by the predecessor firm. Thus, the technical requirement would be that the auditor provides a consent for 5 years after the audit date, since 5 years of audited financial highlights would normally be presented in the registration statement and financial highlights on the annual report included or incorporated into the filing. However, the SEC will accept filings that only contain consent for just the year that the statement of changes is included or incorporated in a filing. For example, if the predecessor auditor audited the statement of changes for the year ended December 31, 2005, consent would need to be included for filings including or incorporated that statement of changes, which would normally be the 2006 and 2007 filings for an open-end investment company. A registrant which fails to include the required consent of the auditor is deemed to be non-compliant.

When incorporating a set of financial statements, the filer should incorporate all financial statements, as well as the auditor's opinion(s). Since the audit report of the predecessor auditor covering the prior year financial statements is not normally included in the current year's financial statement filing on form N-CSR, the registration statement should either incorporate by reference the prior year's financial statements that would include the predecessor auditor report or include a predecessor auditor report in the filing.

An predecessor auditor is not required to issue a separate opinion just on the statement of changes that is included – the original opinion is sufficient. If the auditor elects to issue a new opinion due to the occurrence of a subsequent event, all older opinions would not need to be incorporated

- XIII. Independence: ICC and Private Equity Initiatives–** The SEC indicated that it has not forgotten the auditor independence initiatives relating to the Investment Company Complex private equity, but noted that the 206(4)-2 no-action letter is more pressing at the current moment. The Division of Corporate Finance is responsible for the private equity issue.

Other Projects

- XIV. CCO Reporting –**The subcommittee has presented its proposed auditor reports/letters associated with engagements related to 38a-1 to AITF. The AITF was supportive of the recommendations of the Task Force. The AITF

did note that it would have concerns if a listing of actual testing procedures and results were included along with an attestation report. It may be possible to discuss procedures and results in an agreed-upon procedures report, although such would not be preferable.

AICPA Investment Companies Expert Panel

August 28, 2006 Meeting Highlights

Financial Accounting/Reporting Issues

I. Redemption Fees on a Multi-Class Fund – Many funds have adopted a policy of charging redemption fees to prevent or curb short-term or excessive trading. The Expert Panel (the “EP”) discussed how funds with multiple share classes should record redemption fees. A shareholder in a specific class may redeem shares, triggering the assessment of a redemption fee. Fund groups usually record the redemption in one of two ways:

- a) Increase the capital balance of the specific class or
- b) Allocate the redemption fee across the capital balances of each class based on the relative net assets of each class or some other reasonable basis.

A prevalent view is that the short-term or excessive trading raises certain costs incurred by all funds, causes dilution in all share classes, and effectively harms each class of a fund. For this reason, funds generally follow option b). Funds using option a) believe that the specific class is harmed more than the other classes because each class incurs and records specific transfer agency or other transactional charges based on the volume of shareholder transactions. Thus, as shareholder trading increases, so do the costs of the class.

The EP noted that funds should justify the rationale for the approach that they have taken. In determining the most appropriate approach, funds should consider the wording in the prospectus relative to redemption fees and whether the wording would suggest that one of the two options should be followed.

II. Investments in Loans/Notes – The EP noted that investments in loans and notes should be valued at fair value.

III. Fair Value Measurements Exposure Draft is due to be issued in September. The EP noted that the FASB Board continues to re-deliberate the exposure draft and had provided a recent summary of deliberations. The EP discussed the following:

- a) Many hedge fund complexes are not using an outside vendor to perform fair valuations of the investments. They are more likely to use an outside vendor if the same complex has mutual funds and hedge

funds. Exposure draft would require an entity to adjust a valuation under the following circumstances:

“...the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity’s own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.”(paragraph 30)

The EP noted, however, that this adjustment will not be necessary if it is immaterial to the fund.

- b) The majority of money market funds use amortized cost to value their securities. The EP noted that this would not be an issue for registered funds as they would be following practice permitted in Rule 2a-7 promulgated under Investment Company Act of 1940. However, this will be a potential issue for non-registered money market funds.
- c) Transaction costs– The FV ED notes that the fair value should not reflect transaction costs. If a fund buys a liquid security at the end of the trading day and incurs a transaction cost, the audit guide would require that the cost of the security include the transaction cost. While the FV ED does not change this requirement, it does require that the fair value exclude such costs.

For funds holding securities traded on an exchange, transaction costs would likely be insignificant. However, for a private equity fund, certain transaction costs associated with buying a private equity holding may be significant. The EP noted that if the purchased cost (excluding transaction costs) reflects the true fair value of the holding on the valuation date, the fund would recognize depreciation on the investment equal to the amount of the transaction costs incurred. The EP also noted that private equity funds should evaluate the appropriateness of the “transaction” costs. If certain costs do not truly meet the definition of transaction costs, they should be expensed when incurred.

- IV. Proposed Amendment to FAS 109 Relating to Uncertain Tax Positions –**
The EP discussed the release of the amendment to FAS 109 relating to uncertain tax positions. There are two steps outlined in the amendment: Recognition and Measurement. Recognition, the first tier, requires that an entity meet the 50.1% criterion, while measurement introduces a probability-based model that helps an entity determine the amount of the tax benefit associated with the uncertain tax position that could be recognized.

The EP noted that while the draft permits an entity to use administrative practices and precedents (such as the experiences of other funds or the IRS' handling of other uncertain tax position questions) to demonstrate that a tax position meets the more than likely criteria necessary for recognition of the tax position, it does not explicitly permit such for the measurement criteria. However, the FASB has indicated informally that such would be allowable for investment companies.

Funds should create an inventory of uncertain positions. At a minimum such list will include risk areas relating to tax identified in the risk section of prospectuses. The EP noted that it may be helpful for the investment company industry to develop a list of best practices for how investment companies should document their conclusions that certain tax position met the recognition and measurement tests. The industry then might share the list with the audit firms to gain their perspective. ICI may not want to undertake this project due to potential liability.

Following are the list of additional topics discussed:

1. SEC view has been in the past that because funds strike NAVs daily, such constitutes daily reporting. Thus a fund would need to adjust the daily NAV if a liability exists upon adoption of FIN 48.
2. Audit approach to deal with uncertain tax positions would include understanding the process and sampling uncertain positions. Scope would include not only positions open at the end of the day but also scenarios when a fund group divests of a position that created an uncertainty that does not meet the more than likely, because the statute of limitations on the uncertain position would not be complete yet.
3. There are different criteria for booking asset and liability. As a result, RIC may wind up with a situation when an asset will have to stay on the books even after the liability has been removed.
4. Treatment of the minimum amount the fund would be willing to settle an uncertain position in order to avoid costly and time-consuming litigation is a consideration. Many funds would be inclined to settle rather than litigate position that they are certainly comfortable with. More likely than not decision does not contemplate settlement.
5. If fund has a deficiency distribution, it will need to record any penalty and interest.
6. Due diligence that fund complex may perform around uncertain tax positions would include checking with counterparts in the industry and documenting results, using analogies to other situations for which the

IRS has provided guidance, using prior history, and obtaining legal opinions. There is an inherent conflict that exists between requirement that audit firms have to be able to complete their audits and information that law firms would be willing to provide. It was noted that audit firms may need to understand how a law firm reached an opinion and that law firms may be opposed to sharing the background underlying their decision because doing so may provide information that could be used against their clients in the event of actual litigation.

- V. Private Equity/Venture Capital/Alternative Investments Valuation Testing** – Auditors face numerous challenges in auditing funds investing in venture capital or private equity, including lack of GAAP-based financial statements for underlying investee funds, unique calculations, and values based on inside information or on the perception of management. A lack of available information or the use of non-GAAP based valuations may lead to a qualified or adverse opinion. Additionally, even if a partnership agreement specifies the use of a comprehensive basis of accounting other than GAAP, investors such as pension plans may still require GAAP financials.

The EP discussed the results of an AICPA-led Task Force which was formed to provide clarification relating to AU 9332, the audit interpretation relating to an auditor's testing of the valuation and existence assertions for alternative investments. As a result of recommendations made by the Task Force, a Technical Practice Aid has been developed. The practice aid permits alternative procedures instead of requiring the auditor to confirm and re-value each of the underlying positions. It suggests that receiving audited financial statements can be a very important source of evidential matter for the auditor. The practice aid also stresses the need for management to gain sufficient evidence in order to record the investments at fair value.

- VI. 529 Plans with Stable Value Options** – At previous meetings, the EP discussed whether contract value accounting was appropriate for stable value options of a 529 Plan subject to GASB, especially synthetic GICs. The EP noted that GASB's current project relating to accounting for derivatives will likely address synthetic GICs. The EP prepared an education document to provide to the government EP to assist in working with GASB on synthetic GICs.

Certain members of the EP had a conference call with the AICPA Government Expert Panel to discuss this education document.

The Stable Value Investment Association is working with valuation issues. When it comes to a consensus on this issue, its representatives will attend an EP meeting. Anticipated timeline is by December 2006. Questions that are raised are: should there be an outside vendor to verify evaluations and how many variables would it need to accumulate. There is also a question on

presentation of wrapper on financial statements – whether it should be similar to an option or a swap.

Technical Practice Aids

VII. TPAs to be sent to Planning Subcommittee of AcSEC: The EP submitted the following TPAs to the Planning Subcommittee of AcSEC:

a. Recognition of Premium/Discount on Short Positions in Fixed-Income Securities - An investment company should recognize premium and discounts on short fixed-income positions in the statement of operations, similar to how it recognizes coupon interest as interest expense on its short positions.

b. Presentation of Reverse Repurchase Agreements – Reverse repurchase agreements should be presented in the financial statements of investment companies at cost.

c. Accounting Treatment of Offering Costs incurred by Investment Partnerships - An investment partnership may defer offering costs incurred prior to the commencement of operations and then amortize them to expense over the period that it continually offers its interests, up to a maximum of twelve months. The straight-line method of amortization should generally be used.

SEC Update

VIII. Registration of Hedge Fund Advisers - As a result of the decision of the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC* (“Goldstein decision”), the Court of Appeals vacated rule 203(b)(3)-2 under the Investment Advisers Act of 1940 as well as other related rule amendments. SEC decided not to appeal Goldstein decision.

On August 10, 2006 Division of Investment Management of SEC has issued No-Action Letter to restore some of the rules that were eliminated because of vacated rule 203(b)(3)-2. One of them is a requirement to deliver fund of funds financial statements within 180 days following the fiscal year-end.

IX. 206(4)-2 No-Action Letter – The SEC staff indicated that today it is issuing the no-action relief requested by the audit firms relative to newly registered investment advisers and their ability to use the audit exception in Rule 206 and avoid the security count requirement when the auditor of the related hedge fund product(s) managed by the adviser was not independent under SEC rules (but was independent under AICPA rules). Additionally such services

prohibited by the Commission's independence rules cease no later than June 30, 2007.

The SEC believes that when an adviser wants to use the no-action relief, it should disclose in the notes to the financial statements of the funds that the auditor is not independent under SEC rules, that accountant is independent under AICPA rules, the general reason why accountant is not independent under the SEC independence rules and description of the relief and duration of the relief granted by the staff.

- X. FIN 48** – The Chief Accountant's Office, Division of Investment Management, is interested in identifying any situations in which RICs that intend to qualify under Subchapter M believe they may have to record a tax liability for financial reporting purposes in order to comply with FIN 48.

The SEC expressed a strong preference for the NAV for financial reporting purposes to be the same as that used to execute transactions under Rule 22c-1, but it is possible that the SEC may grant the use of different NAV for Rule 22c-1 purposes under special circumstances.

The EP had a specific question about excise tax – whether it would be subject to FIN 48 or not. SEC has not concluded on this issue but was interested in what the EP was thinking. The EP noted that one view would be that excise tax is not an income tax, and as such would not be subject to FIN 48.

The SEC encouraged funds to talk with the IRS and the Treasury Department regarding any uncertain positions funds might identify and to seek opinions on uncertain positions from those agencies.

As a general matter, the SEC encouraged registrants to come to SEC on one-on-one basis with specific issues.

It was also noted that ICI would meet with SEC in September and working group of audit firms will meet with FASB to discuss this issue.

- XI. Change in Issuer's Year-End** – The SEC indicated that it periodically receives requests from registrants who have changed their year ends and want the SEC to grant relief from the requirement to provide financial statements for a certain period. For example, if a fund changed its year end from 12/31 to 7/31, it might request that it be permitted not to submit 6/30 semi-annual financial statements since its annual financial statements would be due one month later. The SEC noted that it has granted many of these requests, although relief varies based on the circumstances. The SEC reminded the EP that the certifications in the N-CSR and N-Q relating to internal control cover a 90 day period only. To the extent that a fund does not file the semi-annual

report (as in the example), the certifications in the N-CSR would need to cover all periods since the last certification (the N-Q at 3/31, approximately 122 days). Funds should seek exemptive relief from the SEC to enable them to expand the certification to include a period longer than 90 days.

- XII. 17f-2 counts**– The SEC indicated that there are number of 17f-2 count reports that are being filed with SEC as late as a year and a half from the date of the procedures. SEC indicated that such lateness was not acceptable, and they would be monitoring how late these reports are filed. The EP noted that there may be some objective reasons why an audit firm may not be able to complete the procedures timely, such as difficulties in receiving confirmation responses timely.

The EP inquired as to whether the SEC would permit audit firms to perform alternative procedures if confirmations are not returned in a timely manner. The SEC indicated that it would determine whether the requirement to perform a 17f-2 count was a statutory rule. If it is, there is less ability to permit such procedures without amending the rule itself. If it is not, there may be room for alternative procedures.

- XIII. Inspections of Registered Investment Advisors** – frequency of inspection will depend on a risk profile: higher risk – one exam every 3 years; not as high risk – no specific timeframe. Area of particular interest for the inspections are the following:
- a. compliance programs and procedures (effectiveness, resolution of violations, timelines of resolutions);
 - b. CCO programs and violations identified through CCO procedures;
 - c. business continuity (backup sites, testing, etc.)

Audit Issues

- XIV. Auditor Consents**- Audit firms are required to provide consent to a registrant whenever the registrant makes a filing that includes or incorporates by reference the auditor’s opinion on the financial statements. If a report is not included or incorporated, consent is not necessary. Nevertheless, the audit firms on the EP noted that registrants sometimes still ask for consent. The audit firms indicated that they generally are willing to provide the consent after performing limited procedures on the filing.

Other Projects

XV. CCO Reporting – In the previous meetings the subcommittee has presented its proposed auditor reports/letters associated with engagements related to 38a-1 to Audit Issues Task Force (“AITF”). The AITF was supportive of the recommendations of the Task Force. The AITF did note that it would have concerns if a listing of actual testing procedures and results were included along with an attestation report. It may be possible to discuss procedures and results in an agreed-upon procedures report, although such would not be preferable.

**AICPA Investment Companies Expert Panel
Meeting Highlights
October 31, 2006
AICPA offices, New York City**

Financial Accounting/Reporting Issues

- I. Scope SOP** – The Expert Panel noted that the FASB, at its September 13, 2006 meeting, did not object to the issuance of the SOP, subject to certain revisions. These revisions were further considered by AcSEC. The Expert Panel expected that the Scope SOP will be issued in the first quarter of 2007 and effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. Scope SOP is the last authoritative SOP to be issued by AICPA.
- II. Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*** (“SFAS 157”) - The Expert Panel discussed various implementation issues relating to SFAS 157:

- i. Use of zero trigger in valuing fair value securities. SFAS 157, paragraph 26 states:

In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.[emphasis added]

The Expert Panel noted that it is common practice for asset managers to use proxies to monitor the valuation of foreign equity securities. A majority of advisors with proxies use triggers and some fund complexes have also adopted a zero trigger. The Expert Panel noted that complexes that use triggers will have difficulty justifying that their foreign securities fall within the level 1 category if the pricing service has made any adjustments to the level 1 price.

- ii. Fixed income securities. The Expert Panel noted that pricing services employ a variety of methodologies to value fixed income

securities. Therefore, some fixed income instruments may be rated as a level 1, 2 or 3 depending on the availability of a quoted price or other observable inputs.

- iii. Transaction costs. Please refer to the August 2006 AICPA Investment Companies Expert Panel meeting highlights for further discussion of accounting for transaction costs.

SEC Update

- III. **Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act** – On November 1, 2005, representatives from certain public accounting firms met with representatives of the SEC Staff to discuss the application of the SEC independence rules in connection with the Audit Exemption provided in Rule 206(4)-2 of the Adviser’s Act. The concern was whether the SEC’s auditor independence rules are applicable to the audit of a non-registered hedge fund when a registered investment adviser uses an exception for the security count examination, as permitted under the “Custody of Funds or Securities of Clients by Investment Advisors” (the “Custody Rule”).

In the SEC Release *Staff Responses to Questions About Amended Custody Rule*, as updated in January 2005, the SEC Staff indicated in its response to question VI.5 that for a registered investment adviser to meet the security count exception, the auditors of each of the adviser’s hedge funds would need to comply with “U.S. Generally Accepted Auditing Standards” and, in particular, with Article I, Section 2(d) of Regulation S-X governing independence standards. On August 2, 2006, a letter was submitted by Deloitte & Touche LLP on behalf of a number of public accounting firms requesting transitional relief from the independence rules imposed by this SEC view for auditors of funds associated with newly registered investment advisers. On August 28, 2006 the SEC Staff issued a letter to Deloitte & Touche LLP in response to the request granting relief upon certain prescribed conditions. However, even to the extent relief has been granted there are certain interpretive questions that still needed to be resolved. The Expert Panel inquired the SEC Staff about the best approach to address these interpretive questions. The Expert Panel suggested documenting open issues in a white paper and submitting its perspective to the SEC. The SEC Staff was receptive to that approach.

- IV. **Staff Accounting Bulletin No. 108**– SEC has inquired whether the Expert Panel was aware of any issues for registered investment companies relating to the issuance of Staff Accounting Bulletin No. 108. The Expert Panel was not aware of any such issues.

- V. **XBRL** – The SEC Staff has noted that it received a second filing from investment management companies using XBRL. The Expert Panel inquired whether N-Q data will be tagged in XBRL. The SEC Staff noted that registrants have an option of tagging N-Q data. The *Spotlight On: Interactive Data and XBRL Initiatives* section on the SEC’s website contains information on the XBRL process (<http://www.sec.gov/spotlight/xbrl.htm>).
- VI. **FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 (“FIN 48”) and investment companies registered under the Investment Company Act of 1940** – Please refer to the August 2006 AICPA Investment Companies Expert Panel meeting highlights for further discussion of this item. The AICPA Investment Companies Expert Panel will continue to be a resource to ICI and SEC in dealing with FIN 48.
- VII. **17f-2 Counts** – Please refer to the August 2006 AICPA Investment Companies Expert Panel meeting highlights for further discussion of this item. SEC Staff indicated that IM Office of Chief Counsel is evaluating this issue and any questions raised.
- VIII. **Consolidation by Investment Companies** - Rule 6-03(c)(1) of Regulation S-X provides guidance relating to consolidation by registered investment companies. It states “... *statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies.*” The current AICPA Audit and Accounting Guide *Investment Companies* (“Audit Guide”), paragraph 7.05 provides an exception to this general principle and states that consolidation of an operating company is appropriate when “the investment company has an investment in an operating company that provides services to the investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment.” The SEC Staff has indicated that they interpret S-X 6-03(c)(1) generally to prohibit the consolidation by a registered investment company of any entities other than registered investment companies.

The SEC Staff have raised particular concerns about consolidation of entities providing services to registered investment companies, because the resulting mixing of fair value accounting and historical accounting may distort the investment company's reported performance. The SEC Staff have indicated that, pursuant to written requests citing specific facts and circumstances, they have not objected to consolidation of non-registered investment companies that are generally wholly-owned by a registered investment company and, in certain cases, operating companies providing all or substantially all of their services or operations to a registered investment company and/or its portfolio companies. The SEC Staff recommends that registrants seek pre-approval when a registered investment company intends to consolidate an entity other

than another registered investment company. For those entities that are currently presenting consolidated financial statements but should not be, the registrant would need to determine whether deconsolidation results in correction of error or change in reporting entity pursuant to FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*. Furthermore, the SEC Staff noted that it does not generally believe that consolidation needs to occur when a master-feeder or typical fund of funds structure exists.

The SEC Staff has indicated that there have been situations where they did not object to the following entities being consolidated: financing subsidiaries, tax blocker entities, advisor providing substantially all of the services to the fund and/or the fund portfolio companies, wholly-owned finance companies, small business investment companies. At the same time, SEC Staff requested that registrants pre-clear any situation in which a registered investment company would be consolidating an entity other than a registered investment company even in those instances when such fact pattern matches a previous fact pattern for which SEC Staff did not object consolidation in the past. Registrants should follow the consultation guidance posted on the SEC.GOV website (<http://www.sec.gov/info/accountants/ocasubguidance.htm>).

- IX. Statements of Financial Accounting Standards No. 157, *Fair Value Measurements*** (“SFAS 157”) – The SEC Staff inquired of any SFAS 157 issues that the investment management industry has come across, and whether advisors have any difficulties in determining whether the security falls within level 1, 2 or 3 categories. The Expert Panel inquired whether the SEC Staff expects to see many securities at level 3 in the mutual fund environment. The SEC Staff did not form a view relating to this question.

The Expert Panel inquired as to whether there were any views on the presentation of SFAS 157 disclosures. The SEC Staff acknowledged that they have seen some preliminary disclosure drafts. The SEC Staff will look to ICI and the Expert Panel to put together a sample presentation.

- X. Enforcement update** – The SEC Staff provided an update of recent SEC enforcement actions:

- One matter involved a materially misleading statement by an investment advisor and the failure of the advisor to fully and effectively disclose material facts in the fund’s shareholder reports concerning forbearance agreements that the fund entered into with obligors on bonds in the fund’s portfolio. Under the forbearance agreement the fund agreed to temporarily accept partial payment of the original coupon interest rates. One of the bonds was the fund’s largest single holding during the relevant period. Absent these forbearance agreements, the bonds would have been in default for failure to make required interest payments.

The advisor that was responsible for making the fund's disclosures and public filings did not disclose to investors in the fund's portfolio that the fund had entered into forbearance agreements with the obligors on these bonds. Furthermore, in the portfolio manager's letter for the fund's semiannual report, the advisor reported to investors that the percentage of defaulted securities in the Fund's portfolio had fallen below 10% of assets. The statement that the default rate had fallen below 10% was misleading because the report failed to also disclose that bonds comprising an additional 14% of the Fund's net assets were subject to deferred-interest forbearance agreements.

Moreover, the advisor did not designate the bonds subject to the forbearance agreements as partial-interest-paying bonds in the fund's financial statements, as required by Regulation S-X. Note 5 of Article 12-12 of Regulation S-X requires investment companies' schedules identifying securities of unaffiliated issuers to denote those bonds that are producing "partial payment of interest" as of the bonds' last interest payment date. In the fund's schedules of investments in the fund's financial statements, the advisor did not identify the bonds with forbearance agreements as partial-interest-paying bonds, even though the issuers were only paying part of the original coupon interest pursuant to forbearance agreements.

The commission imposed sanctions on the advisor.

- Another matter involved an advisor that failed to ensure a receivable owed to the fund was paid in a timely fashion. This situation resulted in a prohibited borrowing from an investment company. In addition, this advisor purchased bonds for the money market fund that exceeded the maturity limit for money market fund securities under Rule 2a-7 of the Investment Company Act. As a result of its impermissible investments, the fund was prohibited from holding itself out as a money market fund.

The commission imposed sanctions on the advisor.

- XI. Section 19** – The SEC Staff indicated they are considering recommendations from the industry which include but are not limited to exempting certain funds (money market and tax advantage funds) from Rule 19(a)(1), establishing a materiality threshold for section 19(a) notices, whether to allow funds to use the internet to send Rule 19(a) notices or allow funds to file Section 19(a) notices on Edgar. The SEC Staff also stated that they are considering how to deal with shareholders that make up an omnibus account and how these shareholders should receive Rule 19(a) notices. Finally, the SEC staff indicated they are considering allowing funds to provide performance information in the Rule 19(a) notices in order for shareholders to determine if the performance of the fund reflects the distribution amounts.

Public Accounting Firm Issues

- XII. AICPA Practice Aid “Alternative Investments- Audit Considerations, A Practice Aid for Auditors” (the “Practice Aid”)** – In 2006 AICPA issued *Alternative Investments - Audit Considerations - A Practice Aid for Auditors* that addresses challenges associated with auditing investments for which a readily determinable fair value does not exist. These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are referred to as “alternative investments.” Investors in alternative investments include, but are not limited to, colleges and universities, hospitals, pension plans, and investment companies – including funds of funds.

One of the aspects that this Practice Aid addresses is the auditor’s reports, and the inclusion of the Emphasis of a Matter Paragraph in the audit opinion. The Practice Aid included the following guidance:

“Reporting

Emphasis of a Matter Paragraph

The more complex or illiquid the underlying investments are, the greater the inherent uncertainty in management’s estimated fair value. As the inherent uncertainty in the estimate increases, as well as the significance of the alternative investments to the financial statements, auditors may consider inclusion of an emphasis of matter paragraph in the auditors’ report such as the following, tailored for the specific facts and circumstances:

As explained in note X, the financial statements include investments valued at \$ _____ (____ percent of net assets), whose fair values have been estimated by management in the absence of readily determinable fair values. Management’s estimates are based on information provided by the fund managers or the general partners.

An emphasis of matter paragraph is not used to introduce information to the financial statements and neither replaces any required financial statement note disclosure nor reduces the required audit evidence needed to support an unqualified opinion. Such paragraphs are never required and are included solely at the auditor’s discretion. The above emphasis of matter paragraph would be consistent with GAAP disclosures made in the financial statements.”

The Expert Panel discussed various quantitative and qualitative factors that the auditor would consider in deciding to include an emphasis of matter paragraph.

XIII. Money Market Fund SOI Presentation –The SEC’s shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments (“SOI”) for a money market fund from the semi-annual or annual shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform the shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the audit guide do not currently permit a fund to exclude the SOI from the financial statements. As auditors have been unable to provide an unqualified opinion to a money market fund excluding the SOI, money market funds have been unable to take advantage of the option. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal.

At the May 24, 2006 meeting, the EP noted that proposing a modification of GAAP that would allow a SOI to be omitted from financial statements for a money market fund would require FASB to issue guidance, which might be a time-consuming process. Alternatively, given the fact that a portfolio is actually prepared and included in the fund’s filing with the SEC, the EP considered the issuance of an unqualified report referencing the full SOI maintained in an external document (Item 6 of Form N-CSR). This approach would require coordination with the AICPA and the PCAOB (as the funds in question are registrants and issuers).

The EP briefly discussed a draft of such a report at various 2006 meetings and solicited comments. The EP noted that in order for a firm to issue an unqualified report that references Form N-CSR, Form N-CSR must be filed concurrently with the delivery of the shareholder report. If such did not occur, the auditor would be referencing a document (Form N-CSR) that did not exist.

XIV. Transfer Agent and Custodian SAS 70 Reports – The Expert Panel discussed the following considerations relating to the use of the SAS 70 reports during audits of the investment companies:

- Custody SAS 70 Reports. The Expert Panel acknowledged that the necessity to obtain a custodian SAS 70 report will depend on whether custody services are integrated into the fund’s financial accounting process (for example, the custodian provides dividend and interest notifications) or if the custodian only custodies the fund’s assets. If the custodian contributes data to the fund’s financial accounting system, the auditor will need to obtain a SAS 70 report. However, if the custodian is not integrated into the

financial accounting process and just custodies the fund's assets, the SAS 70 report will not be necessary.

- Further considerations relating to the inclusion of SAS 70 in auditor's workpapers. If the auditor maintains SAS 70 in its workpapers, the auditor needs to consider addressing audit steps during "dark periods" and steps relating to user control considerations. The auditor will need to properly document such audit steps. One of the steps that the auditor will need to perform during "dark periods" is to discuss with the fund management and the service provider management any changes in the control environment. At the same time, the Expert Panel acknowledged that the service provider auditor typically will not be able to comment on any changes in the control environment. The auditor should also consider testing controls during the "dark periods."
- Availability of SAS 70 reports. The Expert Panel noted that many prime brokers and some transfer agents do not have SAS 70 reports to provide to their clients or to their auditors.

XV. Rating Agencies AMPS Agreed-Upon Procedures - many of the closed end investment companies have engaged their respective audit firms to provide certain agreed upon procedures as a condition to the funds being rated by a nationally recognized rating agency such as Standard and Poor's Corporation, Moody's Investor's Services, Inc. or Fitch, Inc. (collectively the "Rating Agencies"). The investment and operating metrics that a fund must meet and on which the agreed upon procedures are performed (as well as the on-going compliance requirements) are normally found in the Amended By-Laws of the fund (specifically detailing the rights, privileges and obligations relative to the preferred stock) or in a similar document.

AT 201.07 provides that "to satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties." In these situations, given that the rating agencies request the report, both the rating agencies and the management of the fund would be considered to be "specified parties" or users of the report.

Because the Rating Agencies are specified parties, audit firms obtain their affirmative acknowledgment that they agree with the procedures and take responsibility for the sufficiency of the procedures for their purposes. Representatives of the firms noted that they have experienced some difficulty in obtaining appropriate affirmation from certain rating agencies.

The Expert Panel agreed to contact the rating agencies to remind the agencies of the professional standards that the audit firms are required to abide by and to offer to meet with representatives from the rating agencies to discuss the most effective and efficient manner to obtain the appropriate affirmations, acknowledging that the lack of receipt of the appropriate affirmation would preclude the rating agency from receiving the report.

Other Projects

XVI. CCO Reporting – The Expert Panel was updated on the status of CCO SOP drafting.

XVII. The Stable Value Investment Association Presentation – Traditionally, stable value fund wrap contracts were valued as the difference between the contract value and the market value of underlying securities. In December 2005, FASB published *FASB Staff Position AAG INV-1 and SOP 94-4-1* (“FSP”). This FSP includes a requirement for a fund to disclose a fair value for all instruments including wrap contracts (complete text of this FSP is posted on FASB website at: http://www.fasb.org/fasb_staff_positions/fsp_aag_inv-1&sop_94-4-1.pdf).

The Stable Value Investment Association made a presentation at the Investment Companies Expert Panel meeting in October of 2006. The presentation included discussion of the valuation methodologies for wrapper contracts and challenges relating to this process.

**AICPA Investment Companies Expert Panel
Meeting Highlights
December 19, 2006
AICPA offices, Washington, DC**

Financial Accounting/Reporting Issues

- I. **FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 (“FIN 48”)*, and investment companies registered under the Investment Company Act of 1940** – Representatives from ICI joined the meeting to discuss unique issues that registered investment companies are facing relating to the implementation of FIN 48:

- lack of administrative practices;
- retroactive application of the IRS guidance;
- adequate time to allow for reasonable diligence to be able to estimate accurate FIN 48 accruals;
- guidance on whether a fund need not reduce its NAV for a tax liability when it has been the administrative practice of the fund’s advisor or another relevant party to pay or reimburse the fund for errors the advisor or other party has made (i.e., indemnification issue); and
- concerns stemming from alternative investments.

The Expert Panel acknowledged that many of the small investment company complexes are struggling with these and other implementation issues. The Expert Panel offered help to the ICI representatives in working with the SEC and FASB on addressing these issues.

- II. **Tender Option Bond Transactions and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*** - The Expert Panel raised a question of accounting by investment companies for tender option bond transactions and failed sale treatment under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125 (“SFAS 140”)*. Some members of the Expert Panel have seen hedge funds engaging in the tender option bond transactions that failed sale accounting treatment under SFAS 140.

The Expert Panel noted that in tender option bond transaction, an analysis would need to be performed to determine whether sale treatment criteria have been met according to the paragraph 9 of SFAS 140. To the extent the transaction should not be recorded as a sale, it would be accounted for as a

secured borrowing with the bond remaining on the books of the fund and an associated loan or borrowing being established.

The Expert Panel further discussed the economic benefits of entering into tender option bond transactions. Lastly, the Expert Panel recognized difficulties in detecting linkage between transfer of the bond and subsequent purchase of residual interest because trade authorizations for subsequent purchase of residual interest typically do not associate to the original transfer of the bonds to the Tender Option Bond Trust.

III. **FASB Staff Position AAG INV-1 and SOP 94-4-1** - Stable Value Task Force of the AICPA Employee Benefit Plan Expert Panel (“EBP EP”) has joined the Investment Companies Expert Panel meeting to get feedback on some of the questions relating to the implementation of FASB Staff Position *AAG INV-1 and SOP 94-4-1, Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans* (“FSP”):

- *Question: paragraph 11. b. of the FSP requires inclusion of a reconciliation of the change in the balance sheet "adjustment" account (i.e., the difference between net assets reflecting all investments at fair value and net assets at contract value) for each period in which a statement of changes in net assets is presented. Is a single line item disclosure of the net change in the "adjustment" account sufficient to meet the requirements of this section?*

Question: paragraph 11.c. of the FSP requires disclosure of the average yield earned by the entire fund. In describing the disclosure, the FSP refers to annualized earnings of all investments in the fund divided by the fair value of all the investments in the fund. Is the disclosure to be based on the actual investment income of the fund over the period divided by the average fair value during the period, or the estimated period-end portfolio earnings rate divided by the period-end fair value?

The Investment Companies Expert Panel discussed different alternatives to the answers and recommended that EBP EP seeks further guidance from FASB on these issues. Both Panels further discussed the request for deferral of the FSP to allow additional time for the marketplace to deal with these and other implementation issues.

IV. **Statements of Financial Accounting Standards No. 157** - The Expert Panel discussed the following questions relating to the implementation of Financial Accounting Standards No. 157, *Fair Value Measurements* (“SFAS 157”):

- Many registered and non-registered money market funds value their investments at the amortized cost. What category would these values

fall under according to SFAS 157? The Expert Panel agreed that investment of the money market funds do not fit into the level 1 category definition. At the same time, the level 3 category does not seem to coincide with the spirit of what FASB intended while writing this standard. Furthermore, the Expert Panel noted that even if the registered money market fund performs “shadow pricing” as required by Rule 2a-7 promulgated under Investment Company Act of 1940, securities that are valued at the amortized cost would not fall within the level 1 category unless the fund chose to use the shadow price received in valuing the fund as of the reporting date and the shadow price was reflective of market price.

- The Expert Panel discussed whether private equity firms and venture capital firms are changing their valuation policies to address SFAS 157 guidance. The Expert Panel noted that the following guidance in SFAS 157 is helpful in understanding when a change is needed:

*“In developing unobservable inputs, the reporting entity **need not undertake all possible efforts** to obtain information about market participant assumptions. However, the reporting entity **shall not ignore** information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity’s own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.”¹ [emphasis added]*

- Furthermore, the Expert Panel discussed paragraph 26 in the SFAS 157 that states:

“In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.”

In the investment company context it is important to determine what the measurement date and the close of business as of that date is. A question was raised as to a situation where a fund chooses a valuation policy that establishes the market prices of securities at 4 pm EDT as the value to use in computing the net asset value of the fund. If the fund does not transact

¹ Paragraph 30 of SFAS 157.

business after that time, does that mean the close of business is 4 pm? If the fund executes trades after 4pm, does that mean events occurring after 4 pm for all securities (including the value of after hour trades) would need to be considered for financial reporting purposes? If so, the financial reporting NAV could differ substantially from the NAV used to process shares.

- V. **Calculation of Total Return Ratio in the Financial Highlights** – Refer to the January 2007 Expert Panel meeting highlights for discussion of this item.
- VI. **Presentation of Cash Balances at Prime Brokers** – There was discussion on whether cash balances at prime brokers can be presented net and whether FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, or FSP FIN 39-1, *Amendment of FASB Interpretation No. 39* (the “FSP”), addresses this issue. It was noted that the FSP addresses netting of derivatives.

Public Accounting Firm Issues

- VII. **Money Market Fund SOI Presentation** - Refer to the previous expert panel meeting highlights for discussion of this item.

SEC Update

- VIII. **Staffing Announcement** - Brian Bullard, Chief Accountant of the Division of Investment Management, left the Commission in December 2006.
- IX. **Consolidation by Investment Companies** –The SEC Staff noted that they have been approached recently by a registrant that requested guidance on whether to consolidate by a registrant that wholly owned a tax blocker offshore entity. The SEC Staff, based on particular circumstances of that case, did not object to the consolidation. The Staff also requested that registrant make disclosures about tax consequences of investing in tax blocker. At the same time, the SEC Staff requested that registrants approach SEC Staff for specific guidance even in those instances when the fact pattern of the scenario in question matches a previous scenario for which the SEC Staff did not object to consolidation in the past. Registrants should follow the consultation guidance posted on the SEC.GOV website (<http://www.sec.gov/info/accountants/ocasubguidance.htm>).
- X. **Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act** - On November 1, 2005, representatives from certain public accounting firms met with representatives of the SEC Staff to discuss the application of the SEC independence rules in connection with the Audit Exemption provided in Rule

206(4)-2 of the Adviser's Act. Specifically, the concern was whether the SEC's auditor independence rules are applicable to the audit of a non-registered hedge fund when a registered investment adviser uses an exception for the security count examination, as permitted under the "Custody of Funds or Securities of Clients by Investment Advisors" (the "Custody Rule").

In the SEC Release *Staff Responses to Questions About Amended Custody Rule* as updated in January 2005, the SEC Staff indicated in its response to question VI.5 that for a registered investment adviser to meet the security count exception, the auditors of each of the adviser's hedge funds would need to comply with "U.S. Generally Accepted Auditing Standards" and, in particular with Article I, Section 2(d) of Regulation S-X (governing independence standards). On August 2, 2006, a letter was submitted by Deloitte & Touche LLP on behalf of a number of public accounting firms requesting transitional relief from the independence rules imposed by this SEC view for auditors of funds associated with newly registered investment advisers. On August 28, 2006 the SEC Staff issued a letter to Deloitte & Touche LLP in response to the request granting relief upon certain prescribed conditions. However, even to the extent relief has been granted there are certain interpretive questions that still needed to be resolved. On November 30, 2006, representatives from certain public accounting firms met with representatives of the SEC Staff and raised questions that required further clarification. Some of these questions have been answered at the meeting; however, there remained others that required further guidance (for example, questions relating to the determination of affiliates and engagement management).

The SEC Staff indicated that they are currently deliberating issues relating to the definition of affiliates and some of the engagement management issues. One issue that the SEC Staff expressed at the December 19, 2006 AICPA Investment Companies Expert Panel meeting relates to the use of the legal protective clauses.

According to the codification as reiterated in the Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions "Other Matters"-Question 4 (issued December 13, 2004), indemnification and limitations of liability clause restrictions were intended to apply to registrants. Therefore, representatives from certain public accounting firms did not believe that these restrictions would apply to audits of non-registered funds, and thus, representatives from certain public accounting firms believed that the non-registered funds' engagement letters may continue to contain indemnification and limitation of liability clauses to the extent permitted by AICPA Professional Standards.

The preliminary and tentative view of the SEC Staff was that the legal protective clause in the engagement letter relating to the audit of a non-

registered hedge fund when a registered investment adviser uses an exception for the security count examination, as permitted under the Custody Rule, creates a conflict, and thus SEC prohibits use of such legal protective clauses. However, the SEC Staff also noted that they have not asserted a position relating to punitive damages and arbitration clauses.

- XI. **FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109* (“FIN 48”), and investment companies registered under the Investment Company Act of 1940** – The Expert Panel inquired whether additional guidance is planned to be issued as the industry is struggling with implementation issues that are unique to the registered investment companies. The SEC Staff could not comment on this issue, but acknowledged that it is getting appropriate attention at the Commission. The SEC Staff further encouraged any registrant that has a specific matter that needs guidance to reach out to the SEC Staff for further discussion.

The SEC Staff further acknowledged that relating to the question as to whether the registered company excise tax is in scope of FIN 48 – the SEC Staff will need to look into this question further. The SEC Staff does not have a definite view on this issue, and will continue discussions with the Office of Chief Accountant on this matter.

- XII. **17f-2 counts** – As documented in the August 2006 AICPA Investment Companies Expert Panel meeting highlights, the SEC Staff expressed a concern that there are number of 17f-2 count reports that are being filed with the SEC as late as a year and a half from the date of the procedures. The Expert Panel noted at the August 2006 meeting that there may be some objective reasons why an audit firm may not be able to complete the procedures in a timely fashion, such as difficulties in receiving confirmation responses promptly.

The Expert Panel inquired as to whether the SEC would permit audit firms to perform alternative procedures if confirmations are not returned in a timely manner. The SEC Staff encouraged the Expert Panel to identify registrants that would approach the SEC with a no-action request to modify the current guidance to allow for alternative procedures.

- XIII. **Fund of Funds Rule** – In June of 2006 the Securities and Exchange Commission adopted three new rules under the Investment Company Act of 1940 that address the ability of investment companies (“funds”) to acquire shares of another fund. As part of this adoption, the SEC has made amendments to the fee table. These amendments require funds to disclose in their fee tables the expenses of investing in other funds under a line item titled “Acquired Fund Fees and Expenses” (“AFFE”). The Expert Panel inquired about the application of the Rule in a situation where an acquiring fund lends

portfolio securities and invests the cash collateral received in a money market fund or other cash sweep vehicle. In such a situation must the acquiring fund include the fees and expenses associated with the investment of the cash collateral in the calculation of AFFE? The SEC Staff replied that fees and expenses associated with investment of cash collateral received in connection with loans of portfolio securities in a money market fund or other cash sweep vehicle Fund do not have to be included in the calculation of AFFE.

Note: SEC has subsequently provided additional guidance relating to this question - refer to the *Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses* that can be found at

<http://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>.

XIV. **Certifications Contained in Form N-CSR** - The SEC staff noted some instances of outdated certifications by the principal executive and principal financial officer contained in Form N-CSR. Such certifications are required by Rule 30a-2(a) under the Investment Company Act of 1940 (the “Act”). As a result, some Form N-CSR filings were missing required certifications regarding the effectiveness of the registrant’s disclosure controls and procedures as defined in Rule 30a-3(c) under the Act. Therefore, registrants should ensure they are using the most current certifications contained in Form N-CSR.

XV. **Form N-14 Filings** – The SEC Staff noted some instances when the registrant did not include independent public accountant consents in Form N-14 filings.

In addition, some of the registrants inquired about proper disclosures relating to the portfolio positions that do not meet the investment objectives of the survivor fund and will need to be sold as a result of the merger. The SEC Staff did not recommend showing expected realized gain/loss as a pro-forma adjustment, but rather suggested to footnote such securities on the Schedule of Investments and adding a relating footnote to the tax disclosure. Further, the SEC Staff noted that funds are factoring changes in economies of scale in revised fee table disclosure, and such revision would not be appropriate. The SEC Staff also noted that to the extent that the registrants are getting reviewer comments that are inconsistent with this recommendation to appeal these comments or reach out to the Office of Chief Accountant of the Division of Investment Management.

XVI. **Expense recaptures and investment companies registered under the Investment Company Act of 1940** – The SEC Staff has noted some instances when registered funds inappropriately recaptured expenses that have been previously waived or reimbursed. For example, the expense cap is set at 50 bp for the period from January 1 through June 30. The expense cap is raised to 100 bp from July 1 though December 31. In the period from July 1 to December 31 some registered funds would go back and charge back to the

fund some of the expenses that were capped during first six months of the fiscal year. The SEC Staff believes that all expenses and waivers need to be tracked separately, and recapture between different expense cap thresholds is not appropriate.

Registrants should consider recording a liability pursuant to FASB Statement No. 5 if they anticipate reimbursing the advisor under the recapture agreement.

- XVII. **Other Reporting Matters** – The SEC Staff was asked about the frequency of the review of the registered fund financial statements. The SEC Staff indicated that typically registered fund financial statements will be reviewed every three (3) years. The SEC is currently on schedule with this goal.

Furthermore, the SEC Staff was asked if it had noted any repeating comments that come up in the review process relating to registered funds it could share with the Expert Panel. The SEC indicated that it appears that the comments made to the Expert Panel and expressed at various conferences generally do not seem to repeat.

Other Projects

- XVIII. **CCO Reporting** – This item was discussed at the previous AICPA Investment Companies Expert Panel meetings. The expected timing of issuance is June of 2007.

**AICPA Investment Companies Expert Panel
Meeting Highlights
January 23, 2007
AICPA offices, New York City**

Public Accounting Firm Issues

- I. Audit Confirmations** - The Expert Panel noted that a number of brokers have been refusing to sign auditor confirmations, or even if they sign a confirmation, their reply often contains a disclaimer relating to the accuracy of the information. In other instances, brokers are directing the auditors to a website where they can obtain information, such as prices, in lieu of sending signed confirmations, and these websites often contain similar disclaimers. These issues are particularly prevalent with derivative confirmations. Similar matters were discussed during 2004 and 2005 AICPA Investment Companies Expert Panel meetings.

Audit firms should work through the client to ensure they received properly authorized signed confirmations that do not contain any disclaimers as to their reliability. Audit firms should consider what alternative audit procedures are necessary when confirmations are received without signatures or with the disclaimers, as the confirmations in such form would not constitute sufficient audit evidence.

- II. Inclusion of the change in auditors in the footnotes to the audited financial statements** – The Expert Panel discussed the issues that arise when audited financial statements make a reference to change of the independent accountants. The SEC has indicated in previous guidance (December 30, 1998 Dear CFO letter) that it would be appropriate for the disclosure of the auditor change to be included either within the footnotes to the financial statements or outside the basic financial statements. The Expert Panel noted this type of disclosure should not typically be presented in the audited financial statements as the disclosure does not relate to the financial performance of the fund.
- III. Attestation engagements related to compliance with partnership agreements** – The Expert Panel noted that there is pressure in the marketplace to perform attestation engagements relating to compliance with partnership agreements. The Expert Panel noted that it would be helpful to provide some guidance relating to the form and the content of such a report, since most firms are generally reluctant to perform such attestation engagements.

Financial Accounting/Reporting Issues

- IV. Calculation of Total Return Ratio in the Financial Highlights** – The Expert Panel acknowledged that there is diversity in the practice as it relates to use of audited GAAP vs. unaudited published net asset value per share (NAV) in the calculation of the total return ratio presented in the audited financial statements. There are justifiable reasons for the differences between GAAP and unaudited NAV that include T+1 transactions and year-end closing adjustments. The Expert Panel noted that the total return ratio should be calculated based on an audited GAAP NAV. However, when some entities choose to calculate the total return ratio in the financial highlights based on an unaudited NAV, they should perform an assessment as to whether the total return ratio is not materially different from the one calculated based on the audited GAAP NAV. The Expert Panel also noted that for a fund that does not have distributions, the total return ratio should be recalculated from the face of the audited GAAP financial statements.
- V. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*, and investment companies**

The Expert Panel discussed the application of FIN 48 to non-registered investment companies. FIN 48 is effective in the first reporting period for fiscal years beginning after December 15, 2006. The Expert Panel acknowledged that some of the non-registered investment companies are not required by their offering documents to prepare semi-annual financial statements or calculate a net asset value per share on a GAAP basis. Thus, such funds will be guided by their offering documents in the calculation of any adjustments and incorporation of any disclosures to be made during the interim reporting period. However, as long as the GAAP semi-annual financial statements are prepared or the GAAP net asset value per share is reported to shareholders, non-registered investment companies would need to incorporate the implementation of FIN 48.

The Expert Panel further recognized that because partnerships are pass-through entities, many FIN 48-related liabilities would not be fund-level liabilities, but would rather pass to the partnership investors. The Expert Panel recognized that there is an inherent issue for funds of funds that would need to have information from the underlying partnerships to be able to appropriately identify and measure such uncertain tax positions.

Refer to “SEC UPDATE” section in these meeting highlights for further discussion.

VI. Tender Option Bond Transactions and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125* -
The Expert Panel continued to discuss issues raised at the previous meeting relating to accounting by investment companies for tender option bond transactions and failed sale treatment under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125* (“FAS 140”). Issues discussed:

- Some registrants analogized tender option bond transactions with security lending transactions and were considering whether net presentation on the statement of operations of income and expenses relating to tender option bond transactions would be appropriate. Net presentation for security lending transactions was discussed during deliberations of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Expert Panel acknowledged that net income statement presentation of tender option bond transactions is not supported by current accounting literature. Some of the registrants discussed net income statement presentation with the regulator. The Expert Panel acknowledged that achieving net income statement presentation would be difficult, as such guidance would apply not only to registered investment companies, but to other companies as well, unless it can be demonstrated that registered investment companies have some unique features that would set them aside from other companies.
- The Expert Panel noted that in evaluating tender option bond transactions that would be recorded as securitized borrowings, registrants evaluated the impact of recording the secured borrowings on
 - a. Leverage limits;
 - b. Expense capsFurthermore, some registrants made a request to the Securities and Exchange Commission to extend the deadlines for filing with the SEC and mailing to the shareholders of the annual reports.
- The Expert Panel further discussed shortfall agreements and economic factors that are typically present for a broker to require one in the tender option bond transaction.
- Tender option bonds transactions also triggered discussion of relating tax issues, such as re-performance of quarterly diversification tests, tax treatment of bond transfers to the broker, and wash sales issues.
- The Expert Panel discussed disclosures made by the registrants in Item 11 in the Form N-CSR and their consistency with the report of independent

registered public accounting firm on internal control included in the Form N-SAR.

Refer to “SEC UPDATE” section in these meeting highlights for further discussion.

VII. Convertible Bond Interest – The Expert Panel acknowledged that there is diversity in the accounting practice for amortization of convertible bond premiums. Paragraph 2.53 of the AICPA Audit and Accounting Guide *Investment Companies* generally requires premiums and discounts for fixed-income securities to be amortized using the interest method. The Expert Panel discussed two alternatives:

- A. Paragraph 199 of FASB Statement No. 133 observes that a convertible bond is comprised of a debt instrument and an embedded option contract representing the conversion feature. That paragraph further states that, for an investor in convertible debt, the embedded option is not "clearly and closely related to an investment in an interest-bearing note" and should be separated from the host debt instrument. Accordingly, the portion of the cost of the security related to the embedded conversion option should be separated from the underlying debt instrument and not subject to amortization. Any remaining premium should be amortized in accordance with paragraph 2.53.
- B. Separation of the embedded conversion option may cause the host debt instrument's remaining cost to be at a discount to par, which paragraph 2.53 would also require to be amortized. Such amortization, however, would often result in the combined amortized cost on the convertible bond and the embedded option premium exceeding the bond's par value (or its cash value upon an earlier call by the issuer). Paragraph 2.54 of the Audit Guide states, "An investment company should consider collectibility of interest in making accruals". An investment company should not amortize discount on a host debt instrument if the resulting combined (amortized) cost of the host and the embedded option premium would exceed the amount collectible upon cash redemption of the bond.

The Expert Panel noted that further consultation with the derivative experts may be needed to determine proper accounting. The Expert Panel will consider this issue for potential TPA.

VIII. Money Market Fund SOI Presentation – The SEC’s shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments (“SOI”) for a money market fund from the semi-annual or annual

shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform the shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the audit guide do not currently permit a fund to exclude the SOI from the financial statements. As auditors have been unable to provide an unqualified opinion to a money market fund excluding the SOI, money market funds have been unable to take advantage of the option. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal.

At the May 24, 2006 meeting, the EP noted that proposing a modification of GAAP that would allow a SOI to be omitted from financial statements for a money market fund would require FASB to issue guidance, which might be a time-consuming process. Alternatively, given the fact that a portfolio is actually prepared and included in the fund's filing with the SEC, the EP considered the issuance of an unqualified report referencing the full SOI maintained in an external document (Item 6 of Form N-CSR). This approach would require coordination with the AICPA and the PCAOB, as these funds are registrants and issuers).

The EP briefly discussed a draft of such a report at various 2006 meetings and solicited comments. The EP noted that in order for a firm to issue an unqualified report that references Form N-CSR, Form N-CSR must be filed concurrently with the delivery of the shareholder report. If such did not occur, the auditor would be referencing a document (Form N-CSR) that did not exist.

The Expert Panel discussed its plans to present this draft opinion for discussion with the Planning Subcommittee of AcSEC and the Audit Issues Task Force of ASB.

SEC Update

- IX. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser's Act** – On November 1, 2005, representatives from certain public accounting firms met with representatives of the SEC Staff to discuss the application of the SEC independence rules in connection with the Audit Exemption provided in Rule 206(4)-2 of the Adviser's Act. Specifically, the concern was whether the SEC's auditor independence rules are applicable to the audit of a non-registered hedge fund when a registered investment adviser uses an exception for the security count examination, as permitted under the "Custody of Funds or Securities of Clients by Investment Advisors" (the "Custody Rule").

In the SEC Release *Staff Responses to Questions About Amended Custody Rule* as updated in January 2005, the SEC Staff indicated in its response to

question VI.5 that for a registered investment adviser to meet the security count exception, the auditors of each of the adviser's hedge funds would need to comply with "U.S. Generally Accepted Auditing Standards" and, in particular with Article I, Section 2(d) of Regulation S-X (governing independence standards). On August 2, 2006, a letter was submitted by Deloitte & Touche LLP on behalf of a number of public accounting firms requesting transitional relief from the independence rules imposed by this SEC view for auditors of funds associated with newly registered investment advisers. On August 28, 2006 the SEC Staff issued a letter to Deloitte & Touche LLP in response to the request granting relief upon certain prescribed conditions. However, even to the extent relief has been granted, there are certain interpretive questions that still needed to be resolved. On November 30, 2006, representatives from certain public accounting firms met with representatives of the SEC Staff and raised the following questions that required further clarification. Some of these questions have been answered at the meeting; however, there remained others that required further guidance (for example, questions relating to determination of affiliates and engagement management). Representatives from certain public accounting firms are planning to have a follow up discussion with the SEC Staff on these questions.

The Expert Panel also recognized that once the SEC Staff views are clarified on this matter, a mechanism will need to be established to make them public.

X. Tender Option Bond Transactions and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125* ("FAS 140") – The SEC Staff acknowledged that many registrants are restating their financial statements to comply with the proper accounting for tender option bond transactions in accordance with FAS 140. There are numerous requests for guidance that were voiced by the registrants and accounting firms relating to this process. The SEC Staff addressed some of these questions:

- **Materiality** – Securities and Exchange Commission did not provide specific materiality guidance relating to tender option bond transaction restatements. Previously, the SEC Staff provided some guidance on materiality-related matters in SAB 99 and SAB 108. Further materiality considerations are left to the registrant and its independent accountants.
- **Form N-SAR** – The SEC Staff would expect to see a revised N-SAR letter with every restated annual report.
- **Timing of the restatement filings** – The SEC Staff acknowledged that everyone was working hard on issuing restated financial statements quickly. It is difficult for the SEC to set additional guidelines on timing. It is important that a registrant works with its independent accountants on this issue.

- **Timing and process of notifying shareholders about imminent or existing restatement of financial statements** – The SEC Staff acknowledged that there are no specific rules relating to the notification process for registered investment companies. Registrants should work with their legal counsel and develop answers based on facts and circumstances.
- **Tender option bond transactions and leverage** – The SEC Staff was not prepared to answer the question of whether tender option bond transactions create leverage for the fund.

XI. FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 (“FIN 48”), and investment companies registered under the Investment Company Act of 1940 – The Expert Panel inquired whether additional guidance is planned to be issued as SEC December 22, 2006 *Letter to ICI re: Implementation of FASB Interpretation No. 48* (“December 22, 2006 Letter to ICI”) did not address all the implementation issues that are unique to the registered investment companies.

Furthermore, the Expert Panel noted that pursuant to the *December 22, 2006 Letter to ICI*, investment companies registered under the Investment Company Act of 1940 may use a delayed implementation of FIN 48 for the purposes of their NAV calculation. The Expert Panel further noted that some questions came up in practice relating to the implementation dates of FIN 48 in the NAV calculation. Table below summarizes the SEC Staff clarification of the implementation dates for open-end and closed-end registered investment companies.

Registered open-end or closed-end fund year-end	Delayed Implementation Date of FASB Interpretation No. 48 for NAV Calculations¹
12/31/2006	6/29/2007
1/31/2007	7/31/2007
2/28/2007	8/31/2007
3/31/2007	9/28/2007
4/30/2007	10/31/2007
5/31/2007	11/30/2007
6/30/2007	12/31/2007
7/31/2007	1/31/2008
8/31/2007	2/29/2008

¹ Last NAV calculation in the first required financial statement reporting period for its fiscal year beginning after December 15, 2006. Date corresponds with the last business date of the semi-annual period and the fund's NAV on that date. The NAV computed for any date thereafter should reflect any liabilities that would required to be recorded under FIN 48.

9/30/2007	3/31/2008
10/31/2007	4/30/2008
11/30/2007	5/30/2008

XII. Consolidation by Investment Companies – Rule 6-03(c)(1) of Regulation S-X provides guidance relating to consolidation by registered investment companies. It states “... *statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies.*” The current AICPA Audit and Accounting Guide *Investment Companies* (“Audit Guide”), paragraph 7.05 provides an exception to this general principle and states that consolidation of an operating company is appropriate when “the investment company has an investment in an operating company that provides services to the investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment.” The SEC Staff has indicated that they interpret S-X 6-03(c)(1) generally to prohibit the consolidation by a registered investment company of any entities other than registered investment companies. The SEC Staff has indicated that they interpret S-X 6-03(c)(1) generally to prohibit the consolidation by a registered investment company of any entities other than registered investment companies; however the SEC is looking into whether such rule should be amended to allow for other consolidation.

The SEC Staff have raised particular concerns about consolidation of entities providing services to registered investment companies, because the resulting mixing of fair value accounting and historical accounting may distort the investment company's reported performance. The SEC Staff have indicated that, pursuant to written requests citing specific facts and circumstances, they have not objected to consolidation of non-registered investment companies that are generally wholly-owned by a registered investment company and, in certain cases, operating companies providing all or substantially all of their services or operations to a registered investment company and/or its portfolio companies. When the SEC has allowed consolidation of a non-investment company, it has been in situations when the consolidated entity is a cost center and not a revenue center (e.g. substantially all services are provided to the investment company or its investees.) The Expert Panel asked whether the SEC could provide a bright line as to the meaning of “substantially all” and an SEC Staff member indicated that they have looked to 85 -95% and such meaning should be similar to other GAAP terminology.

The SEC Staff recommends that registrants seek pre-approval when a registered investment company intends to consolidate an entity other than another registered investment company. For those entities that are currently presenting consolidated financial statements but should not be, the registrant would need to determine whether deconsolidation results in correction of error or change in reporting entity pursuant to FASB Statement No. 154,

Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. Furthermore, the SEC Staff noted that it does not generally believe that consolidation needs to occur when a master-feeder or typical fund of funds structure exists.

The SEC Staff held recent consolidation discussions for Business Development Companies and commodity funds which create offshore investment companies to serve as tax blockers. In addition, a question was posed to the SEC Staff inquiring whether a fund should consult the SEC Staff if a fund does not want to consolidate a non-investment company which provides services to the fund. The SEC Staff indicated that if a fund complies with S-X, there is no need to consult.

Other Projects

- XIII. Removal of old Technical Practice Aid** – The Expert Panel voted to remove old Technical Practice Aid 6910.03, *Basis for Valuation of Investments in Rental Property*. In accordance with paragraphs 1.33 and 2.28 of the AICPA Audit and Accounting Guide *Investment Companies* the rental property in a client's portfolio should be accounted for at fair value. Therefore, the guidance provided by this Technical Practice Aid is duplicating what is already clearly described in the Guide and no longer necessary.
- XIV. CCO Reporting** – This item was discussed at the previous AICPA Investment Companies Expert Panel meetings. The expected timing of issuance is summer 2007.

**AICPA Investment Companies Expert Panel
Meeting Highlights
March 6, 2007
AICPA offices, New York City**

Administrative Matters

- I. **AICPA Audit Risk Alert: Investment Companies Industry Developments -**
The AICPA Publications technical manager informed the Expert Panel that the *Audit Risk Alert “Investment Companies Industry Developments—2006/07”* is expected to be released within two weeks.
- II. **AICPA Audit and Accounting Guide, Audits of Investment Companies –** the new AICPA staff member that will be working on the investment companies industry publications, including 2007 conforming changes for the AICPA Audit and Accounting Guide, *Investment Companies*, and Audit Risk Alert, was introduced to the Expert Panel.

Financial Accounting/Reporting Issues

- III. **Tender Option Bond Restatements by Registered Investment Companies -**
The Expert Panel continued to discuss issues raised at the previous meetings relating to accounting by investment companies for tender option bond transactions and failed sale treatment under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125 (“FAS 140”)*. Issues discussed:

Status of the Restatement Process – the Expert Panel indicated that most registrants have completed or are in the process of completing the restatement process. The Expert Panel also noted that the ICI is considering the formation of a committee that would discuss the application of new accounting pronouncements and might develop guidance for the investment company industry with the goal to avoid situations similar to tender option bond restatements.

Material Weakness Disclosures - Expert Panel further noted that almost every restated set of financial statements filed with Securities and Exchange Commission was accompanied by the material weakness discussion in the form N-SAR. The Expert Panel noted that in the instances when the restatement was discovered subsequent to the fund’s year-end, the SEC Staff recommended that the registrant describe the material weakness in the amended N-CSR filing and discuss the weakness and its remediation in the N-Q filing covering the period in which the weakness was identified.

The Expert Panel further noted that ICI has written a letter to the PCAOB on their views relating to what constitutes a material weakness.

Economics and Accounting of the Tender Option Bond Transactions - Expert Panel noted that two funds that hold identical inverse floater investments could reflect different treatment of the tender option bond transaction in their respective financial statements if the transactions were entered into differently. If a fund participated in the transfer of the municipal bond into tender option bond trust at the outset of the transaction, it would have a higher expense ratio than the fund that has just purchased an inverse floater and did not transfer a municipal bond into the tender option bond trust.

Partial Sale - Expert Panel further noted no instances when partial sale was achieved by any of the mutual funds that transferred municipal bonds into the tender option bond trust, but recognized that partial sale could be achieved if all criteria outlined of paragraph 9 of FAS 140 are met.

Tender Option Bonds Gain Share Treatment - The Private Placement Memorandum for each Tender Option Bond (“TOB”) Trust provides information on the termination for each Trust and how proceeds are allocated to various parties. On the Mandatory Tender Date, Termination Event or Liquidity Event (collectively, the “Event”), the proceeds of the sale of the underlying security are distributed based upon a priority schedule. Upon distribution, the holders of floater certificates are entitled to receive 10% (5% in newer TOB transaction) of the excess, if any, of the sale price (not including accrued interest) over the Bond Base Price (“Cost”). There is not a significant secondary market for the floating certificates and, therefore, the floating certificate holders do not typically change during the period of the Trust. The gain share is due to the party that owns the floating rate certificates at the time of the Event.

The Expert Panel noted that pricing services capture prices of the inverse floater investments with and without gain share consideration. The Expert Panel also noted that many fund complexes are not considering a gain share in the value of the inverse floater and challenged whether such consideration would be appropriate. Expert Panel noted that the issuer can potentially early adopt FASB Statement No. 159 (provided it also elects to apply the provisions of FASB Statement No. 157) and thus account for gain share in the fair value of liability to floating rate certificate holders.

- IV. **FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109, and investment companies registered under the Investment Company Act of 1940** – representative of FASB joined the call for this part of the discussion. The Expert Panel recognized that the mutual fund industry is struggling with implementation issues relating to

FASB Interpretation No. 48 (“FIN 48”). On December 22, 2006, Securities and Exchange Commission Staff provided a letter to ICI re: Implementation of FASB Interpretation No. 48 that addressed some of the implementation issues that the mutual fund industry was facing, however, it did not resolve all of the open questions. There are two unique implementation issues that mutual funds face relating to FIN 48:

(1) clarification that a fund does not need to reduce its NAV for a tax liability when it has been the practice of the fund’s advisor or another party to pay or reimburse the fund for errors the advisor or other party has been associated with (“indemnification issue”), and

(2) an adequate time to allow for accurate FIN 48 accruals (“timing issue”).

Relating to the indemnification issue, the Expert Panel noted that iron clad indemnification concept was brought up by Scott Taub, Deputy Chief Accountant in the SEC Office of the Chief Accountant, during the call among SEC, FASB, representatives of the Expert Panel and ICI in November of 2006. The Expert Panel noted that under current accounting literature the value of the indemnification that fund would book would not necessarily correspond with the liability the fund would book under FIN 48 guidelines. As a result, fund NAV would be impacted. The Expert Panel noted that it would be helpful if guidance was provided that would allow for a fund to record an indemnification asset equal to the FIN 48 liability, and if both asset and liability would adjust in perfect correlation. The Expert Panel further discussed that if indemnification guidance is provided, it probably would require that the indemnification agreement need to be documented contractually by the issuer.

- V. **Statements of Financial Accounting Standards No. 157, *Fair Value Measurements*** (“FAS 157”) – A representative of FASB joined the Expert Panel meeting to discuss recommended changes to the *AICPA Audit and Accounting Guide, Audits of Investment Companies* (“Guide”) relating to FAS 157. The Expert Panel discussed the instances when investments into the non-registered fund may be restricted to the shareholder redemptions (e.g. lockup period) and whether adjustment to the NAV of the fund would be appropriate to reflect such restriction. The Expert Panel noted that consideration of the adjustment would be appropriate while redemption restriction is in place.

The Expert Panel further discussed that Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* provides explicit guidance relating to transactional costs that is not consistent with the Guide. At the same time, FAS 157 states that “transaction costs should be accounted for in accordance with the provisions of other accounting pronouncements.”

- VI. **Scope SOP** – The EP was updated on the status of this SOP.

- VII. **Payments/Reimbursements Received by a Fund from Advisor** – The Expert Panel acknowledged that the Guide did not provide clear guidance for presenting reimbursements received by a fund from its advisor. Chapter 12 of the guide is limited to some specific instances and provides guidance on when certain reimbursements will be presented as a separate line on the Statement of Operations. The Expert Panel agreed that to determine the appropriate presentation in the fund’s financial statements, one would need to determine the nature of the payment. The EP noted that reimbursement receipts would be presented as a separate item in the Statement of Operations when they relate to amounts previously posted on the Statement of Operations. In the absence of the ability to relate amounts to amounts previously posted, the reimbursement will go through a separate line on the Statement of Changes and in the per share section of the Financial Highlights, if material.

Additionally, Expert Panel noted that market timing payments received by the fund should not be split between statement of operations and statement of changes in net assets. The topic of presentation of market timing payments and other regulatory settlements was previously discussed at July 2006 Expert Panel meeting highlights.

- VIII. **Carried Interest** - The majority of the private equity clients account for the carry on the accrual basis, however a smaller percentage are only accounting for the carry in accordance with the fund legal documents. The Expert Panel noted that even if not consistent with the partnership agreement, the GAAP financial statement presentation of carried interest would follow GAAP, that is, the financial statements would reflect carried interest accrued on both realized and unrealized gains and losses.

Public Accounting Firm Issues

- IX. **Rating Agencies AMPS Agreed-Upon Procedures** – many of the closed end investment companies have engaged their respective audit firms to provide certain agreed upon procedures as a condition to the funds being rated by a nationally recognized rating agency such as Standard and Poor’s Corporation, Moody’s Investor’s Services, Inc. or Fitch, Inc. (collectively the “Rating Agencies”). The investment and operating metrics that a fund must meet and on which the agreed upon procedures are performed (as well as the on-going compliance requirements) are normally found in the Amended By-Laws of the fund (specifically detailing the rights, privileges and obligations relative to the preferred stock) or in a similar document.

AT 201.07 provides that “To satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties.” In these situations, given that the rating agencies request the report, both

the rating agencies and the management of the fund would be considered to be “specified parties” or users of the report.

Because the Rating Agencies are specified parties, audit firms obtain their affirmative acknowledgment that they agree with the procedures and take responsibility for the sufficiency of the procedures for their purposes. Representatives of the firms noted that they have experienced some difficulty in obtaining appropriate affirmation from certain rating agencies.

The Expert Panel agreed to contact the rating agencies to remind the agencies of the professional standards that the audit firms are required to abide by and to offer to meet with representatives from the rating agencies to discuss the most effective and efficient manner to obtain the appropriate affirmations; acknowledging that the lack of receipt of the appropriate affirmation would preclude the rating agency from receiving the report.

- X. SAS No. 112 *Communicating Internal Control Related Matters Identified in an Audit* (“SAS 112”) - The Expert Panel noted that many smaller clients are not aware of SAS 112. At the same time, smaller clients would typically be more prone to have significant deficiencies or material weaknesses, particularly relating to the segregation of duties.

SEC Update

- XI. **Expansion of Interactive Data Voluntary Program to Include Mutual Fund Information** - The Securities and Exchange Commission voted to propose rule amendments to enable mutual funds to submit risk/return summary information from their prospectuses using interactive data under the Commission's voluntary program. The risk/return summary at the front of every mutual fund prospectus includes information about a fund's investment objectives and strategies, risks, costs, and historical performance. The submission of tagged risk/return summary information would be supplemental and would not replace the required official versions of the information.
- XII. **Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act** – The SEC Staff has indicated that it is continuing to look at the application of the SEC independence rules in connection with the audit exemption provided in rule 206(4)-2 of the Adviser’s Act. The Division of Investment Management encouraged CPA Firms to reach out to SEC Staff with any specific questions relating to specific fact-based scenarios.
- XIII. **17f-2 counts**– The SEC Staff clarified that 17f-2 counts are not required to be performed at the fund’s fiscal year-end, but did reaffirm that procedures are required to be performed three (3) times a year. SEC Staff indicated that the AICPA Audit and Accounting Guide, *Investment Companies*, would need to be

updated to provide correct guidance. The SEC Staff encouraged registrants to submit to SEC a no-action request that would discuss alternative procedures when confirmations relating to 17f-2 procedures are not returned in a timely manner.

- XIV. Receivable from advisor** – The SEC Staff noted one recurring issue relating to the receivable from advisor on fund books: this receivable balance is not settled timely. The expectation of the SEC Staff would be that such receivable balance would settle with the same frequency as the advisor receives its fees (typically monthly). The SEC Staff would expect receivable balances from other related parties to settle in a similar manner.

This issue is relevant to registered investment companies as well as to registered investment advisors. The SEC Staff has a concern that some advisors may not have an ability to settle large outstanding the receivable balances on fund's books.

- XV. Tender Option Bond Restatements by Registered Investment Companies -** The SEC Staff noted that they are monitoring restatements as they come in. The Staff did not have any preliminary reaction relating to the restated filings.

- XVI. Consolidation by Investment Companies** –Rule 6-03(c)(1) of Regulation S-X provides guidance relating to consolidation by registered investment companies. It states “... *statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies.*” The current AICPA Audit and Accounting Guide for Investment Companies (“Audit Guide”), paragraph 7.05 states that consolidation is appropriate when “the investment company has an investment in an operating company that provides services to the investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment.” The SEC Staff has indicated that they interpret S-X 6-03(c)(1) generally to prohibit the consolidation by a registered investment company of any entities other than registered investment companies.

The SEC Staff have raised particular concerns about consolidation of entities providing services to registered investment companies, because the resulting mixing of fair value accounting and historical accounting may distort the investment company's reported performance. The SEC Staff have indicated that, pursuant to written requests citing specific facts and circumstances, they have not objected to consolidation of non-registered investment companies that are wholly-owned (or substantially wholly-owned) by a registered investment company and, in certain cases, operating companies providing all or substantially all of their services or operations to a registered investment company and/or its portfolio companies. The SEC Staff recommends that registrants seek pre-approval when a registered investment company intends to consolidate an entity other than another registered investment company. For those entities that are currently presenting consolidated financial statements but should not be, the SEC Staff has not

determined the appropriate way to report a change to de-consolidate the entity, although it would probably represent a change in the reporting entity. The SEC Staff indicated that they anticipate to develop some guidance, but also noted that goal of this guidance will not be to set a new standard, but rather to clarify an existing one. Furthermore, the SEC Staff noted that it does not generally believe that consolidation needs to occur when a master-feeder or typical fund of funds structure exists.

Recently the SEC Staff was consulted on a consolidation question relating to the master-feeder structure where there is a Cayman tax blocker which is 100% owned by feeder fund. This blocker was created for the purposes of tax structuring: the blocker entity receives the income associated with UBTI income and then distributes it to the feeder as dividend income. SEC Staff did not object to the feeder fund consolidating tax blocker based on facts presented in this case.

XVII. Reaction to Scope SOP –The SEC representatives were aware of the issues relating to the Scope SOP; however have not worked through all the details.

XVIII. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109* - the Expert Panel inquired as to applicability of SEC December 22, 2006 Letter to ICI re: Implementation of FASB Interpretation No. 48 (“December 22, 2006 Letter”) to 1933 and 1934 fund registrants that are not registered under 1940 Act. These funds would strike a net asset value per share similar to 1940 Act mutual funds. The SEC Staff noted that the December 22, 2006 Letter specifically applies to 1940 Act registrants, but encouraged registrants to talk to their auditors and to reach out to SEC Staff for further guidance, if such guidance is needed.

Other Projects

XIX. AICPA Employee Benefit Plans Expert Panel joined the Investment Companies Expert Panel to discuss ***Stable Value Qs & As – DRAFT Questions Relating to FSP AAG INV-1 and SOP 94-4-1, Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans.*** Employee Benefit Plans Expert Panel has drafted this Q&A to clarify paragraphs 11.c and 11.d of FSP AAG INV-1 and SOP 94-4-1 relating to average yield calculations for investment companies; this Q&A will be further discussed with FASB. Investment Companies Expert Panel provided its feedback on drafted Q&A that will be further considered by Employee Benefit Plans Expert Panel.

**AICPA Investment Companies Expert Panel
Meeting Highlights
May 1, 2007
AICPA offices, New York City**

Financial Accounting/Reporting Issues

- I. **FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*, and investment companies registered under the Investment Company Act of 1940** – Expert Panel recognized that the mutual fund industry is struggling with implementation issues relating to FASB Interpretation No. 48 (“FIN 48”). On December 22, 2006, Securities and Exchange Commission Staff provided a letter to ICI re: Implementation of FASB Interpretation No. 48 that addressed some of the problems that the mutual fund industry was facing, however, it did not resolve all of the open questions. On March 28, 2007, several companies have submitted a petition for rulemaking to the Securities and Exchange Commission asking them to provide additional guidance to address the remaining issues. Additionally, a letter was submitted to FASB with a request for implementation guidance relating to FIN 48 to address some of the unique issues that exist for investment companies. Refer to the SEC Update section for a detailed discussion of some of these unique implementation issues that the mutual fund industry is facing.

The Expert Panel further acknowledged that there is diversity in views as to whether excise tax is in scope of FIN 48.

- II. **Statements of Financial Accounting Standards No. 159**– Expert Panel members acknowledged that they were not currently aware of any mutual fund companies considering applying Statements of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (“Statement”). The Expert Panel also noted that a number of real estate funds and private equity companies with long-term debt might consider applying this Statement.
- III. **Calculation of ratios to average net assets in a multi-class fund** – In the funds with multiple classes of shares, the difference in ratios to average net assets (i.e., ratios of expenses and net investment income to average net assets) every so often does not correlate exactly with a difference in class-specific expenses (e.g., distribution fees). This inconsistency is more likely to be present in a fund with dissimilar class size and different growth/decline dynamic. Typically, such differences in financial highlight ratios compared with differences with class-specific expenses are immaterial and limited to a few basis points.

The Expert Panel noted that there are many justifiable reasons for such differences. For example, unequal size classes with dissimilar growth/decline

dynamic coupled with revisions in expense estimates or timing of dividend income might produce such inconsistency. The Expert Panel acknowledged that there is diversity in practice as it relates to the calculation of ratios to average net assets (“ratios”). Some entities take an approach of forcing ratios to be equal to the class-specific expense differences. Expert Panel noted, however, that a more justified approach would be not to force ratios, even if there is a variance between class-specific expense differences and class-specific ratios.

Furthermore, SEC Staff noted that the calculation of the expense tables in the Prospectus fund should be using expense ratios presented in the annual report rather than forcing them to be equal class-specific expense ratios.

- IV. **AICPA Audit and Accounting Guide *Investment Companies*** (“Audit Guide”) – The Expert Panel noted certain administrative changes relating to the confirming changes to the Audit Guide and raised a concern that some of the changes to the Audit Guide discussed at the previous meetings have not been incorporated. It further discussed the difference between conforming and interpretive changes, and the distinction in the process of incorporating them in the Audit Guide. An AICPA representative recommended incorporating certain proposed changes into Audit Risk Alert. The Audit Guide is expected to be issued by July 31, 2007, and the Audit Risk Alert in fall of 2007. The AICPA staff recommended that the Expert Panel comes up with a list of suggestions of how to improve the Audit Guide process in the upcoming year.
- V. **Statement of Financial Accounting Standards No. 157** - The Expert Panel has created a subgroup to work on implementation issues relating to Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”). Members of the subgroup discussed the ICI initiative to address FAS 157 implementation issues. The Expert Panel further discussed the incorporation of any deliverables of the subgroup into 2007 Audit Risk Alert.
- VI. **Upfront Payments on Swap Contracts** – The Expert Panel revisited an issue discussed at the previous meeting. When an investment company enters into a swap agreement, neither it nor the counterparty makes an upfront payment, if the yield to maturity set at the inception of the contract equates both parties. However, in certain instances, such as when a fund assumes an existing swap contract, or due to the credit risk of the counterparty, one party may make an upfront payment to the other. Most commonly, funds amortize the upfront payment over the remaining life of the contract since it is essentially an adjustment of the yield. Another practice is to defer the payment and recognize it as a gain/loss at the conclusion of the swap, which might be permissible. However, the EP believes that recognizing the entire payment as a gain or loss at the inception of the contract would not be appropriate.
- VII. **Money Market Fund SOI Presentation** – The SEC’s shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments

(“SOI”) for a money market fund from the semi-annual or annual shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform the shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the audit guide do not currently permit a fund to exclude the SOI from the financial statements. As auditors have been unable to provide an unqualified opinion to a money market fund excluding the SOI, money market funds have been unable to take advantage of the option. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal.

The EP briefly discussed a draft of such a report at various 2006 meetings and solicited comments. The EP noted that in order for a firm to issue an unqualified report that references Form N-CSR, Form N-CSR must be filed concurrently with the delivery of the shareholder report. If such did not occur, the auditor would be referencing a document (Form N-CSR) that did not exist.

The Expert Panel discussed its plans to seek informal views on this proposal from the PSC of AcSEC and AITF before addressing the SEC Regulations Committee at its July 10th meeting.

- VIII. **Fund of Funds** – The Expert Panel recognizes that there is a need to address existing financial reporting questions relating to fund of funds structures. An example of one such issue is classification of underlying fund income. The EP discussed that such guidance could be disseminated through Audit Risk Alert. The Expert Panel formed a subgroup to address existing fund of fund issues.

Public Accounting Firm Issues

- IX. **Rating Agencies AMPS Agreed-Upon Procedures** – Many of the closed-end investment companies have engaged their respective audit firms to provide certain agreed upon procedures as a condition to the funds being rated by a nationally recognized rating agency such as Standard and Poor’s Corporation, Moody’s Investor’s Services, Inc. or Fitch, Inc. (collectively the “Rating Agencies”). The investment and operating metrics that a fund must meet and on which the agreed upon procedures are performed (as well as the on-going compliance requirements) are normally found in the Amended By-Laws of the fund (specifically detailing the rights, privileges and obligations relative to the preferred stock) or in a similar document.

AT 201.07 provides that “to satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified

parties.” In these situations, given that the rating agencies request the report, both the rating agencies and the management of the fund would be considered to be “specified parties” or users of the report.

Because the Rating Agencies are specified parties, audit firms obtain their affirmative acknowledgment that they agree with the procedures and take responsibility for the sufficiency of the procedures for their purposes. Representatives of the firms noted that they have experienced some difficulty in obtaining appropriate affirmation from certain rating agencies.

The Expert Panel agreed to contact the rating agencies to remind the agencies of the professional standards that the audit firms are required to abide by and to offer to meet with representatives from the rating agencies to discuss the most effective and efficient manner to obtain the appropriate affirmations, acknowledging that the lack of receipt of the appropriate affirmation would preclude the rating agency from receiving the report.

SEC Update

- X. **Staffing Announcement** – The Securities and Exchange Commission Division of Investment Management is looking to fill two (2) Assistant Chief Accountant fellowship positions with duration of 2 years with a prospect of being extended to 4 years.

- XI. **Emphasis of Matter Paragraph** – In 2006 AICPA issued *Alternative Investments - Audit Considerations - A Practice Aid for Auditors ("Practice Aid")*. This Practice Aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist. These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are referred to as “alternative investments.” Investors in alternative investments include, but are not limited to, colleges and universities, hospitals, pension plans, and investment companies – including funds of funds.

One of the aspects that this Practice Aid addresses is auditor's reports, and the inclusion of the Emphasis of a Matter Paragraph in the audit opinion. The Practice Aid included the following guidance:

“Reporting

Emphasis of a Matter Paragraph

The more complex or illiquid the underlying investments are, the greater the inherent uncertainty in management’s estimated fair value. As the inherent

uncertainty in the estimate increases, as well as the significance of the alternative investments to the financial statements, auditors may consider inclusion of an emphasis of matter paragraph in the auditors' report such as the following, tailored for the specific facts and circumstances:

As explained in note X, the financial statements include investments valued at \$ _____ (____ percent of net assets), whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners.

An emphasis of matter paragraph is not used to introduce information to the financial statements and neither replaces any required financial statement note disclosure nor reduces the required audit evidence needed to support an unqualified opinion. Such paragraphs are never required and are included solely at the auditor's discretion. The above emphasis of matter paragraph would be consistent with GAAP disclosures made in the financial statements."

To the extent the auditor decides to include an emphasis of matter paragraph in situations where a fund has invested in a hedge fund it is possible that certain registered fund of hedge funds that invests in the securities meeting this criterion may include auditor's reports that include this paragraph in filings with the Securities and Exchange Commission as long as the addition of this paragraph is not a result of scope exception and the auditors were truly able to audit this information.

The Expert Panel acknowledged that the question of the SEC Staff reaction to the emphasis of matter paragraph has come up previously, and the Expert Panel understanding was that the SEC Staff view was to accept it without penalty to the issuer (as long as there is no qualification). The Expert Panel wanted to confirm this view. The SEC Staff from Division of Investment Management ("Division") confirmed that the emphasis of matter paragraph is not viewed as a qualification, and as such, will not be concerning to the Division Staff. The SEC Staff also indicated that they will confirm with the Division of Corporate Finance on their views relating to the emphasis of matter paragraph.

- XII. FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 ("FIN 48"), and investment companies registered under the Investment Company Act of 1940** – On March 28, 2007, the Securities and Exchange Commission received a petition for rulemaking relating to implementation of FIN 48 by investment companies registered under the Investment Company act of 1940. The SEC Staff recognized that registered funds are seeking guidance relating to two unique fund implementation matters:

- adequate time to allow for accurate FIN 48 accruals (“timing issue”), and
- clarification that a fund need not reduce its NAV for a tax liability when it has been the administrative practice of the fund’s advisor or another relevant party to pay or reimburse the fund for errors the advisor or other party has made (“indemnification issue”).

SEC Staff was also aware that FASB was looking into these two questions.

The Expert Panel noted that procedurally it is unlikely that FASB will be able to provide any formal guidance before the end of June. The Expert Panel also noted that FASB may not be able to address the timing issue. Daily calculation of NAV on GAAP basis is a regulatory requirement rather than a GAAP requirement. It was the belief of the EP that, to the extent additional guidance would be forthcoming, FASB is more likely to provide guidance relating to the indemnification issue.

Furthermore, the Expert Panel inquired as to the applicability of *SEC December 22, 2006 Letter to ICI re: Implementation of FASB Interpretation No. 48* (“December 22, 2006 Letter”) to 1933 and 1934 fund registrants that are not registered under 1940 Act. These funds would strike a net asset value per share similar to 1940 Act mutual funds. The SEC Staff noted there is some flexibility based on what the offering document says about how the NAV is calculated. The SEC Staff encouraged any registrant to talk to their auditors and to reach out to SEC Staff for further guidance

XIII. Tender Option Bond Restatements by Registered Investment Companies

Internal Control- The SEC Staff noted that as part of the review process of registered investment company financial statements, the SEC reviewers compare disclosures made by the registrant in Item 11 in the Form N-CSR with the report of independent registered public accounting firm on internal controls included in the Form N-SAR. To the extent that reviewers find inconsistencies between these two documents, they would raise concerns with the registrant.

Expense Ratios- The SEC Staff noted the following presentation of expense ratios in a Form N-14 filing. One fund subject to the merger restated its financial statements for the proper accounting for tender option bond transactions in accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125 (“FAS 140”)*, (“Fund A”) and the second fund subject to the same merger did not restate its financial statements as tender option bond transactions were not material to the financial statements taken as a whole (“Fund B”). When Form N-14 disclosures were prepared, a footnote was added explaining the impact of tender option bond transactions on Fund B’s expense ratio. The SEC Staff was receptive to such presentation.

Furthermore, the SEC Staff has noted that some registrants included in the financial statements a footnote explaining that the additional interest expense that

was recorded after a fund has properly accounted for tender option bond transactions in accordance with FAS 140 approximated additional income booked as a result of proper accounting for tender option bond transactions. The SEC Staff did not object to such a footnote.

- XIV. **Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser's Act** – The SEC Staff has indicated that application of the SEC independence rules in connection with the audit exemption provided in rule 206(4)-2 of the Adviser's Act is one of the priorities of the SEC Division of Investment Management. The Division of Investment Management has answered some questions raised by individual public accounting firms relating to specific fact-based scenarios and is continuing to work on addressing the issues raised by a group of public accounting firms.
- XV. **Fund marketing materials** – The SEC Staff indicated that they have noticed some instances when fund marketing materials on the registrant's website are not consistent with information submitted in the SEC filings.
- XVI. **Brokerage Commissions** – The SEC Division of Investment Management Staff recently has discussed a question of clarity of current literature as it relates to the proper accounting for brokerage commissions as a cost associated with the acquisition of a portfolio investment. The SEC Staff requested the Expert Panel views on this matter.

The Expert Panel expressed the view that from the investment company perspective, guidance on capitalization of brokerage commissions for purchases is clear. The Expert Panel referred to two specific sources of guidance that support capitalization of commissions for investment companies: Audit and Accounting Guide, *Audits of Investment Companies* and the Securities and Exchange Commission interpretive guidance on the use of soft dollars under Section 28(e) of the Securities Exchange Act of 1934 (commonly referred to as *SEC Soft Dollar Release*).

Other Projects

- XVII. **CCO Reporting** – The expected timing of the SOP issuance is summer 2007. See minutes of previous meetings for the detailed discussion of this project.

**AICPA Investment Companies Expert Panel
Meeting Highlights
July 10, 2007
AICPA offices, New York City**

Financial Accounting/Reporting Issues

- I. Scope SOP** – In June 2007, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (“Scope SOP”). Scope SOP provides guidance for auditors to determine whether an entity is within the scope of the AICPA Audit and Accounting Guide, *Investment Companies*. In addition, Scope SOP modifies FASB Emerging Issues Task Force (EITF) Issue No. 85-12 by establishing conditions for the retention of investment company accounting by parent companies in consolidation and by equity method investors, and requiring various disclosures if investment company accounting is retained. Scope SOP is effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged.

A number of implementation issues were discussed by the Expert Panel relating to the Scope SOP:

- i. interaction of Scope SOP and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (“FAS 159”), in cases when a parent company or equity method investor would unwind investment company accounting and investments carried at the fair value on investment company books are ineligible for FAS 159 fair value option.
- ii. availability of the fair value option for financial instruments that include a component associated with significant future services;
- iii. disclosure requirements of the parent company consolidating an investment company relating to the schedule of investments and financial highlights.

Specifically, paragraph 50 of the Scope SOP provides the following guidance about disclosure requirements when investment company accounting is retained in the consolidated financial statements:

“If investment company accounting is retained in the consolidated financial statements for investment company subsidiaries, the following should be disclosed:

- a. *The fact that investment company accounting is retained in the consolidated financial statements.*
- b. *The carrying amount (fair value) as reported in the consolidated financial statements and cost of the portfolio of investment company subsidiaries for which investment company accounting has been retained as of each balance sheet date.*
- c. *Disclosures about significant transactions between the parent company or its related parties and the investees of the investment company or their affiliates:*
 - (1) *The nature of the relationship(s) involved.*
 - (2) *A description of the transactions for each of the periods for which income statements are presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements, such as the amount of gross profit (or similar measure) from the transactions.*
 - (3) *The dollar amounts of transactions, such as sales and similar revenues, for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.*
 - (4) *Amounts due from or to investees or their affiliates as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.*
- d. *Gross unrealized aggregate appreciation and aggregate depreciation of investments in the investment company's(ies) investment portfolio as of each balance sheet date.*
- e. *Net realized gains or losses from investments in the investment portfolio of investment company subsidiaries for which investment company accounting has been retained for each year an income statement is presented.*
- f. *Net increase (decrease) in unrealized appreciation (or depreciation) of the investment portfolio (change in unrealized amounts during the year) for each year an income statement is presented.*
- g. *The policy for distinguishing the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies.”*

The Expert Panel discussed various considerations that the parent company would deliberate in deciding whether financial highlights and schedule of investments of the investment company are required in the parent company financial statements. Such the considerations included specific disclosure requirements of the parent company and materiality of the investment company to the parent company financial statements.

II. Statements of Financial Accounting Standards No. 157 - The Expert Panel has created a subgroup to work on implementation issues relating to the Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”). Currently, there are three (3) main topics on the agenda of this subgroup:

- 1) definition of the measurement period for registered investment companies;
- 2) rollforward disclosure (see *SEC Update* section in this document for discussion of this item);
- 3) valuation issues relating to fund-of-funds.

The working group requested the Expert Panel to provide feedback on its deliverables. The Expert Panel also noted that FASB continues to assess whether and to what extent additional and more specific valuation guidance is required for financial reporting purposes beyond the guidance provided in FAS 157.

III. Financial highlights for affiliates - Statement of Position 03-4, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships*, in paragraph A-24 (“paragraph A-24”) states:

*“AcSEC observes that, generally, the determination of expenses for computing the expense ratio should follow the presentation of expenses in the fund’s statement of operations. Accordingly, if the manager’s or general partner’s incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of the expense ratio. Because an incentive allocation of profits is not presented as an expense, it should not be considered part of the standard expense ratio. However, to avoid potentially significant inconsistencies in ratio presentation based solely on the structuring of incentives as fees or allocations, all incentives should be reflected in the disclosure of financial highlights. Additionally, disclosure should be made in the expense ratio of the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 7.38 of the Guide, and of expense offsets, as described in paragraphs 7.40 and 7.41 of the Guide. **Agreements to waive a portion or all of certain fees to a specific investor which do not relate to the share class as a whole do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements should disclose that an individual investor’s ratio may vary from those ratios. One respondent to the exposure draft had requested reconsideration of the requirement that the expense ratio should be based on expenses incurred by the investor class as a whole, expressing preference for presentation of the ratio based on a standard rate (for advisory fees and/or incentives) stated in offering documents. The respondent stated that this would be more useful to prospective investors, and also noted that investors charged other than the standard rate could more easily make adjustments to the expense ratio (and other highlights) presented in this manner to reflect their own rate. AcSEC noted, however, that in certain cases only a minority of the capital of a fund may be subject to the standard rate, so that presentation of a ratio in this manner may not be representative of the actual operations of the fund. Also, AcSEC noted that a fund’s ability to present incentives in the expense ratio on a standard rate based on historical data could be extremely difficult if investors’ incentive charges***

were reduced because of the existence of loss carryforwards. Accordingly, AcSEC declined to change the guidance in the SOP.” [emphasis added]

The Expert Panel acknowledged that there might be a diversity in practice relating to the calculation of financial highlights for classes of shares that include capital from certain affiliates of a general partner (such as friends and family members of the general partner officers).

Often the expenses charged to the affiliates of a general partner are consistent with those charged to the general partner and charges such as incentive allocations are not made. As a result, the financial highlight ratios for such classes may not represent standard rates available to the nonaffiliated investors. In practice, some funds follow the guidance, as described in a paragraph A-24 and calculate financial highlights ratios by including all relevant data for the affiliated investors. Other funds take a view that such presentation may be considered misleading, and although technically in line with a view described in paragraph A-24, is not as meaningful. They further believe that view described in paragraph A-24 contemplated classes of shares that have a variety of investors with variety of different expense ratios rather than some investors affiliated with the advisor with waived expenses.

- IV. Money Market Fund SOI Presentation** – Please refer to previous meetings for discussion of this item. The SEC Regulations committee of the Center for Audit Quality requested that the Expert Panel prepare a document that outlines alternative approaches and related considerations that would allow registered money market funds to take advantage of an option to exclude the SOI from the annual report mailed to the shareholders.

Public Accounting Firm Issues

- V. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act** - Please refer to previous meetings for discussion of this item.
- VI. Rating Agencies AMPS Agreed-Upon Procedures** – Please refer to previous meetings for discussion of this item.

SEC Update

VII. Staffing Announcement – the SEC Staff introduced two (2) new members of SEC Division of Investment Management – Bryan Morris and Chad Gazzillo, Assistant Chief Accountants.

VIII. Statements of Financial Accounting Standards No. 157 - The SEC Staff noted that they have received a question whether the N-Q filings would need to include disclosures required by FAS 157. The SEC Staff believes once an entity adopts FAS 157, the N-Q filings made by registered investment companies should include disclosures required by FAS 157. Inclusion of the disclosures in fund N-Q filings will enhance ability of the reader of the financial statements to compare liquidity of the fund investments from quarter to quarter and will provide meaningful background information about fund holdings.

The Expert Panel raised the following question to SEC Staff:

Paragraph 32c of FAS 157 requires “For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period related to the following:

- (1) Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities)*
- (2) Purchases, sales, issuances or settlements (net)*
- (3) Transfers in and/or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)”.*

This disclosure requirement appears to be a reporting period concept. For example, the reconciliation would be presented if a Level 3 security was held at either the beginning or ending of a reporting period.

The Expert Panel wanted to confirm that the activity relating to the securities that are level 1 or 2 at the beginning and end of the reporting period, but are categorized as level 3 during the period and similarly, securities are categorized as level 3 during the entire time held by the investment company, but purchased subsequent to the beginning of period and sold prior to the period - end (collectively, “in and out level 3 activity”) would not need to be captured in the disclosures required by paragraph 32c. The Expert Panel also discussed system limitations to be able to capture in and out level 3 activities.

The SEC Staff responded that they will need to give this question further consideration and will discuss it at the future meetings. The SEC Staff

recommended that a written submission of this question be provided for further consideration.

- IX. Tender Option Bond Transactions and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125 (“FAS 140”)*** - The SEC Staff noted that they have reached out to some of the registrants to confirm that they are up to date with the filing of the restated financial statements and received a positive response.

The Expert Panel noted that FASB (“Board”) is working to address FAS 140 issues related to (1) the permitted activities of a qualifying special-purpose entity (QSPE), (2) isolation criteria, and (3) other issues that arose during redeliberations on the amendment of Statement 140 in order to improve the comparability of financial statements.

At the May 30, 2007 meeting, the Board decided that removing the qualifying special-purpose entity (SPE) concept from FAS 140 is an approach worthy of further research. Additionally, the Board instructed its staff to further develop a linked-presentation model as a solution to the issues in the short-term project to amend Statement 140.

- X. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 (“FIN 48”)*, and investment companies registered under the Investment Company Act of 1940** – SEC Staff inquired about industry reaction to the June 28, 2007 Letter to Fidelity Investments, Massachusetts Financial Services Company and OppenheimerFunds, Inc. re: Implementation of FASB Interpretation No. 48 from Richard F. Sennett, Chief Accountant of SEC Division of Investment Management and Conrad Hewitt, SEC Chief Accountant.

The Expert Panel noted that one of the questions raised in practice relates to proper presentation of the indemnification from an advisor relating to FIN 48 accruals. SEC Staff noted that issuers should follow the guidance from S-X and would not object if issuers present income tax expense separately from reimbursements as a separate line item, that is, show gross presentation. Similar presentation will made for indemnification amounts that relate to capital gain tax.

The Expert Panel further noted that next step for the industry is to document policies and procedures relating to FIN 48 considerations, particularly for new products.

- XI. Partner Rotation** – The Expert Panel Chair provided background to the issue stating that in 2003 the Securities and Exchange Commission (“SEC” or “Commission”) adopted amendments to its existing requirements regarding

auditor independence (<http://www.sec.gov/rules/final/33-8183.htm>) (the “Rule”). Among other matters, the Rule prohibited certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement.

Under the Rule, a lead audit partner performing audit, review, or attestation services for any registered investment company (RIC) entity in the investment company complex could only do so if they had not served five consecutive years on any RIC entity in the same investment company complex. Those partners affected by the rotation requirement would have had to remain completely off any RIC engagements in the investment company complex for a period of five years before they could again audit one of the RICs.

The unique structure of investment company complexes allows for many different fiscal year-ends within the same investment company complex. In order to allow a partner to serve the total number of allowable periods on any one RIC audit in the complex, while still requiring partners to rotate off an investment company complex at the end of their specific periods, the SEC defined consecutive years of service for the investment companies. According to the SEC, consecutive year of service for audit partners includes all fiscal year-end audits of investment companies in the same investment company complex that are performed in a continuous 12-month period. This would allow audit partners auditing multiple RICs in the same investment company complex to audit each investment company for five or seven complete fiscal years, as appropriate.

Because of the unique structure of the investment company complex, a question has arisen as to how to count the “cooling off” period (5 years for a lead audit partner or concurring review partner, 2 years for an audit partner serving in a 7 year rotation position) that an audit partner would need to be off the engagement for before they would be permitted to be reassigned. SEC Staff provided the following example: in a situation when a lead audit partner rolled off the engagement upon completion of the December 1999 audit, when would the partner be eligible to be reassigned to the investment company complex?

SEC Staff clarified that in the situation described above, the partner would be able to come back to the engagement after the lead audit partner was off the engagement for 5 consecutive years measured at the investment company complex and individual fund level. So for example, if the lead audit partner served his fifth year of service on funds within the complex with fiscal years ended January 31, 1999 and December 31, 1999, then the lead audit partner could rotate back onto the complex and could perform the audits for fiscal year ended January 31, 2005 (which the fiscal period begins February 1, 2004)

and December 31, 2005 (which the fiscal period begins January 1, 2005). The SEC staff also clarified that in a situation when a new fund ("New Fund") commenced operations during the period the partner was originally assigned to the complex, the partner would not be able to serve New Fund after he/she was assigned to the complex for the maximum allowed time (5 or 7 years) and could not return as the partner on New Fund until he/she was eligible to return to the complex. So for example, if New Fund commences operations in 1998 and has a fiscal year end of June 30, the lead audit partner could perform audits for fiscal year ended June 30, 1998 and June 30, 1999. However the lead audit partner would have to rotate off the investment company complex after the completion of the December 31, 1999 audits and would be not eligible to perform audits for New Fund until fiscal year end June 30, 2005 (in which the fiscal period begins July 1, 2004).

The Expert Panel further discussed that in the situation described by SEC Staff there would be a symmetry of cooling off period: if partner A was off the engagement for 5 years and partner B was on the engagement for 5 years, partner A can come back to the investment company complex when partner B is required to roll off. Even if there are new funds that are seeded in the investment company complex, the counting of tenure time of the lead audit partner will start with the first fund in the complex that he or she is responsible for.

The Expert Panel further discussed a question relating to that control testing on the investment company complex which is often performed on the overall basis: if such testing is performed prior to partner A coming back, should the work be signed off by partner A, even if performed during partner B tenure? The Expert Panel noted that one of the views was that partner B would be responsible for control testing performed during his/her tenure.

The Expert Panel further discussed a definition of the lead partner role that was presented on the chart included in the meeting materials titled *Application of Partner Rotation Rules to ICC* ("Chart"). The Expert Panel discussed that some firms developed the "lead audit partner" definition through informal discussions with the SEC. Many of the engagements may have several partners, and only one of them typically is the lead audit partner. At the same time, the Expert Panel acknowledged that in the example when a complex has two different fund families, some accounting firms would have signing partners that both would need to roll off in five (5) years.

The Expert Panel further discussed that the role of the lead audit partner would be to have communications with the Audit Committee, establishment of the firm's overall audit approach, and dealing with complex accounting issues. The lead audit partner would establish the firm's overall audit approach for the entire fund family and remains responsible for audits of all funds on the engagement, even if he/she does not sign the opinion and review

the work of each individual fund. The Expert Panel acknowledged that the lead audit partner could be considered potentially responsible in case of an audit failure.

The EP will discuss this issue at a future meeting.

XII. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser's Act – The SEC Staff has indicated that application of the SEC independence rules in connection with the audit exemption provided in rule 206(4)-2 of the Adviser's Act is one of the priorities of the SEC Division of Investment Management. The Division of Investment Management has answered some questions raised by individual public accounting firms relating to specific fact-based scenarios, and is continuing to work on addressing the issues raised by a group of public accounting firms.

XIII. IFRS Concept Release – The SEC Staff noted that the SEC is planning to publish in August 2007, the *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in accordance with International Financial Reporting Standards* (“Concept Release”) to obtain information about the extent and nature of the public's interest in 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 (“IFRS”), as published by the International Accounting Standards Board, for purposes of complying with the rules and regulations of the Commission.

U.S. issuers presently prepare their financial statements in accordance with generally accepted accounting principles as used in the United States (“U.S. GAAP”). Under U.S. GAAP, investment company financial statements have unique disclosure requirements. For example, Regulation S-X contains specific disclosure requirements for investment companies relating to investments in unaffiliated issuers, investments in affiliates, securities sold short, open option contracts written and investments other than securities.¹ Also, Rule 6-05 of Regulation S-X permits investment companies to include a Statement of Net Assets in lieu of the balance sheet, if at least 95 percent of the investment company's total assets are represented by investments in securities of unaffiliated issuers. The non-financial statement portion of an investment company's shareholder report may require disclosures that are based on financial statement information. For example, investment companies must include an expense table and a graphical representation of holdings.²

¹ See Rules 12-12 through 12-14 of Regulation S-X [17 CFR 210.12-12, 12-12A, 12-12B, 12-12C, 12-13 and 1214.]

² See Items 22(d)(1), (2) of Form N-1A.

Particular differences between IFRS and U.S. GAAP would result in different presentations in practice. For example, IFRS does not require a schedule of investments or financial highlights; however, U.S. GAAP requires this information, as discussed above, in an investment company's financial statements. As another example, IFRS does not provide an exemption from consolidation of subsidiaries in an investment company, whereas U.S. GAAP provides exemptions from consolidating subsidiaries in certain areas which could result, for example, in different treatment for master-feeder funds.³

The SEC will be seeking input to better understand the nature and extent of the public's interest in giving U.S. issuers, including investment companies, the option to file with the Commission financial statements prepared in accordance with IFRS as published by the IASB.

XIV. Extension of Interactive Data Voluntary Reporting Program on the Edgar System to Include Mutual Fund Risk/Return Summary Information – The SEC Staff is adopting rule amendments to extend the current interactive data voluntary reporting program to enable mutual funds voluntarily to submit supplemental tagged information contained in the risk/return summary section of their prospectuses. A mutual fund choosing to tag its risk/return summary information also would continue to file this information in HTML or ASCII format, as currently required. This extension of the voluntary program is intended to help us evaluate the usefulness to investors, third-party analysts, registrants, the Commission, and the marketplace of data tagging and, in particular, of tagging mutual fund information. The effective date of the rule is August 20, 2007.

XV. Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses– The Staff of the Division of Investment Management has prepared the responses to certain questions raised in connection with amendments to the fee table adopted in the Fund of Funds release in June 2006.⁴ These amendments require funds to disclose in their fee tables the expenses of investing in other funds under a line item titled “Acquired Fund Fees and Expenses” (“AFFE”). Staff Responses can be found at <http://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>.

³ A master-feeder fund is a two-tiered arrangement in which one or more “feeder” funds hold shares of a single “master” fund in accordance with Section 12(d)(1)(E) of the Investment Company Act of 1940.

⁴ Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) [71 FR 36640 (June 27, 2006)] (“Adopting Release”). The Release can be found at: <http://www.sec.gov/rules/final/2006/33-8713.pdf>.

Other Projects

- XVI. CCO Reporting** – This project was discussed at the previous meetings. The expected timing of the SOP issuance is fall of 2007.
- XVII. Tuck School of Business in Dartmouth Private Equity Leadership Summit** (“Summit”) – The Expert Panel discussed recent Summit that focused on valuation issues relating to private equity funds and industry sentiment relating to the inconsistency of audit requests. The Expert Panel further discussed the required audit procedures in the situation when investee fund is a fund of funds.
- XVIII. Investment Company Institute Accounting Policy Subcommittee** – Investment Company Institute (“ICI”) has created a subcommittee to address new accounting pronouncements (“subcommittee”). The subcommittee will meet quarterly with the first meeting in San Diego during the 2007 ICI Tax and Accounting Conference. The subgroup will have representatives from industry and each Big 4 accounting firm.

**AICPA Investment Companies Expert Panel
Meeting Highlights
August 21, 2007
AICPA offices, New York City**

Administrative Updates

- I. Rotation of the Chair position of the AICPA Investment Companies Expert Panel** – Brian Gallagher, current Chair of the AICPA Expert Panel (“Chair”), announced that his tenure as the Chair has come to a close and congratulated Richard Grueter as the new Chair starting with the November 2007 meeting.

- II. Audit Risk Alert, *Investment Companies Industry Developments—2007/08*** – The Expert Panel discussed timing and suggested content for the 2007/08 Audit Risk Alert.

Financial Accounting/Reporting Issues

- III. Scope SOP** – In June 2007, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (“Scope SOP”). Scope SOP provides guidance for auditors to determine whether an entity is within the scope of the AICPA Audit and Accounting Guide, *Investment Companies*. In addition, Scope SOP modifies FASB Emerging Issues Task Force (EITF) Issue No. 85-12 by establishing conditions for the retention of investment company accounting by parent companies in consolidation and by equity method investors, and requiring various disclosures if investment company accounting is retained. Scope SOP is effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged.

A number of implementation issues were raised to AICPA and FASB relating to the Scope SOP. The AICPA Accounting Standards Executive Committee (“AcSEC”) has proposed a set of non-authoritative technical practice aids intended to clarify implementation issues relating to Scope SOP.

The Expert Panel discussed the following implementation issues:

- i. definition of similar investment and application of paragraph 30(b) to the equity method investor. Paragraph 30(b) of Scope SOP states:

“In order to retain investment company accounting in the financial statements of the parent company, the consolidated group (the parent company and its consolidated subsidiaries) should follow established policies that effectively distinguish the nature and type of

investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies. Those policies should address, at a minimum, (1) the degree of influence held by the investment company and its related parties over the investees of the investment company, (2) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (3) the level of ownership interest held in the investment company by the consolidated group... “

The Expert Panel discussed considerations relating to companies having different policies that would result in dissimilar accounting under Scope SOP.

- ii. issue relating to investor ("Fund A") that invested into the fund ("Fund B") and whether prohibition *"of the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a noninvestment company member of the consolidated group"* (par 30(b) of Scope SOP) would only relate to Fund A or whether it would need to be applied to Fund B.
- iii. interaction of Scope SOP and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115 ("FAS 159")*, in cases when investor would unwind investment company accounting and investments carried at the fair value on investment company books are ineligible for FAS 159 fair value option;
- iv. issue relating to a general partner that sponsors a fund of funds and the fund of funds invests in other funds managed by the general partner – whether the general partner's receipt of an incentive allocation in the investee funds enables the general partner to receive a benefit unavailable to another market participant (e.g. investing for strategic operating purposes) which could preclude the general partner from retaining investment company accounting upon consolidation or application of the equity method;
- v. availability of the fair value option for financial instruments that include a component associated with significant future services.

IV. Statement of Financial Accounting Standards No. 157 - The Expert Panel has created a subgroup to work on implementation issues relating to Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”). Currently, there are four (4) main topics on the agenda of this subgroup:

- 1) definition of the measurement period for registered investment companies;
- 2) rollforward disclosure;
- 3) valuation issues relating to fund-of-funds;
- 4) accounting for transaction costs.

The Expert Panel noted that FASB (“Board”) continues to assess whether and to what extent additional and more specific valuation guidance is required for financial reporting purposes beyond the guidance provided in FAS 157. The Board seeks to solicit the views of its constituents through the formation of a resource group tasked with assisting the Board in matters involving valuation for financial reporting purposes (“FASB resource group”). The FASB resource group has reached out to AICPA, and accordingly AICPA reached out to various expert panels, including the Investment Company Expert Panel, asking to identify potential implementation issues that require additional guidance. The due date for the submission is September 5, 2007. The Expert Panel is working on a submission to the FASB resource group.

V. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*, and investment companies registered under the Investment Company Act of 1940 – The Expert Panel recognized that the mutual fund industry is struggling with implementation issues relating to FASB Interpretation No. 48 (“FIN 48”). The Expert Panel discussed that for instances when a client has obtained a legal opinion supporting a more-likely-than-not assertion, the audit firm would be required to assess and concur with that conclusion. The Expert Panel acknowledged that some clients may not fully appreciate that the audit firm would not automatically accept the legal opinion on its face, and would want to reach its own conclusions. Further, the Expert Panel noted that there might be some instances when different legal opinions were presented for similar fact patterns.

Additionally, the Expert Panel discussed that there is a potential conflict that exists between the audit firm's requirement to fully assess all audit evidence during audits and concerns that law firms might have over the confidentiality of the information. It was noted that an audit firm would need to understand how a law firm reached an opinion while the law firm may be opposed to sharing information underlying its decision to the extent it may provide information that could be used against its clients in the event of actual litigation.

The Expert Panel reiterated that, as discussed at the previous meetings, foreign withholding tax considerations would fall under FIN 48's scope. The Expert Panel members further noted that they were not aware of any funds accruing FIN 48-related liabilities. The Expert Panel also discussed required disclosures for FIN 48. The Expert Panel acknowledged that for the most part, registrants are providing FIN 48-related disclosures in their semi-annual reports.

Further, the Expert Panel acknowledged that there might be inconsistencies in how the audit firms execute their respective audit approaches related to FIN 48 considerations.

Lastly, the Expert Panel noted that the AICPA has issued a Technical Practice Aid "*Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48*" ("Practice Guide"). The Practice Guide is not authoritative, but is intended to assist members in understanding the requirements of FIN 48. The Practice Guide is available the AICPA website at tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.

- VI. Real Estate Funds Task Force ("RETF")** – members of the RETF joined the Expert Panel to discuss financial reporting and accounting issues in adopting the Scope SOP for funds that invest in real estate. The RETF is planning to meet with AcSEC in September to discuss some of the issues. RETF and EP discussed challenges that real estate companies will have in applying the Investment Companies Guide and inconsistencies that the application will raise in practice. The Expert Panel raised a concern about issuing any guidance that would impact other investment companies by analogy and recommended that any guidance be limited to real estate funds.
- VII. Money Market Fund SOI Presentation** – The SEC's shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments ("SOI") for a money market fund from the semi-annual or annual shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform the shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the audit guide do not currently permit a fund to exclude the SOI from the financial statements. Current accounting and reporting guidance would indicate the portfolio of investments would be considered a required GAAP disclosure that would need to be included with the other financial statements being opined on. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal.

At the May 24, 2006 meeting, the Expert Panel noted that proposing a modification of GAAP that would allow a SOI to be omitted from financial statements for a money market fund would require FASB to issue guidance, which might be a time-consuming process. Alternatively, given the fact that a portfolio is actually prepared and included in the fund's filing with the SEC, the EP considered the issuance of an unqualified report referencing the full SOI maintained in an external document (Item 6 of Form N-CSR). This approach would require coordination with the AICPA and the PCAOB (as the funds in question are registrants and issuers).

The Expert Panel briefly discussed a draft of such a report at various 2006 meetings. The Expert Panel noted that in order for a firm to issue an unqualified report that references Form N-CSR, Form N-CSR must be filed concurrently with the delivery of the shareholder report. If such did not occur, the auditor would be referencing a document (Form N-CSR) that did not exist.

The SEC Regulations committee of Center for Audit Quality requested that the Expert Panel prepare a document that outlines alternative approaches and related considerations that would allow registered money market funds to take advantage of an option to exclude the SOI.

VIII. *Conditions in the Subprime Markets and Impact on Investment Companies.* The Expert Panel discussed that liquidity in the market for subprime mortgage backed securities has deteriorated significantly since early July 2007 when the major rating agencies began to downgrade a number of issues where the underlying mortgages had increased delinquencies and foreclosures. Further, the Expert Panel discussed the repercussions of the subprime issues and similarity of liquidity issues between current conditions and those experienced during the Orange County bankruptcy.

The Expert Panel noted that price quotations for subprime asset-backed securities have become increasingly difficult to obtain, and, when obtained, exhibit wide bid-asked spreads. Further, actual transactions periodically occur at values significantly different from quoted prices, due to both the general market illiquidity and the presence of distressed sellers.

The Expert Panel discussed several business and accounting issues that arose as a result of the conditions in the subprime markets, many of which relate to the measurement of the fair value of securities in the current illiquid market and the devaluation of commercial paper or other securities in money market funds or held as collateral for security lending transactions.

The Expert Panel noted that pricing services, such as Interactive Data Pricing and Reference Data, have issued press releases to inform users that they are experiencing difficulties in obtaining a typical amount of consistent market information in the production of valuations of subprime related securities. The

Securities and Exchange Commission made inquiries of some registrants about the pricing of some specific securities. The Expert Panel further discussed SEC concerns about individual organizations contacting pricing services with request to override a price. The Expert Panel noted that one organization hired an outside advisor to look at its pricing process and reasonableness of fair value prices.

The Expert Panel recognized that various money market funds (both registered and unregistered) have acknowledged investments in troubled paper. Some of the funds have enhanced their monitoring procedures of differences between net asset value as determined using amortized cost and market values of securities, as required by Rule 2a-7 under the Investment Company Act of 1940 or other equivalent regulations. The Expert Panel further noted that it was not aware of any registered money market fund that either failed its compliance with Rule 2a-7 that resulted in NAV per share that differed from \$1 per share or suspended its dividends.

The Expert Panel further discussed considerations relating to the ability of the money market fund to enter into credit default derivatives and any requirement to fair value individual instruments. It noted guidance provided in a November 1, 1994 *Dear Financial Officer Letter* from Lawrence A. Friend, SEC Chief Accountant, that can be considered by registrants in the existing market conditions. See further discussion of this item in the *SEC Update* section in these highlights.

Lastly, the Expert Panel discussed that management will need to place controls in place to identify problem credits and pricing concerns, validate the reliability of pricing and/or institute fair value procedures, if necessary, and monitor the collectibility of accrued income. There was a discussion of the need to enhance audit procedures to ensure prices obtained from pricing services are reasonable, including the use of multiple pricing sources and/or the use of valuation experts to review any pricing models or fair value methodologies put in place. Consideration should also be made of additional financial statement disclosures.

Public Accounting Firm Issues

- IX. Report on Internal Control Required by the SEC Under Form N-SAR -** The Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (“Auditing Standard No. 5”), which was approved by the SEC on July 25, 2007. Among other things, Auditing Standard No. 5 modified the definitions of "material weakness" and "significant deficiency" to be used in the audits of issuers' financial statements under PCAOB standards. The Expert Panel prepared a draft Form N-SAR report on internal controls for review by the SEC and

PCAOB. Once approved, this report will be posted on the AICPA website and included in 2008 *AICPA Audit and Accounting Guide, Audits of Investment Companies*. The Expert Panel noted that while Auditing Standard No. 5 is fully effective for reports issued for fiscal years ending after November 15, 2007, independent registered public accounting firms are encouraged to apply it for reports due on or after August 27, 2007.

X. AU 9332 and Agreed-Upon Procedure Reports— The Expert Panel noted that some investees engage accounting firms to perform agreed-upon procedures relating to the valuation of their assets in an effort to assist the investor to perform on-going monitoring of the investee entity. The Expert Panel noted that receiving and reviewing agreed-upon procedure reports is one of the steps that an investor’s management can perform as part of on-going monitoring of the alternative investment, and is consistent with monitoring procedures described in the Practice Aid *Alternative Investments—Audit Considerations* published by the AICPA in summer of 2006. The Expert Panel further noted, however, that such an agreed-upon procedure report would not normally provide comfort around the alternative investment valuations assertion as of the investor’s year-end, as the auditor of the investor is typically not identified as a user of that agreed-upon procedures report.

XI. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act - On November 1, 2005, representatives from certain public accounting firms met with representatives of the SEC Staff to discuss the application of the SEC independence rules in connection with the Audit Exemption provided in Rule 206(4)-2 of the Adviser’s Act. Specifically, the concern was whether the SEC’s auditor independence rules are applicable to the audit of a non-registered hedge fund when a registered investment adviser uses an exception for the security count examination, as permitted under the “Custody of Funds or Securities of Clients by Investment Advisors” (the “Custody Rule”).

In the SEC Release *Staff Responses to Questions About Amended Custody Rule* as updated in January 2005, the SEC Staff indicated in its response to question VI.5 that for a registered investment adviser to meet the security count exception, the auditors of each of the adviser’s hedge funds would need to comply with “U.S. Generally Accepted Auditing Standards” and, in particular with Article I, Section 2(d) of Regulation S-X (governing independence standards). On August 2, 2006, a letter was submitted by Deloitte & Touche LLP on behalf of a number of public accounting firms requesting transitional relief from the independence rules imposed by this SEC view for auditors of funds associated with newly registered investment advisers. On August 28, 2006 the SEC Staff issued a letter to Deloitte & Touche LLP in response to the request granting relief upon certain prescribed conditions. However, even to the extent relief has been granted, certain

interpretive questions still needed to be resolved. On November 30, 2006 and May 22, 2007, representatives from certain public accounting firms met with representatives of the SEC Staff and raised the questions that required further clarification. Some of these questions were answered at the meeting; however, others required further guidance (for example, questions relating to determination of affiliates and engagement management). Representatives from certain public accounting firms are planning to have a follow up discussion with the SEC Staff on these questions.

The Expert Panel also recognized that once the SEC Staff views are clarified on this matter, a mechanism will need to be established to make them public. Additionally, the Expert Panel noted that private equity groups are reaching out to SEC Staff for guidance. Issues that private equity funds are facing are similar to the ones described above. This will provide an opportunity to invigorate the discussion around independence issues at the SEC.

XII. Rating Agencies AMPS Agreed-Upon Procedures – Many closed end investment companies have engaged their audit firms to provide certain agreed upon procedures as a condition to the fund’s being rated by a nationally recognized rating agency such as Standard and Poor’s Corporation, Moody’s Investors Services, Inc. or Fitch, Inc. (collectively the “Rating Agencies”). The investment and operating metrics that a fund must meet and on which the agreed upon procedures are performed (as well as the on-going compliance requirements) are normally found in the Amended By-Laws of the fund (specifically detailing the rights, privileges and obligations relative to the preferred stock) or in a similar document.

AT 201.07 provides that “to satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties.” In these situations, given that the rating agencies request the report, both the rating agencies and the management of the fund would be considered to be “specified parties” or users of the report.

In order for the Rating Agencies to be identified as specified parties, audit firms are required to obtain affirmative acknowledgment from the Rating Agencies that they agree with the procedures and take responsibility for the sufficiency of the procedures for their purposes. Representatives of the firms noted that they have experienced some difficulty in obtaining appropriate affirmation from certain rating agencies.

Representatives from the Expert Panel met with one of the Rating Agencies to inform the agency of the professional standards that the audit firms are required to abide by and to discuss the most effective and efficient manner to

obtain the appropriate affirmations; acknowledging that the lack of receipt of the appropriate affirmation would preclude the rating agency from receiving the report.

EP members agreed to coordinate with a standard affirmation letter and process that would be presented to the rating agency for further discussion.

SEC Update

- XIII. Statement of Financial Accounting Standards No. 157** - The SEC Staff noted that they have received a question whether the N-Q filings would need to include disclosures required by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”). The SEC Staff believes once an entity adopts FASB Statement No. 157, the N-Q filings made by registered investment companies should include disclosures required by FAS 157. Inclusion of the disclosures in fund N-Q filings will enhance ability of the reader of financial statements to compare liquidity of the fund investments from quarter to quarter and will provide with meaningful background information about fund holdings.
- XIV. Emphasis of Matter Paragraph** – In 2006 AICPA issued *Alternative Investments - Audit Considerations - A Practice Aid for Auditors ("Practice Aid")*. This Practice Aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist. These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are referred to as “alternative investments.” Investors in alternative investments include, but are not limited to, colleges and universities, hospitals, pension plans, and investment companies – including funds of funds.

One of the aspects that this Practice Aid addresses is the consideration of the inclusion of the Emphasis of a Matter Paragraph in the audit opinion. The Practice Aid included the following guidance:

“Reporting

Emphasis of a Matter Paragraph

The more complex or illiquid the underlying investments are, the greater the inherent uncertainty in management’s estimated fair value. As the inherent uncertainty in the estimate increases, as well as the significance of the alternative investments to the financial statements, auditors may consider inclusion of an emphasis of matter paragraph in the auditors’ report such as the following, tailored for the specific facts and circumstances:

As explained in note X, the financial statements include investments valued at \$ _____ (____ percent of net assets), whose fair values have been estimated by management in the absence of readily determinable fair values. Management’s estimates are based on information provided by the fund managers or the general partners. An emphasis of matter paragraph is not used to introduce information to the financial statements and neither replaces any required financial statement

note disclosure nor reduces the required audit evidence needed to support an unqualified opinion. Such paragraphs are never required and are included solely at the auditor's discretion. The above emphasis of matter paragraph would be consistent with GAAP disclosures made in the financial statements."

To the extent the auditor decides to include an emphasis of matter paragraph in situations where a fund has invested in a hedge fund it is possible that certain registered funds of hedge funds meeting this criteria may include auditors' reports containing this paragraph in filings with the Securities and Exchange Commission as long as the addition of this paragraph is not a result of a scope limitation.

The Expert Panel acknowledged that the question of the SEC Staff reaction to the emphasis of matter paragraph has come up previously, and the Expert Panel understanding was that the SEC Staff view was to accept it without penalty to the issuer (as long as there is no qualification). The Expert Panel wanted to confirm this view. The SEC Division of Investment Management ("Division") Staff confirmed that the emphasis of matter paragraph is not viewed as a qualification, and as such, will not raise concerns with the Division Staff. The SEC Staff also indicated that they did confirm with the Division of Corporation Finance their views relating to the emphasis of matter paragraph. The SEC staff also indicated that they would expect the language used in the emphasis of the matter paragraph to be tailored and track closely with the disclosure requirements under SFAS 157.

XV. FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 ("FIN 48"), and investment companies registered under the Investment Company Act of 1940

– At the previous Expert Panel meeting a question was raised as to the proper presentation of an advisor (or other party's) indemnification relating to FIN 48 accrual. SEC Staff noted issuers should follow the guidance in S-X and would not object if issuers present income tax expense separately from reimbursements, that is, show gross presentation. Similar presentation will be made for indemnification amounts that relate to capital gain tax.

XVI. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Advisers Act

– The SEC Staff has indicated that application of the SEC independence rules in connection with the audit exemption provided in rule 206(4)-2 of the Advisers Act is one of the priorities of the SEC Division of Investment Management. The Division of Investment Management has answered some questions raised by individual public accounting firms relating to specific fact-based scenarios, and is continuing to work on addressing the issues raised by a group of public accounting firms. It further noted that the Commission has updated *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions*, which are posted on the SEC website at <http://www.sec.gov/info/accountants/ocafaqauidind080607.htm>.

XVII. Money Market Funds and Exposure to Turbulent Conditions in the Subprime Market – The November 1, 1994 *Dear Financial Officer Letter* from Lawrence A. Friend, SEC Chief Accountant (“Dear CFO Letter”) provides the following guidance for affiliate purchases at a price in excess of current market value:

“Affiliated purchases at a price in excess of the current market value¹ 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.”

The Expert Panel inquired whether this guidance reflects the current views of SEC Staff as to financial statement presentation of affiliate purchases in excess of current market value. SEC Staff replied that its position on this issue has evolved since guidance was provided in 1994 Dear CFO Letter. The SEC Staff believes that the amount by which the payment exceeds the current market value of the investments purchased is considered a reimbursement, and should be presented in the Statement of Operations in accordance with the guidance in Chapter 7 of the Audit and Accounting Guide *Investment Companies*.

Furthermore, SEC Staff and Expert Panel discussed Rule 17a-9 promulgated under the Investment Company Act of 1940 that states that:

The purchase of a security that is no longer an Eligible Security (as defined in [paragraph \(a\)\(10\)](#) of Rule 2a-7) from an open-end investment company holding itself out as a "money market" fund shall be exempt from [Section 17\(a\)](#) of the Act, provided that;

- a. The purchase price is paid in cash; and*
- b. The purchase price is equal to the greater of the amortized cost of the security or its market price (in each case, including accrued interest).*

The Expert Panel noted that in the subprime environment, some registrants may have to rely on this rule to keep NAV of a money market fund at \$1. per share.

¹ *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.*

XVIII. IFRS Concept Release – During August of 2007, the Securities and Exchange Commission published the *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in accordance with International Financial Reporting Standards* (“Concept Release”) (<http://www.sec.gov/rules/concept/2007/33-8831fr.pdf>) to obtain information about the extent and nature of the public’s interest in 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 (“IFRS”), as published by the International Accounting Standards Board for purposes of complying with the rules and regulations of the Commission.

U.S. issuers presently prepare their financial statements in accordance with generally accepted accounting principles as used in the United States (“U.S. GAAP”). Under U.S. GAAP, investment company financial statements have unique disclosure requirements. For example, Regulation S-X contains specific disclosure requirements for investment companies relating to investments in unaffiliated issuers, investments in affiliates, securities sold short, open option contracts written and investments other than securities.² Also, Rule 6-05 of Regulation S-X permits investment companies to include a Statement of Net Assets in lieu of the balance sheet if at least 95 percent of the investment company’s total assets are represented by investments in securities of unaffiliated issuers. The non-financial statement portion of an investment company’s shareholder report may require disclosures that are based on financial statement information. For example, investment companies must include an expense table and a graphical representation of holdings.³ Particular differences between IFRS and U.S. GAAP would result in different presentations in practice. For example, IFRS does not require a schedule of investments or financial highlights; however, U.S. GAAP requires this information, as discussed above, in an investment company’s financial statements. As another example, IFRS does not provide an exemption from consolidation of subsidiaries in an investment company, whereas U.S. GAAP provides exemptions from consolidating subsidiaries in certain areas which could result, for example, in different treatment for master-feeder funds.⁴

In light of the ongoing convergence efforts of the IASB and the FASB and the movement outside the United States towards accepting financial statements

² See Rules 12-12 through 12-14 of Regulation S-X [17 CFR 210.12-12, 12-12A, 12-12B, 12-12C, 12-13 and 1214.]

³ See Items 22(d)(1), (2) of Form N-1A.

⁴ A master-feeder fund is a two-tiered arrangement in which one or more “feeder” funds hold shares of a single “master” fund in accordance with Section 12(d)(1)(E) of the Investment Company Act of 1940.

prepared in accordance with IFRS, the Commission is seeking input in the Concept Release regarding the role of IFRS as published by the IASB as a basis of financial reporting in the U.S. public capital market by U.S. issuers.

Specifically, the Commission is seeking input to better understand the nature and extent of the public's interest in giving U.S. issuers, including investment companies, the option to file with the Commission financial statements prepared in accordance with IFRS as published by the IASB. Comments should be submitted on or before November 13, 2007.

- XIX. Form 12b-25 Extension** – If a registered investment company is unable to file all or any portion of a Form N-CSR or N-SAR within the prescribed time period, Form 12b-25 is required to be filed with the SEC within one business day after the due date of the report, disclosing the reasons for the delay. If the registrant files the applicable report or portion thereof within fifteen calendar days following the due date in the case of an annual report, and meets the other conditions under Rule 12b-25, the registrant will be deemed to have filed its report on a timely basis for purposes of determining its eligibility for the use of certain 1933 Act registration forms.

Rule 30e-1 (“Rule”) - *Reports to Stockholders of Management Companies* promulgated under the Investment Company Act of 1940 requires that each report shall be transmitted (mailed) to shareholders within 60 days after the close of the period for which such report is being made. The Rule further notes that:

“The period of time within which any report prescribed by this rule shall be transmitted may be extended by the Commission upon written request showing good cause therefor.”

SEC Staff noted that the Form 12b-25 is designed to be used only for late filings with the Commission, but not for the late transmittal of the reports to the shareholders. Mailing extensions are generally not allowed by the Commission, although they have been granted in the past in the most extreme circumstances.

The Expert Panel discussed with SEC staff a concern that if a registered investment company is not able to file Form N-CSR due to delay in completing an audit, it would also not have been able to transmit the shareholder reports timely. Additionally, the SEC Staff indicated that they would expect registrants to attach an exhibit obtained from their auditor when the auditor is unable to furnish an audit opinion by the required filing date. See Exchange Act Rule 12b-25(c).

- XX. Financial Statements Review Comments** – SEC Staff has recently encountered a situation when a registered fund of hedge funds (“Fund”) used the cost recovery method for accounting for its investments. As an example,

Fund invested \$5 million in a hedge fund. This investment appreciated to \$7 million when Fund decided to withdraw \$6 million. The Fund recorded \$1 million of gain on the redemption and decreased cost of its investment in the hedge fund to \$0. SEC Staff acknowledged that such treatment appears consistent with the tax treatment, but challenged whether it is consistent with GAAP. The Expert Panel further discussed whether the cost recovery method was an appropriate GAAP method, and specifically discussed references to cost recovery in APB 10 *Omnibus Opinion—1966* and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan, an amendment of FASB Statements No. 5 and 15*. This topic will be further discussed at future meetings.

Other Projects

- XXI. CCO Reporting** – This project was discussed at previous meetings. The expected timing of the SOP's issuance is fall of 2007.

**AICPA Investment Companies Expert Panel
Meeting Highlights
September 25, 2007
AICPA offices, New York City**

Administrative Updates

- I. **Audit Risk Alert, *Investment Companies Industry Developments—2007/08***
– The Expert Panel discussed timing and suggested content for the 2007/08 Audit Risk Alert.

- II. **AICPA Audit and Accounting Guide, *Investment Companies***– The Expert Panel discussed various planning items related to conforming changes to the 2008 version of the AICPA Audit and Accounting Guide, *Investment Companies* (the “Guide”).

Financial Accounting/Reporting Issues

- III. **Scope SOP** – In June 2007, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (“Scope SOP”). Scope SOP provides guidance for auditors to determine whether an entity is within the scope of the Guide. In addition, Scope SOP modifies FASB Emerging Issues Task Force (EITF) Issue No. 85-12 by establishing conditions for the retention of investment company accounting by parent companies in consolidation and by equity method investors, and requiring various disclosures if investment company accounting is retained¹.

A number of implementation issues were raised to the AICPA and FASB relating to the Scope SOP. AcSEC is considering a set of non-authoritative technical practice aids intended to clarify implementation issues relating to Scope SOP.

The Expert Panel discussed the following implementation issues:

- i. Interaction of Scope SOP and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (“FAS 159”)
– The Expert Panel discussed whether an entity which early

¹ Subsequent to this meeting, as per the project update at the FASB website at http://www.fasb.org/project/deferral_aicpa_sop07-1.shtml, “At the October 17, 2007 Board meeting, the Board decided to issue a proposed FASB Staff Position (FSP) that would indefinitely defer the effective date of SOP 07-1. For entities that have not yet adopted the provisions of SOP 07-1, early adoption would not be permitted. The Board directed the staff to prepare a draft of the proposed FSP for vote by written ballot. The Board decided that the proposed FSP should have a 30-day comment period.”

adopted FAS 159 but did not elect the fair value option on its investment in an investment company because the entity did not adopt Scope SOP which had not been issued until June 2007, can apply the fair value option to such investment upon adoption of Scope SOP.

- ii. Implementation issues raised in the Securities Industry and Financial Markets Association (SIFMA) letter.

IV. Statement of Financial Accounting Standards No. 157 - The Expert Panel has created a subgroup to work on implementation issues relating to Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”). The AICPA has also created the AICPA Fair Value Resource Panel (“AICPA Fair Value Panel”) comprised of valuation specialists, preparers, auditors, and users representing different industries. The objective of the AICPA Fair Value Panel is to identify areas where detailed implementation guidance relating to valuation for financial reporting purposes may be needed and to develop such non-authoritative guidance.

The Expert Panel noted that FASB continues to assess whether and to what extent additional and more specific valuation guidance is required for financial reporting purposes beyond the guidance provided in FAS 157. FASB seeks to solicit the views of its constituents through the formation of a resource group tasked with assisting the Board in matters involving valuation for financial reporting purposes (“FASB resource group.”) The FASB resource group has reached out to AICPA, and accordingly AICPA reached out to various expert panels, including Investment Company Expert Panel, asking to identify potential implementation issues that require additional guidance. The Expert Panel will submit whitepapers on the following FAS 157 implementation issues to the FASB resource group:

- 1) Valuation issues relating to fund-of-funds
- 2) Level 3 rollforward disclosures²

The Expert Panel discussed the process to submit new issues to the FASB resource group.

The Expert Panel also discussed the valuation of fund-of-funds investments upon adoption of FAS 157 and the classification of fund-of-funds investments in the fair value hierarchy. The Expert Panel also discussed whether the Level 3 rollforward is a reporting period concept or if a fund needs to track and report all Level 3 intra period activity. The Expert Panel also discussed the presentation of derivatives on the Level 3 rollforward and whether for derivatives, the Level 3 rollforward should be presented based on fair value or

² The final AICPA whitepaper submission to the FASB resource group, which occurred subsequent to this meeting and included input from various AICPA expert panels and task forces, excluded Level 3 rollforward disclosures.

based on gross notional amounts. The Expert Panel also discussed preparation of the Level 3 rollforward for derivatives which begin the period as assets and end the period as liabilities and vice versa.

- V. Money Market Fund SOI Presentation** – The SEC’s shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments (“SOI”) for a money market fund from the semi-annual or annual shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform the shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the Guide do not currently permit a fund to exclude the SOI from the financial statements. Current accounting and reporting guidance would indicate the portfolio of investments would be considered a required GAAP disclosure that would need to be included with the other financial statements being opined on. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal.

The SEC Regulations committee of the Center for Audit Quality requested that the Expert Panel prepare a document that outlines alternative approaches and related considerations that would allow registered money market funds to take advantage of an option to exclude the SOI. This document will also be provided to the SEC Division of Investment Management staff.

- VI. Conditions in the Subprime Markets and Impact on Investment Companies** - The Expert Panel discussed that liquidity in the market for subprime mortgage backed securities has deteriorated significantly since early July 2007 when the major rating agencies began to downgrade their ratings on a number of issues where the underlying mortgages had increased delinquencies and foreclosures. Further, the Expert Panel discussed the repercussions of the subprime issues.

The Expert Panel noted that the Center for Audit Quality has prepared 3 whitepapers on illiquidity in the markets. The whitepapers are: 1) Measurements of Fair Value in Illiquid (or Less Liquid) Markets; 2) Consolidation of Commercial Paper Conduits; and 3) Accounting for Underwriting and Loan Commitments. These whitepapers can be viewed at http://www.aicpa.org/caq/download/CAQAlert2007_51_10032007.pdf The Expert Panel noted that price quotations for subprime asset-backed securities have become increasingly difficult to obtain, and, when obtained, exhibit wide bid-asked spreads. Further, actual transactions periodically occur at values significantly different from quoted prices, due to both the general market illiquidity and the presence of distressed sellers.

The Expert Panel discussed several business and accounting issues that arose as a result of the conditions in the subprime markets, many of which relate to the measurement of the fair value of securities in the current illiquid market and the devaluation of commercial paper or other securities in money market funds or held as collateral for security lending transactions.

The Expert Panel noted that pricing services, such as Interactive Data Pricing and Reference Data, have issued press releases to inform users that they are experiencing difficulties in obtaining a typical amount of consistent market information in the production of valuations of subprime related securities. The Expert Panel noted that model pricing provided by some pricing services may not represent fair value if models are not updated to catch up to the market.

The SEC staff made inquiries of some registrants regarding their pricing of some specific securities, as well as of audit firms regarding their procedures to audit valuations of subprime instruments.

The Expert Panel recognized that various money market funds (both registered and unregistered) have acknowledged investments in troubled paper. Some of the funds have enhanced their monitoring procedures of differences between net asset value as determined using amortized cost and market values of securities, as required by Rule 2a-7 under the Investment Company Act of 1940 or other equivalent regulations.

The Expert Panel further discussed funds' valuations of liquidity puts issued to funds by their advisers whereby an adviser will reimburse the fund for the difference between proceeds received and amortized cost when a subprime instrument is sold or matures. The issues are whether valuation of the liquidity put should be based on the difference between amortized cost and fair value, or if the valuation should be something different due to the fact that the liquidity put is a derivative. The Expert Panel noted that the SEC had indicated that if registrants had questions on the valuations of such financial instruments, registrants should formalize questions in written communications to the SEC. The Expert Panel also noted that some funds are purchasing insurance to protect themselves from subprime losses. The Expert Panel also discussed whether money market funds can value certain securities in their portfolios using amortized cost while valuing other securities in their portfolios using fair value.

Lastly, the Expert Panel discussed that management will need to place controls in place to identify problem credits and pricing concerns, validate the reliability of pricing and/or institute fair value procedures, if necessary, and monitor the collectibility of accrued income. There was a discussion of the need to enhance audit procedures to ensure prices obtained from pricing services are reasonable, including the use of multiple pricing sources and/or the use of valuation experts to review any pricing models or fair value

methodologies put in place. In addition, auditors can consider reviewing subsequent trades and comparing them with valuations reported by the funds. Consideration should also be made of additional financial statement disclosures.

- VII. Deferred Management Fees** – The Expert Panel discussed a potential inconsistency in practice regarding the accounting for deferred management fees by private equity funds. One example of a deferred management fee arrangement is one in which the general partner of a private equity fund can elect in advance to forego its management fee for an equivalent carried interest allocation in the waterfall. This also exchanges the tax character of any return from ordinary income to capital gain. The Expert Panel noted there were different variations of such deferred management fee arrangements in practice.

Public Accounting Firm Issues

- VIII. Report on Internal Control Required by the SEC Under Form N-SAR** - The Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (“Auditing Standard No. 5”), which was approved by the SEC on July 25, 2007. Among other things, Auditing Standard No. 5 modified the definitions of "material weakness" and "significant deficiency" to be used in the audits of issuers' financial statements under PCAOB standards. The Expert Panel prepared a draft Form N-SAR report on internal controls for review by the SEC and PCAOB. Once approved, this report will be posted on the AICPA website and included in the 2008 Guide. The Expert Panel noted that while Auditing Standard No. 5 is fully effective for reports issued for fiscal years ending after November 15, 2007, independent registered public accounting firms are encouraged to apply it for reports due on or after August 27, 2007.

- IX. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Advisers Act** - Please refer to minutes from previous meetings for discussion of this item. No additional information was discussed by the Expert Panel at this meeting.

- X. Audit Confirmations** –

The Expert Panel continued discussing disclaimers auditors receive on broker confirmations. See excerpts of current and previous meeting discussions below.

The Expert Panel noted that a number of brokers have been refusing to sign auditor confirmations, or, if they sign a confirmation, often include a disclaimer relating to the accuracy of the information. In other instances,

brokers are directing the auditors to a website where they can obtain information, such as prices, in lieu of sending signed confirmations, and these websites often contain similar disclaimers. These issues are particularly prevalent with derivative confirmations. Similar matters were discussed during 2004 and 2005 AICPA Investment Companies Expert Panel meetings.

Audit firms may consider working with the client to ensure they receive properly authorized signed confirmations that do not contain disclaimers as to their reliability. Audit firms may also consider what alternative audit procedures are necessary when confirmations are received without signatures or with the disclaimers, as the confirmations in such form would not constitute sufficient audit evidence.

- XI. Partner Rotation** – The Expert Panel discussed partner rotation requirements. Please refer to minutes from previous meetings for discussion of this item.

SEC Update

- XII. Staffing Announcement** – The SEC Division of Investment Management’s Office of the Chief Accountant is looking to fill one (1) Assistant Chief Accountant fellowship position with a duration of 2 years with a prospect of being extended for an additional 2 years.

- XIII. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Advisers Act** – The SEC Staff has indicated that application of the SEC independence rules in connection with the audit exemption provided in rule 206(4)-2 of the Advisers Act is one of the priorities of the SEC Division of Investment Management’s Office of the Chief Accountant. The Division of Investment Management’s Office of the Chief Accountant has answered some questions raised by individual public accounting firms relating to specific fact-based scenarios, and is continuing to work on addressing the issues raised by a group of public accounting firms. The SEC Staff indicated that if there are additional questions related to independence, the SEC Staff can be consulted on a one-on-one basis. It further noted that Commission has updated *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions* and they are posted on SEC website at <http://www.sec.gov/info/accountants/ocafaqaudind080607.htm>.

- XIV. Form 12b-25 Extension** – If a registered investment company is unable to file all or any portion of a Form N-CSR or N-SAR within the prescribed time period, Form 12b-25 is required to be filed with the SEC within one business day after the due date of the report, disclosing the reasons for the delay. If the registrant files the applicable report or portion thereof within fifteen calendar days following the due date in the case of an annual report, and meets the other

conditions under Rule 12b-25, the registrant will be deemed to have filed its report on a timely basis for purposes of determining its eligibility for the use of certain 1933 Act registration forms.

Rule 30e-1 (“Rule”) - *Reports to Stockholders of Management Companies* promulgated under the Investment Company Act of 1940 requires that each report shall be transmitted (mailed) to shareholders within 60 days after the close of the period for which such report is being made. The Rule further notes that:

“The period of time within which any report prescribed by this rule shall be transmitted may be extended by the Commission upon written request showing good cause therefor.”

SEC Staff noted that the Form 12b-25 is designed to be used only for late filings with the Commission, but not for the late transmittal of the reports to shareholders. Mailing extensions are generally not permitted by the Commission, although they have been granted in the past in the most extreme circumstances.

The SEC staff indicated that if the delay is due to an audit firm’s inability to furnish an audit report timely, the registrant needs to submit the form and include in the Appendix a letter signed by the audit firm indicating why the audit cannot be completed timely. The SEC staff also indicated that it would be acceptable for an audit firm to indicate that the audit firm does not disagree with the registrant’s reasons for requesting a filing extension instead of the audit firm providing its own detailed explanation of the reason for the delay.

The Expert Panel discussed with SEC a concern that if registered investment company is not able to file Form N-CSR due to delay in completing an audit, it also would not be able to transmit shareholder reports timely.

- XV. Periods presented for depositors filing financial statements prepared in accordance with statutory accounting principles contained in insurance product registration statements** - Items 28, 23, and 24 of Forms N-3, N-4, and N-6 respectively, permit depositors to file financial statements prepared in accordance with statutory accounting principles in lieu of GAAP if the depositor has no other reason to prepare GAAP financial statements except for the use in its registration statement (the “Statutory Exception”). The instructions pertaining to depositor financial statements require depositors to include financial statements and schedules required by Regulation S-X. Rule 3-02 *Consolidated Statements of Income and Changes in Financial Position* of Regulation S-X requires, among other things, audited consolidated statements of income and cash flows for each of the last three fiscal years. However, the SEC staff noted that some depositors presented these statements and the statements of changes in capital and surplus for two years in their annual updates to the insurance products' registration statement consistent with statutory presentation. The SEC staff reminds registrants that

Rule 3-02 of Regulation S-X applies equally to all depositors, regardless of the basis of accounting used to prepare the depositor's financial statements. Therefore, depositors relying on the Statutory Exception are required to include statements of income, cash flows and changes in capital and surplus for the latest three years when updating their registration statements.

- XVI. Payments to the fund made by unaffiliated entities** – The SEC Staff and the Expert Panel discussed the accounting treatment for payments made to a fund by non-affiliates (e.g., an unaffiliated sub-advisor violates an investment restriction in the prospectus and agrees to reimburse the fund) and whether such reimbursements should follow the guidance for payments received from affiliates in Paragraphs 7.56-7.58 of the Guide relating to Net Increase From Payments by Affiliates. The SEC Staff indicated that the geography of the reimbursement depends on the nature of the transaction and the reason for reimbursement. For example, if the reimbursement related to an investment transaction, it would be reflected in the realized and unrealized gain/loss section of the statement of operations.
- XVII. Money Market Funds and Exposure to Turbulent Conditions in the Subprime Market** - In a prior meeting, the SEC Staff indicated that they believe that the amount by which the payment received by a fund from its advisor exceeds the current market value of the investments purchased is considered a reimbursement, and should be presented in the Statement of Operations accordingly. The applicable guidance to be followed is paragraphs 7.56-7.58 of the Guide relating to Net Increase From Payments by Affiliates. The SEC Staff clarified that such guidance provided applies to money market funds and any other types of funds. In addition, the SEC Staff indicated that this should not be shown as a capital contribution in the statement of changes in net assets.
- XVIII. SEC Rule “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles”** – The SEC issued the rule “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles” which is effective September 10, 2007 <http://www.sec.gov/rules/final/2007/ia-2628.pdf>. The Expert Panel asked the SEC staff if there are any additional auditor responsibilities or reporting issues as a result of the issuance of this rule and whether the auditor is indirectly or directly responsible for compliance with this rule. The SEC staff indicated that they will answer these questions at a future meeting.

Other Projects

- XIX. CCO Reporting** – This project was discussed at the previous meetings. The expected timing of the SOP issuance is fall of 2007.

**AICPA Investment Companies Expert Panel
Meeting Highlights
November 6, 2007
AICPA offices, New York City**

Administrative Updates

- I. Audit Risk Alert, *Investment Companies Industry Developments—2007/08*** – The AICPA indicated the 2007/08 Audit Risk Alert is in production and discussed the timing of expected issuance.
- II. AICPA Audit and Accounting Guide, *Investment Companies***– The Expert Panel discussed various planning items related to conforming changes to the 2008 version of the AICPA Audit and Accounting Guide, *Investment Companies* (the “Guide”).
- III. AICPA Investment Company Checklist** – The Expert Panel discussed the expected timing of the issuance of the Investment Company Checklist.
- IV. 2008 Expert Panel Meetings** – The Expert Panel discussed the 2008 meetings schedule and tentatively agreed the meetings would be held as follows:
 - February 12, 2008 conference call
 - April 17, 2008 AICPA New York City office
 - July 22, 2008 AICPA New York City office
 - October 16, 2008 AICPA New York City office
 - December 9, 2008 AICPA Washington, D.C. office
 - Additional meeting in spring/early summer to be proposed

Financial Accounting/Reporting Issues

- V. SOP 07-1** – In June 2007, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (“Scope SOP”). The Scope SOP provides guidance for auditors to determine whether an entity is within the scope of the Guide. In addition, the Scope SOP modifies FASB Emerging Issues Task Force (EITF) Issue No. 85-12 by establishing conditions for the retention of investment company accounting by parent companies in consolidation and by equity method investors, and requiring various disclosures if investment company accounting is retained.

The Expert Panel discussed that at the October 17, 2007 FASB meeting, the Board decided to issue a proposed FASB Staff Position (FSP) that would indefinitely defer the effective date of SOP 07-1. The primary reason for deferral was due to implementation issues relating to the retention of

investment company accounting by the parent company and equity method investor.

In prior meetings, the Expert Panel discussed implementation issues that were raised to the AICPA and FASB relating to the Scope SOP and also had noted that AcSEC has been considering issuing a set of non-authoritative technical practice aids intended to clarify implementation issues. The Expert Panel discussed that comment letters relating to the proposed FSP may refer to the various implementation issues that were previously raised.

At the current meeting, as a result of the pending deferral, the Expert Panel discussed whether an entity that would have met the definition of an investment company based on paragraphs 5-29 of the Scope SOP would meet the definition of an investment company as per the current Audit Guide. The Expert Panel also discussed effects the deferral of the Scope SOP would have on real estate funds.

- VI. Statement of Financial Accounting Standards No. 157** - The Expert Panel noted that no additional items have been submitted to the FASB Valuation Resource Group (“FASB resource group”) by the Expert Panel subgroup. As discussed in prior meetings, the FASB resource group was formed to assist the Board in matters involving valuation for financial reporting purposes.

The Expert Panel also discussed the status of the ICI’s whitepaper on FAS 157 footnote disclosures, including the Level 3 rollforward and tabular disclosure of the portfolio based by Level of the fair value hierarchy. The Expert Panel indicated members will provide comments to the ICI. The Expert Panel discussed whether the Level 3 rollforward is a reporting period concept or if a fund needs to track and report all Level 3 intra period activity. There was also discussion on the Level 3 rollforward relating to transfers in and out and how to account for gains and losses, as well as discussions on how to account for cash derivatives.

The Expert Panel also discussed whether or not NAV represents the fair value of an investment in an underlying fund (held, for example, in a fund-of-funds structure) under FAS 157. This issue was submitted to the FASB resource group which briefly discussed it at its previous meeting. In addition, the Expert Panel discussed at which level investments in underlying funds would be classified within the fair value hierarchy. The Expert Panel FAS 157 subgroup will consider adding this question to its list of implementation issues and will also consider creating a short list of additional implementation issues for registered and non-registered funds.

- VII. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109* (“FIN 48”)** – The Expert Panel discussed the agenda for the FASB meeting to be held on

11/7/07 and noted that the Board will discuss the deferral of FIN 48 for non-public entities and will discuss the application of FIN 48 to pass through entities.

- VII. Money Market Fund SOI Presentation** – The SEC’s shareholder reporting rule, finalized in February 2004, permits the exclusion of the schedule of investments (“SOI”) for a money market fund from the semi-annual or annual shareholder report provided that a full audited schedule of investments is included in Item 6 of Form N-CSR and the financial statements inform the shareholder as to how the shareholder may obtain a complete schedule of investments. The GAAP guidelines described in the Guide do not currently permit a fund to exclude the SOI from the financial statements. Current accounting and reporting guidance would indicate the portfolio of investments would be considered a required GAAP disclosure that would need to be included with the other financial statements being opined on. However, many money market funds would like to take advantage of the option to exclude the SOI, and the EP considered alternatives on what could be done to accomplish this goal.

There was discussion on recent developments relating to Money Market Fund SOI Presentation and recent discussions with that were held with different groups (PSC, AITF, and SEC Regs Committee of CAQ).

- VIII. Conditions in the Subprime Markets and Impact on Investment Companies** - The Expert Panel discussed the current volatility in the asset-backed securities markets, including the difficulties some funds had with obtaining prices in those markets and in the swap market. In addition, it was noted that funds need to obtain an understanding of where vendors obtain their quotes and whether funds can really transact at such quotes, as some broker quotes may not be indicative of fair value. Also, there are still industry concerns about valuations in the collateralized loan obligation (CLO) and collateralized debt obligation markets.

The Expert Panel noted that pricing services, such as Bear Stearns and Interactive Data Pricing, have issued letters to users indicating their difficulties in obtaining quotes for subprime assets and recommending that users perform additional due diligence on valuations.

The Expert Panel discussed that in 2004, the SEC indicated that although the current market may seem distressed, registrants cannot take a longer view of the market and not consider distressed values of the securities.

The Expert Panel also discussed a recent no-action letter issued by the SEC to a registrant which held a security which had been downgraded, for which the adviser intended to provide support against loss. This no-action letter was posted to the SEC’s website.

The Expert Panel noted that some money market fund complexes are still performing daily shadow pricing and some are comparing prices to multiple sources, reviewing activity in the marketplace, and reviewing the guarantors of the subprime assets. Some fund complexes are also having analysts review the prices.

The Expert Panel also discussed whether a fund can price a downgraded or defaulted money market security at fair value while pricing the rest of the portfolio at amortized cost, or if a fund would need to report the whole portfolio at amortized cost.

The Expert Panel discussed that some common collective trusts and funds which engage in securities lending may have received subprime collateral. In addition, it was noted that some funds receiving cash collateral may have invested in enhanced yield securities, such as short term bond funds, which have a longer duration and more risk and/or may have invested in subprime assets. Some of these funds may value their investments at amortized cost instead of fair value, and may not perform shadow pricing with the same level of rigor required by SEC Rule 2a-7. The Expert Panel also noted that sometimes declines in the market value across all securities in these funds may be individually small, but can add up and become material to the fund as a whole.

The Expert Panel also noted that there has been a push to ensure that funds have adequate support for their values of subprime assets and funds have been relying on internal valuation committees to fair value securities.

Public Accounting Firm Issues

IX. Report on Internal Control Required by the SEC Under Form N-SAR - The Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (“Auditing Standard No. 5”), which was approved by the SEC on July 25, 2007. Among other things, Auditing Standard No. 5 modified the definitions of "material weakness" and "significant deficiency" to be used in the audits of issuers' financial statements under PCAOB standards.

The Expert Panel prepared a draft Form N-SAR report on internal controls and there were suggested modifications that will be made to the letter. Once approved by the SEC and PCAOB, the revised letter is effective for fiscal years ending after November 15, 2007. Therefore, the audit firms will need to issue the revised letter for funds with November 30, 2007 year-ends.

- X. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act** - Please refer to minutes from previous meetings for discussion of this item. There was no additional information discussed by the Expert Panel at this meeting.
- XI. Auditor Independence** – The Expert Panel discussed whether a firm can perform non-attest services (e.g., fund administration) for a private unregistered investment fund when that fund's investment adviser's financial statements are audited by the same firm.
- XII. Partner Rotation** – The Expert Panel discussed partner rotation requirements. Please refer to minutes from previous meetings for discussion of this item.
- XIII. Implementation of Risk Assessment Auditing Standards 104-111**– The Expert Panel discussed how audit firms are implementing SASs 104-111.
- XIV. SEC proposed rule “Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Amending FAST and DRS Limited Participant Requirements for Transfer Agents”** – On May 25, 2007, the SEC proposed the rule “Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Amending FAST and DRS Limited Participant Requirements for Transfer Agents,” Release # 34-55816, (“Proposed Rule”). Item 11 of the Proposed Rule states:
- “The transfer agent must provide on an annual basis to DTC within ten (10) business days of filing with the SEC an accountant’s report (pursuant to Exchange Act Rule 17Ad -13, Annual Study of Evaluation of Internal Accounting Controls) attesting to the soundness of controls to safeguard securities assets and reliability and integrity of computer systems, including confidentiality of customer account or other non-public information. To the extent that a transfer agent obtains a SAS-70 audit report, the transfer agent shall provide DTC with a copy of the report within ten (10) business days of the transfer agent’s receipt of the report. In addition, the transfer agent must provide, within the same time frame as required for such report, a report from an external certified public accountant:
- a. certifying that the transfer agent is complying with all of DTC’s requirements relating to FAST agents including and without limitation to (a) those listed herein, (b) the Operational Criteria for FAST Transfer Agent Processing, (c) the Operational Agreement and (d) the Balance Certificate Agreement;

- b. certifying that the agent meets any SEC requirements for business continuity planning; and
- c. containing an SSAE 10 report (or the equivalent) attesting to the soundness of the transfer agent's control in meeting the requirements set forth herein; however an SSAE-10 need not be provided if the transfer agent has provided a SAS-70 audit report in accordance with the provisions of this paragraph 11."

The Expert Panel noted that while external accountants currently provide an accountant's report pursuant to Rule 17Ad-13 of the Securities Exchange Act of 1934 (refer to the 2007 AICPA Audit and Accounting Guide for Investment Companies, paragraph 11.22 for an example), the Proposed Rule has a number of other requirements that might be of concern to the accounting firms. The Expert Panel also noted that the comment period for the Proposed Rule ended on June 22, 2007 and there were no comments from large accounting firms posted on SEC website. See further discussion about the SEC's reaction in the SEC Update section below.

SEC Update

- XV. FAS 157 Form N-Q Disclosures** – The SEC Staff indicated all FAS 157 required disclosures should be included in Form N-Q filings. Such disclosures include both the classification of the portfolio by fair value hierarchy level as well as the Level 3 roll forward. The SEC Staff indicated that based on the nature of investment companies, they believe it is critical to for a user to see activity in illiquid type securities, and therefore, they believe the Level 3 roll forward is relevant in Form N-Q filings. The SEC Staff indicated that Form N-Q refers to Rule 12b-20 of the Exchange Act which indicates that a registrant can include additional information in order to make the schedule not misleading. The Expert Panel asked whether the Level 3 roll forward would be required if Level 3 securities are immaterial and the SEC Staff indicated that FAS 157 stipulates that it need not apply to immaterial items.
- XVI. FIN 48** – The Expert Panel and the SEC Staff discussed the SEC Staff's June 28, 2007 letter which indicates, among other things, that if the advisor determines the fund needs to record a tax liability, such liability can be offset with a receivable if there is a contract in place in which the advisor is contractually obligated to indemnify the Fund. The Expert Panel asked the SEC Staff whether in order for the receivable to be recorded, the contract needs to specify the items and amounts that will be indemnified. The SEC Staff indicated that although this is not a live scenario, they have been discussing this situation and have not formulated a formal position because the circumstances are fact specific and they would need to understand facts and circumstances for each scenario in order to conclude. The SEC Staff

mentioned that they have been discussing that if subsequent to a reporting date a fund determines that it should have recorded a FIN 48 liability on the reporting date and subsequently the fund records the liability as of the reporting date, whether this should be treated as a correction of an error depending on materiality. The SEC Staff indicated that the June letter does not address this issue and therefore, if funds conclude that this is a correction of an error, funds should deal with this situation in the same manner in which they would deal with other NAV errors. The SEC Staff also indicated that although an indemnification contract between the advisor and fund must be in place in order for the fund to record an offsetting receivable to a FIN 48 liability, if a fund uncovers a tax issue and knows the advisor will indemnify the fund, the fund can record the receivable as long as the formal contract is drawn up within a reasonable time period. The SEC Staff indicated that if an advisor agrees to indemnify a fund, this indemnification does not need to be settled in cash. The SEC Staff mentioned that if a fund records both a receivable and tax liability on its books as a result of the adviser contractually agreeing to indemnify the fund, when the statute of limitations expires and the liability is not settled, the fund can simultaneously remove both the liability and the receivable from its books.

XVII. FAS 157 and 4 pm price vs. Sunday value for year-ends falling on a Sunday – The Expert Panel and the SEC Staff discussed dating the financial statements when the last business day is on a Friday but the year-end date falls on the weekend. The SEC Staff indicated that their thinking in the November 1996 Dear CFO letter which allows financial statements to be dated on the last business date if the year-end falls on a weekend is that the SEC Staff prefers, whenever possible, the financial statements' NAV to align with the NAV that is transacted upon. The Expert Panel asked the SEC Staff whether a US equity fund whose last business day is on a Friday and whose year-end is on Sunday would need to determine if there was a significant event between Friday and Sunday in order to date the financial statements on Sunday subsequent to adopting FAS 157, as FAS 157 indicates that you must consider events after the close of business through the measurement date. It was noted that the background and basis for conclusions in FAS 157 indicates that you don't have to make every possible effort to identify all relevant information for the close of business. The SEC Staff indicated they do not think the intent of FAS 157 would be for an S&P 500 index fund to fair value its whole portfolio. There was also discussion about what to do if a significant event occurred between the close of business on 12/31 at 4pm EST and midnight. The SEC Staff indicated that if a fund dates its financial statements on the last business day, the fund can disclose that it valued its portfolio using the closing price and consider other disclosure describing the significant event and its impact to the fund. There was also discussion on whether the financial statements can be valued at 4pm or if the time of valuation extends to midnight and what constitutes the fund's principal market, especially if the fund engages in after hours trading. There was also discussion on the fact that

Asian markets open in the evening U.S. time, and if a fund is required to monitor prices through midnight whether the fund would need to look at trading in the Asian markets and re-price its portfolio. The SEC Staff indicated that monitoring for significant events after the close of business is done already for daily NAV calculations, and therefore FAS 157 should not be creating any additional burdens. There was also discussion among the Expert Panel as to whether significant events after the close of business warrant disclosure. The Expert Panel mentioned that there will be an ICI call on 11/7/07 to discuss FAS 157 implementation questions and the ICI will discuss any potential solutions with the SEC Staff.

XVIII. SEC Staff's observation on registrants' issues related to subprime loans/SIVs – The SEC Staff mentioned that a no-action letter was posted to their website which provided money market funds with relief from Section 17 of the 1940 Act in connection with the money market funds' advisor (or affiliates of the advisor) absorbing losses from distressed securities held by the money market funds. The advisor will bear all costs of a letter of credit between the money market funds and the advisor's parent and the money market funds would be permitted to draw on the letter of credit to the extent that interest and/or principal payments are not made to the money market funds by the issuer of the distressed securities. The SEC Staff indicated that these letters cannot be broadly relied upon and registrants need to consult directly with the SEC Staff. The SEC Staff also discussed Rule 17a-9 of the 1940 Act which enables an advisor of a money market fund to purchase securities from a money market fund for cash at a purchase price equal to the greater of the amortized cost of the security or its market price if the security is no longer "Eligible." The SEC Staff indicated this guidance in Rule 17a-9 is only for money market funds and all other types of funds would need to seek relief from Section 17. The SEC Staff mentioned that attorneys at the SEC have been directly speaking with advisors and their counsel regarding various solutions to ensure money market funds do not "break the buck." Despite the prohibitions in Section 17, the SEC Staff indicated that if advisors are willing to step up and make funds whole to avoid breaking the buck, the SEC Staff does not want the prohibitions contained in the 1940 Act to be a deterrent. The SEC Staff is willing to work with registrants to provide relief and encourages consultation. The SEC Staff indicated there has been a fair amount of activity in this area and have been dealing with registrants directly.

XIX. SEC proposed rule "*Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Amending FAST and DRS Limited Participant Requirements for Transfer Agents*" – The Expert Panel relayed to the SEC Staff its concerns about this rule proposal which is requesting auditors to audit items that cannot be audited. The SEC Staff asked the Expert Panel to prepare a document summarizing the Expert Panel's concerns about this proposed rule.

- XX. SEC Release No. IA-2628; File No. S7-25-06, effective September 10, 2007, “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles”** –The Expert Panel asked the SEC Staff whether this release would impact the independent audits of hedge funds and if there are any additional auditor responsibilities or reporting issues as a result of the issuance of this rule. In addition, the Expert Panel asked the SEC Staff whether the auditor is indirectly or directly responsible for compliance with this rule. The SEC Staff referred the Expert Panel to AU 316 – 317 which outline the auditor’s overall responsibility for illegal acts. If something comes to the auditor’s attention which indicates an illegal act occurred, the auditor must perform procedures to determine whether there is a financial statement impact. The SEC Staff indicated that the question of whether there are additional responsibilities placed on auditors as a result of this rule is really a legal question, and if an auditor becomes aware of a violation, the auditor should consult legal counsel. The SEC Staff indicated that there are no additional responsibilities placed on the advisor, but there would be clarification if a pooled investment vehicle is a client of the advisor or individual investor. The Expert Panel asked the SEC Staff about whether failure to disclose side letters to all investors may be considered fraud under the rule. The SEC Staff responded that if a fund has a contractual or legal obligation to disclose a side letter, then failure to do so would be considered fraud under the rule.
- XXI. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser’s Act** – The SEC Staff indicated that they are actively reviewing the auditor independence rules. The focus of the Division of Investment Management’s Office of the Chief Accountant is on the definition of an affiliate of an investment company. The SEC Staff is considering the notion that one investment company complex (ICC) definition would apply equally to funds regulated under the 1940 Act and hedge funds that are tied to the Adviser’s Act under the custody rules. The SEC staff indicated that they will seek the Expert Panel’s input on these matters in the future.
- XXII. Comments on proposed wording changes to the auditor’s report on internal control required by SEC under form N-SAR (submitted on August 23, 2007)** – The SEC Staff indicated they have already provided comments on the revised N-SAR letter and do not have any additional comments. The Expert Panel informed the SEC Staff of additional revisions that will be made to the letter which may include the full definition of a system of internal control that appears in PCAOB Auditing Standard No. 5, as opposed to only referencing the safeguarding of securities.
- XXIII. Financial Statement Review Comments** – The SEC Staff indicated they had no new financial statement review comments to report.

Other Projects

XXIV. CCO Reporting – The Expert Panel indicated that SOP 07-2 has been issued.

AICPA Investment Companies Expert Panel December 18, 2007 Meeting Highlights

Administrative Updates

- I. **Audit Risk Alert, *Investment Companies Industry Developments—2007/08*** - AICPA staff has provided an update to the Expert Panel that the Audit Risk Alert has been issued.

- II. **AICPA Audit and Accounting Guide, *Investment Companies*** (“Audit Guide”) – the Expert Panel discussed suggested confirming changes to the Audit Guide, such as example disclosures for Statements of Financial Accounting Standards No. 157, *Fair Value Measurements* (“SFAS 157”), and the related approval process.

Financial Accounting/Reporting Issues

- III. **SFAS 157 and Use of Net Asset Value in Fund of Funds Investments** - The Expert Panel subgroup that worked on implementation issues relating to SFAS 157 made a submission, through the AICPA Fair Value Expert Panel, to the FASB Valuation Resource Group tasked with assisting the FASB in matters involving valuation for financial reporting purposes (“VRG”).

The Expert Panel raised the SFAS 157 implementation issue relating to use of net asset value in fund of funds investments. Registered and unregistered funds invest in other funds through different vehicles such as, registered fund of hedge funds, hedge funds, private equity funds, and venture capital funds. Interests can be in the form of partnership capital, LLC interests, or shares in a unitized vehicle. Aside from registered funds, many other fund investment vehicles include some type of restriction on redemptions (e.g., initial investment lock-up provisions, private equity fund investments redemption restrictions for the life of the fund and side pocket investments - capital which can't be liquidated until underlying investments are sold).

In accordance with the Audit Guide, investor funds are required to measure their investment in the investee funds at fair value. Historically, management of an investor fund would determine the fair value of the investee funds based on the reported net asset value (per share for unitized funds or partner's capital in partnerships and LLCs) that investee funds have computed and furnished to them.

After the adoption of SFAS 157 one might conclude that the net asset value of the underlying fund would not represent the price that would be received to sell the asset (in this case, the investment in the underlying fund) in a transaction between market participants at the measurement date. As such,

the adoption of SFAS 157 could result in the investor needing to adjust the value of many individual fund investments due to lock-up provisions or side pocket investments.

The Expert Panel raised the following concerns relating to application of SFAS 157 guidance to investments into pooled investment vehicles:

- i. operational hurdles that it poses,
- ii. consistency in fair value reporting, and
- iii. potential exposure of registered investment companies to market-timing.

VRG group had a meeting in October of 2007 and discussed the issues raised by the Expert Panel described above. AICPA staff present at the VRG meeting provided an update to the Expert Panel on this issue.

During the VRG meeting there was a sense that NAV does not always represent fair value under the framework of SFAS 157, and consideration would need to be made for the impact of restrictions on investors in pooled investment vehicles. It was noted that this issue is not unique to investment management industry - many of the endowments and pension plans would face similar question.

VRG group, however, did not submit this issue for discussion to the FASB Board. AICPA staff noted that FASB does not post minutes of VRG meetings. It was further noted that December meeting of VRG group was rescheduled till February, thus there will be no clarifying guidance on this issue in 2007. The Expert Panel further discussed the best course of action to address the issue.

IV. SFAS 157 and Transaction Costs - the Expert Panel acknowledged that with issuance of SFAS 157 and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, there are many questions that came up in practice relating to accounting for transaction costs.

The Expert Panel noted that SFAS 157 specifically states: “Transaction costs should be accounted for in accordance with the provisions of other accounting pronouncements.” The Expert Panel further noted that paragraph 3 of SFAS No. 159 states “Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred.”

The Expert Panel reached out to VRG group through the AICPA observer to clarify that investment companies could follow existing guidance provided in

the Audit Guide. The AICPA Staff updated the Expert Panel that VRG group had a discussion of this question but did not come to a conclusion¹.

The Expert Panel further discussed the existing guidance that is included in the Audit Guide. The Expert Panel further discussed what typical transaction costs of private equity funds and real estate fund would comprise.

- V. SFAS 157 and Use of Broker Quotes and Pricing Services** - Investment Company Institute (“ICI”) has created a subgroup to address new accounting pronouncements (“subgroup”). One of the areas of subgroup focus was developing informal guidance to help investment companies to categorize fund investments according to SFAS 157 hierarchy.

A question has come up in practice as to level of hierarchy that broker quote and pricing service quote would represent. The Expert Panel noted that to take overall responsibility for determining fair value and the related disclosures, management will need to (1) understand the method the pricing service or broker uses to determine fair value and (2) assess the appropriateness of the values. This may include understanding the valuation techniques and the inputs to those techniques. On the basis of this understanding, management should determine where within the hierarchy the fair value measurement falls.

Expert Panel noted many pricing services may assert that their valuation are at level 2, however, their valuations may not necessarily be based on observable inputs. The Expert Panel noted that the quotes from a pricing service or broker must meet this definition of observable inputs in SFAS 157 to be considered Level 1 or Level 2.

The Expert Panel further discussed the criteria that broker quote would meet to be considered observable inputs, such as binding quotes or quotes that represent actual market transactions supporting the quote.

- VI. Classification of Interest Income and Expense on Dollar Roll Arrangements** – the Expert Panel discussed application of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125* (“SFAS 140”) to mortgage dollar roll transactions.

The Expert Panel noted that dollar roll repurchase agreements are arrangements to sell and repurchase financial assets and, thus they are similar

¹ However, in the informal discussion between AICPA Staff and FASB Staff, FASB Staff confirmed that SFAS 157 did not change existing accounting literature for transaction costs, and thus investment companies will follow existing guidance reflected in the AICPA Audit and Accounting Guide, *Investment Companies*, as it relate to capitalization of transaction costs in the investment cost. However, as it relates to the fair value of the investment on the subsequent measurement date, fair value would need to be determined in accordance with SFAS 157 (that is, excluding transaction costs).

to repurchase agreements, except that they allow for the repurchase of financial assets that are considered substantially the same as, but not necessarily identical to, the financial assets initially transferred. Otherwise, the economic returns of dollar roll arrangements and repurchase agreements are viewed as being the same. The Expert Panel further discussed which mortgage dollar roll transactions are in scope of SFAS 140, and acknowledged that some of the white papers on mortgage dollar rolls were issued by ICI prior to adoption of SFAS 140, and thus need to be updated to reflect the current accounting guidance.

The Expert Panel discussed similarity of dollar roll arrangements accounted for as secured borrowings transactions² and other transactions that are accounted for as secured borrowings, such as reverse repurchase arrangements, and further discussed similarity in accounting treatment in both transactions. The Expert Panel discussed the recognition of interest expense associated with secured borrowing dollar roll arrangements and reverse repurchase arrangements. The Expert Panel noted that there is existing guidance in the paragraph 7.43(i) of the AICPA Audit and Accounting Guide, *Investment Companies*, that acknowledges that investment companies commonly report interest expense associated with reverse repurchase agreements separately in the statement of operations. The Expert Panel noted that this guidance is consistent with that provided on secured borrowing dollar roll agreements in prior versions of the AICPA Accounting and Auditing Guide, *Credit Unions*.

The Expert Panel further noted the income statement presentation of security lending transactions and current guidance in the AICPA Audit and Accounting Guide, *Investment Companies*.

The Expert Panel further discussed the accounting for short sales and practice of some funds to net the presentation of interest income and interest expense incurred in the cash balances held at the broker dealer administering the short sales. The Expert Panel noted the parallel between short sales balance credits and compensating balances, and acknowledged operational issues with grossing up expenses relating to short sale balance credits. The Expert Panel noted existing guidance in FASB Interpretation No.39, *Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105*, that should be followed by the entity that choose to net certain balances for financial reporting purposes.

VII. IFRS Concept Release – The Expert Panel discussed significant differences between IFRS and GAAP as it relates to investment company presentation of financial statements. They have been discussed at the previous Expert Panel

² SFAS 140 provides guidance for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

meetings. The Expert Panel had a concern that IFRS does not support specialized accounting and acknowledged that there is a need for specialized accounting for the investment company industry. Refer to **SEC Update** section for further discussion.

- VIII. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*, and nonpublic investment companies** – The Expert Panel discussed proposed FASB deferral of FASB Interpretation No. 48 (“FIN 48”) for nonpublic companies.

Public Accounting Firm Issues

- IX. PCAOB Staff Audit Practice Alert No. 2** – The Expert Panel has discussed the PCAOB Staff Audit Practice Alert No. 2 (“Practice Alert”) issued on December 10, 2007. Refer to **SEC Update** section for further discussion.
- X. Money Market Funds Adviser's Application of FIN 46(R)** - Rule 2a-7 of the Investment Company Act of 1940 regulates money market mutual funds (“MMFs”). The rule places certain restrictions on MMFs to help minimize the credit risk of their underlying asset portfolio. Accordingly, regulated MMFs generally invest in short-term investments, including certificates of deposit, commercial paper and government securities, and pay dividends to shareholders that generally reflect short-term interest rates. Although credit losses in the underlying portfolio of an MMF are possible, they are typically managed with the goal of keeping losses to a minimum. Some MMFs have sought to increase yields by investing in highly rated short-term debt issued by structured investment vehicles (SIVs), which issue such debt to buy higher yielding securities. Debt issued by SIVs may decline in value when the SIV securities experience default or are downgraded by rating agencies. The realized (or, in the event of downgraded but non-defaulted securities, the unrealized) losses may then cause the MMF to report an NAV of less than \$1.00.

To prevent NAV from falling below \$1.00, an MMF sponsor (that is often also the fund's advisor) may step in and provide credit support to the MMF. This support may include, but is not necessarily limited to, capital contributions, standby letters of credit, guarantees of principal and interest, and agreements to purchase troubled securities at par. Such support is almost never contractually required and, if provided, is given at the sole discretion of the sponsor.

The Expert Panel noted that there is currently a discussion in the industry relating to proper application of FIN 46(R), and specifically, VIE considerations, by the sponsor of the MMF. This issue will be brought to the ETIF agenda committee for potential discussion by the EITF.

- XI. Rating Agencies AMPS Agreed-Upon Procedures** – Refer to prior meetings for discussion of this item.

SEC Update

- XII. Staffing Announcement** – the SEC Staff introduced a new member of the SEC's Division of Investment Management - Office of the Chief Accountant – Jaime Eichen, Assistant Chief Accountant.
- XIII. Application of the SEC's Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Adviser's Act** – Refer to prior meetings for detailed discussion of this item. The SEC Staff has reiterated that application of the SEC's independence rules in connection with the audit exemption provided in rule 206(4)-2 of the Adviser's Act is one of the priorities of the SEC's Division of Investment Management - Office of the Chief Accountant. The SEC Staff is currently focused on the definition of the affiliate of the audit client in applying the independence standards.
- XIV. SEC Releases Sample Format for Proposed Mutual Fund Summary Prospectus** - The Securities and Exchange Commission has published a rule proposal, including a prototype "summary prospectus" for mutual funds, and asked for public comment from investors. The proposed streamlined summary prospectus would enable investors to quickly learn key information about a mutual fund. The proposal would enable funds to satisfy prospectus delivery obligations by posting the statutory prospectus online. The SEC is proposing that the following information be included in a mutual fund summary prospectus:
- investment objectives
 - costs
 - principal investment strategies, risks, and performance
 - top 10 portfolio holdings
 - identity of investment advisers and portfolio managers
 - brief purchase, sale, and tax information
 - information about broker compensation and conflicts.

During the comment period, the SEC is seeking investors' input about what improvements would make the summary prospectus easier to read and understand, and what key information investors would like to see included. Comments are due by February 28, 2008. Refer for additional information to: <http://www.sec.gov/news/press/2007/2007-249.htm>.

- XV. PCAOB Staff Audit Practice Alert No. 2** – The SEC Staff noted that PCAOB Staff Audit Practice Alert No. 2 (“Practice Alert”) was issued on December 10, 2007. The SEC Staff clarified that the Practice Alert did not alter any of the SEC Staff’s views relating to pricing testing articulated in the Commission’s Accounting Series Releases (ASRs) ASR 113 and 118 and *Dear Chief Financial Officer Letter* dated November 1, 1994.

The Expert Panel discussed with the SEC Staff that there is generally a lack of availability of type II SAS 70 reports for pricing services.

- XVI. Money Market Funds and Exposure to Turbulent Conditions in the Subprime Market** – The SEC Staff has noted that there were several publicly available no-action letters issued relating to support agreements provided to money market funds that experienced asset deterioration relating to subprime exposure. These letters describe an obligation of an affiliate to guarantee payment of any scheduled principal and interest payments that are not made, including principal and final interest payment for a group of securities or an individual security that a money market fund is holding. The guarantee is supported by the sponsor obtaining a letter of credit from a highly rated financial institution that has a credit rating comparable to other eligible money market investments.

Under such arrangements, money market funds bear no costs relating to the support agreements. No-action letters can be found at:
<http://www.sec.gov/divisions/investment/im-noaction.shtml#chron>.

The SEC Staff has noted that these no-action letters are not intended to be used as general guidance, as these letters are exemptive orders that are limited to the specific registrants for which the no-action letter was issued. Other registrants would need to approach the SEC Staff before entering into similar arrangements.

Further, the SEC Staff noted that the issued no-action letters are not intended to provide accounting and valuation guidance

- XVII. Statement of Financial Accounting Standards No. 157 and funds of hedge funds** – refer to background relating to this item to **Financial Accounting/Reporting Issues** section of these meeting highlights.

The Expert Panel raised the concern to the SEC Staff that if the issues described above are not addressed by the VRG and FASB, there may be significant operational hurdles posed for those investing in pooled vehicles. Additionally, there are further concerns about consistency in fair value reporting. Implementation of SFAS 157 for multiple investments in pooled fund vehicles could produce a wide disparity in the valuation of investments.

The Expert Panel further raised a concern about potential market-timing risk that funds of hedge funds may be exposed to upon adoption of SFAS 157.

The SEC Staff responded that these issues are not new issues for investment companies regulated under the Investment Company Act and should not be the result of SFAS 157. The SEC Staff stated that SFAS 157 is generally consistent with the guidance in ASR 113 and ASR 118. For that reason, the valuation issues raised by the Expert Panel regarding Fund of Hedge Funds should also be an issue under the Investment Company Act.

XVIII. Money Market Fund SOI Presentation – Refer to previous meeting for detailed discussion of this item. SEC Staff noted, and the Expert Panel concurred, that in the current market conditions there may be some differences in views as to relevance of the guidance provided in the SEC’s shareholder reporting rule, finalized in February 2004. The Rule permits the exclusion of a money market fund’s schedule of investments in the semi-annual or annual shareholder report transmitted to shareholders provided that a full audited schedule of investments is included in Form N-CSR and the report transmitted to shareholders informs the shareholder as to how they may obtain a complete schedule of investments.

XIX. Report on Internal Control Required by the SEC Under Form N-SAR - The Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (“Auditing Standard No. 5”), which was then approved by the SEC on July 25, 2007. Among other things, Auditing Standard No. 5 modified the definitions of "material weakness" and "significant deficiency" to be used in the audits of issuers' financial statements under PCAOB standards. The Expert Panel prepared a draft Form N-SAR report on internal controls and submitted it for review to the SEC and PCAOB. The SEC Staff confirmed that they have no further comments on the submitted N-SAR letter. The letter can be viewed at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm.

XX. Accountant’s Report Pursuant to Exchange Act Rule 17Ad -13 - On May 25, 2007, the SEC proposed a rule “Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Amending FAST and DRS Limited Participant Requirements for Transfer Agents,” Release # 34-55816 (“proposed rule”).

Item 11 of the proposed rule states:

“The transfer agent must provide on an annual basis to DTC within ten (10) business days of filing with the SEC an accountant’s report (pursuant to Exchange Act Rule 17Ad -13, Annual Study of Evaluation of Internal Accounting Controls) attesting to the soundness of controls to safeguard

securities assets and reliability and integrity of computer systems, including confidentiality of customer account or other non-public information. To the extent that a transfer agent obtains a SAS-70 audit report, the transfer agent shall provide DTC with a copy of the report within ten (10) business days of the transfer agent's receipt of the report. In addition, the transfer agent must provide, within the same time frame as required for such report, a report from an external certified public accountant:

- a. certifying that the transfer agent is complying with all of DTC's requirements relating to FAST agents including and without limitation to (a) those listed herein, (b) the Operational Criteria for FAST Transfer Agent Processing, (c) the Operational Agreement and (d) the Balance Certificate Agreement;*
- b. certifying that the agent meets any SEC requirements for business continuity planning; and*
- c. containing an SSAE 10 report (or the equivalent) attesting to the soundness of the transfer agent's control in meeting the requirements set forth herein; however an SSAE-10 need not be provided if the transfer agent has provided a SAS-70 audit report in accordance with the provisions of this paragraph 11."*

While external accountants currently provide an accountant's report pursuant to rule 17Ad-13 of the Securities Exchange Act of 1934 (refer to the Audit Guide, paragraph 11.22 for an example), the proposed rule has a number of other requirements that might be of concern to the external certified public accountant. The comment period for the proposed rule ended on June 22, 2007. There were no comments from large accounting firms posted on the SEC's website.

The Expert Panel raised concerns to the SEC Staff about the proposed rule at the previous meeting. The SEC Staff inquired whether any of the Firms represented at the Expert Panel had an opportunity to make comment submissions since the last meeting, and indicated that the SEC Staff will be receptive to receiving comments even after the end of the comment period. The Expert Panel acknowledged concerns relating to this proposed rule and logistical difficulties in issuing one comment letter on behalf of the Expert Panel.

- XXI. IFRS Concept Release** – During August of 2007, the Securities and Exchange Commission published the *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* (“Concept Release”) (<http://www.sec.gov/rules/concept/2007/33-8831fr.pdf>) to obtain information about the extent and nature of the public's interest in 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 (“IFRS”) as published by the International Accounting Standards Board for purposes of complying with the rules and

regulations of the Commission. Comments were due on or before November 13, 2007. Refer to previous meeting highlights for a detailed discussion of this item.

The SEC Staff acknowledged that they are reviewing received comment letters. They acknowledged significant differences between IFRS and U.S. GAAP as they relate to financial reporting. The SEC Staff indicated that many commenters expressed that investment company financial statements under IFRS are not as transparent as U.S. GAAP financial statements. This item will be of continuous interest and will be discussed in the future.

XXII. Financial Statements Review Comments – SEC Staff noted that a closed-end fund recently restated its seed financial statements because they failed to record a liability to the adviser under a recoupment plan. The SEC Staff stated that the note disclosure accompanying the seed financial statements indicated that the adviser will recoup organization costs after a specified period of time. Unlike traditional recoupment plans, where uncertainty exists as to whether a fund’s net assets will increase to a level that will permit repayment and not exceed a predefined expense cap, it was probable that the adviser would recoup fees from the fund after a specified period of time.

The SEC Staff also noted that one of the business development companies (“BDC”) restated its financial statements for improper accounting for income tax expense. Although the BDC elected to qualify under Subchapter M of the Internal Revenue Code (“IRC”), the BDC accrued a deferred tax liability related to the unrealized appreciation of portfolio securities. The deferred tax liability had been recorded by BDC due to its perceived uncertainty surrounding the ability to maintain its qualification. Paragraph 6.04 of Audit Guide states: *“Income tax expense related to net investment income and net realized gains on investments should be recorded when it is probable that an investment company subject to subchapter M of the IRC will not qualify under that subchapter. Some funds also may be required to record deferred tax expense if it is probable that the company will not qualify for a period longer than one year.”* The SEC Staff questioned whether the BDC should have recorded a deferred tax liability given the Fund's history of qualification under Subchapter M and its intent to continue to do so. The BDC ultimately concluded that the deferred tax liability was not appropriate and restated its financial statements to correct the error.

The SEC Staff further noted that one open-end fund chose not to comply with Subchapter M of the IRC, and therefore, elected to be taxed as a corporation. This registrant did not accrue, however, any deferred tax liabilities on the net unrealized appreciation of portfolio securities as required under FASB Statement No. 109, *Accounting for Income Taxes* (“SFAS 109”). The registrant made a correction by recognizing the deferred tax liabilities in accordance with SFAS 109.

AICPA Investment Companies Expert Panel February 12, 2008 Conference Call Highlights

Administrative Updates

- I. **CPE Credits** –The AICPA staff informed the panel members that beginning in January 2008, the Institute is offering CPE credit for qualified presentations at committee meetings. The committees that qualify for consideration of CPE credits are committees and expert panels who are approved via the AICPA committee approval process. Credit is offered only for educational sessions.
- II. **AICPA Expert Panel Meeting Minutes** – The AICPA Staff updated the Expert Panel on the status of review of previous meeting highlights.
- III. **AICPA Audit and Accounting Guide *Investment Companies*** (“Audit Guide”) – The Expert Panel members discussed suggested conforming changes to the Audit Guide, such as example disclosures for Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“SFAS 157”). The Expert Panel further discussed the approval process the Audit Guide would require to incorporate these changes.
- IV. **XBRL** – Market Outreach Working Group, which focuses on educating and building awareness of the US GAAP Taxonomies and Preparer Guidance, will make a presentation to the members of the Investment Companies Expert Panel to obtain their feedback on the taxonomies and guidance at the April 17, 2008 meeting.

Financial Accounting/Reporting Issues

- V. **SFAS 157 and Use of Net Asset Value in Fund of Funds Investments**- This topic was discussed at the previous meetings. The Expert Panel discussed the next steps in addressing this question.
- VI. **Investments in Funds of Funds and Use of Equity Method of Accounting** – The Expert Panel discussed guidance outlined in paragraph 7.04 of the Audit Guide that states:

“Except as discussed in [paragraphs 7.05](#) and [7.06](#), consolidation or use of the equity method of accounting by an investment company of a non-investment company investee is not appropriate.”

The Expert Panel further discussed the following:

- using the equity method of accounting for investees which carry their investments at fair value, as compared with directly valuing

the investee at fair value, may result in different accounting results, particularly if the investor entity takes a view that the investee's NAV does not represent fair value as defined by SFAS 157;

- whether use of a time lag by an investor entity in accounting for a fair value equity method investee is permissible, considering the guidance in paragraph 19(g) of APB 18 that states that "*if financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily should record its share of the earnings or losses of an investee from the most recent available financial statements*", and the impact of the lag on accounting results, particularly if performance of the investee during the interim period is volatile.

The Expert Panel acknowledged that the issues discussed are relevant to the entities in many industries, and not just to investment companies.

VII. Application of SFAS 157 to newly launched funds - The Expert Panel discussed the following situation:

A mutual fund that is a portfolio within a series company was organized and commenced operations in December 2007. The series company is the legal entity/registrant. All of the funds in the series company have the same fiscal year end of January 31st and the financial statements of all the funds within the series are presented in the same annual report - columnar presentation on the basic statements.

Since the funds are separate reporting entities for financial statement purposes, the Expert Panel discussed whether the new fund has to adopt SFAS 157 in its financial statements for its fiscal year ended January 31, 2008. The Expert Panel noted that all of the other funds in the series would not be required to adopt SFAS 157 until their fiscal year February 1, 2008 and in fact couldn't early adopt since they have already issued interim financial statements in the previous fiscal year.

The Expert Panel noted that it seems difficult to argue the accounting policies are adopted at the legal entity level when each fund is a separate reporting entity for financial statement purposes. The EP members shared views on this matter and discussed whether the answer would change if the new fund was not part of a series company and/or was not contained in the same annual report with the other series.

Certain members of the Expert Panel have had informal conversations with the SEC Staff during which the SEC Staff expressed the view that they would not require the SFAS 157 disclosures when a portfolio within the series was organized subsequent to November 15, 2007. It was believed that it would be

potentially misleading or confusing for one fund to include the FAS 157 information in a filing while all other funds included within the same filing excluded it. SEC staff did not specifically address the single-report situation. The Expert Panel discussed the merits of the view that so long as the initial "stub" period is reasonably short (less than six months, since 6 months would be the normal implementation for interim fund financials), the entity may consider not including SFAS 157 disclosure. The Expert Panel further discussed that if one would take that view, it may not be consistent with how other new standards were implemented in the past.

- VIII. SFAS 157 and evaluation of significant events that occurred after-hours but before the end of the fiscal year** – The Expert Panel discussed that while SFAS 157 does not require adjustments for all post-closing events, at a minimum, the reporting entities should adjust such prices for significant events affecting the fair value of the asset or liability. The Expert Panel discussed guidance in paragraph 26 of SFAS 157, which gives examples of significant events and in paragraph C70, which states, in part:

The reporting entity need not undertake all possible efforts to obtain information about after-hours trading or news events. However, the reporting entity should not ignore information that is available at the reporting date (for example, a large change in the price in another market after the close of the principal market in which the asset or liability trades).

The Expert Panel discussed guidance in paragraph 26 that further indicates that the "reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements."

A subgroup of the Expert Panel discussed developing certain considerations that could be followed by investment companies whenever the fiscal year-end is not a business day. This subgroup will further discuss these procedures at the ICI Accounting Policy subcommittee meeting on March 5, 2008 in Washington DC with a goal of developing best practices that industry participants may find helpful.

- IX. Stable Value Investments** – The Stable Value Investment Association (SVIA) made a presentation to the EP at a previous meeting as to how they would value wrappers within stable value funds. Some members of the Expert Panel expressed a concern that, during the current volatile investment environment that has caused fluctuations in both credit ratings and interest rates, issuers had continued to confirm values of wrapper contracts which were unchanged from their original bids and thus resulted in the wrapper contracts continuing to be valued at negligible amounts. Some Expert Panel members expected that the current credit market issues would have had an impact on wrapper and guaranteed investment contract ("GIC") valuations.

The Expert Panel proposed inviting representatives from the SVIA to again meet with representatives of both the AICPA Employee Benefit Plans and Investment Companies Expert Panels to discuss their views of the wrappers and GICs in light of the current market environment.

- X. Disclosure requirements of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (“FIN 48”)** - The Expert Panel discussed requirements of paragraph 21(e) that necessitates disclosures of “[a] description of tax years that remain subject to examination by major tax jurisdictions.” The Expert Panel discussed considerations involved in determining major tax jurisdictions and highlighted that major tax jurisdictions disclosure is connected with entity’s open tax years rather than uncertain tax positions. The Expert Panel discussed a practice of some registrants to set quantitative thresholds (such as 20%) to determine major tax jurisdictions.
- XI. FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises* (“FSP FIN 48-2”)** - The Expert Panel discussed FSP FIN 48-2 and its impact on non-registered investment companies. The Expert Panel noted that FSP FIN 48-2 states:

“For nonpublic enterprises (as defined in paragraph 289, as amended, of Statement 109), except for nonpublic consolidated entities of public enterprises that apply U.S. GAAP, this Interpretation shall be effective for annual financial statements for fiscal years beginning after December 15, 2007 (applied as of the beginning of the enterprise’s fiscal year) unless the nonpublic enterprises issued a full set of annual financial statements using the recognition, measurement, and disclosure provisions of this Interpretation before the issuance of FSP FIN 48-2, Effective Date of Interpretation No. 48 for Certain Nonpublic Enterprises.” (Emphasis added).

The Expert Panel further noted that FSP FIN 48-2 states:

This FSP defers the effective date of Interpretation 48 for nonpublic enterprises included within this FSP’s scope to the annual financial statements for fiscal years beginning after December 15, 2007. When effective, Interpretation 48 should be applied as of the beginning of the enterprise’s fiscal year.

The Expert Panel noted that a calendar year-end investment company that qualifies for FSP FIN 48-2 deferral would not need to reflect the impact of FIN 48 in its interim financial statements or periodic NAV’s until preparation of the annual December 31, 2008 financial statements, which would reflect the impact of FIN 48 retroactive to January 1, 2008.

FSP FIN 48-2 can be found at http://www.fasb.org/pdf/fsp_fin48-2.pdf.

Public Accounting Firm Issues

- XII. PCAOB Staff Audit Practice Alert No. 2** – The Expert Panel continued discussing PCAOB Staff Audit Practice Alert No. 2 (“Practice Alert”) issued on December 10, 2007. The Expert Panel members shared their concerns with indemnifications present on the broker confirmations and the EP’s previous efforts to engage SEC Staff to address this issue.
- XIII. SEC proposed rule “Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Amending FAST and DRS Limited Participant Requirements for Transfer Agents”** – Refer to prior meetings for discussion of this item. The Expert Panel discussed the possibility of providing a coordinated response to this proposed rule.

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

SEC Update

- XIV. Proposed Disclosures of Credit Support in the Financial Statements of Registered Money Market Funds** - During late January and early February, the Securities and Exchange Commission Division of Investment Management Office of the Chief Accountant (SEC Staff) reached out to several registrants and their auditors to provide informal guidance relating to the accounting and reporting of credit support arrangements in the financial statements of registered money market funds (“MMFs”). The Staff noted that this informal guidance does not represent new guidance, but rather is a compilation of existing accounting literature.

Background

Rule 2a-7 of the Investment Company Act of 1940 provides valuation guidance for MMFs. The rule places certain investment restrictions on MMFs that would minimize the impact of valuation volatility of their underlying asset portfolio. Accordingly, MMFs generally invest in short-term investments, including certificates of deposit, commercial paper, and government securities, and pay dividends to shareholders that generally reflect short-term interest rates. Although credit losses in the underlying portfolio of MMFs are possible, they are typically managed with the goal of keeping losses to a minimum. Some MMFs sought to increase yields by investing in highly rated short-term debt tranches issued by structured investment vehicles (SIVs), which hold higher yielding securities. Recent events in the credit

markets have created situations in which the short-term debt issued by SIVs could not be rolled over due to concerns about some of the assets they held, causing buyers to be reluctant to purchase new paper. Additionally, in some cases, rating agencies downgraded SIV debt ratings due to asset concerns. This left the SIVs in a very illiquid position and in some cases the SIVs defaulted on their short-term debt, resulting in reduced market values. The decline in market value could become so significant that it could potentially result in the MMF's non-compliance with Rule 2a-7, requiring the MMF to convert its valuation methodology from amortized cost to fair value and causing the Net Asset Value per share to fall below \$1.00.

To prevent NAV from falling below \$1.00, the sponsor or investment advisor of the MMF may intervene and provide some level of financial support to the MMF. This support may include, but is not necessarily limited to, capital contributions, guarantees of value of specific investment securities (which may be supported through letters of credit), guarantees of principal of the overall funds, and agreements to purchase troubled securities at a value different than current market value (typically at amortized cost). The offering documents of the MMF typically indicate that the shareholders in the MMF are subject to the risk of loss of principal, and the sponsor or advisor of the MMF does not commit, by contract or otherwise, to financially support the fund prior to any valuation event occurring. The decision to provide additional financial support is made on a case by case basis as a specific fund encounters difficulty.

During the later part of 2007 and early 2008 the SEC's Division of Investment Management Staff received several requests from registrants for regulatory relief to the extent the sponsor or advisor entered into financial arrangements with affiliated money market funds that were encountering valuation difficulties as a result of the credit crisis. In response the SEC's Division of Investment Management Staff issued several no-action letters providing relief to the MMF and its sponsor or advisor for situations where the sponsor or advisor, at no cost to the MMF, would provide support for the benefit of the MMF, in the event the specific MMF security or identified group of securities ("security subject to credit support agreement") failed to pay principal and/or interest as due or to the extent the MMF was forced to sell the security at a value less than amortized cost. The SEC's Division of Investment Management Staff has required that credit support agreements, consistent with Rule 2a-7's maturity and quality requirements, have a short lifespan and the party providing the credit support agreement either itself have a high credit standing or is able to obtain a letter of credit from a financial institution with a high credit rating. No-action letters can be found at: <http://www.sec.gov/divisions/investment/im-noaction.shtml#chron>.

Informal SEC Guidance

A MMF should present securities that are not subject to credit support agreement(s) (and otherwise comply with the Rule 2a-7 guidelines) at amortized cost. As the credit support agreement is a derivative, both the credit support agreement and the securities covered by it should be presented within the financial statements at fair value. Registrants should indicate, within the SOI, which securities are subject to the agreement and that such securities are being carried at fair value. The existence and value of the credit support agreement should be identified separately on the Schedule of Investments and on the Statement of Assets and Liabilities and a reference made to the note explaining the agreement¹.

For the MMFs that have credit support agreements, the SEC Staff indicated that the combination of the credit support agreement at fair value and the fair value of the covered securities should be sufficient to maintain the MMF's NAV above the regulatory threshold of \$0.995. The SEC Staff would not anticipate a significant discount being applied for the purpose of valuing the agreement given its short term nature, the existence of a "backstop" provision (see below), and the probability of payment.

The SEC Staff indicated that they would expect to see the following disclosures, in "Plain English" relating to credit support agreements:

- 1) date of the agreement;
- 2) entities that are parties to the agreement (including clear identification of any affiliated parties);
- 3) objectives of the agreement;
- 4) triggering events for payments stipulated in the agreement (for example, sale of the security or determination by a court that full repayment will not occur);
- 5) terms of "backstop" provisions (that is, provisions requiring, upon maturity of the agreement, that the MMF sell or otherwise dispose of the securities involved, triggering payment under the agreement);
- 6) specific securities subject to the credit support agreement and their fair value and amortized cost as of reporting date;
- 7) date of termination of the credit support agreement;
- 8) fair value of the credit support agreement at the reporting date;
- 9) credit standing of the counterparty providing credit support agreement (as noted, the expectation is that this counterparty will have high credit standing);
- 10) disclosure on the Schedule of Investments which securities are carried at fair value (i.e., not at amortized cost);
- 11) disclosure on the Schedule of Investments of non-income producing securities² and securities that made partial principal/interest payments;

¹ Refer to Regulation S-X, Article 6.

² Refer to Regulation S-X, Rule 12-12.

- 12) change in unrealized appreciation/depreciation for the securities subject to the credit support agreement (to be presented in the Statement of Operations);
- 13) change in unrealized appreciation/depreciation on the credit support agreement (to be presented as a separate line item on the Statement of Operations under the caption “Unrealized appreciation from affiliates”); and
- 14) realized gain/loss, if any, relating to the credit support agreement (to be presented separately on the Statement of Operations).

The SEC Staff indicated that many of the disclosure requirements described above were derived from FASB guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and FASB Statement No. 57, *Related Party Disclosures*. The SEC Staff further indicated that these disclosures should be placed in a separate, readily identifiable, easy to understand footnote to the financial statements, and should *not* be placed within another note (such as a valuation policy or related party transactions note). MMFs should avoid copying language directly from the credit support agreement into the notes to the financial statements.

Furthermore, the SEC Staff described additional disclosures that should be considered when a MMF holds securities affected by the credit crisis, even if not covered by a support agreement, there are no defaults, and NAV is not dramatically impaired:

- 1) disclosures about credit quality required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*;
- 2) disclosures relating to risk concentrations of investments in the real estate or affected financial services industries (or in SIVs), as described in FAS 107 and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

The SEC Staff is still considering potential additional disclosures that would need to be enhanced in the MMFs’ financial statements and registration statements. The SEC Staff plans to provide this and further informal guidance, if necessary, to the ICI for further consideration. Further informal guidance, if necessary, will also be communicated to the Expert Panel.

The Expert Panel inquired what financial highlights disclosures will need to be included relating to credit support agreements, and the SEC Staff indicated that they will address this question at future meetings.

XV. Application of the SEC Independence Rules in Connection with the Audit Exemption Provided in Rule 206(4)-2 of the Advisers Act – Refer to prior meetings for detailed discussion of this item. The SEC Staff has reiterated that application of the SEC independence rules in connection with the audit

exemption provided in rule 206(4)-2 of the Advisers Act is one of the priorities of the SEC Staff. SEC Staff is currently focused on the definition of "affiliate" in applying the independence standards.

XVI. Financial Statement Review Comments

- SEC Staff discussed situations when an investment company retains capital gains and pays tax on behalf of the shareholders, and the proper presentation of such tax in the statement of operations and financial highlights. This topic will be further discussed at future meetings.
- The SEC Staff reminded the Expert Panel that registration statements for "principal protected funds" (that is, funds which offer third-party guarantees for return of the original investment (less sales charges) or some other minimum value upon completion of a specified period) should include financial statements of the guarantor.

XVII. Proposed Rule on Disclosure of Divestment by Registered Investment Companies in Accordance With Sudan Accountability and Divestment Act of 2007

– The SEC Staff discussed proposed amendments to Form N–CSR and Form N–SAR that would, if adopted, require disclosure by a registered investment company that divests, in accordance with the Sudan Accountability and Divestment Act of 2007 (“Sudan Divestment Act”), from securities of issuers that the investment company determines conduct or directly invest in certain business operations in Sudan.

On December 31, 2007, the President signed the Sudan Divestment Act into law. Among other things, the Sudan Divestment Act provides that no person may bring any civil, criminal, or administrative action against any registered investment company, or any employee, officer, director, or investment adviser of the investment company, based solely upon the investment company divesting from, or avoiding investing in, securities issued by persons that the investment company determines, using credible information that is available to the public, conduct or have direct investments in certain business operations in Sudan. This limitation on actions does not apply to a registered investment company or any of its employees, officers, directors, or investment advisers, unless the investment company makes disclosures about the divestments in accordance with regulations prescribed by the Commission. To implement the Sudan Divestment Act, SEC proposed to require each registered investment company that divests securities in accordance with the Sudan Divestment Act to disclose the divestment on the next Form N–CSR or Form N–SAR that it files following the divestment. SEC proposed to require disclosure of information that would identify the securities divested and the magnitude of the divestment. For purposes of determining when a divestment should be reported, if a registered investment company divests its holdings in a particular security in a related series of transactions, the company may deem the divestment to occur at the time of the final transaction in the series. As a

result, a registrant could choose either to report each transaction in the next Form N-CSR or Form N-SAR filed following the individual transaction or to report the entire series of transactions in the next Form N-CSR or Form N-SAR filed following the final transaction in the series.

Comments relating to the proposed rule should be submitted to SEC on or before March 17, 2008.

XVIII. Money Market Fund SOI Presentation – Refer to previous meetings for detailed discussion of this item.

AICPA Investment Companies Expert Panel April 17, 2008 Meeting Highlights

I. AICPA Audit and Accounting Guide *Investment Companies*:

The Expert Panel discussed with AICPA staff the evolution of the Audit and Accounting Guide over the next few years based on potential changes in accounting standards:

A. IFRS - In upcoming months, the SEC is expected to formally propose a rule under which public companies could, over a period of time, transition to International Financial Reporting Standards (IFRS).

1. What accounting standards are foreign investment companies following for reporting in their home countries? Do any follow IFRS even though those standards are not industry-specific?
2. Should we begin the process for updating/overhauling the IC Guide for IFRS?

The AICPA staff inquired whether Expert Panel members had any issues or concerns about adopting IFRS. The Expert Panel discussed that IFRS currently does not contain industry specific guidance for investment companies. The Expert Panel members indicated that, while they generally support to the conversion to IFRS, the lack of industry-specific guidance could impact the accounting and reporting for investment companies. In particular, Expert Panel members observed that under existing IFRS guidance there would be potential consolidation issues with respect to funds of funds and master-feeder funds, as well as requiring many private equity and venture capital funds to consolidate operating investee companies.

The Expert Panel also noted that the Canadian regulators are requiring public companies to adopt IFRS by 2011.

B. FASB Codification - In January 2008, the FASB launched the one-year verification phase of the *FASB Accounting Standards Codification*[™] (Codification). During the verification period, constituents are encouraged to use the online Codification Research System free of charge to research accounting issues and provide feedback on whether the Codification content accurately reflects existing U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. Users are advised that the Codification content is not yet approved as authoritative and, therefore, they must verify research results using their existing resources for the currently effective literature.

After addressing the issues raised during the constituent feedback process, the FASB is expected to formally approve the Codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). To improve usability, the Codification will include authoritative content issued by the SEC, as well as selected SEC staff interpretations. Upon approval by the FASB, all accounting standards (other than the SEC guidance) used to populate the Codification will be superseded. At that time, with the exception of any SEC or grandfathered guidance, all other accounting literature not included in the Codification (including the

accounting guidance contained in the Audit and Accounting Guide) will become non-authoritative.

The AICPA staff encouraged the Expert Panel members to have their respective firms review and comment on the Codification for Investment Companies prior to the final release in April 2009.

After the Codification is adopted in final form, future versions of the Guide either will refer to authoritative guidance in the Codification or express non-authoritative views of AcSEC as AICPA's senior technical body. The Expert Panel discussed whether it should consider updating the Guide for U. S. GAAP issues (presuming that a major re-write is unnecessary), or completely revisit certain chapters recognizing that accounting guidance will now largely reflect non-authoritative statements of views. There was particular discussion about providing industry interpretive guidance for applying FASB Statement No. 157.

II. AICPA Publications – status update

1. Status of Investment Companies Audit Guide 2008-conforming changes

The AICPA staff appreciated the comments on the Guide received to date from the Expert Panel members. The updated Guide is expected to be issued in July 2008.

2. Status of IC EP meeting notes (Expert Panel and SEC review) – November/December 2007 meetings and February 2008 conference call

The AICPA staff received comments on the November/December 2007 Expert Panel minutes from the SEC earlier in the day. The AICPA staff will distribute the February 2008 Expert Panel meeting notes for comments shortly.

3. Status of Commodities Practice Aid revision - comments received from Investment Company Expert Panel

The AICPA Commodities Task Force had requested Investment Company EP members review its draft chapter on commodity pool financial statements. The AICPA staff compiled comments received on that chapter, with comments particularly related to the illustrative financial statements. The final Practice Aid will be available sometime in 2008.

III. Accounting/Reporting Issues

1. FASB Statement No. 157, *Fair Value Measurements*

a. *Subgroup activity report on valuation of investments in other investment funds*

Expert Panel members reviewed a draft matrix of the factors to consider in valuing investments in other investment funds.

b. *Formation of a multi-EP task force to provide guidance on valuing investments in other investment funds*

The Investment Companies Expert Panel representatives will participate in a joint task force with members from the Employee Benefit Plans, Non-Profit Organizations and Health Care Expert Panels to provide valuation considerations for both auditors and management with respect to valuing investments in hedge and other non-registered funds under FAS 157. This Task Force will develop some type of valuation guidance with respect to factors to consider (e.g. lockup periods, frequency of withdrawals, notification requirements for withdrawals, etc.) when determining the reasonableness of valuations.

The Expert Panel also discussed what other guidance could be developed to assist the investment management industry with dealing with FAS 157 implementation issues. This discussion included the following topics:

- Linking the FAS 157 levels with the valuation considerations.
- Determining the impact on the valuation considerations with respect to the FSP on FAS 132 which may have possible issues for benefit plans and corporate entities.
- Sharing the draft FAS 157 matrix with the other AICPA Expert Panels, after taking into consideration of the impact on private equity companies.

c. *FAS 157 implementation questions*

- *Valuation of in-kind distributions*

Background

Many venture capital funds are required by the terms of their partnership agreements to use an average value (e.g. 3 day closing, 5 day closing, 5 days before and 5 days after the distribution date) for purposes of valuing in-kind distributions for purposes of computing realized gains to determine incentive allocations. The panel members generally agreed that such in-kind distributions should be valued only at the closing price on the date of the distribution for financial reporting purposes under GAAP.

Issue

Because of differences between GAAP and the method used to compute incentives, ending capital accounts presented in the financial statements do not necessarily reflect the actual division of ownership interests (particularly between GP and LPs) in the remaining assets of a fund.

The Expert Panel discussed concerns about the differences between the values used for financial statement purposes and those used for in-kind distributions. One of the Expert Panel members presented a financial statement example comparing "GAAP" vs. "Partnership Agreement" allocations for which the Expert Panel members asked a series of questions.

The member noted that the average values set forth in the venture capital funds' partnership agreement to be used as a basis for valuation are arm's-length negotiated terms between the two parties and are also the basis for valuing assets used in determining or settling lookbacks, should a GP be required to return previous incentives.

It was also noted that the literature regarding fair value estimates appears to address assets held at the reporting date (rather than assets disposed of during the period), and there does not appear to be clear guidance under generally accepted accounting principles permitting in-kind distributions to be valued at something other than what is prescribed in the fund's financial statements.

Expert Panel members are expected to further consider this issue at future meetings.

- ***Level 3 rollforward -- fair value used for transfers in and out of level 3***

The Expert Panel members indicated that prevailing industry practice appears to be to value securities transferred into Level 3 classification in their rollforwards using fair values determined as of the beginning of the reporting period. There was also a discussion of SEC's point of view that it would be preferable to present the Level 3 rollforward in Forms N-Q as well as in full financial statements.

2. FASB Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities"

The Expert Panel discussed the tabular disclosures, in particular the presentation of gains/losses by hedging strategy, vs. the current Regulation S-X guidance which requires presentation by instrument type (specifically for written options, and in practice most other derivatives). The Expert Panel members believed that FAS 161 would not materially affect the financial reporting of mutual funds/hedge funds.

3. Stable Value Investments

In 2006, the Stable Value Investment Association (SVIA) made a presentation to the Expert Panel about the valuation of "wrapper" contracts within stable value funds (see October 31, 2006 Meeting Highlights). Its methodology often results in a near-zero valuation of the contract since it is based on the difference, if any, in the wrapper provider's estimate of the replacement cost of the wrapper contract (i.e., the fee it would charge currently for the contract) and the original fee. Experience has indicated that fees rarely change. During a number of retirement plan audits wrapper providers continued to advise that the fees continued to stay the same and values remained nominal, although some auditors expected to see changes in quoted values as a result of the volatile investment markets.

On March 26, 2008, representatives of the AICPA Investment Companies and Employee Benefit Plans Panels participated in a conference call with SVIA representatives to discuss their views of the wrappers and GICs in light of the current market environment. The Expert Panel discussed a re-bidding process with the wrap provider. SVIA representatives noted that, since an existing portfolio is already being "wrapped", unless there were actual defaults in the assets the risks of the specific portfolio have not changed from the original agreement. They also noted that, if there was a material change in risk, the provider would be more likely not to provide a quote for wrapper agreement at all than to place a new bid at a different rate. During the call, there was also a discussion around what is considered a "termination event" which could result in a change in value of the wrapper.

4. Accounting for "break-up fee"

An Expert Panel member raised a practice issue, in which a private equity fund had agreed to acquire an investee, but later withdrew from the agreement. Under the agreement, the fund was required to pay a "break-up fee" to the prospective investee. The question had arisen whether the fee should be classified as an operating expense or realized loss. The Expert Panel members noted factors in favor of operating expense classification that no investment actually had been made (and thus no loss had been incurred on an investment), and that the fee could be analogized to "failed deal" costs which in practice are generally considered an operating expense. The Expert Panel members also noted the possible tax classification of the breakup fee as a factor to be considered.

IV. Discussion of IC EP TPAs (Appendix B)

The Expert Panel discussed the status of the Cash Flow, Deferred Fees and Financial Highlights TPAs, which were close to finalization. The EP was scheduled to clear the EPs with AcSEC's Planning Subcommittee (PSC) at the PSC's May meeting, and, assuming clearance, they are expected to be issued shortly thereafter.

V. Audit and Attest Issues

1. Agreed Upon Procedures Reports for Rating Agencies

The Expert Panel members noted that a specific rating agency, by policy, does not acknowledge the sufficiency of agreed-upon procedures in connection with auction rate preferred shares issued by closed-end funds, and, as a result, is not being identified in reports as a specified user in accordance with AT 201. Expert Panel members were asked if they would be willing to participate in a meeting with the rating agencies in connection with these agreed-upon procedures reports, following up meetings held in prior years.

2. AU 332 implications for fund with a single investment in another fund

The Expert Panel discussed whether an auditor would have sufficient audit evidence to issue a report by confirming the investment and obtaining the audited financial statements from the investee fund, noting that the auditor needs to understand management's process with getting comfortable with the NAV of the underlying fund. The Expert Panel also noted the client's responsibility to perform ongoing due diligence of the investee fund.

3. DTC's rule proposal to update requirements related to the Fast Automated Securities Transfer Program (FAST)

The Expert Panel noted that DTC's proposed rule "*Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Amending FAST and DRS Limited Participant Requirements for Transfer Agents*" has been amended and re-filed with the SEC. In that re-filing, the requirement that the transfer agent provide a report issued by an external certified public accountant has been revised. The Expert Panel discussed the re-filed amendment and, while noting that certain concerns about the original proposal had been addressed, the wording of the proposal continued to raise concerns about its application by independent auditors.

4. Updates from previous meetings:

a. Money Market Fund SOI Presentation Update

AICPA Staff and some Expert Panel members participated in a call with Auditing Issues Task Force (AITF) members on February 13, 2008, during which the AITF continued to express concerns about auditor report modification to accommodate the SEC's rule permitting money market funds to omit investment portfolios in reports issued to shareholders, so long as full portfolios were filed in related Form N-CSRs. An Expert Panel member noted that the Professional Practice Executive Committee of the Center for Audit Quality (CAQ) had recently advised the EP that it would postpone the planned discussion of the proposal from its April 22, 2008 meeting to its July 2008 meeting.

VI. CFTC Discussion

Members of the CFTC staff participated by conference call during the meeting, raising a question relating to the interaction of GAAP and CFTC rule compliance. Specifically, they noted that CFTC commodity pool rules require reporting of the total net asset values of a pool. Certain corporate structures, such as Delaware trusts, permit the organization of multiple series within one legal entity. In some cases, Statements of Financial Condition and Statements of Operations are presented in columnar form, and it was agreed that they should not be added up in a "total" column. The staff inquired whether it was permissible to issue financial statements presenting only one series of the entity, rather than all of them.

The Expert Panel members noted that it is not uncommon to issue a report on one series. There typically would be a footnote outlining that there were other series within the pool. Sometimes the footnote states whether or not the assets of one series could be used to satisfy debts of another series, and, if they could, whether such exposure actually exists at the financial reporting date. The Expert Panel members confirmed that they would not expect that the assets of the individual pools would be added up.

Disclaimer

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VII. SEC Update

1. IFRS

The Expert Panel and representatives of the SEC Division of Investment Management discussed the current status of the SEC's IFRS Concept Release. The SEC staff indicated that they are in the process of reviewing the responses specific to the investment management industry.

2. FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*

The staff does not have any specific comments to date on FAS 161 as they are still in the process of evaluating the statement's potential impact. The Expert Panel members discussed with the staff the potential effects of the FAS 161 tabular disclosures noted earlier in these Highlights.

3. Money market funds, including financial statement disclosures (valuation policies, credit, liquidity and market risk disclosures) and presentation for credit support agreements.

The staff indicated that they continue to receive requests for no-action relief for money market fund support arrangements. They also have been communicating with registrants about the accounting and reporting implications of these support arrangements which should be presented at fair value (see February 2008 Meeting Highlights).

4. SEC Corporation Finance "Dear CFO" letter regarding MD&A disclosures in about assets and liabilities carried at fair value

The SEC staff indicated that the "Dear CFO" letter issued by the Division of Corporation Finance in late March (available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>) was not addressed to investment companies specifically, and the Investment Management staff would not object if open-end or closed-end fund registrants do not apply its guidance. However, they noted that the guidance likely would be appropriate with respect to Business Development Companies (BDCs), although the application of such guidance by BDCs is not required.

5. Application of "good accounting practice" to Section 19a dividend notices

The SEC staff noted that certain informal comments at a recent industry meeting may have been misinterpreted as accepting tax-basis accounting as a "good accounting practice" under Section 19. The staff indicated that based upon legislative history and the statutes, the staff believes that the Section 19 requirement to apply "good accounting practice" may be interpreted as referring to GAAP, although the staff recognizes that certain fund organizations have applied tax-basis or some other combination of the book and tax bases of accounting. They emphasized that fund groups should, at a minimum, apply consistent principles in preparing their Section 19 notices and may not switch between methods in order to avoid sending Section 19 notices.

One of the Expert Panel members requested clarification from the SEC staff with respect to interim Section 19a notices for Real Estate Funds (that is, funds that invest predominantly in REITs), including using estimates and sending out revised 1099s to the extent that the actual amounts are materially different than estimated amounts. The SEC staff indicated that Rule 19a-1 provides flexibility that if estimates change from the initial classifications, registrants can send corrected notices to investors. However, Section 19 and Rule 19a-1 are not applicable to 1099s.

6. Application of PCAOB standards to reports on 1940-Act only filers

The SEC staff discussed the application of PCAOB auditing standards to investment companies that file only under the Investment Company Act ("1940 Act-only filers").

Examples of such a filer include a master funds or registered hedge funds that file financial statements on Form N-CSR. Financial statements filed by these registrants are available in the public domain just like the financial statements of 1933 Act filers' and other 1934 Act issuers. The SEC staff indicated that PCAOB auditing standards are required for the audit of any registrant that is an issuer, as defined within the Sarbanes-Oxley Act. However, PCAOB standards may be applied in any audit.

7. Independence – update on Rule 206(4)-2 (or any other) efforts

The SEC staff indicated that there are no new matters to report with respect to independence. The SEC staff is still working on independence matters.

8. Recent financial statement review comments

The SEC staff indicated that they recently found that a closed-end fund had disclosed distribution rates on its website, which provided no explanatory context about its composition (distribution had significant return of capital and capital gains components), which the SEC staff commented on.

The staff noted this is an example of their practice of reviewing registrants' websites and other marketing material in connection with their review of the registrant's financial statements. One of their standard questions includes, "What processes do you have in place to ensure that third parties (e.g. S&P, Morningstar and Lipper) are reporting periodic performance completely and accurately for registered mutual funds?"

9. FAS 157 Questions

The SEC Staff indicated that they have received questions in connection with the adoption of SFAS 157 for newly-formed funds. Specifically, registrants have inquired whether a fund that commenced operations between November 15, 2007 ("the Effective Date") and October 31, 2008 would have to comply with SFAS 157 in its initial stub-period GAAP financial statements, even though other funds in the same complex, having the same fiscal year-end, would not be required to comply with SFAS 157. The SEC Staff provided the following example; if a fund commenced operations on April 1, 2008 and the fiscal year-end of the fund was October 31, 2008, the SEC Staff would not object if the newly-formed fund adopted SFAS 157 at the same time as the funds having operating history prior to the Effective Date. The SEC Staff further pointed out that all funds commencing operations subsequent to October 31, 2008 must comply with SFAS 157 in their stub period GAAP financial statements.

The EP raised the question whether the SEC Staff would take the same position if a newly-formed fund was presented alone in an annual report versus being presented together with other funds that commenced operations prior to the Effective Date. The Staff advised that their position would be consistent regardless of whether the newly-formed fund was presented in a stand-alone book or with other funds in the same book where the other funds commenced operations prior to the Effective Date.

10. Other

XBRL-The SEC staff noted the April 7 press release on the SEC's viewer of risk/return summaries, and noted that 18 registered investment management companies have voluntarily filed their Risk/Return Summaries in XBRL format with the SEC.

VIII. XBRL – Market Outreach Working Group

Market Outreach Working Group, which focuses on educating and building awareness of the US GAAP Taxonomies and Preparer Guidance, made a presentation to the members of the Investment Companies Expert Panel, including discussion of the recent SEC rule proposals, the current status of the industry taxonomy for investment companies, and why/how members of the Expert Panel could get involved in the XBRL process.

AICPA Investment Companies Expert Panel July 22, 2008 Meeting Highlights

I. AICPA matters:

1. The Chairman of the Expert Panel reviewed the composition of the Expert Panel for the 2008-2009 volunteer year.

2. AICPA Publications – status update

a. AICPA Audit and Accounting Guide for Investment Companies (the "Guide")

The AICPA staff reviewed the status of the conforming changes to the Guide. A preliminary final version will be distributed for review by the Expert Panel. FASB staff was requested to review revised guidance relating to FAS 157 in the Guide. The AICPA staff also intends to provide EP members with a matrix of comments they provided and their disposition.

b. Audit Risk Alert

The AICPA staff described the timing of the distribution of the draft 2008 AICPA Risk Alert *Investment Companies*. The schedule will incorporate time for regulators' review and enable the EP to include any other significant matters which may be discussed during the ICI Tax and Accounting Conference scheduled for September 15-18, 2008.

c. Status of Commodities Practice Aid overhaul

Earlier this year, the Investment Companies Expert Panel members provided comments on one of the chapters of the Commodities Practice Aid draft, developed by the Commodities Task Force. The Practice Aid is expected to be issued by the end of 2008.

II. Accounting/Reporting Issues

1. FASB Statement No. 157, *Fair Value Measurements*

a. AICPA Fair Value initiatives

An AICPA staff discussed the formation of a joint task force with representatives of the AICPA Investment Companies, Employee Benefit Plans, Non-Profit Organizations, and Health Care Expert Panels to develop guidance on the factors to consider in valuing investments in other investment funds. A high level document (Technical Practice Aid or similar) will be prepared to outline factors to consider when valuing hedge funds or private equity funds, with the objective of

providing implementation guidance before December 31, 2008. The Expert Panel also discussed the recent issuance of issue summaries for the FASB Valuation Resource Group along with FASB staff commentary, which indicates, among other things, that net asset value may be considered the starting point for valuation purposes, but that other factors should also be considered in assessing valuation under FAS 157. An Expert Panel member noted that this could be a significant issue for pension plans, in particular, for inclusion of plan assets in employer financial statements in accordance with FAS 158.

The AICPA staff also discussed the formation of a separate task force to develop a practice aid on valuation of hedge funds as an asset class by itself, including accounting and auditing matters. This practice aid is expected to be issued within the next eighteen to 24 months.

- b. An EP member sought EP members' views on what they are seeing clients doing with respect to whether hedge fund of funds are adjusting the reported NAV of underlying hedge funds when *valuing underlying funds subject to a 3 year lock up on their investment*, or simply carrying the investment at the reported NAV. Certain members indicated that based on their own inquiries, they are not aware of any hedge fund of fund clients that are planning on adjusting the reported NAV. However, it was also noted that, in the event a "gate" was imposed limiting withdrawals, or other factors arose, an adjustment might be supported.
- c. *July 9, 2008 SEC Roundtable on Fair Value Accounting* - An Expert Panel member discussed some of the topics covered during this meeting, including whether fair value was the right model to be applied, noting that no specific questions were raised with respect to the mutual fund industry. There were also some discussions about obtaining better transparency around transactions in the structured debt area.
- d. *FAS 157 Classification Levels* -The Expert Panel discussed what they are seeing with respect to classification levels, disclosures and accounting. There was discussion with respect to classification of investments in other hedge funds as Level 2 or Level 3. While the EP believed that Level 3 valuations would initially be presumed, a Level 2 classification could be justified. Factors to be considered include the observability of market inputs for underlying investments, the investments' liquidity, whether there was full transparency to the portfolio, and whether the underlying assets and liabilities in the hedge fund are properly fair valued (or carried at fair value under GAAP). The Expert Panel also discussed the observability of actual hedge fund capital (i.e., subscription and redemption) transactions. There were also discussions on whether transactions in secondary markets for funds of funds were readily available.

The Expert Panel also discussed FAS 157 considerations for feeder funds in the valuation process.

2. *Liquidation Basis of Accounting by Unregistered Funds* -The Expert Panel members discussed focusing on management's intentions with respect to a plan of liquidation and an evaluation on whether the liquidation could be longer than twelve months. The Expert Panel also discussed other topics to consider, including whether the company/fund should be accruing for management fees, the timing of the liquidation (is it "imminent"?), providing for a statement of operations for entities operating under the liquidation basis of accounting, etc. The Expert Panel members observed that accounting and auditing guidance on the liquidation basis of accounting is limited to that provided in:
 - AICPA Statement on Auditing Standards Interpretation No. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*
 - Footnote 6 of AICPA Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*
 - AICPA Technical Practice Aids, Section 9110, "Special Reports"
 - EITF Issue No. 88-25, "Ongoing Accounting and Reporting for a Newly Created Liquidating Bank"
 - SEC Financial Reporting Release 16, *Rescission of Interpretation Relating to Certification of Financial Statements*.
3. *FASB project on FASB Statement No. 132 (R)* –The EP chair noted that he had responded to an inquiry from FASB staff on how benefit plans can get information about holdings of underlying assets in mutual funds, collective funds, and hedge funds for classification by category in the proposed FSP, which soon would be redeliberated by FASB.
4. *FSP FAS 133-b and FIN 45-c* - The Panel discussed concerns about the level of detail with respect to disclosures.
5. *Mortgage dollar roll accounting* -The Expert Panel discussed an issue related to mortgage dollar roll accounting, in particular whether funds were commonly reporting dollar rolls as purchases and sales or financings under applicable GAAP. The guidance of paragraph 49 of FAS 140 was noted, which states that a transferor must at all times have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets.
6. *FASB Statement No. 161*- The Expert Panel discussed questions/issues being raised as companies begin to think about implementing FAS 161, including:
 - How the tabular information required for the balance sheet and income statement should be presented
 - Impact on footnote disclosures
 - Disclosure of exposure on a contract by contract, or summary, basis
 - System considerations to collect data, including gains/losses by risks whereas current practice is accumulate the gains/losses by security type.

The EP also discussed the activities of the ICI Accounting Policy Sub-Committee to provide implementation guidance and considered what role the EP should play more directly in providing guidance

7. An issue was raised to the EP regarding securities lending pools which have a policy of transacting at a constant net asset value (usually \$1.00), typically based on amortized cost, so long as the portfolio is not considered “impaired”, even if fair valuation, on a mark-to-market basis, falls below \$1.00. It was discussed that the decision to continue to transact at \$1.00 even though the mark-to-market NAV was less than \$1.00 was a legal issue and business risk consideration and that the terms of the organizational and/or offering documents of the fund should be considered. The question arose as to whether an investment in the fund held by another entity should be valued at the fair value per unit of the underlying assets or the constant \$1.00 per unit transaction value. EP members believed that a \$1.00 per unit value might be justified but that this conclusion would be based on numerous individual facts and circumstances, including, among others, the amount of deviation from \$1.00, whether new investors were willing to purchase shares at \$1.00, whether the maturity of the securities causing the deviation from \$1.00 were relatively short, the extent (if any) to which the net asset value declines represented credit deterioration of underlying investments instead of purely market dislocations, and any credit support arrangements. (These factors do not necessarily represent a full list of the factors discussed by the Panel.)

III. Real Estate Funds

A member of the special real estate funds task force discussed the status of their development of various “Q&As” relating to the application of the Guide by real estate pools and their ongoing discussions with AcSEC. In particular, they discussed the status of a question raised by AcSEC as to whether direct investments in property by a real estate fund required the application of related FASB statements (e.g., leases, interest capitalization) even though the real estate fund was considered an investment company under GAAP, which was being referred to FASB staff. The Expert Panel discussed their views on the issue and possible next steps to consider to assist in its resolution.

IV. Audit and Attest Issues

1. Rule 17f-2 -- Custody of Investments by Registered Management Investment Company

The Expert Panel had a general discussion of the practical difficulties and costs associated with complying with the Rule as currently written and whether interpretive guidance or relief could be sought. No action was taken.

2. Updates from previous meetings:

a. Money Market Fund SOI Presentation Update

The Expert Panel discussed a conference call among Expert Panel members, AICPA staff, the Audit Issues Task Force, and members of Professional Practice Executive Committee (PPEC) of the Center of Audit Quality on July 10, 2008. The subject of the discussion was whether PPEC would agree with a proposal to issue an audit opinion on money market funds in annual reports to shareholders that referred to a schedule of investments not physically included in the report but filed separately on Form N-CSR. (Refer to November 6, 2007 meeting highlights.) . The PPEC did not agree with the proposal, based on concerns about the precedent it may set for other entities, and a view that it would be more appropriate to evaluate it as part of overall electronic issuance of financial information, including in XBRL format, which may have broader implications for financial statement presentations.

b. DTC FAST Rule

The Expert Panel members discussed the status of comments on the DTC's proposed rule to update and standardize the requirements related to the Fast Automated Securities Transfer Program (FAST). One of the member firms of the Expert Panel will follow up with DTC.

c. FASB Codification Project

Based on a request from the AICPA to more formally evaluate industry guidance contained in the Codification, the Expert Panel staff discussed the status of comments already made on investment company guidance by individual member firms. The Expert Panel will consider making comments. The Expert Panel discussed the possibility of dividing the Codification Project industry topics among the member firms.

v. SEC Update

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1. **Fair Value Accounting (including reactions to the July 9, 2008 SEC Roundtable on Fair Value Accounting)** -The SEC staff noted that most of the discussions at the SEC Roundtable on Fair Value Accounting related to Division of Corporation Finance registrants.
2. **IFRS roadmap** -The SEC staff did not have any further updates to this topic, noting that comments received are under consideration.

3. **Reaction from latest N-Q filing regarding FAS 157-** The SEC staff noted that they had contacted registrants who omitted the fair value hierarchy level disclosures and/or the Level 3 rollforwards in their latest Form N-Q filings.
4. **Independence – update on Rule 206(4)-2 (or any other) efforts-**The SEC staff did not have any updates to independence matters at this time.
5. **Recent financial statement review comments**

The SEC staff has, as part of their financial statement reviews, also been reviewing the websites of closed-end funds which have managed distributions and disclose distribution yields. The SEC staff is concerned about the adequacy of the disclosures about what these yields mean and how the yields are calculated. The SEC staff is also concerned about ensuring shareholders understand the sources of distributions, as distributions may be a return of capital which depletes the assets of the fund, and ensuring that shareholders do not confuse distribution yield with performance, particularly when distributions are a return of capital. The SEC staff also commented that information presented in the Section 19(A) distribution notices which are linked to some registrants' websites have been inconsistent with other information on some registrants' websites, and there is no explanation of the reasons for these inconsistencies. The SEC staff also noted that some funds have been incorrectly basing their expense ratios disclosed on the website only on average total assets vs. average net assets applicable to common shares, and advised that, if other ratios are presented, the required expense ratio under SEC rules must also be presented. The SEC staff also noted that some funds have been improperly excluding the impact of interest expense on expense ratios. The SEC staff noted that they have been contacting registrants to discuss comments related to website disclosures.
6. **No action letter related to auction rate preferred substitution** - In recent months, a major closed-end fund complex received no-action relief enabling them to substitute a new form of preferred stock for auction-rate preferred, for which auctions have failed. Other closed-end funds have de-levered their funds which had auction rate preferred shares.
7. **Valuation Guidance** -The SEC staff noted that the proposed release of valuation guidance for public comment is still being worked on. The SEC staff did not expect that the proposal would be released before the end of the Summer.

VI. Discussion of IC TPAs:

1. TPAs going forward-The Expert Panel had a general discussion of possible areas going forward to consider for TPAs. There was a request to consider topics for potential TPAs for the October 16, 2008 Expert Panel meeting.
2. The Expert Panel discussed the latest draft of the TPA related to "carried interest, clawback / lookback recognition, and unrealized gains," including comments to specific questions in specific situations, such as when total capital has not been called. There have been no changes conceptually in the proposals as outlined, though the panel members will ensure that all parties are in agreement on how the provisions work in certain situations.

The next Expert Panel meeting is scheduled for October 16, 2008.

AICPA Investment Companies Expert Panel October 16, 2008 Meeting Highlights

I. AICPA matters:

1. 2009 Expert Panel Meetings -- The Expert Panel discussed the 2009 meetings schedule.

2. AICPA Publications – status update

a. AICPA Audit and Accounting Guide *Investment Companies* (the "Guide")

The AICPA staff informed the Expert Panel that the AICPA Audit and Accounting Guide *Investment Companies* May 1, 2008 edition has been issued. The Expert Panel discussed various planning items related to conforming changes to the 2009 version of the Guide, particularly given the FASB Codification Project.

b. Audit Risk Alert

The AICPA staff indicated the 2008/2009 Audit Risk Alert was in production and discussed the timing of expected issuance. The Expert Panel members requested the AICPA staff attempt to expedite the publication of the Audit Risk Alert.

c. Status of Expert Panel April and July meeting notes

The AICPA staff informed the Expert Panel that the April meeting notes were posted to the AICPA website and that the July meeting notes were distributed for review.

d. New Investment Companies Industry Publications Technical Manager

The AICPA staff introduced the new Technical Manager who would be working on the investment companies' industry publications to the Expert Panel.

3. FASB Codification Project

The AICPA staff updated the Expert Panel on the status of their project to compare the AICPA Audit and Accounting Guide *Investment Companies* (the Guide) to the Investment Companies Topic section of the FASB Codification. The AICPA staff asked the Expert Panel for their feedback by October 24th on

whether any of the AICPA staff's proposed comments should be communicated to the FASB. The AICPA staff updated the Expert Panel on the status of the FASB Codification project. After the FASB Codification Project is implemented, there will be significant changes to the Guide, similar to all other AICPA Guides, in that all literature will be identified as either codified with a reference to the Codification, or as non-authoritative.

(Note: FASB subsequently announced that the Codification is expected to become effective in July 2009.)

4. AcSEC and Issues Paper

The AICPA staff informed the Expert Panel that AcSEC would be willing to review guidance relative to matters stemming from the current financial crisis developed by various Expert Panels and consider that guidance for future AcSEC Issues Papers.

5. XBRL Taxonomies

An AICPA staff member reminded the Expert Panel about the scheduled webcast training on Investment Companies Taxonomies on Wednesday, October 29th.

II. Accounting/Reporting Issues

1. Credit Crisis – emerging issues

a. "Buy-ins" of security loan positions where Lehman was the counterparty (borrower) and is no longer in a position to deliver (that is, collateral was seized and the proceeds were used to buy the equivalent position) - Expert Panel members observed FASB Statement 140 suggests that financing accounting treatment is no longer appropriate when counterparty defaults under the agreement. As such, the securities on loan would be recorded as sold and the buy-in treated as a purchase.

b. Treasury's Temporary Guarantee Program for Money Market Funds

The Expert Panel discussed the Treasury's Temporary Guarantee Program for Money Market Funds.

Background

The U.S. Treasury Department has established a Temporary Guarantee Program for Money Market Funds. Under this program, the U.S. Treasury will guarantee to investors that they will receive \$1 for each money market fund share held as of close of business on September 19, 2008. Eligible funds

must be regulated under Rule 2a-7 of the Investment Company Act of 1940, must maintain a stable share price of \$1 and must be publicly offered and registered with the Securities and Exchange Commission. Funds with a net asset value below \$0.995 as of the close of business on September 19, 2008, may not participate in the program. Funds paying both taxable and non-taxable dividends are eligible for this program. To participate in the program, eligible funds must pay a fee and complete the Guarantee Agreement and corresponding documents (refer to the U.S. Treasury's website at <http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml>). As this program covers all shareholders in a participating eligible fund as of close of business on September 19, 2008, individual investors cannot sign-up for the program. The guarantee will be triggered if a participating fund's net asset value falls below \$0.995, commonly referred to as breaking the buck.

The program will exist for an initial three month term, after which the Secretary of the Treasury will review the need and terms for extending the program.

Accounting and Reporting Considerations

- 1) The Expert Panel discussed the accounting treatment for the upfront fee that money market funds are required to pay to participate in the program. The Expert Panel expressed a view that the cost of the upfront fee is a fund expense, since the fund is required to register for the program, and it may be appropriate to record as a prepaid and amortize it to expense over the initial three month period covered by the program.
- 2) An Expert Panel member asked if Advisors of money market funds are reimbursing funds for the cost of the program. Members of the Expert Panel noted that some Advisors were reimbursing money market funds for the cost and others were not. The Expert Panel noted that if Advisors are reimbursing money market funds for the cost of the program then the total expenses of the fund should be grossed up with a corresponding waiver presented in the statement of operations consistent with Chapter 8 of the Audit Guide.
- 3) An Expert Panel member discussed whether the upfront fee should be considered an "extraordinary" expense. The Expert Panel noted that the expense is not itself "unusual" (insurance) and in the past there had been some limited private money fund insurance programs. Accordingly, the fee would not appear to meet the definition of an extraordinary item in accordance with APB 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. The Expert Panel noted that firms would need to review the definitions described in their respective

management and expense limitation agreements and obtain approval from their Boards to conclude whether the upfront fee is an “extraordinary” expense” for the purpose of calculating maximum expenses and waivers.

Refer to the SEC Update below for informal guidance on the impact of the upfront fee on the Fee Table that is presented in the Prospectus and suggested reporting of the program by money market funds.

c. Technical Practice Aid

AICPA staff issued a new nonauthoritative Technical Practice Aid (TPA) addressing the potential accounting and auditing implications for a non-governmental entity investing in a money market fund or other short-term investment vehicle, when the fund or its trustee imposes restrictions on the entity's ability to withdraw its balance. The TPA covers balance sheet classification, disclosures, debt covenants, subsequent events and going-concern considerations, among other things. Please visit http://www.aicpa.org/download/acctstd/TIS1100_15.pdf.

d. Discussion of Investment Companies TPAs

The Expert Panel had a general discussion of potential topics for future TPAs.

e. SEC Division of Investment Management’s October 10, 2008 no-action letter

The SEC issued no-action relief to the Investment Company Institute on October 10, 2008, enabling a money market fund to comply with rule 2a-7 by “shadow pricing” certain of its portfolio securities by reference to their amortized cost rather than using available market quotations (or an appropriate substitute that reflects current market conditions) through January 12, 2009, unless the particular circumstances, (such as the impairment of the creditworthiness of the issuer) suggest that amortized cost is no longer appropriate. This no-action relief is limited to portfolio securities that (i) have a remaining maturity of 60 days or less, (ii) are First Tier Securities as that term is defined in paragraph (a)(12) of rule 2a-7, and (iii) the fund reasonably expects to hold to maturity.

The no-action letter can be found on the SEC’s website at:

<http://www.sec.gov/divisions/investment/noaction/2008/ici101008.htm>

The Expert Panel discussed the matters that auditors should consider in assessing compliance with the no-action letter, including (not an all-inclusive list):

- The security has a Tier 1 rating;
- The security is not impaired;
- That the actual maturity is used, not a variable or reset date;
- Management’s intent to hold the security until maturity;
- Auditors should understand what fund firms’ procedures are for these securities, such as, subsequent sales testing, credit quality checks, etc.

The Expert Panel noted that audit firms may vouch the maturity of securities with maturities of less than 60 days to test valuation as of the period-end date.

The Expert Panel noted that non-registered funds that follow rule 2a-7 already price securities with maturities less than 60 days at amortized cost in accordance with ASR 219 *Money Market Funds*.

f. Securities lending pools below \$1 per share

At the July Expert Panel meeting, an issue was raised to the EP regarding securities lending pools which have a policy of transacting at a constant net asset value (usually \$1.00), typically based on amortized cost, so long as the portfolio is not considered “impaired”, even if fair valuation, on a mark-to-market basis, falls below \$1.00. It was discussed that the decision to continue to transact at \$1.00 even though the mark-to-market NAV was less than \$1.00 was a legal issue and business risk consideration and that the terms of the organizational and/or offering documents of the fund should be considered. The question arose as to whether an investment in the fund held by another entity should be valued at the fair value per unit of the underlying assets or the constant \$1.00 per unit transaction value. EP members believed that a \$1.00 per unit value might be justified but that this conclusion would be based on numerous individual facts and circumstances, including, among others, the amount of deviation from \$1.00, whether new investors were willing to purchase shares at \$1.00, whether the maturity of the securities causing the deviation from \$1.00 were relatively short, the extent (if any) to which the net asset value declines represented credit deterioration of underlying investments instead of purely market dislocations, and any credit support arrangements. (These factors do not necessarily represent a full list of the factors discussed by the Panel.)

An Expert Panel member noted that the securities lending pool of a major financial institution recently broke a dollar (that is, the NAV was less than \$1.00 per share). The Expert Panel held a discussion on the various accounting considerations and certain steps that firms and auditors should consider.

2. FASB Statement No. 157, *Fair Value Measurements*

- a. The Expert Panel discussed the *Clarifications on Fair Value Accounting* released by the SEC Office of the Chief Accountant and FASB Staff on September 30, 2008 (see release on FASB website at <http://www.fasb.org/news/2008-FairValue.pdf>).
- b. The Expert Panel discussed FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (see release on FASB website at http://www.fasb.org/pdf/fsp_fas157-3.pdf)

c. AICPA Fair Value Initiatives

An AICPA staff provided an update to the Expert Panel on the joint task force (AICPA NAV task force) comprising representatives of the AICPA Investment Companies, Employee Benefit Plans, Not-For-Profit Organizations, Stockbrokerage and Investment Banking, and Health Care Expert Panels (see previous meeting highlights). The Chair of the task force and AICPA staff informed the members of the Expert Panel that the AICPA NAV task force shared draft guidance on factors to consider in valuing investments in other investment funds with the AcSEC Planning Subcommittee (PSC). At this time, the AICPA plans to release an Issues Paper that will be posted to the AICPA website.

The Expert Panel members noted that firms and auditors might consider using valuation specialists to assist in determining/assessing fair value of investments in investment funds and ask those specialists to provide “how to” guidance. An Expert Panel member noted that liquidity discounts may vary fund by fund based on the individual facts and circumstances and a standard liquidity discount should not be applied in all situations.

An Expert Panel member noted that to date they have not seen any changes to the reporting for an investment in an underlying fund from its NAV, except for significant events, liquidation, etc. An Expert Panel member noted that funds may have valuation issues for investments in funds that are starting to implement restrictions, lock-up and gate provisions, etc.

3. Valuation of Credit Support Agreements for Registered Money Market Funds

The Expert Panel discussed the SEC’s informal guidance about the accounting and reporting implications of credit support agreements provided at the February 2008 Investment Companies Expert Panel Meeting (see February 2008 Meeting Highlights). As the credit support agreement is a derivative

pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, both the credit support agreement and the securities covered by it should be presented within the financial statements at fair value. For the money market funds that have credit support agreements, the SEC Staff previously indicated that the combination of the credit support agreement at fair value and the fair value of the covered securities should be sufficient to maintain the money market fund's NAV above the regulatory threshold of \$0.995. The SEC Staff would not anticipate a significant discount being applied for the purpose of valuing the agreement given its short term nature, the existence of a "backstop" provision, and the probability of payment. There was a discussion by the Expert Panel as to whether the valuation of a credit support agreement by the sponsor or investment advisor would be materially different than the valuation presented in the financial statements of the money market fund. Expert Panel members noted that they would generally not expect a significant, if any, difference.

4. FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises* ("FSP FIN 48-2") - Update

The Expert Panel discussed the FASB's decision to propose an additional one-year delay of the effective date of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (Interpretation 48), on accounting for uncertainty in income taxes for all nonpublic entities that have not already applied the Interpretation's provisions.¹ The proposal would add to the one-year deferral for nonpublic entities granted in February.² Assuming the proposed FASB Staff Position is adopted, the effective date of Interpretation 48 for nonpublic entities that have not already applied Interpretation 48 in a full set of annual financial statements would be for periods beginning after December 15, 2008.

Earlier this month, the FASB decided not to propose a deferral for all nonpublic entities, deciding instead to propose a deferral only for pass-through entities. The FASB's new decision to provide a deferral for all nonpublic entities responded to questions raised about the scope of the proposed deferral for pass-through entities.

The FASB plans to issue another Staff Position in 2009 that would provide the guidance on those issues, including guidance on the application of Interpretation 48 to pass-through entities.

¹ FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, available at www.fasb.org.

² FASB Staff Position No. FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, February 1, 2008, available at www.fasb.org.

The Expert Panel discussed some concerns in the hedge fund industry given the increase in redemption activity and how FSP FIN 48-2 would impact NAVs (for example, adoption on 1/1/09 with an adjustment that affects NAV).

III. Audit and Attest Issues

1. Confirmations of transactions with Lehman Brothers Holding, Inc.

The Expert Panel discussed the guidance outlined in paragraph 2.158 of the Guide that states:

“Custody of securities. For a registered investment company, the auditor should confirm all securities with the custodian, including securities held by the custodian on behalf of the investment company in a central securities system or similar omnibus account, or physically examine the securities as applicable under the circumstances. Additionally, the SEC requires the auditor to confirm all unsettled securities purchased with the party responsible for delivery. For those confirmations not received, the auditor should perform alternative procedures deemed appropriate in the circumstances. ^{fn.45} For nonregistered investment companies, the timing and extent of testing custody is a matter of the auditor's judgment.”

^{fn 45} SEC *Codification of Financial Reporting Policies* section 404.03.

Lehman Brothers Holding, Inc. (LBHI or Lehman) filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code on Monday, September 15, 2008, in the United States Bankruptcy Court for the Southern District of New York. Subsequently, at least 16 additional affiliates of LHBI filed petitions in the United States Bankruptcy Court for the Southern District of New York seeking relief under chapter 11 of the United States Bankruptcy Code.

The Expert Panel discussed that as a result of the bankruptcy filings of LBHI and its affiliates, LBHI and its affiliates will not return any confirmations of account balances, transactions, or agreements to auditors open as of the date of the bankruptcy filings. In accordance with paragraph 2.158 of the Guide, “for those confirmations not received, the auditor should perform alternative procedures deemed appropriate in the circumstances.” Therefore, auditors will need to perform alternative procedures, including vouching cash movement, if possible, and obtain other audit support such as contractual agreements, trade tickets, etc. Auditors will need to evaluate whether a situation exists where there is such significant exposure to LBHI and its affiliates that the auditor could not perform sufficient alternative procedures and would have other than an unqualified opinion.

IV. SEC Update

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

1. Credit Crisis reactions:

a) Lehman not confirming transactions as of August 31, 2008

The Expert Panel informed the SEC staff that Lehman Brothers has affirmed that they will not confirm transactions as of August 31, 2008 and that the audit firms will need to conduct alternative procedures to substantiate existence of investments. The Expert Panel discussed whether a registrant that receives a qualified opinion from an audit firm would be able to have a complete registration statement and, therefore, be unable to sell shares. The SEC staff indicated that if auditors believe they need to qualify their opinion, both the registrant and auditors should consult with the SEC staff.

b) Treasury's Temporary Guarantee Program for Money Market Funds

The SEC staff noted that money market funds that have registered for the Treasury's Temporary Guarantee Program for Money Market Funds ("the Program") have been filing amendments, or stickers, to the respective Prospectuses filed with the SEC and that fee tables are not required in these amendments. However, the SEC staff noted that if a registrant files an updated registration statement pursuant to Rule 485 of the 1933 Act, a fee table is required. The SEC staff noted that it is the registrant's responsibility to assess materiality of the upfront fee paid by the Fund to participate in the Program to determine whether the cost should be included in the fee table. The SEC staff noted that when making this materiality assessment, the fee should not be annualized.

The SEC staff indicated that they would expect registrants to disclose, in a fair and balanced manner, the material terms and limitations of the Program in the amendments to the Prospectus. The disclosure should include, among other things:

- 1) The shares that are guaranteed are the lesser of shares outstanding as of September 19, 2008 or shares outstanding as of the date of the guarantee event;
- 2) The initial term period of the Program is limited in duration and expires on December 18, 2008;
- 3) If the guarantee is triggered, the fund will be liquidated within 30 days;
- 4) There is a cost associated with participating in the Program, although Funds do not need to disclose the cost in the amendment to the Prospectus
- 5) The guarantee payment is based on the availability of funds in the Exchange Stabilization Fund, as funds are available on a first come first serve basis

The SEC staff further indicated that these disclosures should also be included in a separate, readily identifiable, easy to understand footnote to the financial statements, and should not be placed within another note. The SEC staff would also expect to see disclosure of the party paying for the cost of the program, whether it is the Fund or the Advisor.

c) **Portfolio Turn-Over Calculation for “Buy-Ins” of Security Loan Positions from Lehman Brothers Holding, Inc.**

The Expert Panel indicated that there have been “buy-ins” of security loan positions where Lehman was the counterparty and is no longer in a position to deliver (that is, the collateral was seized and the proceeds were used to buy the equivalent position). The SEC staff noted that if it was concluded that in accordance with GAAP the "buy-in" transaction was considered a sale of the original position and a purchase of a new lot in the same security, the sale and purchase should be taken into consideration in calculating the portfolio turnover ratio.

2. **FASB Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities" (FAS 161)**

An Expert Panel member asked what, if anything, would be required for implementation for financial statement periods ending February 28, 2009, March 31, 2009, and April 30, 2009. The Expert Panel member also asked whether the SEC staff considered the quarterly filing on Form N-Q to be a financial statement for purposes of SFAS 161 adoption.

The SEC staff indicated that they would expect, at a minimum, to see the SAB 74 new accounting pronouncement disclosures in financial statements for periods ending earlier than May 31, 2009. Further, they reminded the panel that early adoption of FAS 161 is permitted.

The SEC staff also reminded the Expert Panel that FAS 161 disclosure might be appropriate for Form N-Q, based upon a materiality assessment by the preparer. The SEC staff referred the Expert Panel to the instructions for Form N-Q and its reference to Rule 12b-20 of the Exchange Act.

3. *Clarifications on Fair Value Accounting* released by the SEC Office of the Chief Accountant and FASB Staff on September 30, 2008 (see release on FASB website at <http://www.fasb.org/news/2008-FairValue.pdf>).

The Expert Panel discussed FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (see release on FASB website at http://www.fasb.org/pdf/fsp_fas157-3.pdf)

The SEC staff indicated that they believe these releases provided clarification and did not constitute a change to the use of fair value measurements within GAAP.

4. **IFRS roadmap** -The SEC staff did not have any further updates to this topic, noting that comments received are under consideration.
5. **Reaction from latest N-Q filings** - The SEC staff noted that based on their recent reviews of N-Q filings, they observed that most registrants are including the fair value hierarchy level disclosures and Level 3 rollforwards, if applicable. The SEC staff noted that they have contacted registrants who have not been complying with applicable FAS 157 disclosures in their N-Q filings.
6. **Recent financial statement review comments** – The SEC Staff did not report any financial statement review comments.
7. **Independence – update on Rule 206(4)-2 (or any other) efforts** – The SEC staff did not have any update on rulemaking efforts related to auditor independence.
8. **Valuation Guidance** - The SEC Staff noted that the Division of Investment Management continues to work on valuation guidance, however, they do not have a timeframe for its expected release.
9. **XBRL Taxonomy** – The SEC staff noted that the XBRL Risk/Return Summary Taxonomy and Schedule of Investments Taxonomy will be issued next week for public comment.

V. Discussion of IC TPAs:

1. At the July 2008 meeting, a member of the Expert Panel suggested creating a subgroup of the Expert Panel that will prepare a possible topics list of Investment Companies TPAs for the Expert Panel's consideration in the future. The Expert Panel discussed suggestions on topics received to date. No action taken.
2. The Expert Panel discussed the latest draft of the TPA related to "carried interest, clawback / lookback recognition, unrealized gains" and some specific questions in specific situations, in particular when total capital has not been called. At this time, no further changes to the draft TPA were required. The next step would be for members of the Expert Panel to attempt to have the draft TPA reviewed by the AcSEC Planning Subcommittee (PSC) in late 2008 or early 2009.
3. An Expert Panel member asked the AICPA staff whether they would still issue TPAs given the proposed FASB Codification Project. The AICPA staff indicated that the AICPA would probably still issue TPAs as interim guidance until the next scheduled version of the Guide is issued.

The next Expert Panel meeting is scheduled for December 9, 2008.

AICPA Investment Companies Expert Panel December 9, 2008 Meeting Highlights

I. AICPA matters:

- 1. 2009 Expert Panel Meetings** - The Expert Panel discussed the 2009 meetings schedule and tentatively agreed the meetings and conference calls would be held as follows:

- Wednesday, January 7, 2009 conference call
- Tuesday, February 3, 2009 conference call
- Tuesday, March 3, 2009 conference call
- Tuesday, April 7, 2009 conference call
- Tuesday, April 28, 2009 AICPA New York City office
- Tuesday, June 2, 2009 conference call
- Tuesday, July 7, 2009 conference call
- Tuesday, August 4, 2009 conference call
- Wednesday, September 9, 2009 AICPA New York City office
- Tuesday, October 6, 2009 conference call
- Tuesday, November 3, 2009 conference call
- Tuesday, December 15, 2009 AICPA Washington, D.C. office

- 2. AICPA Publications – status update**

- a. Audit Risk Alert**

The AICPA staff indicated the 2008/2009 Audit Risk Alert was in production and discussed the timing of the expected issuance of an electronic copy (PDF) in January 2009 and hard copy in February 2009. The Expert Panel members and AICPA staff discussed moving the publication of the 2009 Audit Risk Alert to the fall in 2009.

II. Discussion of IC TPAs:

- 1.** The Expert Panel discussed the latest draft of the TPA related to "carried interest, clawback / lookback recognition, unrealized gains". The Expert Panel proposed some minor revisions to the draft TPA. The Expert Panel representatives will discuss the draft TPA with the AcSEC Planning Subcommittee (PSC) in January 2009.
- 2.** At the July 2008 meeting, a member of the Expert Panel suggested creating a subgroup of the Expert Panel that will prepare a possible topics list of Investment Companies TPAs for the Expert Panel's consideration in the future. The Expert Panel discussed suggestions on topics received to date. No action taken.

III. Accounting/Reporting Issues

1. Unregistered Security Lending Collateral Pools:

The Expert Panel discussed certain issues surrounding the valuation of a security lending customer's investment in an unregistered security lending collateral pool under Statement 157 in light of certain current market and economic events.

Background

Security lending agents/custodians administer pools, often collective investment funds, to invest cash collateral received by their customers in security lending transactions. Many of these funds have historically maintained a NAV of \$1.00 per unit; the investments held by the funds are typically short-term in nature and of high credit quality. However, the unregistered funds are not subject to the requirements of Rule 2a-7.

As a result of the credit market events of the past year, a number of the security lending pools no longer have NAVs that equal \$1.00 per unit on a rounded basis when their investments are valued at fair value rather than carried at amortized cost. Certain of the funds have been impacted by specific events such as the Lehman bankruptcy or the impairment / restructuring of certain structured investment vehicles (SIVs) which have resulted in realized losses in these funds. Certain funds, though not affected by credit events, have been impacted by general market conditions which have caused value decreases in many non-government fixed income securities.

GAAP (investment company accounting) requires the collective funds to carry their investments at fair value. Therefore, financial statements prepared in accordance with GAAP would reflect NAVs of less than \$1.00 per unit for certain affected funds unless a capital support agreement has been put in place by the sponsor of the fund.

A number of security lending pools continue to process "ordinary" security lending activity at \$1.00 per share. In these cases, the security lending agent/custodian has made a legal determination that under the governing legal documents, the fund is able to process transactions at \$1.00 per unit (amortized cost) even if GAAP/fair value NAV is less than \$1.00 per unit. Although "ordinary" security lending activity continues to be processed at \$1.00 per unit, many of these funds have imposed restrictions on significant redemptions or full withdrawals. Most of these restrictions result either in receiving securities in kind, delayed receipt of cash proceeds, or immediate cash at NAV determined at fair value if there is a significant redemption or withdrawal by a customer.

Fair Value of an Investment in a Securities Lending Pool

The Expert Panel observed that the objective under Statement 157 is to determine the price that would be received by an investor upon a sale of its interest to a market participant in a hypothetical, orderly, market transaction.

The Expert Panel members noted that if there is absolute liquidity (that is, no restrictions/gate provisions, no in-kind redemptions, etc.), transactions continue to be processed at \$1.00, the deviation between the fair value NAV and amortized cost NAV was not material, and the deviation was the result of temporary market dislocation on the fair values of very short term securities (for example, less than 60 days to maturity), and the portfolio did not hold credit-impaired securities, the fair value of a customer's investment in the collateral pool would likely be \$1.00.

The Expert Panel discussed that, due to recent credit market events, interests in securities lending pools that have experienced difficulties are generally not being offered to any significant new investors at \$1.00 and/or restrictions are being placed on significant redemptions. The Expert Panel discussed that the determination of fair value for an investor's interest in a securities lending collateral fund would depend on the specific facts and circumstances involved. Numerous factors should be considered, including the following:

- Restrictions on redemptions at \$1.00, including the imposition by the fund of in-kind redemptions
- Whether significant new investors are investing at \$1.00 per unit
- The amount of deviation between NAV calculated based on fair value versus NAV calculated based on amortized cost
- Whether actual credit losses (Lehman, SIVs, etc.) are causing the deviation (or a portion of the deviation)
- The period to maturity of the securities that are causing the deviation
- The existence of any credit support arrangements by the fund sponsor

The Expert Panel members generally observed that in situations where a securities lending collateral fund has realized credit loss (such as Lehman, certain SIVs, etc.), the fair value of an investor's interest in such a pool should reflect these losses. In addition, the Expert Panel members noted the following strong indicators that the value of an investor's interest in a securities lending collateral pool would not equal \$1.00 per unit:

1. Credit deterioration of the issuer of individual securities held by the collateral pool;
2. The NAV of the collateral pool based on fair value is less than \$1.00 AND there are restrictions or gate provisions on redemptions from the collateral pool, or redemptions are made in-kind, or partially in-kind, versus cash.

Additional Observations

An Expert Panel member noted that some collateral pools have also been split into partial pools – one collateral pool with an NAV at \$1.00 and a second collateral pool with an NAV less than \$1.00.

An Expert Panel member noted that if the value of a customer's investment in the securities lending collateral pool equaled \$1.00 in the customer's account statement, the customer should still assess the materiality of the variance between the fair value NAV and \$1.00 to determine whether the fair value of their investment is indeed \$1.00.

2. Valuation Issues:

- a. The Expert Panel members discussed whether valuations of over-the-counter derivatives should be adjusted for changes in credit risk of the counterparty in the current environment. The Expert Panel members discussed that Statement 157 would require the consideration of changes in credit quality of the counterparties if such changes would be considered by a hypothetical market participant. The Expert Panel members discussed several matters, including the observation that historically, most funds have used settlement value for the valuation of over-the-counter derivatives because any counterparty risk was deemed immaterial. Recent market events and current conditions may require higher spreads to take into account the greater counterparty risk.

b. AICPA Fair Value Initiatives

An AICPA staff provided an update to the Expert Panel on the joint task force (AICPA NAV task force) comprising representatives of the AICPA Investment Companies, Employee Benefit Plans, Not-For-Profit Organizations, Stockbrokerage and Investment Banking, and Health Care Expert Panels (see previous meeting highlights). The AICPA NAV task force shared *draft guidance on factors to consider in valuing investments in other investment funds* with the AcSEC Planning Subcommittee (PSC). The chair of the Expert Panel and AICPA staff of the AICPA NAV task force informed the Expert Panel members on the outcome of the conference call with the PSC on November 19th and the comments received from the PSC on the draft guidance, including a question as to whether subscription and redemption transactions directly with an open-end alternative investment fund as issuer can be viewed as a "principal market" under FAS 157. The AICPA staff noted that the FASB is considering the matters that are being addressed by the AICPA NAV task force as a potential future project.

The AICPA plans to release an Issues Paper by year-end (not a Technical Practice Aid) that will be posted to the AICPA website. The purpose of the Issues Paper would be to help users think through the issues. An Expert Panel member noted that the secondary market activity for alternative investment funds may increase significantly in the near future. To the extent such information is available, Fund firms and auditors will

need to assess the relevance of such transactions on their fair value determinations.

c. **FAS 157 disclosure for “master/feeder” funds**

In a “master/feeder” structure, the master fund presents its FAS 157 “Level” disclosure for its direct investments in securities. The Expert Panel members discussed that while technically FAS 157 would seem to require the feeder fund to classify the Level of its investment in the master, in this case it may appear confusing to report “investment in master” as, for example, entirely Level 1 or Level 2 while the accompanying master financial statements present a completely different breakdown of FAS 157 asset classifications. Refer to **SEC Update** for further discussion.

d. The Expert Panel members shared *recent experiences and accounting, tax and disclosure issues relating to valuations*.

An Expert Panel member noted that Boards have been more interested in the differences that audit firms are seeing between pricing services and what audit firms are doing about the variances. An Expert Panel member noted that some pricing services have stopped providing prices for certain security types that they did not have significant experience with previously. An Expert Panel member also noted that some pricing services have stopped providing prices for mortgage-backed securities that are not backed by the U.S. Government.

An Expert Panel member noted that they have seen an increase in the number of securities that are priced by only one pricing service, and an increase in the number of securities that are labeled “fair-valued” in financial statements.

An Expert Panel member noted that firms need to understand whether brokers are providing quotes that are firm prices or bids. Another Expert Panel member noted that some brokers have been providing an accommodation quote for their clients that work closely with the brokers, and that firms and auditors need to evaluate whether these quotes are reliable.

An Expert Panel member reiterated that as a result of the bankruptcy filings of Lehman Brothers Holding, Inc. (LBHI or Lehman) and its affiliates, LBHI and its affiliates will not return any confirmations of account balances, transactions, or agreements to auditors as of the date of the bankruptcy filings.

e. **FAS 157 level 3 roll-forward disclosure**

The Expert Panel members observed that some funds may opt to exclude the FAS 157 Level 3 roll-forward from the disclosures in financial statements where the fair value measurements categorized in Level 3 are immaterial.

f. **Suspension of Redemptions and Gates**

Due to current market factors, multiple hedge funds have been reported to have suspended redemptions or initiated gate provisions. For some offshore funds (for example, Cayman), the suspension of redemptions has been reported to have occurred because the fund cannot determine or calculate the NAV or that the Fund is prohibited from calculating NAV during a redemption suspension. An EP member asked what the implications are to the audit and financial statement reporting when such declarations have been made by the Fund, particularly whether an audit can be performed if management has informed its investors it can't strike a NAV.

The Expert Panel members discussed the concern of performing an audit when the Fund has declared that it cannot determine the NAV in a reasonable and timely manner or that the Fund cannot determine or calculate the NAV. This issue is a risk management/business decision of the audit firm as to whether to perform an audit under these conditions. One expert panel member pointed out the inconsistency that if a fund has the ability to prepare financial statements in accordance with GAAP and the auditor is able to issue an unqualified opinion on those financial statements, the fund therefore must be able to calculate an NAV in accordance with GAAP. Another expert panel member pointed out the importance of fund organizations with offshore funds understanding the implications of such declarations before making them.

3. IFRS Roadmap

On November 14, 2008, the Securities and Exchange Commission (SEC) published a rule proposal *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers* (the Roadmap) (see Roadmap on the SEC's website at <http://www.sec.gov/rules/proposed/2008/33-8982.pdf>). The SEC is proposing a Roadmap for the potential use of financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board by U.S. issuers for purposes of their filings with the SEC. This Roadmap sets forth several

milestones that, if achieved, could lead to the required use of IFRS by U.S. issuers in 2014 if the SEC believes it to be in the public interest and for the protection of investors. The SEC has asked for comments on the proposed rule by February 14, 2009. The Roadmap has scoped out issuers defined as Investment Companies under the Investment Company Act of 1940.

The AICPA staff held a discussion with the members of the Expert Panel on whether it is appropriate to exclude Investment Companies and other regulated entities filing or furnishing reports with the SEC from the scope of the Roadmap. While acknowledging the overall trend to convergence, some Expert Panel members expressed concerns about the use of IFRS for Investment Companies because the absence of specialized industry guidance results in fundamental accounting and presentation differences from the current US GAAP reporting model, including significantly reduced disclosures. An Expert Panel member noted that if IFRS were adopted for Investment Companies, the SEC would need to revisit regulations for Investment Companies. Members also noted that in other countries that have adopted IFRS, Investment Companies continue to follow the local regulatory based GAAP.

4. Money market funds - Money Market Investor Funding Facility:

On October 21, 2008, the Federal Reserve Board announced the creation of the Money Market Investor Funding Facility (MMIFF), which will support a private-sector initiative designed to provide liquidity to U.S. money market investors.

Under the MMIFF, the Federal Reserve Bank of New York (FRBNY) will provide senior secured funding to a series of special purpose vehicles to facilitate an industry-supported private-sector initiative to finance the purchase of eligible assets from eligible investors. Eligible assets will include U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less. Eligible investors will include U.S. money market mutual funds and over time may include other U.S. money market investors (see press release on Federal Reserve website at: <http://www.federalreserve.gov/newsevents/press/monetary/20081021a.htm>)

The Expert Panel members were not aware of any organizations that have participated in the MMIFF to date. The Expert Panel members discussed various accounting and reporting considerations related to the MMIFF, including sale accounting considerations pursuant to the guidance in paragraph 9 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

5. ICI Accounting & Treasurers meeting - The members of the Expert Panel and observers held a discussion about the relevant information discussed during the recent ICI Accounting & Treasurers meeting on December 4, 2008, including certain tax matters related to infusions of cash to registered investment companies and the U.S. income tax treaty with Norway.

6. FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (FAS 161):

- a. The Expert Panel members discussed the timing of the required adoption and disclosures of FAS 161 for partial year financial statements and for inclusion in filings on Form N-Q. FAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. Refer to the **SEC Update** section for further discussion.
- b. The Expert Panel members discussed the guidance in paragraph 44(2) of FAS 161 that states:

“Information that would enable users of its financial statements to understand the volume of its derivative activity. Entities shall select the format and the specifics of disclosures relating to their volume of derivative activity that are most relevant and practicable for their individual facts and circumstances.”

The Expert Panel members discussed the considerations for FAS 161 disclosures around the volume of derivative transactions (that is, notional, number of contracts, underlying exposure). Refer to **SEC Update** for further discussion.

- c. The Investment Company Institute has distributed a draft of the ICI White Paper on FAS 161 to the industry for comment. A representative from the ICI Accounting Policy Subcommittee provided an update to the Expert Panel on the status and the next steps for the ICI White Paper on FAS 161, which include:
 - 1. Revisions to the Effective Date and Implementation Schedule with respect to disclosures on Form N-Q;
 - 2. Additional guidance on the requirement for enhanced disclosures of the volume or level of derivative activity (see section III.6.b. above);
 - 3. Revisions to the sample disclosure for Credit Default Swaps to identify those disclosures required pursuant to FAS 161 and those required pursuant to FSP FAS 133-1.

The ICI plans to issue the White Paper on FAS 161 implementation by December 31st.

7. FSP FAS 133-1 and FIN 45-4 Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 (FSP FAS 133-1 and FIN 45-4)

On September 12, 2008, the FASB issued FSP FAS 133-1 and FIN 45-4. This FSP amends FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), to require disclosures by sellers of credit derivatives, including credit derivatives embedded in a hybrid instrument. This FSP also amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), to require an additional disclosure about the current status of the payment/performance risk of a guarantee. The provisions of this FSP that amend FAS 133 and FIN 45 shall be effective for reporting periods (annual or interim) ending after November 15, 2008. (see release on FASB website at http://www.fasb.org/pdf/fsp_fas133-1&fin45-4.pdf)

The Expert Panel members shared views on *the application of the FSP to investments in credit-linked notes* (where the investment at risk is on-balance sheet); how funds plan to address the requirement to disclose the events or circumstances that would require the fund to perform, and the requirement to disclose the current status of the payment/performance risk.

8. Annualization of Net Investment Income Ratio (NII) for financial highlights of non-registered funds

An Expert Panel member raised a practice question: For partial year non-registered funds, when annualizing the NII ratio, should an adjustment be made for the same non-recurring items that are adjusted for in the expense ratio?

For example, partial year non-registered funds do not annualize certain non-recurring expenses, such as organizational costs in their expense ratio. Some funds have considered those in determining the NII ratio, while other funds have just annualized based on number of days with no adjustment for non-recurring expenses.

Paragraph 7.78 of the AICPA and Accounting Guide, *Investment Companies* (the "Guide") states:

“The expense and net investment income ratios should be calculated by non-registered investment partnerships based on the expenses allocated to each common or investor class (for example, the limited partner class) prior to the effects of any incentive allocation. Adequate disclosure should be made to indicate that the net investment income ratio does not reflect the effects of any incentive allocation. Expenses directly related to the total return of the fund, such as incentive fees, and nonrecurring expenses, such as organizational costs,

should not be annualized when determining the expense ratio. Disclosure should be made of the expenses that have not been annualized”

The Expert Panel members acknowledged diversity in practice on whether to annualize some items in the NII ratio for non-registered funds.

IV. SEC Update

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

1. **FAS 157 disclosure for “master/feeder” funds** -- An Expert Panel member asked the SEC staff whether the financial statements of a feeder fund are required to include FAS 157 "level" disclosures for its investment in the master fund. The Expert Panel member noted that the master fund will present its "Level" disclosure for its direct investments in securities within the financial statements of the Master.

The SEC staff responded that they would not object if the feeder fund either refers to the financial statements of the master fund in its financial statements or presents the “level” disclosure in its own financial statements. Further, the SEC staff said that direct investments made by the feeder, if any, should be accompanied by appropriate FAS 157 disclosures in the feeder’s financial statements.

2. **Securities lending pools with non-money market funds falling below \$1.00.** -- The Expert Panel discussed with the SEC staff the issues the industry is experiencing with securities lending pools with non-registered funds falling below \$1.00 (see above for details).
3. **Utilizing International Auditing Standards (IAS) for SEC Registered Investment Advisors to comply with Rule 206(4)-2 of the Investment Advisers Act of 1940 (“Custody Rule”)** -- An Expert Panel member asked whether an audit performed in accordance with IAS would satisfy the requirements of the Custody Rule. Foreign pooled investment vehicles that are managed by SEC registered investment advisers often obtain audits performed in accordance with IAS as a result of either local regulations or the requirements of their offering documents. Because audits are required to be performed under US GAAS to satisfy the Custody Rule, an Expert Panel member indicated that their firm often issues two audit reports (that is, one in accordance with IAS and one in accordance with US GAAS). The Expert Panel member mentioned that this is unnecessarily costly and wondered whether an audit in accordance with IAS could satisfy the SEC’s rules.

The SEC staff indicated they would be willing to discuss the matter in further detail; however, they could not provide any answers at this time.

4. FASB Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities" (FAS 161):

- a) An Expert Panel member asked the SEC staff about their expectations for the timing of required adoption of FAS 161 for partial year financial statements and for filings on Form N-Q.

When funds commence operations during the year and prepare partial year financial statements, the SEC staff noted that registrants should look to other funds with the same year-end to determine whether to adopt FAS 161. For example, a fund with a fiscal year-end of April 30th that commenced operations on January 31st should look to other existing funds with fiscal year-ends of April 30th to determine whether to adopt FAS 161. See also FAS 161 discussion from October 2008 meeting highlights regarding timing of required FAS 161 adoption.

- b) An Expert Panel member asked the SEC staff to comment regarding their expectations as to the FAS 161 disclosures of the volume of derivative transactions (e.g. notional, number of contracts, underlying exposure). FAS 133 paragraph 44(2), as amended by FAS 161, states:

“Information that would enable users of its financial statements to understand the volume of its derivative activity. Entities shall select the format and the specifics of disclosures relating to their volume of derivative activity that are most relevant and practicable for their individual facts and circumstances.”

The SEC staff responded that their view was generally consistent with the view expressed in the draft ICI Whitepaper on FAS 161 which describes that the disclosures should be representative of the activity that occurred during the year and should be based on facts and circumstances.

5. Valuation Guidance - The SEC staff noted that the proposed release of valuation guidance for public comment is still being worked on and did not have a timeframe for its expected release.

6. IFRS roadmap -- On November 14, 2008, the Securities and Exchange Commission (SEC) published a rule proposal *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers* (the Roadmap) (see above for details).

The SEC staff noted that Investment Companies as defined by Section 3A of the Investment Company Act of 1940 fall outside of the scope of the Roadmap. However, there are questions in the Roadmap asking commenters whether

investment companies should be excluded or included in the scope of the Roadmap.

7. SEC Division of Investment Management’s October 10, 2008 no-action letter -- An Expert Panel member noted discussion by industry representatives at the recent ICI Accounting & Treasurers meeting on December 4th about seeking an extension of the January 12, 2009 expiration date in the October 10, 2008 no-action letter permitting the use of amortized cost in the “shadow pricing” of a limited number of securities held by money market funds. The SEC staff responded that they were not aware of any planned extension upon expiration.

8. Recent financial statement review comments

a) Registration statements for principal protected funds -- The SEC Staff reminded the Expert Panel that registration statements for "principal protected funds" (that is, funds which offer third-party guarantees for return of the original investment (less sales charges) or some other minimum value upon completion of a specified period) should include financial statements of both the fund and the entity providing the protection.

b) Managements Discussion of Fund Performance (MDFP) -- The SEC staff noted that the Financial Industry Regulatory Authority (FINRA) has determined that the MDFP qualifies as a communication to shareholders in accordance with rule 2210 *Communications with the Public* and, therefore, FINRA has required that registrants provide standardized performance, including gross expense ratios with waivers, in the MDFP. FINRA requires the expense ratios to correspond to the ratios presented in the most recent prospectus. This can result in a fund presenting a “stale” expense ratio in the MDFP, as the expense ratio from the most recent prospectus is over one year old. The SEC staff did not comment on FINRA’s interpretation, but indicated they believe a current ratio should also be presented in the MDFP (that is, a ratio that agrees to the current financial highlights).

9. Regulatory Filings

a) Form N-14 filings -- The SEC staff noted that the November 1995 Dear CFO letter indicates that for registrants contemplating multiple fund mergers (that is, merger of 3 or more funds), the staff would not object if registrants present 1 set of pro-forma financial statements assuming all funds merged in Form N-14 filings.

For funds contemplating multiple mergers, the SEC staff would not object to either of the following alternative presentations of the fee tables presented in Form N-14 filings:

- (1) Present a fee table for the most likely combination of funds **and** present fee tables showing a range of possibilities (that is, show the highest possible fees and lowest possible fees); **or**
- (2) Present a fee table for the most likely combination of funds **and** present fee tables as if each target fund merged with the acquiring fund (e.g. If Fund A is the acquiring fund and Funds 1, 2 and 3 are the target funds, then present 3 additional fee tables showing the fees that would be incurred if (1) Fund A merged with Fund 1, (2) if Fund A merged with Fund 2, and (3) if Fund A merged with Fund 3).

Note that if the funds involved in the proposed merger have multiple classes merging, fee tables would be presented at the class level.

The SEC staff noted that they would not object to the following alternative presentations of the capitalization tables presented on Form N-14 in a proposed multiple fund merger:

- (1) Present capitalization tables for the same combinations presented in the fee tables; **or**
- (2) Present one capitalization tables for the most likely combination of funds.

Note that if the funds involved in the proposed merger have multiple classes merging, capitalization tables would be presented at the class level.

The SEC staff noted that when filing Form N-14, many registrants rely on Rule 488 of Regulation C of the Securities Act of 1933 which provides that the filing will be immediately effective within 30 days if a complete and materially accurate filing is made. The staff noted that registrants are encouraged to send pro-forma financial statements, fee tables, capitalization tables etc. to the SEC on a preliminary basis for review prior to the full filing to expedite the staff comment process.

b) Form N-1A filings and Subsequent Events -- The SEC staff discussed incorporation by reference of financial statements within a registration statement. The SEC staff noted that some registrants had identified subsequent events that occurred after the initial issuance of the financial statements but prior to the re-issuance of the financial statements included in the registration statement. Within the N-1A filing, certain registrants incorporated the financial statements by reference to Form N-CSR and also included a new subsequent event footnote. The SEC staff noted that the subsequent event footnote should be included as part of the full financial statements, and not as a separate footnote in the N-1A filing. The SEC staff noted it is permissible to either (i) amend the N-CSR to add the subsequent event footnote and incorporate the amended N-CSR by reference or (ii) present a complete set of

financial statements, including the subsequent event footnote within the filing on Form N-1A.

In response to a follow up question from an Expert Panel member regarding subsequent events, the SEC staff noted that some registrants have obtained an audit opinion with a dual date from the auditors and others have marked the footnote “unaudited” and, therefore, did not obtain a dual dated audit opinion.

- 10. Results of recent Office of Compliance Inspections and Examinations ("OCIE") examinations --** The SEC staff informed the Expert Panel about the results of some recent examinations performed by the OCIE on Closed End Funds. The SEC staff noted that during the examinations, the OCIE noted that some Closed End Funds had invested in the Auction Rate Preferred Securities (ARPS) of other Closed End Funds and that these ARPS were valued at par in accordance with the valuation policies and procedures of the Closed End Funds. The SEC noted that upon purchase of the ARPS by the Closed End Funds, the ARPs were valued at par when the auctions were functioning properly. During the examinations, the OCIE questioned whether par is still representative of fair value for the ARPS since the auctions have failed and Closed End Funds do not have the ability to sell them.
- 11. OCIE Communication to CEOs of SEC-Registered Firms –** The SEC staff informed the Expert Panel of a communication by the OCIE to CEOs of SEC-registered firms, including broker-dealers, investment advisers, investment companies and transfer agents, reminding these firms of their legal obligation to maintain adequate compliance programs and the critical role played by the firms’ compliance programs in helping to meet obligations under the securities laws (see communication on SEC website at <http://www.sec.gov/about/offices/ocie/ceoletter.htm>).
- 12. OCIE Investment Adviser Exam Core Initial Request List –** The SEC staff informed the Expert Panel that the OCIE posted a communication indicating core initial information that the OCIE examiners will request for the examination of an investment adviser (see communication on SEC website at <http://www.sec.gov/info/cco/requestlistcore1108.htm>).
- 13. Custody Rule for Liquidating Funds --** The SEC staff discussed with the Expert Panel the application of the Custody Rule for pooled investment vehicles in the year of liquidation. The SEC staff noted that pooled investment vehicles need to comply with the Custody Rule in the year of liquidation and therefore must avail themselves of one of the 3 options provided in the Custody Rule. The SEC staff reminded the Expert Panel that they are available for questions relating to the application of the Custody Rule.

14. Independence – update on Rule 206(4)-2 (or any other) efforts – The SEC staff noted that there was no update on this matter.

15. PCOAB Activities

- a) On October 21, 2008, the Public Company Accounting Oversight Board ("PCAOB") issued a release proposing changes to its auditing standards related to the auditor's assessment of and response to risk (see release on PCAOB's website at http://www.pcaobus.org/Rules/Docket_026/2008-10-21_Release_No_2008-006.pdf).
- b) On December 5, 2008, the PCAOB issued a Staff Audit Practice Alert (PCAOB Alert No. 3) to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis in audits of financial statements and audits of internal control over financial reporting.
The SEC staff noted that PCAOB Alert No. 3 affirmed the guidance in PCAOB Alert No. 2 in connection with auditing fair value measurements. (see PCAOB Alert No. 3 at http://www.pcaobus.org/News_and_Events/News/2008/12-05b.aspx).

16. XBRL Taxonomies – The SEC staff noted that the comment period has ended for the Schedule of Investments Taxonomy and the Risk/Return Summary Taxonomy; however, comments can still be made. The SEC staff also reminded the Expert Panel of the proposed rule that would require the Risk/Return Summary to be filed in XBRL format.

An Expert Panel conference call is scheduled for January 7, 2009. No formal highlights will be issued.

AICPA Investment Companies Expert Panel
April 28, 2009 Meeting Highlights

I. Administrative Items

The panel members were informed that membership applications' process for next volunteer year continues through May 15, 2009, with the national offices of each of the big four firms submitting their members names directly; the new volunteer year 2009-2010 will begin in the fall 2009.

II. Accounting/Reporting Issues

1. 2009 conforming changes to the AICPA A&A Guide *Investment Companies* status update

The AICPA staff informed the panel that proposed conforming changes to the AICPA Accounting and Auditing Guide *Investment Companies* [the Guide] are currently being reviewed and the Guide will be issued on July 21, 2009. The staff reminded that the effective date of the new guide will be May 1st. The panel also discussed consolidation by investment companies issue in the Guide and noted that paragraphs 7.04 and 7.05 of the Guide, which existed before the issuance of SOP 07-1, had been incorrectly included among the "indefinitely deferred" sections of SOP 07-1 in the Codification. The AICPA staff worked with FASB staff to fix the error in the FASB ASC and it appears as though the issues have been addressed by the FASB.

The panel members and staff also discussed FSP FAS 157-4 and its implications, including proposed wording for disaggregated disclosures for chapter 7 and observed that the industry would benefit from adding sample financials statements of certain entities currently not presented in the Guide to this year's update of the Guide.

2. FASB May 6, 2009 meeting

- i. Potential FSP to be issued on how to estimate fair value for investments in alternative investment companies.
- ii. FASB intends to issue an exposure draft with the aim to have a final FSP by the end of June or early July.
- iii. FASB has introduced the concept of using NAV as a practical expedient to determine the fair value of an investment in an alternative fund (e.g. hedge funds, private equity funds)
- iv. Update: FASB issued FSP FAS 157-g on June 8th with a 30-day comment period.

3. Financial Highlights

- a. Calculation of total return for funds winding down operations
 - i. How to calculate total return when a fund is winding down operations, returning sales/maturity proceeds to investors in periodic cash distributions, and actively prohibiting reinvestment

- of distributions or purchase of new interests. The total return calculation guidance in the Guide states that distribution reinvestment is to be assumed, which has resulted situations where assuming reinvestment of distributions is leading to potentially incorrect results. Results seem to be misleading since actual reinvestment is not occurring.
- ii. One suggested approach would be to treat dividends as liquidating distributions and exclude them from the total return calculation. Panel members agreed the disclosure should identify what methodology is being utilized in these circumstances.
- b. EP members discussed that for nonregistered unitized funds the financial highlights total return/ per share information is generally presented for the permanent series in a class where the fund utilizes series accounting in accordance with the Guide paragraph 7.76 (a) which states “Permanent series of a class of share should be the basis for which that share’s financial highlights are determined and presented”. For the ratios, paragraph 7.78 (a) states “*When determining expense and net investment income ratios, nonregistered investment partnerships should calculate average net assets (ANA) by using the fund's (or class's) weighted-average net assets as measured at each accounting period or periodic valuation*”. Panel members acknowledged inconsistencies in practice exist on the financial ratios where some nonregistered unitized funds utilize the class as a whole in determining the income and expense ratios and others utilize the permanent series which is presented for the total return. Panel members noted funds should disclose how the ratios are calculated.

4. Inflation indexed securities

Over the past several months U. S. Treasury TIPS have had an extended deflationary period during which inflation-indexed par values have been reduced. There have been numerous industry questions about how to handle those adjustments in the financial statements - are they a negative income item or an adjustment to cost?

- a. Security purchased earlier in fiscal year, and deflationary adjustments reduce par below that at which security was originally purchased. One possible accounting treatment, consistent with guidance on high-yield securities with purchased interest that subsequently defaults, is to simply allow the cost of the “lost” par to remain in the cost of the purchased security. Another alternative, which is analogous to EITF 99-20, is to charge the “lost” par to realized loss (however, EITF 99-20 technically only applies to securitizations). Some have seen some situations where these debits were charged to interest income, resulting in reported “negative” income on the bond (and on rare occasions in total).

b. Security purchased in prior fiscal year. If par reductions eliminate interest income recorded in the prior fiscal year, should that reduction be charged against current-year interest income, or should the charge be limited only to interest recognized in the current fiscal year (in other words, treat a beginning-of-year par in the same manner as purchased par)?

c. Finally, should interest be debited for par reductions only to the extent of previous inflation adjustments or should coupon accruals on the bond also be considered in computing the debit?

When last discussed, it was proposed that current income should be reduced to the extent that it existed within the reporting period with amounts exceeding current income posted as realized losses. Some panel members thought amounts might be recorded in cost basis of security, thereby deferring any loss. While negative income does not seem to be correct, the panel members noted that currently no on-point standard exists to use in arriving at an answer.

5. The panel members discussed **the latest version of a proposed TPA for investments in other funds** that deals with aggregation of investments in investee funds exceeding five percent of the investor fund's net assets. Items discussed include consideration of guarantees to investee funds as well as how to aggregate across investee funds when considering the five percent test for non-registered funds.

III. The panel members briefly discussed **the PCAOB Concept Release on Possible Revisions to Audit Confirmation Standard.**

IV. SEC Update

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

- a. The commission is considering several regulatory options for hedge funds, registered investment advisors as well as the financial industry in general. Options may include hedge fund registration as well as the expansion of third party custody counts. (Update: the SEC's "custody" proposal was issued May 20, 2009 with comments due July 28, 2009.)
- b. SEC continues to focus on those 1940 Act funds which are performance outliers to monitor incorrect performance reporting. Findings may be recommended to OCIE for closer inspection.

- c. A question regarding certain RIAs which had typically relied upon the audit portion of the custody rule. Certain funds will get scope limited opinions this year because of issues out of their control (i.e. Lehman bankruptcy)
 - i. SEC reiterated that the intent was to get an unqualified opinion
 - ii. If a specific advisor has an issue, they should reach out to the SEC with their problem.
- d. Emphasis on recent Buddy Donahue speech
 - i. Industry needs to do a better job of improving disclosure
 - ii. Even if the technical legal requirements are met, consideration must still be given to form and content of disclosure.
 - iii. Looking to find ways to improve the shareholder disclosure process
- e. Financial Statement Comments
 - i. Discovered instances where the counterparties to total return swaps and futures were not disclosed even though the SEC found them to be material
 - ii. XBRL: The SOI and Risk/Return taxonomies are out and participation in the voluntary program continues to be encouraged.
- f. Discussion about FSP 157-4 disclosure requirements
 - i. Preparers express concern about the potential length and effort required to comply with the FSP's updated disclosure requirements around the fair value hierarchy.
 - 1. Open to suggestions, but the SEC does not have a specific answer to this issue
- g. Registrants need to consider updating Form N-1A as expense ratios may have been impacted by large drops in assets under management. Thresholds of 15bps were mentioned in a speech made by Buddy Donahue on March 23, 2009 at the ICI Conference, but should not be considered a bright line test.

See <http://www.sec.gov/news/speech/2009/spch032309ajd.htm>

AICPA Investment Companies Expert Panel September 9, 2009 Expert Panel meeting highlights

I. Administrative items/AICPA matters:

1. TPAs issued

The AICPA staff discussed the issuance of the following Technical Practice Aids:

- a.** 6910.30 “Disclosure requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership’s Net Assets”.
- b.** 6910.31 “The Nonregistered Investment Partnership’s Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the “5 Percent Test” Described in TIS Section 6910.30”.
- c.** 6910.32 “Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund’s Debt”.

2. Notes from April meeting

The AICPA staff noted that the Expert Panel meeting highlights from the April 2009 meeting were available online.

3. AICPA publications update:

a. Investment Companies Audit Risk Alert status –

The AICPA staff reminded that the Expert Panel members’ comments on the draft of the Alert are due September 18, 2009. Representatives of one of the Expert Panel members will summarize SEC staff remarks from the ICI Tax and Accounting Conference by September 25, 2009, for inclusion in the Alert.

b. Preparing for the AICPA Audit and Accounting Guide *Investment Companies* (the Guide) with 2010 conforming changes.

The Expert Panel discussed FAS 141(R)'s elimination of much of the guidance related to combinations of investment companies from Chapter 8 of the Guide. Summary pro forma financial information would be required for public companies as if the merger happened at the beginning of the fiscal year. The Expert Panel discussed a possibility of amending the introduction to Appendix E of the Guide with respect to the pro forma financial information. The Expert Panel further discussed whether the elimination of the industry-specific guidance now required investment companies to recognize, for book purposes only, the cost of investments acquired in a merger at their fair value on the merger date, regardless of whether the merger was

taxable or tax-free, which would result in a requirement to record a step up/step down (if depreciated) of the cost of the acquired investments. There also seemed to be general acknowledgment that this result would not only create substantial accounting complexities for preparers, but could make the resulting financial statements less useful for readers by making it more difficult to understand taxable gains potentially distributable to them. A subgroup of the AICPA Expert Panel plans to discuss this issue further and consider developing a nonauthoritative technical practice aid.

The Expert Panel also considered developing/reviewing new illustrative financial statements for those types of entities not currently presented in the Investment Companies Audit Guide, including hedge funds, commodity pools, and private equity funds.

Disaggregating chapter 12 “Basis for Conclusions” guidance into other chapters –

Because the Audit Guide is now non-authoritative, the continued maintenance of AcSEC's "Basis for Conclusions" related to the last update (in 2000) is now unneeded. However, panel members agreed that certain information in that Chapter, though not codified, had continued relevance to preparers and auditors and deserved to be retained in the Guide as non-authoritative guidance. A task force of Panel members will be formed to assess what to retain and where to place it in the Guide.

A separate task force consisting of Expert Panel members will be formed to incorporate guidance from current investment companies TPAs into the 2010 Investment Companies Guide as non-authoritative guidance.

II. Accounting/Reporting Issues

1. FAS 157 Issues

- A. The Expert Panel members discussed the current status of proposed FSP FAS 157-g, *Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide, Investment Companies*
 1. The chair and staff of the NAV task force informed the panel about the next steps the NAV task force plans to take with respect to the AICPA Issues Paper once the FSP is finalized and issued by FASB.
 2. The Expert Panel discussed the appropriate level within the FAS 157 hierarchy to classify valuations of alternative investments when entities are availing themselves of the practical expedient to determine fair value.
- B. The Expert Panel members discussed the proposed amendments to FAS 157—*Improving Disclosures about Fair Value Measurements*
- C. The Expert Panel members discussed the disclosure requirements described in paragraph 20 of FSP FAS 157-4—*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have*

Significantly Decreased and Identifying Transactions That Are Not Orderly. The Expert Panel noted that there was a disparity of practice with respect to disclosures, with a few disclosures extending for many pages. There was a view that this may be excessive, and that practice would likely evolve over time to a more consistent presentation.

2. EITF Issue 09-E - on Friday, September 11, 2009, the FASB EITF would be addressing the issue of whether REIT (and closed-end fund) dividends that were 90% in stock and 10% in cash under temporary IRS relief given at the end of 2008 should be treated as stock dividends with retroactive "restatement", or handled prospectively as discrete share issuances, for per share table purposes.
3. FASB Accounting Standards Update No. 2009-06—*Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities* - the Expert Panel members discussed the final update to FIN 48 providing additional guidance, and eliminating the deferral, on application to pass-through entities.
4. FAS 165 – Registration statements - The Expert Panel members discussed the incorporation by reference of financial statements into a registration statement and whether there would be a need to update the FAS 165 subsequent events disclosure (in particular, the date through which subsequent events had been considered). [Update - in November, 2009, FASB put on its agenda a project to clarify the application of this provision to registration statement updates.] Panel members also discussed the practical application of the requirement to disclose the date of subsequent events consideration to investment companies, with most noting that the date typically is the date financial statements are cleared to print, and often coordinated with both the auditors' opinion date and the date of management's certification meeting.
5. The Expert Panel also discussed the SEC staff's comments about a potential project on changes to Regulation S-X and its request to the Expert Panel to provide items to consider in amending the regulation. No comments had been collected to date. It was noted that the Commission was unlikely to move quickly on this project given other obvious Division of Investment Management priorities at this time, such as money market fund proposal and custody rule amendments.

III. SEC Update

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

1. SEC representatives noted that proposed amendment to Rule 206(4)-2 under the Investment Advisers Act of 1940 and related forms and rules (custody rule) had resulted in over 1,300 comment letters.

2. The comment period for the SEC's money market fund proposals closed on September 8, 2009. The SEC is in the process of completing its posting of comments received onto the SEC website.
3. The staff also discussed the expected SEC project on changes to Regulation S-X, which has been an ongoing project for a number of years. The SEC staff is actively seeking suggestions from the Panel members on potential modifications to Regulation S-X.
4. Financial Statement Comments
 - a. SFAS 165 Subsequent Events – SFAS 165 requires funds to disclose the date through which subsequent events have been evaluated, which generally is the date in which the financial statements are issued. The SEC staff (EITF Topic D-86) has defined issue date as the earlier of A) when the financial statements are widely distributed to shareholders, or B) when financial statements are filed with the SEC. The financial statement issue date for mutual funds and closed-end funds will generally be the date on which the financial statements are transmitted to shareholders. However, it may take a few days for the financial statements of these funds to be printed and subsequently mailed. The SEC staff received a question as to whether these funds can disclose the same date as the audit opinion date to satisfy the SFAS 165 disclosure requirements. The SEC staff indicated that it would be acceptable for the opinion date and the date through which subsequent events have been evaluated to be the same, provided that printing and mailing begin shortly thereafter. The SEC staff also indicated that if a significant event occurs between the opinion date and the mailing date, funds must take appropriate action.
 - b. Fulcrum Fees - The SEC staff has noted some advisers are switching to the use of fulcrum fees as compensation for their advisory services provided to mutual funds. *Fulcrum fees* are performance based fees in which advisers to mutual funds are compensated depending on how well their managed fund performed relative to a particular benchmark. The fulcrum fee is made up of two components—the base fee (also referenced as the “fulcrum fee” in rule 205-2(c) of the Investment Advisers Act of 1940, “Definition of ‘specified period’ Over Which the Asset Value of the Company or Fund under Management is Averaged”), which represents the midpoint of the entire fulcrum fee, and the incentive adjustment. Generally, the adviser is paid the base fee if the fund’s performance matches the performance of the benchmark. If the fund outperforms its benchmark, the adviser receives an incentive payment in addition to the base fee. Conversely, if the fund underperforms its benchmark, the adviser is penalized and the base fee is reduced by a negative incentive adjustment. When calculating payments to advisers under a fulcrum fee arrangement, the incentive portion of the fee is required to be calculated using the average net assets over the rolling performance measurement period. However, when calculating the base portion of the fulcrum fee, funds have

the option to either apply the base rate to average net assets over the rolling performance measurement period or apply the base rate to current level average net assets (or as rule 205-2(c)(2) states, “asset value averaged over the most recent subperiod,” - which represents the period between payments). Whichever option is approved by the fund’s board, it must be applied consistently. In recent months, some funds switching to a fulcrum fee arrangement are opting to rely on rule 205-2(c). Fulcrum fee arrangements pursuant to rule 205-2(c) may result in the adviser reimbursing the fund. This situation can occur when there is a significant decline in assets coupled with poor performance because the negative performance adjustment, when translated from a percentage to dollars, exceeds the base fee. In this scenario, the base portion of the fee is calculated on current level net assets that are much lower than average net assets over the rolling performance measurement period. When funds rely on rule 205-2(c)(2) to calculate the base portion of the fulcrum fee, the SEC staff is reviewing the disclosure describing the terms of the advisory fee agreement and looking for specific disclosure stating that the adviser will reimburse the fund when the negative incentive adjustment exceeds the base fee.

In addition, the SEC staff has observed instances when advisers have attempted to limit the incentive adjustment to a multiple of the base fee (for example, the incentive adjustment cannot exceed two times the base fee). The SEC staff has objected to these adjustments because it results in the incentive adjustment being tied to current level net assets rather than the average net assets over the rolling measurement period. Also, the SEC staff has objected to other fulcrum fee arrangements when the maximum negative incentive adjustment was less than the maximum positive incentive adjustment.

- c. Expense Recapture - The SEC staff discussed changes in fee caps and the potential impact on those funds with expense recaptures and their financial statement disclosures. The staff noted an instance where a fund had established a cap of approximately 60 basis points, and then changed the cap to 120 basis points, resulting in immediate recapture of all previous deferred expenses. The staff noted their view that, if a fund raises the expense cap during a fiscal year, it cannot recapture expenses unless the expense ratio falls below the cap under which the expenses were originally deferred (in this example, the original 60 basis point cap).
- d. Accounting Survivor Determination - The SEC staff provided an example in which the SEC staff disagreed with management’s accounting survivor determination. The example involved two affiliated funds, Fund A and Fund B. Fund A was originally deemed the target fund and it had operating history in excess of 10 years. Fund B was originally deemed the acquiring fund and its operating history was less than one year and its net assets were significantly less than Fund A’s. In addition, Fund B’s performance was better than Fund A’s and Fund B had an external sub-advisor (while the primary advisor was the same). The SEC staff did not believe allowing Fund A to drop 10 years of performance was appropriate.

- e. The Expert Panel discussed with the SEC the impact of FAS 141(R) (see above discussion) and that the Investment Company Expert Panel may develop a technical practice aid to address its implementation.

IV. Audit and Attest Issues

1. Auditor Responsibility in a Feeder Fund audit -The Expert Panel discussed the auditor responsibility with respect to the following scenario. The facts involve a situation where a Feeder fund invests 100% of its assets in a Master Fund but does not attach the financial statements of the Master Fund to the Feeder Fund financial statements. Rather, the Feeder Fund's notes to the financial statements include condensed Master Fund financial information. The Feeder Fund auditor is not the same as the Master Fund auditor. The Expert Panel discussed the possible impact of the condensed information being summarized in the footnotes. Some Expert Panel members thought this may present a scope limitation, while other members thought that this might be similar to a fund of funds, which would not have an impact on the auditor's report as long as there were adequate disclosures on the top tier fund.
2. The Expert Panel discussed current investor needs for auditor attestation reports on controls for hedge funds and hedge fund advisors to provide some level of assurance as to existence and valuation outside the annual audit report (particularly when investors do not have the same year-end as the fund). Because investors only have a direct relationship with the fund, not the advisor, it was not clear that a hedge fund advisor's SAS 70 report on an advisor's controls could be provided to hedge fund investors; further, a SAS 70 report is intended for use by auditors, not as a general purpose report. (It was also noted that similar concerns may arise from the proposed requirement in the SEC custody proposal to indicate to the public on Form ADV whether SAS 70-type reports issued when an entity or an affiliate holds direct custody are unqualified.) There was discussion as to whether a general AT 101 attestation report would be more suitable.

AICPA Investment Companies Expert Panel December 15, 2009 Meeting Highlights

I. Administrative items/AICPA matters:

1. The Expert Panel discussed the 2010 meetings schedule.
2. AICPA staff discussed the issuance of the following Technical Practice Aids (TPAs):
 - a. TIS 6910.33 “Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination”
 - b. TIS 2220.18-.27 (AICPA NAV task force developed TPAs to assist reporting entities in estimating fair value of their investments in certain entities that calculate net asset value)
3. AICPA publications update:
 - a. The AICPA staff discussed the issuance of the 2009/2010 Audit Risk Alert.
 - b. The AICPA staff informed the Expert Panel that they will seek volunteers to review the proposed conforming changes to the 2010 AICPA Accounting and Auditing Guide *Investment Companies* [the Guide].
4. The Expert Panel members discussed their views on the potential changes to the process of drafting notes from conference calls and meeting highlights and their availability on the AICPA website.

II. Accounting/Reporting Issues

1. The Expert Panel members discussed the Proposed Accounting Standards Update (ASU) *Amendments to Statement 167 for Certain Investment Funds* issued on December 4, 2009, and whether the comment letter from AcSEC and the Investment Companies Expert Panel may be needed (the comment period ends January 6, 2010.) The proposed ASU would defer requirements of FASB Statement No. 167 for investment manager’s interest in certain funds until the joint FASB/IASB consolidations project is completed. These funds include, but not limited to, mutual funds, hedge funds, private equity funds, mortgage real estate investment funds, and venture capital funds as long as these entities have all attributes of investment company attributes as specified in FASB *Accounting Standards Codification*TM (ASC) 946-10-15-2 or for which it is industry practice to follow ASC Topic 946 (investment company accounting) for financial reporting purposes, and the investment manager does not have an obligation to fund losses of the entity that could potentially be significant to the entity (the proposal indicates that the latter condition should be evaluated considering any implicit or explicit guarantees by the reporting entity (the

investment manager)). The proposed deferral would also apply to money market mutual funds that are required to comply with or operate within requirements of Rule 2a-7 of the Investment Company Act of 1940. The proposed deferral will not apply to securitization entities, asset-backed financing entities, or those entities formerly classified as special purpose entities (SPEs).

Also, the proposed ASU would clarify guidance in paragraph B22 of Statement 167 that related parties need to be considered in determining whether the decision maker or service provider fee represents a variable interest. The proposal also indicates that for the purposes of such determination, a quantitative analysis whether a decision maker or service provider that holds another interest in the VIE that may be more than insignificant should not be the sole determinant.

The full text of this proposed ASU is available at

<http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819935183&blobheader=application%2Fpdf>

The Expert Panel discussed that although the proposed ASU exempts money market funds from FAS 167, even with credit support agreements, it does not exempt them from a FIN 46R analysis.

A question arose whether under proposed ASU a general partner of a limited partnership (hedge fund, venture capital fund, or a private equity fund,) who by nature, in theory, has an obligation to fund unlimited losses of the entity (fund), would **not** qualify for a deferral based on the proposed requirement that a deferral would apply if, among other things, “the reporting entity does not have an obligation to fund losses of the entity that could potentially be significant to the entity. This condition should be evaluated considering any implicit or explicit guarantees provided by the reporting entity and its related parties, if any.” The panel members expressed a view that FASB may have intended to defer FAS 167 for these funds; however, the final ASU would be required to fully analyze this. It was noted that Limited liability companies may be different since the losses are limited, although it may still be determined to be significant to the fund as defined in the rule.

2. The Expert Panel discussed whether firms have been applying the guidance of TIS Section 6910.29 *Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations* on interim basis. The Expert Panel members observed that firms were applying the guidance in TIS 6910.29 on an interim basis, including the accrual of incentive fees in the financial highlights and semi-annual financial statements.
3. The Expert Panel discussed Accounting Standards Update No. 2009-12 *Fair Value Measurements and Disclosures (Topic 820) -- Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)* with respect to the valuation of investments in investee funds by fund-of-funds and the reporting of the investees in the financial statements of the fund-of-funds. The panel members shared their views on a fund of fund using NAV for fair value measurement where NAV is

prepared on a basis other than US GAAP, such as IFRS or foreign GAAP, in light of guidance from ASU 2009-12 that permits, as a practical expedient, use of NAV for estimating fair value for investments in certain entities that calculate NAV. The panel members noted that the answer would depend on facts and circumstances, including whether the fund is redeeming at non-US GAAP NAV and whether that non-US GAAP NAV is determinative of fair value. When the entity concludes that the practical expedient may not be used (when NAV is not representing a fair value) or makes an election not to use it, general measurement principles of FASB ASC 820 would apply and foreign GAAP NAV may be still be one of the inputs for fair value measurement.

4. The Expert Panel discussed the potential project by the SEC on changes to Regulation S-X and its request to the Expert Panel to provide items to consider in amending the regulation. No comments had been collected to date. The panel considered forming a small subgroup to work on the list of inconsistencies between GAAP and S-X and also focus on convergence with IFRS and how it may be addressed in S-X.
5. The Expert Panel discussed a situation recently identified where a non-registered investment company consolidates another investment company in which a non-controlling interest remains. This raises several questions:

- a) Where should the non-controlling interest be presented on the balance sheet - part of equity, liability, or "mezzanine"?

The Expert Panel expressed a view that the non-controlling interest would be included in equity and disclosed as a separate class of shares. A member noted that the interest needs to be presented as a separate section in the equity section and the fund should disclose what it is (that is, minority interest). A member noted that if it was a non-controlling interest, the fund should not get to different answer. The practitioners should consider guidance from FAS 160 (ASC Topic 810.)

- b) How should net investment income and expense ratios be presented - a) for the entire fund including non-controlling interest; b) for the net assets exclusive of non-controlling interest; or c) both? (Answering this question implicitly answers another - whether the net assets attributable to the non-controlling interest should be included in or excluded from the computation of average net assets.)

The Expert Panel expressed a view to treat the interest as a separate class with separate allocations of income, expenses, and fees. In addition, the financial highlights should be determined separately since the entity would be reporting different classes. Presenting the non-controlling interest as a separate reported class in the financial highlights would not be required and in some cases would be misleading.

6. The Expert Panel discussed that it is clear that the scope of EITF 99-20 includes investment companies *for purposes of income recognition*. (Paragraph 8 of EITF 99-20 says, "The Task Force decided to include within the scope of this issue, for income recognition purposes, beneficial interests classified as trading because it is practice for certain industries (such as... investment companies) to report interest income as a separate item.... even though the instruments are accounted for at fair value.") The question has been raised as to whether this wording is intended to *exclude* investment companies from the remainder of EITF 99-20's guidance regarding recognition of other-than-temporary impairment or other reductions of the cost basis of investments.

An Expert Panel member noted that some firms are using a "modified cost recovery method", for example if the yield is 3% and the coupon is 7%. Others noted that some have seen the guidance applied to high-yield funds and these funds have taken impairment. An Expert Panel member noted that they are not aware of any literature that prevents a firm from taking impairment in an investment fund. A member noted that if a firm applies EITF 99-20, then it seems like you should apply in total instead of in part. A member noted that these issues have been seen mostly in interest only and principal only securities.

7. The Expert Panel discussed that there are situations where a company ("fund") invests in royalty streams on technology in development. Two approaches are under consideration:

- a) the fund pays cash to the holders of the technology. The holders of the technology would use the cash to perform development activities.

- b) the fund makes its investment in the form of agreeing to provide the development activities ('in-kind'). The fund has no employees to provide the services directly, so it will pay for a third-party contract organization to perform this work.

In either case, the fund will receive the same milestone payments and/or rights to a portion of future royalty cash flows.

The fund believes that it otherwise meets the criteria for investment company accounting under the Audit Guide.

The panel members expressed a view that these two situations are not equivalent - in the first situation, a reasonable argument can be made for investment company accounting, as the fund is not involved in hiring a 3rd contract organization, whereas in the second case, the fact that the fund is the primary obligor to provide in-kind services may preclude the fund from investment company accounting (as the fund is providing services relating to the investee's basic operations.) The panel members also noted that several specific facts that may affect that decision for the second case, including:

- Who selects the contract organization?
- Who supervises the contract organization?

- To whom does that organization report?

III. SEC Update

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

1. SEC Custody Rules under Advisers Act Section 206:

The SEC staff informed the Expert Panel that the Commission plans to consider whether to adopt amendments to the investment adviser custody rule (rule 206(4)-2) under the Investment Advisers Act of 1940) and related forms and rules at the next open meeting scheduled on December 16, 2009. The amendments would enhance the protections provided advisory clients when they entrust their funds and securities to an investment adviser.

The Expert Panel will hold a conference call on January 12, 2010 with the SEC Division of Investment Management staff to discuss the final SEC rule “Custody of Funds or Securities of Clients by Investment Advisers” and consider posting notes from that call on the AICPA website.

2. Income tax transactions for hedge funds -- The SEC staff discussed Accounting Standards Update 2009-06 Income Taxes (Topic 740) *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*.

ASU No. 2009-06 states that if income taxes paid by the entity are attributable to the owners, the transaction should be recorded as a transaction with owners (i.e., a redemption rather than income tax expense). The Expert Panel discussed that this may be a change in practice for hedge funds that previously recorded certain income taxes as an expense (contra income item).

Certain EP members expressed a view that registered investment companies can pay tax on realized gains and pass through tax credits to shareholders on Form 1099. Under Regulation S-X, payment of capital gain tax reduces realized gain reported in the statement of operations, therefore, treating such income taxes as an expense:

...7(e) State separately and (1) Federal income taxes and (2) other income taxes applicable to realized and unrealized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes. [Instructions to Statement of Operations for registered investment companies, Reg. § 210.6-07]

The Expert Panel inquired of the SEC staff (1) whether income tax needs to be included in the total return calculation with regards to registered investment companies and (2) whether there are two different approaches for reporting of this tax - one for non-registered funds (such as hedge funds) and one for registered investment companies.

The SEC staff described that there may be an inconsistency in the application of ASU 2009-6 for non-registered funds and Regulation S-X for registered investment companies as the guidance in ASU 2009-6 is to show the income tax as a reduction of capital, however registered funds are still required to follow the requirements of Regulation S-X and show these taxes as an expense.

3. The SEC staff informed the Expert Panel that the Commission is assessing the comments received on the money market proposal and expect the money market rule to be released in the near future.

The SEC staff reminded the Expert Panel that the Commission adopted *Disclosure of Certain Money Market Fund Portfolio Holdings*, an interim final temporary rule under the Investment Company Act of 1940, to require a money market fund to report its portfolio holdings and valuation information to the Commission under certain circumstances. (See <http://www.sec.gov/rules/final/2009/ic-28903.pdf>)

The SEC staff indicated that the trigger for the reporting requirement was a shadow price net asset value of a money market fund of less than .9975. The SEC staff has been evaluating money market funds to determine if more funds should have been filing their portfolios holdings and valuation information with the SEC, and have asked certain funds to provide this information to the SEC if they suspected the funds should have been filing.

4. Financial Statement Disclosures

- a. Derivative Disclosures (FAS 161 / ASC 815) - Derivative volume disclosures in mutual funds' financial statements are generally using gross notional/contract values at period end, as suggested by the Investment Company Institute white paper, and in instances where an advisor determines that period end notional values may not be indicative of volume over the reporting period, industry practice seems to be leaning towards weighted average notional values over the period, a range of notional values or some hybrid thereof. The SEC staff indicated that they have not objected to these disclosures. Registrants should use their judgment when preparing these disclosures and consider reaching out to the SEC staff for further guidance, as needed.
- b. Fair Value Measurements and Disclosures (FAS 157-4 / ASC 820) – The SEC staff previously indicated that registrants should use judgment for preparation of the disclosure of categories of investment securities by major security type and that the goal is meaningful information for shareholders. The SEC staff has seen

a variety of ways to present these disclosures and the SEC staff has not objected to the presentations it has reviewed.

- c. ASU 2009-12 – The SEC staff informed the Expert Panel that they have been asked if the guidance in ASU 2009-12, which permits the use of net asset value (or its equivalent) as a practical expedient, conflicts with Section 2(a)(41) of the Investment Company Act of 1940. The SEC staff's view is that the use of the practical expedient does not conflict with the Section 2(a)(41) of the Investment Company Act of 1940 as long as all criteria identified in ASU 2009-12 are met.
5. The SEC staff indicated that they did not have any financial statement review comments to report to the Expert Panel.

In response to a question from one of the members of the Expert Panel, the SEC responded that no sweep examinations have been circulated recently.

The SEC staff informed the Expert Panel that during recent exams of registered investment advisors by the Commission related to hedge funds, auditors have been criticized for not performing enough procedures related to affiliated transactions.

6. The SEC staff discussed a potential project for updates to Regulation S-X. The goal of the SEC's Division of Investment Management is to make Regulation S-X more meaningful for shareholders since it has not been updated since the 1980s. The SEC staff discussed some examples of potential revisions to Regulation S-X:
 - There are several conflicts between Regulation S-X and U.S. GAAP, as well as certain duplicative areas between Regulation S-X and U.S. GAAP;
 - Distributions to shareholders in the statement of changes in net assets;
 - Consolidation rules for investment companies;
 - Disclosure requirements of Regulation S-X may be revised since some rules are outdated and some S-X disclosures may not be meaningful and are duplicative when compared to US GAAP. Some of these disclosures include: the rollforward of options, restricted securities, tax disclosures in semi-annual financial statements, etc.
 - Guidance on certain areas may be codified, such as performance fees and credit enhancements.

In performing its analysis of differences between Regulation S-X and GAAP, the SEC staff has not been concentrating on addressing differences with IFRS, but may consider doing so in the future.

SEC staff informed the Expert Panel that they would be open to any suggestions that the industry may have.

7. IFRS Roadmap – concept release comment period closed in April 2009. IFRS is still a priority for the Commission driven by the Division of Corporation Finance and the

- Office of the Chief Accountant. The investment companies were excluded from the original roadmap.
8. The SEC staff identified Commission valuation guidance under the Investment Company Act of 1940 (“valuation white paper”) as one of the initiatives the Commission is still working on but could not provide a time frame at this time.
 9. For information pertaining to the SEC Division of Investment Management’ rule-making initiatives, including 12b-1 reform and the “pay to play” rule, the Staff referred the expert panel members to Buddy Donahue’s and other staff speeches available on www.sec.gov.

IV. Audit and Attest Issues

1. Summary Shareholder Reports

A representative from the Investment Company Institute (ICI) informed the Expert Panel that the ICI is considering recommending to the SEC that funds be permitted to provide shareholders with “summary shareholder reports” in lieu of the traditional shareholder report. Similar to the summary prospectus, the summary shareholder report would contain key information and would be provided to shareholders in hard copy through the mail (or electronically with prior consent). Additional information would be available on-line or provided to the shareholder upon request.

The ICI anticipates that none of the disclosures currently required to be included in the shareholder report would be modified. Further, no new disclosures would be added and no existing disclosures would be removed. Instead, certain key information currently provided to shareholders would continue to be provided through the summary shareholder report, while other information would be available on-line or upon request.

Option A:

The ICI representative asked the members of the Expert Panel to assume the summary shareholder report contained only information outside the financial statements, such as:

1. President’s Letter
2. Expense example
3. Graphic Presentation of portfolio
4. Management’s Discussion of Fund Performance (MDFP)
 - a. Portfolio Manager’s (PM) commentary
 - b. Graph/index comparison
 - c. Total return info

The ICI representative asked if the auditors anticipate any auditing standards/consent-related issues that would prohibit this approach. The Expert Panel members did not

identify any auditing standards or consent related issues that would prohibit such approach, as long as there were no references to the audit firm and no incorporation by reference of the financial statements since there are no requirements to consent to the use of any of the other information in the shareholder reports outside of the financial statements.

Option B:

The ICI representative asked the members of the Expert Panel to assume the summary shareholder report includes the information above in Option A and additional information from the financial statements, such as:

1. Full portfolio schedule or summary schedule (Top 50/1%)
2. Financial highlights

The panel members generally expressed reservations about including schedule of investments and financial highlights in the summary shareholder report, regardless of its identification as “audited” or “unaudited” and noted auditing guidance on condensed financial statements and selected financial data in AU Section 552. The panel members will research and consider addressing this issue at future meetings.

2. Management fees paid to advisor outside of fund

The Expert Panel discussed non-registered funds where the investment manager of the fund has a separate contract with the shareholders to receive payment of its management fees directly from the shareholders of the fund (that is, outside of the fund). This is common in collective trust funds and private equity funds. The Expert Panel discussed whether the management fees should be presented on the statement of operations of the funds. The Expert Panel members acknowledged that diversity in industry practice exists whether to disclose the management fees as a gross-up on the statement of operations, however, not presenting the management fees may be more prevalent. The Expert Panel discussed that the management fees paid should be disclosed in the notes to the financial statements. An Expert Panel member noted that some funds present the fees as a reduction of shares through redemption which is presented on the statement of changes in net assets.

AICPA Investment Companies Expert Panel April 28, 2010 meeting highlights

I. Administrative items/AICPA matters

1. The AICPA staff informed the panel members that notes from the January custody call are still being reviewed by the SEC staff. Highlights of the December 2009 Expert Panel (EP) meeting are available online on www.aicpa.org.
2. The panel members discussed dates for remaining 2010 meetings and conference calls.
3. The AICPA staff updated the panel members on the status of the review of the 2010 proposed conforming changes to the AICPA Accounting and Auditing Guide *Investment Companies*. The 2010 Guide will include a discussion of the SEC Custody Rule and, once finalized, an illustrative surprise exam report. At this time, the drafting subgroup is developing an illustrative internal control report under the amended Custody Rule, which would be prepared under AT 101 guidance.

II. Accounting/Reporting Issues

1. The panel members considered *guidance in FASB ASC 946-20-05-2* (paragraph 7.82 of the Investment Companies Guide) about the two reasons affiliates may make payments to a fund related to investment losses and whether there may be payments to a fund other than for those two reasons. Questions have arisen on whether there may be other reasons for such payments and whether this guidance applies to those payments.

7.82 As illustrated by FASB ASC 946-20-05-2, affiliates may make payments to a fund related to investment losses for one of the following two reasons:

a. Payments by affiliates. To reimburse the effect of a loss (realized or unrealized) on a portfolio investment, often caused by a situation outside the fund's, or its affiliates', direct control, such as an issuer default or a decline in fair value.

b. Investment restriction violations (investments not meeting investment guidelines). Occasionally, a fund adviser may purchase an investment for a fund that clearly violates the fund's investment restrictions (investment restrictions are described in the prospectus or statement of additional information for registered funds and in partnership agreements or offering memorandums for nonregistered funds). The investment held in violation of the fund's investment restrictions may appreciate or depreciate in value. In the case where the investment has depreciated in value and the fund has consequently incurred a loss, the fund adviser may make a payment to the fund in lieu of settlement of a potential claim resulting from the violation of the fund's investment restrictions. This payment, in effect, makes the fund whole relative to the loss that it has incurred. This type of transaction is in essence a payment to put the fund's shareholders in the position they would have been in had the violation not occurred.

The EP member suggested including other reasons for making payments to a fund, and discussion of factors for funds to consider on whether to recognize such amounts in the income statement or statement of changes in net assets. The panel members discussed including the 2009 Audit Risk Alert discussion of this issue in the 2010 Guide.

2. TALF loans – the panel members discussed using the FAS 159 fair value option (FVO) for the liability. The fair value of the liability could be different than the carrying value especially now that the TALF program has expired, and the interest rates have changed. As a fund moves towards the settlement of the liability, the fair value of the debt will move towards par, but if an underlying debt defaults, the debt could be "put" on a non-recourse basis in settlement, meaning that in rare cases the difference between par value and the settlement amount could potentially be material to the NAV of the fund. EP members expressed a view that the fund will have to elect the FVO for the liability in order to allow fair valuing the debt should the credit profile of the related asset decline, even though the likelihood of that event occurring may be remote.
3. 5% disclosure on Condensed Schedule of Investments in paragraph 7.21 of the Guide – there is a view that ASC 946-210-50-6, which codified guidance from the Guide (originally appearing in SOP 95-2, superseded by SOP 03-4), is inconsistent with the way the TPA TIS 6910.18 was written and how the industry has been applying the 5% disclosures relating to derivatives. All three examples given in the TPA where there were derivatives did not discuss whether the derivative is in a long or short exposure position - they all refer to the fair value of the derivatives (that is, whether they are in an asset or liability position.) The proponents of this view understand that this is the way the 5% positions should be considered as it relates to derivatives (whether they are in a gain/loss position, not by whether they are in a long/short position). The panel members acknowledged the inconsistency between the SOP (which is now codified in *FASB Accounting Standards Codification (ASC)*) and the TPA. The EP members' view is that the TPA guidance is the more appropriate way of treatment (that is, look at 5% positions from unrealized gains/loss perspective rather than from long/short exposures). The panel members discussed various options of dealing with this inconsistency and plan to follow up at a future EP meeting.
4. The panel members continued discussing Accounting Standards Update (ASU) 2010-06 *Fair Value Measurements and Disclosures (FASB Accounting Standards Codification (ASC) Topic 820): Improving Disclosures about Fair Value Measurements* and its application. During the EP's February 2010 conference call, members noted that this ASU is likely to have to be applied to 3/31 Form N-Qs for calendar-year funds. During the EP's March call, a panel member sought further clarification regarding application of ASU 2010-06 (subtopic 820-10) to funds with a September 30 year-end. Disclosures regarding Transfers In and Out of Levels 1 and 2 are effective for interim and annual reporting periods beginning after December 15, 2009. In this situation, funds with a 9/30 year-end did not include the disclosure in 10/1/2009-12/31/2009 N-Q as the reporting period began before December 15, 2009.

Using that same methodology, the disclosures required under this ASU would not be included in 3/31/2010 semi-annual reports. Also refer to the SEC Update section.

5. FASB/IASB Consolidations project –Expert Panel members will participate in the AcSEC comment letter task force on this project. The panel members observed that the consolidation project appeared to have incorporated the broad concepts of SOP 07-1, and would allow entities defined as investment companies not to consolidate.

The panel members also reflected on other FASB/IASB projects (fair value, financial instruments, and financial statement presentation) and noted that even though investment companies were not fully included in the IFRS roadmap, the industry is taking an active role in forming working groups on such topics so as to assure that FASB and IASB take into account the industry's needs in adopting generally applicable standards.

6. A panel member inquired what other panel members have seen in practice regarding clients wanting to consolidate Master and feeder funds. Panel members noted that some unregistered investment companies having only one feeder fund do consolidate the master fund for financial reporting purposes. The Members agreed that a consolidated presentation wasn't common but that nothing in GAAP currently suggests that feeder funds cannot consolidate master funds. EP members' views are that either consolidated or attached financial statements are allowed; the fundamental question is whether, in the end, the financial statements provide the most meaningful information to users.
7. A question arose about the proper *presentation of up-front payments received or paid under swap agreements in the FAS 161 tabular disclosure*. Some fund groups (both 1940 Act and non-1940 Act funds) will record up-front payments received or paid on the balance sheet under a separate caption, such as "Premiums received (paid) on swap contracts". They will then present separate captions on the balance sheet for "Unrealized appreciation (depreciation) on swap contracts". The schedule of investments for those swap contracts often presents only the unrealized appreciation (depreciation) on the contract and does not include in the value of the swap the up-front premium received or paid. The question that has been raised is whether, in those cases, only the "unrealized appreciation (depreciation)" should be reported as the balance sheet caption in the FAS 161 disclosure, or whether both captions should be reported.

It should be noted that some funds do not separate up-front premiums from unrealized appreciation/depreciation and as a result would include the entire value of the swap contract (in other words, the total of the two lines) as the balance sheet amount in their FAS 161 tables, so the presentation under one line or two captions can (and currently is likely to) lead to inconsistent tabular presentation.

It is possible that this may lead to broader questions about presentation in the schedule of investments, since the same swap could be presented at two different "values" depending on whether up-front premiums are reported as part of the value of the swap contract or only the unrealized appreciation (depreciation) is shown.

At the April meeting, the EP observed that they have rarely seen upfront payments separately disclosed, yet some have seen it in registered funds. Regardless of which way the fair values are being presented, the total value of the swap presented should be the fair value of the swap. Some firms have parenthetically disclosed the fee as the cost basis. Amounts will then fall under the FAS 161 disclosure requirements since they are not in a separate line item. In areas where the upfront fee is so large that it is almost the entire fair value, some EP member firms have disclosed the value as the “fair value” as opposed to “appreciation/depreciation” since they may not technically qualify to be a derivative with such a large portion of the upfront fee being paid.

8. The panel members discussed accounting treatment for “earn-outs” (contingent gains for a private equity (PE) fund - (recognizing at inception at fair value (FAS 160 approach) as opposed to recognizing when realized/realizable (FAS 5). One EP member expressed a view that buyers will fair value the earn-out, but sellers will not, which could result in a mismatch. EP member has seen fair valuing of earn-outs based on probability weighting in certain PE funds.

An EP member believes that whether a fund uses a FAS 160 or a FAS 5 approach is a general policy election, and once elected, that policy should be consistently followed.

9. The panel members discussed ILPA standards for private equity funds relating to auditing of capital accounts, and whether allocations/fees were calculated according to limited partnership agreements (LPAs). An EP member has seen increased requests for certification by CFOs as to whether the funds have complied with terms of the LPA, but nothing from ILPA member firms. Some audit firms have used “supplemental schedules” at the end of the audit report to cover partner capital accounts. There was also discussion on audit firms increasing unwillingness to issue capital letter "certifications" (opinions or attest reports) for individual investor accounts.
10. The accounting group of the Managed Funds Association (MFA – organization that focuses on nonregistered funds) recently has issued a White Paper on FAS 161.

III. Audit and Attest Issues

1. Custody Rule
 - i. The IC EP drafting subgroup is currently developing an illustrative internal control report and management assertion draft.
 - ii. The revised custody rule allows for sampling when doing the surprise examination. The panel members shared views on approaching the sampling exercise. For example, assume there are five accounts in all; would the auditor sample across all five accounts, or sample, say, three of the five accounts, but do a 100% count for the three sampled? The EP members acknowledged that the SEC is leaving the approach to the discretion of the auditor, so long as the approach is allowed by the attestation standards. Also refer to the SEC Update section.
2. Initially presented at the December 15, 2009 meeting, and further discussed at the April 2010 meeting, a representative from the Investment Company Institute (ICI)

informed the Expert Panel that the ICI is considering recommending to the SEC that funds be permitted to provide shareholders with “summary shareholder reports” in lieu of the traditional shareholder report. Similar to the summary prospectus, the summary shareholder report would contain key information and would be provided to shareholders in hard copy through the mail (or electronically with prior consent).

Additional information would be available online or provided to the shareholder upon request.

The ICI anticipates that none of the disclosures currently required to be included in the shareholder report would be modified. Further, no new disclosures would be added and no existing disclosures would be removed. Instead, certain key information currently provided to shareholders would continue to be provided through the summary shareholder report, while other information would be available online or upon request.

IV. SEC Update

Disclaimer

The following comments represent the views of the accounting staff of the Division of Investment Management and do not necessarily reflect the views of the Commission or other members on the Commission Staff.

- 1.** In response to the Expert Panel’s question on the use of International Auditing Standards (IAS) for financial statement audits used to satisfy the Audit Provision under the Custody Rule, the SEC’s Investment Management division staff responded that they discussed the question with the staff of the SEC’s Office of the Chief Accountant (OCA). The staff of OCA’s Professional Practice Group indicated that at this time, the SEC is not considering changing to accepting IAS in addition to the current requirement of US GAAS. EP members shared that they understand that some non-US auditors are not comfortable with performing their audits under US GAAS due to limited familiarity with the standards. The staff indicated they would consider reviewing a proposal showing a listing of differences and reconciliation between local GAAS and US GAAS.
- 2.** The panel members inquired of the SEC staff’s view regarding difference in sampling methodology between managed accounts and pooled investment vehicles (PIVs). The SEC staff stated that the definition of “client accounts” for PIVs refers to the pool itself; therefore sampling across investors in the pool may be appropriate. The PIV’s qualified custodian must send account statements to the investors of the fund under the surprise examination, so to match that, individual investors need to receive the confirmation requests from the audit firm under the surprise exam (See also FAQ VI.3 of the Staff Responses to Questions About the Custody Rule located on the SEC’s website). For managed accounts, sampling would be based on client accounts, and the auditor would confirm with a qualified custodian regarding client account(s) picked as a sample.

The SEC staff did not provide further guidance on sampling, noting that to be a matter of auditor professional judgment. However, the staff would not object to sub-sampling that is allowed under attestation standards.

3. The SEC staff mentioned that there has been a recent Enforcement investigation of an investment adviser which commingled client assets with the adviser's proprietary assets, which is a practice prohibited by paragraph (a)(1) of the Custody Rule. When sampling, the staff suggested generally covering all custodial relationships and sampling within those selected, especially in light of the recent Enforcement investigation.
4. Financial statements' review comments:
In a case where a registered investment company (RIC) invests into a nonregistered investment company, the SEC staff expressed a view that 25% ownership in the non-RIC is the threshold for a RIC to provide underlying fund's audited financial statements. The underlying fund's financial statements should be prepared in accordance with Regulation S-X, including a schedule of investments with the same level of detail as for the registered investment company itself (i.e., both presenting either a complete schedule of investments in the shareholder report, or a condensed schedule under S-X Rule 12-12C in the shareholder report together with a complete schedule in the registered company's Form N-CSR filing). The SEC staff informed the panel that there are no substantive updates at this time on the expected project to update the investment company-related provisions of Regulation S-X.
5. XBRL - the XBRL press release "Mutual Fund Risk/Return Summary Taxonomy Upgrade") is posted to the SEC website. It states that (a) the risk/return summary has been updated for the 2010 taxonomy; (b) the Commission's Previewer/Viewer has been updated to support the Risk/Return Summary taxonomy; and (c) the risk/return submission can be pre-validated to ensure compliance with EDGAR requirements.
6. The SEC staff provided their view on "period beginning" for N-Qs (refer to item II.4. above). The SEC staff would expect to see disclosures in 6/30 N-Q and 9/30 N-CSR in this example. The SEC staff's informal view is that an "interim period" commences at the beginning of any semi-annual period beginning after the effective date of the standard, and may even be the last interim period for the fiscal year (similar to FASB's clarification in FSP FAS 133-1 of the effective date of FAS 161). An EP member pointed out FSP FAS 133-1 clarified FAS 161's effective periods, but no specific guidance was issued for ASU 2010-06.

AICPA Investment Companies Expert Panel

October 6, 2010 Expert Panel Meeting Highlights

I. Administrative items/AICPA matters:

1. The Investment Companies Expert Panel (EP) members discussed the meetings and conference calls schedule for the remainder of 2010 and 2011 and other administrative matters.
2. AICPA Staff informed the EP members that the Planning Subcommittee of AICPA Financial Reporting Executive Committee (FinREC) has approved the amendments to the TIS 6910.18 "*Disclosure of an Investment in an Issuer When One or More Securities and/or One or More Derivative Contracts Are Held – Nonregistered Investment Partnerships*". AICPA staff expects the amended TPA to be released by the end of October 2010.
3. AICPA staff provided an update on the status of the Audit Risk Alert, including potential insertion into the Alert of a summary of the PCAOB's inspectors' observations related to audit risk areas affected by the economic crisis. AICPA Staff expects it to be published in December 2010.
4. EP members and the AICPA staff thanked Richard Grueter for serving as the Chairman for the past three years and welcomed Rob Fabio as the new Chairman.

II. Accounting/Reporting Issues

1. The EP members shared their thoughts about various FASB Convergence projects and their anticipated impact on the investment companies industry. In particular, the EP members discussed the Financial Statement Presentation Project (http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011110) and noted some of the challenges in preparing a cash flow statement under the direct method.

EP members also discussed the FASB/ IASB joint Accounting for Financial Instruments project (http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1175801889654). The discussion focused on expensing transaction costs for investment companies and that there may be some implications. The implications include potentially needing to revise investment management agreements, particularly, where there are expense caps. An EP member highlighted the potential impact for expensing transaction costs for funds with International Swaps and Derivatives Association (ISDA) agreement where the agreement has expense cap limitations. There also may be impacts on marketing and distribution as expense ratios are affected. The implications for fixed income funds would be more complex (as compared to equity funds) as the transaction costs associated with fixed income trades are more challenging to calculate as they are

generally not explicit. An EP member also highlighted some of the implications of the financial instruments exposure draft on the fair value of liabilities.

The AICPA staff and EP members communicated that FinREC's Financial Instruments comment letter included an investment company specialized industry paragraph.

EP members also discussed the FASB/ IASB joint Revenue Recognition project (http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011146) and the challenges for advisers to meet the requirements to recognize management and performance fees, particularly for hedge fund and private equity fund advisers.

The EP members discussed the FASB/ IASB joint Consolidation project and that the FASB reached a tentative decision that would provide for all investments to be carried at fair value (an exception for investment companies to not consolidate other companies). In connection with this project, the FASB has also tentatively decided to provide additional guidance/criteria regarding the definition of an investment company. EP members noted that the IASB reached a tentative decision that an investment company should be required to measure investments in entities that it controls at fair value.

The EP members also discussed the fair value measurement joint project. The proposed FASB Accounting Standards Update (ASU), "Fair Value Measurements and Disclosures (Topic 820) - *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*" removes the word "significant" in the disclosure requirement of transfers between level 1 and level 2.

III. Audit and Attest Issues

1. EP members discussed how under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) many private investment advisers will be required to register with the SEC by July 21, 2011. EP members specifically discussed how this may impact SEC independence requirements for audit firms that audit pooled investment vehicles for advisers that use the audit provision in the custody rule. A specific issue was raised on the timing and whether the audit firm needs to be SEC independent from 1/1/11 or from 7/21/11 when the audit provision is being used. EP members referred to the no-action relief letter issued in 2006 (<http://www.sec.gov/divisions/investment/noaction/2006/deloitte082806.htm>) and discussed the potential of a firm or the EP submitting a similar letter requesting relief to the SEC. This is a large issue due to the affiliate rules, particularly for private equity and venture capital funds if they are required to register and use the custody rule. The definition of venture capital funds has not yet been finalized by the SEC.
2. Custody Rule issues:

- a. The EP members discussed when an adviser is noncompliant with aspects of the Custody Rule and the impact on the security count report (refer to the SEC Update section).
 - b. The EP members held a discussion on what investment advisers have been doing to custody the privately offered securities with a qualified custodian.
3. The EP members shared that the AICPA recently released its clarity redraft of the External Confirmation standard and the PCAOB had issued a similar proposal. The EP members discussed current concerns about the confirmation process for investment companies and what concerns those standards might either address (or newly create). EP members also discussed the use of electronic confirmations, assessing reliability of the addressee, and the indemnifications and caveats that are included in many confirmations.
4. The EP members discussed the report the PCAOB issued on the inspector observations related to audit risk areas affected by the economic crisis. The EP members had a general discussion about the fair value section of the PCAOB report. An area of focus of the PCAOB's comments has been on how management and the auditors are obtaining understanding about valuation quotes from pricing services and brokers in addition to determining whether the leveling of investments (levels 1-3) for financial statement disclosure were in conformity with GAAP.

IV. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the staff of the Commission.

1. EP members discussed with the SEC Staff the registration of private investment advisers in light of the Dodd-Frank Act and the independence concerns with their auditors where they are using the audit provision for the Custody Rule. The issue in particular is related to timing and whether the audit firm would need to be SEC independent from 1/1/11 or from 7/21/11 (the registration requirement). The SEC Staff indicated they will raise the issue with the Commission's Office of the Chief Accountant.
2. Custody Rule
 - a. EP members discussed with the SEC Staff inquiries on the acceptance of International Standards on Auditing (ISA) equivalents of SAS 70 reports for foreign custodians to fulfill the internal control report requirement. The SEC Staff indicated that they have not considered the use of ISA with respect to the internal control report required by the Custody Rule. An EP member mentioned the SEC Release "Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment

AICPA Investment Companies Expert Panel November 2, 2010, Conference Call Meeting Highlights

I. Administrative items/AICPA matters:

1. The Investment Companies Expert Panel (EP) members discussed the meeting schedules for the remainder of 2010 and 2011 calendar years.
2. The AICPA staff informed the panel members that notes from April EP meeting will be available online shortly.
3. The AICPA staff provided an update on the Audit Risk Alert.

II. Accounting/Reporting Issues

1. The EP members shared their thoughts about various FASB Convergence projects and their anticipated impact on the investment companies industry. In particular, the Expert Panel members will form a subgroup to draft a comment letter on Consolidation: Policy and Procedures—Joint Project of the IASB and FASB (Investment Companies). The Exposure Draft is expected to be issued in 4Q of 2010. For more information, visit http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176157178020.
2. The EP members held a discussion on ASU 2010-06, which indicates that a reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item on the statement of assets and liabilities. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities, on the basis of the nature and risks of the assets and liabilities and their classification in the fair value hierarchy. For instance, level 3 assets and liabilities should have a greater level of disaggregation because of the higher level of uncertainty and subjectivity. The entity should also consider the level of disaggregated information required per other Topics in the Codification.
 - a. The EP members discussed the following scenarios and what may be considered in determining the appropriate disaggregation.
 1. For a long/short equity fund, in a case where the fund holds only Level 1 common stock securities, any disaggregation within the footnote may be viewed as repetitive with the schedule of investments. The EP members agreed that if all securities were Level 1, then it may be acceptable to consider ‘common stock’ as a class of asset and that further disaggregation would not be necessary in the footnote. An EP member mentioned that a notation in the footnotes pointing a reader to the schedule of investments for further details on industry and geographical concentration may be a best practice, as opposed to repeating detail already found in the schedule of investments. An EP member also stated that some investment companies use categorization of instrument types per their schedule of investments as a definition of class. The EP members agreed that further disaggregation may be needed if there was a mix between Level 1 and Level 2 securities, and that the factors that

cause the difference in leveling may be used in the determination of what constitutes a class.

2. For fixed income funds or securities, the EP members had generally not seen fixed income securities further disaggregated using the criteria in FASB Accounting Standards Codification (ASC) Topic 320 (such as, geographic concentration, economic characteristics, etc.).
 3. For private equity funds that may not have defined strategies, the EP members discussed what level may be considered in the disaggregation. An EP member indicated that the life stage of the underlying investment may be a relevant factor to consider, as well as industry or geographical classification of the investment. As these investments are generally Level 3, there would likely need to be some disaggregation below the security type. An EP member highlighted that FSP FAS 157-4 previously required disclosure beyond the balance sheet line item to a lower level, and that the factors listed in ASC Topic 320 should also be considered.
3. The EP members discussed the requirement in ASU 2010-06 for a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and 2 and to describe the reasons for the transfers. A question arose on how to determine “significance” per ASU 2010-06’s requirements. An EP Member indicated that it may be acceptable to utilize a percentage threshold of either investments or net assets as a starting point for determining significance under ASU 2010-06. An EP member noted that ASU 2010-06 indicates that significance may also be judged with respect to earnings.

The EP members discussed the utilization of a narrative approach rather than tabular disclosure of the significant transfers in and out of Level 1 and 2. The EP members agreed that a narrative approach or tabular disclosure may meet the spirit of the guidance, but recognized that a narrative approach may also be more cumbersome in certain cases.

4. The EP members shared their thoughts on valuation within the private equity community, noting that there is divergence in practice among valuation methods used by private equity firms. Companies should consider all relevant approaches when valuing the investment, and that specific facts and circumstances should drive each determination.

III. Audit and Attest Issues

1. The EP members discussed an information request that one of the firms received from numerous investment management clients related to completing a certification (as to the auditing standards being followed, and whether the firm is registered with the PCAOB). This certification was sent by an entity that is the custodian of the private funds’ investments. An EP member noted that the party requesting the information could research the PCAOB site

(http://pcaobus.org/Registration/Firms/Documents/Registered_Firms.pdf) to determine if the accounting firm was registered with the PCAOB.

2. The EP members continued discussing the SEC Custody Rule, noting that many SEC Registered Investment Advisers will need security counts performed during 2010 and that in instances of any material noncompliance, independent accountants are required to notify the SEC within one business day about the material noncompliance. The EP members noted that it is their understanding that the SEC anticipates receiving a number of notification letters for 2010.
3. As a result of EP discussions, the current illustrative independent accountant's report on the surprise examination is being edited to add "in all material respects". The EP subgroup' members also suggested updating the management assertion so the dates and periods appearing in the independent accountant's report and the management assertion are consistent. The updated report and assertion will be available at <http://www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTCOMPANIES/Pages/InvestmentCompanies.aspx>.
4. Under the Dodd-Frank Act, certain private investment advisers will be required to be registered with the SEC by July 21, 2011. The EP members discussed how the SEC auditor independence requirement for certain newly registered investment advisers may be impacted where the advisers are using the audit provision or undergoing a security count for a pooled investment vehicle to comply with the custody rule. This issue will be further discussed at the upcoming meetings.
5. The EP members continued to share observations about the confirmation process for investment companies in light of recently issued AICPA clarity redraft of the External Confirmation standard (http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/DownloadableDocuments/Clarified_SASs/Clarified_SAS_External_Confirmations.pdf) and the similar PCAOB proposal. An EP member inquired whether the accounting firms would benefit from the SEC expressing their position related to concerning caveats/disclaimers received in responses from prime brokers. This will be raised at the next EP meeting.

AICPA Investment Companies Expert Panel December 14, 2010 Meeting Highlights

I. Administrative items/AICPA matters:

1. Both October and November meeting and call highlights are available on the AICPA website at <http://www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTCOMPANIES/ICEPMEETINGS/Pages/INVMeetingMaterials.aspx>
2. AICPA staff communicated that the AICPA Audit Risk Alert “Investment Companies Industry Developments” has been published. The AICPA staff also discussed with the Expert Panel (EP) members the schedule for the 2011 update to the AICPA Investment Companies Audit and Accounting Guide *Investment Companies*.
3. The EP members and AICPA staff discussed the timing of the upcoming meetings and conference calls.
4. The EP members discussed a letter issued by the AICPA on December 9, 2010, to the Securities and Exchange Commission (SEC) with a request for no-action relief under the Investment Advisers Act of 1940 (Rule 206(4)-2) for accounting firms that audit pooled investment vehicles (PIVs) where the audit firm is not subject to PCAOB inspection. Subsequent to the EP meeting, on December 23, 2010, the SEC indicated that they are unable to provide such a relief if an investment adviser engaged an independent public accountant that was not subject to regular inspection by the PCAOB. To view the full letter, visit <http://www.sec.gov/divisions/investment/noaction/2010/aicpa122310.pdf>

II. Accounting/Reporting Issues

1. The EP members discussed a consultation the Securities Industry and Financial Markets Association (SIFMA) had with the staff from the Commission’s Office of the Chief Accountant and the Division of Investment Management’s Office of the Chief Accountant. The consultation was regarding FIN 48 (FASB ASC Topic 740) liabilities whether the purchase of FIN 48 insurance by funds (as compared to investment advisers with the adviser indemnifying the fund) would avail them of indemnification accounting whereby they would be able to record a receivable to offset the liabilities on the financial statements. The EP members will continue discussing with the SEC Division of Investment Management staff the appropriate accounting treatment.
2. The AICPA Staff updated the EP members on the IASB and FASB joint projects. The EP members have formed a subgroup to draft a comment letter on Consolidation: Policy and Procedures—Joint Project of the IASB and FASB (Investment Companies). As of November conference call, the Exposure Draft was expected to be issued in 4Q of 2010. EP members noted that the November 29, 2010, Progress

Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards, indicates that IASB and FASB agreed that consolidation of investment companies is no longer a priority for June 2011 and anticipate publication of an Exposure Draft in mid 2011 and completion of the joint project by the end of 2011. The EP members agreed to continue to monitor the status of this project.

3. The EP members continued discussing current FASB's activities, including Financial Instruments, Fair Value Measurements, and Transfers and Servicing proposed Accounting Standards Updates (ASUs). The proposed ASU on Transfers and Servicing may cause certain transactions that currently might be accounted for as a sale of securities with an agreement to repurchase securities (such as certain dollar roll transactions) to instead be accounted for as a secured borrowing transaction. The proposal would be effective for new transfers and existing transactions that are modified as of the beginning of the first interim or annual period after the final Accounting Standards Update is issued. The final update is expected to be issued during the first quarter of 2011. Comments on the proposal are due to the FASB by January 15, 2011. The EP members will continue to monitor this proposed ASU and acknowledged that this impacts registered and non-registered funds. The EP members also acknowledged the operational challenges for advisers and service providers that this ASU may cause.
4. The EP members discussed the FASB project on Balance Sheet offsetting. This project will provide guidance on the criteria that would determine when offsetting on the balance sheet is appropriate, with a focus on financial instruments. At the November 17, 2010, FASB meeting the Board decided to require an entity to offset a recognized financial asset and financial liability only if the entity has the unconditional right of offset and intends to settle net or intends to settle simultaneously. Simultaneous settlement refers to transactions that settle at the same moment. The Boards also decided that an entity cannot offset a recognized financial asset and financial liability if the entity has a conditional right of offset. EP members discussed how this treatment would differ from the current permissible method where master netting agreements may be considered. The exposure draft has not been released, but the EP members will monitor this project.
5. The EP members revisited the December 2008 Expert Panel meeting discussion that for feeder funds that only invested in a master fund, with no other direct investments, the full ASC 820 disclosures may not be necessary for the feeder fund as long as the master fund's financial statements were attached, and the feeder fund clearly refers to the master fund's financial statements. Per these meeting highlights, the SEC had additionally indicated that they would not object to this treatment in such circumstances. EP members discussed that with the issuance of ASU 2009-12, the basis of leveling for fund of funds has shifted towards liquidity rather than valuation inputs. EP members continue to believe that their views on this topic as documented in the December 2008 highlights are still appropriate.

III. Audit and Attest Issues

1. Under the Dodd-Frank Act, certain private investment advisers will be required to be registered with the SEC by July 21, 2011. At the November EP conference call, the EP members discussed how the SEC auditor independence requirement for certain newly registered investment advisers (RIAs) may be impacted where the RIAs are using the audit provision or undergoing a security count for a pooled investment vehicle to comply with the custody rule. The EP members agreed to assemble a sub-group to evaluate issuing a letter to the SEC requesting temporary no-action relief, similar to the no-action relief in August 28, 2006 which can be located at <http://www.sec.gov/divisions/investment/noaction/2006/deloitte082806.htm>
2. The EP members discussed how accounting firms are handling issuance of audit opinions for offshore pooled investment vehicles where the opinions are being used for purposes of the custody rule, but there is a simultaneous requirement by the offshore regulator for the opinion to be issued by the local audit firm, which may not be PCAOB registered and subjected to regular inspection. In some cases each regulator may also require each report to be distributed to investors (for example, Cayman Islands Monetary Authority (CIMA) and the SEC). The EP members specifically discussed that certain accounting firms may under those circumstances need to dual issue the audit opinion (one by the local unregistered firm and one by the US firm who is PCAOB registered and subjected to regular inspection). The EP members discussed approaches firms may consider, such as issuing two separate audit reports attached to two separate financial statements or issuing two separate audit reports that are both attached to one set of financial statements.
3. The EP members discussed issues related to audits of fund of funds. The EP members discussed the adequacy of audit work that can be done on the value of investments in hedge funds and other entities when the auditor does not have visibility into the investments/assets held. The EP members referred to the guidance provided in the AICPA Practice Aid *Alternative Investments - Audit Considerations*. The EP members additionally expressed a view that generally, the auditor of a fund of funds is not relying on the audited financial statements of the investee funds alone, to issue an opinion (as indicated in the funds of funds TPAs, valuation is the assertion of the fund of funds management and the auditor considers management's due diligence and other controls over valuation) so that the audit opinion would not refer to the auditors of the investee funds. (To refer to other auditors in the opinion would indicate that fund of funds management takes no responsibility for the valuation assertion, which is contrary to the general point of view not only of the TPAs but also ASU 2009-12.)

IV. SEC Update

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not constitute a statement of the views of the Commission or the staff of the Commission.

A) Custody Rule:

1. The EP and SEC discussed the application of Question VI.5 of the SEC's FAQs on the Custody Rule where under certain criteria financial statements prepared in accordance with accounting standards other than US GAAP may be accepted. They discussed the use of IFRS for a master feeder structure (with a US adviser, US feeder fund, offshore feeder fund, offshore master fund). If the US feeder fund is presented in accordance with US GAAP and the offshore feeder is presented in accordance with IFRS, the SEC indicated that for purposes of complying with the custody rule the basis of accounting for the master fund would generally be US GAAP; however, if the master fund was prepared on a another basis of accounting that was substantially similar to US GAAP and any material differences were reconciled to US GAAP, this other basis may be permitted.
2. The SEC staff discussed the application of the custody rule to situations where multiple, unrelated investment advisers jointly make an investment in a private company on behalf of funds they manage. These are often referred to as "Club Deals" and are common in private equity funds. In these situations the private investment is owned by a holding company (for example, a LLC structure) and one of the participating investment advisers may act in a role of control (for example, a managing member of the LLC). The SEC and EP members discussed that in these situations, the holding company is generally not audited as a stand-alone entity. An EP member inquired whether the holding company may be considered a client of the investment adviser in the controlling position and, therefore, need to consider the provisions of the custody rule. The SEC staff indicated that if the holding company was considered an advisory client, the adviser could comply with the custody rule by using the audit provision and satisfying the delivery to related person provision (i.e., deliver the holding company's audited financial statements to investors in the private equity fund(s)). The SEC staff encouraged the EP to remind their investment adviser clients to consult with their legal counsel.
3. The EP members discussed with the SEC staff situations where there is an investment adviser with a client account that was closed due to the death of the client and the procedures the independent accountants may perform on the closed account during the independent verification. An EP member proposed the accountant could examine the death benefit disbursement and death certificate to validate that it is in accordance with the annuity contract. The SEC staff stated that accountant's guidance requires independent accountants to include closed accounts within the scope of the surprise exam. The SEC indicated the suggested procedures do not seem like an unreasonable method of complying with the requirement.

4. The SEC staff discussed the applicability of the custody rule to a registered investment adviser that manages a commodity pool that invests in commodities and securities. An example is a commodity pool which invests in commodities and holds treasuries in its margin account (as treasuries are securities). The SEC staff indicated that such commodity pool would be an advisory client and that the adviser is subject to the custody rule with respect to the portion of assets in such commodity pool that are funds and securities. The SEC staff indicated if the commodity pool was audited and the audit meets the audit provision of the custody rule, the adviser would satisfy the custody rule with respect to the commodity pool. The SEC staff also reminded EP members that for an adviser to meet the audit provision in the year of liquidation, the commodity pool would need a liquidation audit, even if the CFTC does not require a liquidation audit.
5. The SEC staff reminded EP members that privately offered securities in a pooled investment vehicle that is not using the audit provision are required to be held with a qualified custodian. For a fund of funds which does not meet the audit provision, this may include the qualified custodians holding the original partnership and subscription agreements for investments in underlying funds.
6. The SEC staff and the EP members discussed 529 Plans advised by RIAs and that these plans may not meet the technical definition of pooled investment vehicles. The SEC indicated that in the absence of no-action relief being provided, it would not be appropriate to analogize to the audit provision since a 529 Plan does not meet the technical definition of a pooled investment vehicle.
7. The SEC staff and EP members discussed the application of Question XII.1 of the SEC's FAQs. Specifically, they discussed the application of the custody rules to an investment adviser whose related person acts as the trustee of a participant-directed defined contribution plan if such adviser is deemed to have custody of the plan because one of the plan's investment options is a pooled investment vehicle managed by the adviser. The EP members asked whether this adviser can satisfy the custody rule with respect to the plan by using the audit provision or whether the adviser would not be permitted to use the audit provision because the plan is not considered a pooled investment vehicle (as per Question X.1 of the FAQs). The SEC staff indicated that in this situation, all the plan assets are subjected to the custody rule as both the plan and the fund are clients of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan, since the plan is not a pooled investment vehicle.

8. The SEC staff and the EP members discussed situations where a pooled investment vehicle may need two audit opinions: one issued by a firm registered with, and subject to regular inspection by, the PCAOB and another issued by a local auditor to satisfy a local regulator requirement. The SEC staff said it would not object to including two audit opinions with one set of financial statements and did not object to advisers distributing a letter to their investors explaining why there are the two audit opinions.
9. The SEC staff communicated to the EP members that they continue to release custody rule FAQs. The SEC staff additionally communicated that there was a speech recently made by Chairman Schapiro part of which discussed eliminating regulatory overlap for broker-dealers that are also related custodians of a registered investment adviser. The text of the speech is located at <http://www.sec.gov/news/speech/2010/spch120610mls.htm>

B) Dodd-Frank Act (Wall Street Reform)

1. The EP members asked the SEC staff about the steps the SEC has taken currently and those planned for the future related to the Dodd-Frank Act (Wall Street Reform) that will impact the industry. <http://sec.gov/spotlight/dodd-frank/accomplishments.shtml> The SEC staff acknowledged that many more advisers will be required to become registered investment advisers as the private advisers' exemption is removed. The SEC encourages comments by January 24, 2011.
2. The SEC staff and the EP members discussed how independence rules will apply to newly registered advisers, particularly those advisers who will utilize audited financial statements of PIVs to comply with the Custody Rules. The SEC reminded the EP members that the independence rules in Article 2 of S-X require will need to be applied. The SEC and the EP members agreed to continue to discuss this matter.

C) The EP members inquired what steps and/or plans the SEC has in proposing new money market fund rules. The SEC staff referred the EP members to a release in which the SEC is seeking comment on recommendations contained in the President Working Group Report on Money Market Reform (<http://www.sec.gov/rules/other/2010/ic-29497.pdf>). Those recommendations include, among other things:

- a floating NAV, rather than the stable \$1.00 NAV prevalent today;
- mandatory redemptions-in-kind for large redemptions (such as by institutional investors);
- “real time” disclosure of shadow NAV;

- a private liquidity facility to provide liquidity to money market funds in times of stress; and
- a possible “two-tiered” system of money market funds, with a stable NAV only for money market funds subject to greater risk-limiting conditions and possible liquidity facility requirements?

D) Accounting matters

1. The SEC discussed with the EP members the potential IFRS transition for registered funds. The SEC issued an update of the Work Plan which gave a status of six key areas related to the SEC’s progress on IFRS adoption. The SEC also indicated that industry specific users and preparers may be contacted directly to provide their input.
2. The SEC staff communicated that they continue to monitor the FASB/IASB activities on Financial Instruments, Consolidations, and Fair Value Measurement. The EP members and SEC staff also discussed the exposure draft titled Transfers and Servicing – Repurchase Agreements and that there could be some issues for mortgage dollar rolls. Comment period for this exposure draft ends in January 2011. The EP members also discussed another FASB project related to balance sheet offsetting that may have an impact to investment companies. This exposure draft has not been issued yet, but the EP members discussed that it may be a larger issue for non-registered funds, particularly, as it relates to due to/from broker balances.

E) Other

1. The SEC staff shared financial statement comments from the SEC financial statement reviews. These included the following:
 - (a) The staff observed that certain BDCs are accruing incentive fees based on the amount by which net realized gains (i.e., realized gains less realized losses) exceed unrealized losses and are excluding unrealized gains in this calculation. The staff believes that this incentive fee accrual methodology is not in accordance with GAAP, and that BDCs should accrue incentive fees based on the amount by which net realized gains and unrealized gains exceed unrealized losses even though Section 205(b)(3) of the Investment Advisers Act prohibits advisers from receiving payment of fees based on unrealized gains. The SEC staff reminded the EP members of the guidance in TIS 6910.29.
 - (b) The SEC staff discussed some consolidation observations related to business development companies (BDCs). An example was cited where a BDC owns 100% of the economic interest in a SPV consisting of underlying investments or a pool of investments. Article 6 of S-X dictates consolidation requirements; however, this is an area that advisers should evaluate if consolidation would be more appropriate or

if there should be additional disclosure to provide transparency in the footnotes of the relationship between the BDC and SPV. The SEC also indicated in certain circumstances there could be a requirement to audit the SPV and attach the related financial statements. The SEC encourages advisers to consult with the Division of Investment Management if presented with similar facts and circumstances.

(c) The SEC staff reminded EP members of the requirements of recording gain contingencies and to monitor the facts and circumstances surrounding them.

2. EP members continued to share observations about the confirmation process for investment companies in light of recently issued AICPA clarity redraft of the External Confirmation standard (http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/DownloadableDocuments/Clarified_SASs/Clarified_SAS_External_Confirmations.pdf) and the similar PCAOB proposal. An EP member asked the SEC staff about its position related to concerning caveats/disclaimers received in responses from prime brokers. The SEC staff indicated it would discuss these observations internally.

AICPA Investment Companies Expert Panel Frequently Asked Questions Regarding the SEC's Revised Custody Rule¹ and Guidance for Accountants²

The following summary and frequently asked questions (FAQs) about the SEC's Revised Custody Rule were developed by the AICPA Investment Companies Expert Panel based on a review of the Custody Rule, the Adopting Release, the SEC staff FAQs posted on the SEC's website (see below), and discussions with the SEC staff. These notes do not necessarily reflect the views of the AICPA, the SEC, or the SEC staff. The expert panel is not authorized to make public statements on behalf of AICPA without clearance from AICPA Council or the Board of Directors on such matters.

The staff of the Division of Investment Management has prepared responses to questions about the rule 206(4)-2, the "custody rule" under the Investment Advisers Act of 1940. They can be viewed at http://sec.gov/divisions/investment/custody_faq_030510.htm. For official SEC responses to accounting and financial reporting questions for SEC-Registered Investment Advisers, please contact the SEC Office of Chief Accountant, Division of Investment Management, by calling (202) 551-6918 or E-mail: IMOCA@sec.gov.

The SEC staff issued a FAQ on March 5, 2010, which has been, and will be, amended from time to time, and can be found on the SEC's website at http://www.sec.gov/divisions/investment/custody_faq_030510.htm. Some of the questions discussed herein have been addressed by this FAQ.

Custody is defined in the rule and custody does not equate to serving as a qualified custodian (QC) which is also defined under the rule.

The rule provides, among other things, four basic customer protections when a registered investment adviser (RIA) has custody under the rule:

1. Requirement to maintain funds and securities with a qualified custodian in a separate account for each client under that client's name; or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients;
2. Requirement that clients are notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information;
3. Requirement that the investment adviser has a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which it maintains funds or securities, identifying the amount of

¹ See *Custody of Funds or Securities of Clients by Investment Advisers*; Rel. No. IA-2968.
<http://sec.gov/rules/final/2009/ia-2968.pdf>.

² See *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*; Rel. No. IA-2969.
<http://sec.gov/rules/final/2009/ia-2969.pdf>.

funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; and

4. Requirement for an independent verification (surprise exam) on an annual basis.

The rule also provides an enhanced protection when a RIA has self-custody³ or custody by a related person to comply with the 4 protections noted above, which includes: (1) the accountant engaged to perform a surprise examination must be registered with, and subject to regular inspection by, the PCAOB and (2) the adviser must obtain or receive from the related person an internal control (IC) report that addresses the safekeeping of client assets at the qualified custodian (QC). An accountant for this internal control report engagement must be registered with, and subject to regular inspection by, the PCAOB.

Qualified custodian internal control report requirement is result of an adviser serving as a qualified custodian or its related person serving as a qualified custodian.

Exceptions to the rule:

1. From surprise exam for those advisers:
 - a. that have custody of funds and securities solely because of their authority of being able to deduct advisory fees
 - b. that have custody of funds and securities solely because of a related person that is operationally independent, as defined by the rule, has custody
2. For adviser to the pooled investment vehicle (this exception is now called “audit provision”):
 - a. the adviser would be deemed to comply with the surprise examination and is not required to comply with the notice and account statements requirements as long as audited financial statements are prepared in accordance with US GAAP and distributed to the investors within 120 days, and for FOFs, distributed to the investors within 180 days;
 - b. the accountant performing the audit of a pooled investment vehicle must be registered with, and subject to regular inspection by, the PCAOB;
 - c. upon liquidation, the financial statements need to be distributed promptly upon completion of the audit
3. Privately offered securities – if a security meets the definition of a privately offered security under the rule, that security then is not required to be held by a QC; exception to this exception – if a pooled investment vehicle is not relying on the “audit provision,” to the extent it holds privately offered securities, those securities must be held by a QC.
4. Investment advisers to SEC registered investment companies are not required to comply with 206(4)-2 with regard to the accounts of a registered company

³ Under the rule an adviser is deemed to have self custody if it also serves as the qualified custodian for its clients.

that they manage, because registered companies are subject to the custody requirements of section 17(f) of the Investment Company Act.

5. Further, where the adviser invests client assets in shares of SEC registered open-end funds (that he/she does not manage), the adviser may use the fund's transfer agent in lieu of a qualified custodian.

Compliance dates:

- Effective date of the amendment is March 12, 2010, subject to certain exceptions:
 - First surprise exam – an investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the examination will take place by December 31, 2010;
 - For those advisers that became subject to the rule after the effective date, first surprise exam shall take place within 6 months of becoming subject to the rule;
 - RIAs that maintain client assets as a QC (self-custody situation when the IA is also a broker-dealer) – first surprise exam would have to take place no later than 6 months after obtaining an IC report;
 - IC report– an adviser must obtain or receive an IC report within 6 months after becoming subject to the rule (for advisers that were registered at the time when the rule became effective, by September 12, 2010).
- For audits of pooled investment vehicles – they can rely on “audit provision” as long as an adviser is contractually obligated to obtain an audit for fiscal years beginning on or after January 1 2010; an accountant must be registered with, and subject to regular inspection by, the PCAOB. As per Question I.5 of the FAQ, the obligation to obtain an audit may be evidenced in a partnership agreement, disclosure statement, or engagement letter with the auditor. See footnote 47 of the 2003 custody rule adopting release at http://sec.gov/rules/final/ia-2176.htm#P127_38487.

Questions and answers prepared by the AICPA Investment Companies Expert Panel:

1. In a number of cases, broker/dealers are dually registered as investment advisers.
 - a. In these instances, would the broker/dealer be a self-custodian rather than an "affiliated" custodian, and thus be required to have both a controls examination and a surprise examination? Or could the custody operations be considered "operationally independent" even though they are part of the same legal entity so long as they meet all the other conditions for independence (i.e., separate organization, personnel and facilities)?

This is a legal determination that should not be made by accountants but rather by an adviser in conjunction with its legal counsel. However, dual registrants ordinarily would be subject to both the surprise exam and internal control report, as (being the same entity) they could not be considered operationally independent.

- b. Page 3 of the adopting release states that the Commission intends to review "potential recommendations to enhance the oversight of broker-dealer custody of customer assets" and that "consideration of additional enhancements.....[will] follow." How will the broker-dealer rules be integrated with this rule to avoid multiple requirements to address the same concerns for dually registered entities? **As the question relates to future rule-making, it cannot be answered at this time.**
- c. If a broker-dealer (or FCM) is in scope, how will surprise examination procedures contemplate the entire stock record balance (e.g., firm inventory, including repos and stock borrow/loan positions), and how would samples be selected?
 - **IC report works with the surprise exam. The auditor should be able to place reliance on the procedures performed in the internal control report when performing the surprise exam (e.g., testing performed on the stock record). Some substantive procedures are already identified in the interpretive guidance, such as requirement to confirm with custodians to verify the existence of funds and securities at unaffiliated entities or unaffiliated custodians may be more appropriately addressed in performing the controls examination.**
 - **As far as the procedures concerning issuance of the IC report, auditors can leverage work performed in connection with other regulatory requirements (such as required regulatory reports on B/D custody) in the current financial statement audit.**

- **Confirmations are not specifically mandated as part of the rule requirement to verify that funds and securities are reconciled to a custodian other than the adviser or its related person. Pursuant to the Guidance for Accountants (see Release No. IA-2969), while direct confirmation with an unrelated custodian would be acceptable, accountants are permitted to perform other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered; for example, obtaining comfort with the completeness and authenticity of the custodian's data flow with DTC which the custodian uses to reconcile securities to DTC may be an appropriate procedure.**
 - **If a related party B/D QC has received an internal control report, an auditor would still need to reconcile the adviser's separate books and records to the B/D QC's books and records in a surprise examination but would not need to re-confirm positions with DTC or other third parties as part of that examination.**
 - **There is no prescriptive guidance regarding sample size selection; however, SAS 70 and attest literature for sampling will apply. Choosing the sample size is a matter of professional judgment.**
2. SAS 70/AT 601 reports - the adopting release and companion interpretation indicate a number of specific control objectives to be present in the internal control reports.
- a. Must each control objective be stated as specified or is there some discretion to tailor to the specific control environment of the qualified custodian? (For example, it is not clear that there is a need for a separate control objective for new/changed security recording if the reconciliation objective is an effective key control in identifying instances of improper security set-up.) **There is no specification as to which particular controls the qualified custodian may need to have, only the control objectives that the qualified custodian should meet. The qualified custodians have discretion how they meet those control objectives. The objectives need not literally be specified as stated in the guidance for accountants, so long as there was enough information in the internal control report that a user could see how the objectives were met.**
 - b. Does the use of the word "client" in the objectives relate to the adviser's client rather than the custodian's client (i.e., the adviser)?

The Guidance for Accountants specifies control objectives that need to be met in the qualified custodian's internal control report. Therefore, the objectives relate to the qualified custodian's clients, which include the adviser's clients.

Registrants or their auditors are encouraged to contact SEC staff on guidance pertaining to the specific facts and circumstances.

c. Transition issues:

1. Some current SAS 70 reports may cover certain objectives but not in the explicit manner of the interpretation (for example, reconciliation of cash and securities between the custodian and depositories "completely, accurately and on a timely basis"). Particularly for large custodians having SAS 70 examinations on a semi-annual or annual basis, it may not be practicable to revise reports within the time frame contemplated by the release to explicitly address the objectives as stated. What procedures should advisers undertake in a transition period until reports can be modified to cover the explicit objectives specified in the interpretation? **As per the response to Question I.9 of the staff FAQ, a qualified custodian that obtained a custody-related SAS 70 report in 2009 is not expected to alter its reporting cycle in 2010 to meet (or allow its related person investment adviser to meet) the initial September 12, 2010 compliance date. However, the control objectives for the 2010 SAS 70 should address the control objectives specified in the Guidance for Accountants and the auditor must verify that funds and securities are reconciled to a custodian other than the adviser or its related person (e.g., DTC).**
 2. If the expectation is for issuance of an annual internal control report before performance of a surprise examination, in 2010 it is likely that most surprise examinations will take place in the second half of the calendar year. Going forward, it is also possible that surprise examinations will be concentrated in periods shortly after the issuance of controls reports to eliminate the need for updated controls testing. **The rule requires the surprise examination to be conducted at a time that is irregular from year to year. If the surprise examinations are concentrated in a certain time period each year, the "surprise" element of the requirement would not be met.**
- d. We noted that control objectives are not listed related to IT (e.g., logical security, program change control, computer operations). We believe that these would be essential to performance of an examination under either SAS 70 or AT 601. **The Guidance for Accountants established general**

control objectives and IT controls were not specifically identified as it likely is already utilized in meeting the specified control objectives.

Additionally, a question arose about situations where IT SAS 70 reports are separated from custody SAS 70 reports (for example, for IT outsourcing or where there is a single SAS 70 examination of a centralized data center handling multiple functions within a large financial services organization). The adviser should obtain all relevant SAS 70 reports that meet the identified control objectives.

- e. How should situations be handled where the adviser has outsourced "middle-office" functions (trade reconciliation function – it is a group that works between portfolio manager and custodian) to a third party but an internal control report for affiliated custody is still required? Would the internal control report requirement apply also to the "middle-office" outsourcer? **The adviser should obtain all relevant internal control reports required for it to meet identified control objectives.**
- f. For purposes of Form ADV reporting, in Schedule D, question 6 in Section 9.C. asks whether the internal controls report contains an "unqualified" opinion (a "yes/no" question). There are two questions related to a SAS 70 report:
 - 1. SAS 70 reports are "auditor-to-auditor" communications for purposes of financial statement audits. Accordingly, a "qualified" opinion in the qualified custodian's internal control report may be overcome by compensating controls at the user organization (i.e., the adviser), such that the combined control environment is effective. How should such a situation be handled in ADV reporting? **The respondent should still state that the report was qualified.**
 - 2. We are assuming that "qualification" means that the overall report on controls in operation contains an "adverse" or "except for" opinion. SAS 70 reports routinely report testing exceptions (e.g., 3 of 90 items selected were not in compliance) but the overall report is otherwise unqualified. **For testing exceptions that do not result in the qualification of the overall internal control report, the response should be that the internal control report was unqualified.**
- g. Will the distribution of the SAS 70/AT 601 reports be limited to the custodian, adviser and the SEC, or would they also be distributable to investors? It is reasonable to believe that, since the reports will be explicitly referred to in Form ADV, some clients or potential clients may ask to obtain or review them. **The report must be maintained by the**

adviser as part of its books and records. Distribution of the report to others is up to the adviser, its auditor and the adviser's clients.

3. For some multinational organizations, not only the main qualified custodian but some foreign subcustodians are related persons of an adviser. If a SAS 70/AT 601 report is required for the main qualified custodian, would similar reports be required for all foreign affiliated subcustodians holding client assets? **The internal control report is required to address the control objectives relative to the main qualified custodian. However, the auditor must verify that funds and securities are reconciled to an unaffiliated custodian.**
4. The companion interpretation permits the use of a sample of client accounts in the surprise examination. What level of sampling would the Commission consider *inadequate* to meet the requirements of the examination? **Sampling methodology chosen should be consistent with auditing literature. See 1c) above.**
5. The Commission requires the filing of a Form ADV-E within one day of the identification of a "material discrepancy" together with an "accountant's certificate". Almost by definition, the examination will not be complete when such a discrepancy is identified. What is the form of "accountant's certificate" contemplated by the Commission in this situation? **No certificate is required upon finding a material discrepancy; the certificate is required at the completion of the examination. The requirement is to *notify* the SEC within one business day of the finding of a material discrepancy.**
6. In some cases, certain pooled investment vehicles ("feeder" or "access" funds) hold only one investment in a non-affiliated fund. What obligation does the "feeder" fund have under the custody rule? **If an adviser is deemed to have custody of a "feeder" fund, an adviser must comply with custody rule.** Does the non-affiliated fund have any obligations? **Although it is unlikely that the adviser would have custody of the non-affiliated fund, if the adviser has custody of the assets of the feeder fund (e.g., has authority to withdraw feeder fund's investment from the underlying fund), the adviser would be subject to the rule.**
7. Under the revised rule, an adviser can treat an SPV either as a separate client or include the SPV's assets with the pooled vehicle(s) of which it has custody indirectly. Compliance with the custody rule would occur if the SPV's financial statements were distributed to investors in accordance with the audit provision (in the first option), or if the assets were subject to scope of the pooled vehicle's financial statement audit or surprise examination (in the second option). Would this be required regardless of the materiality of the assets in the SPV? In some cases, an SPV may not be material to any pooled vehicle and under GAAP and GAAS would not warrant separate reporting or significant audit procedures. **The SPV's assets should be subject to a**

sampling methodology permitted by the auditing literature. The pooled investment vehicle's financial statements should conform to GAAP.

8. Regarding changes in accountants, at what point, if any, should an accountant file a statement on Form ADV-E if they have simply not been engaged in the current year to perform required procedures (that is, there has been no affirmative resignation, dismissal, or replacement by a new accountant - just no execution of a written agreement for the current year)? **The accountant should file a statement on Form ADV-E once it has been informed by the RIA that it has not been engaged to perform a surprise exam. The adviser is obligated to ensure the SEC is informed when there is a change in accountants and the accountant generally should not make its own inferences in the absence of any communications about whether it has been dismissed; however, accounting firms are encouraged to communicate with the adviser if they have not heard from the adviser within a reasonable length of time.**

Also, while the actual filing of Form ADV-E (the form on which accountant changes will be reported) is the accountant's responsibility, the RIA has to give the accountant authority to file that form since the adviser, not the accountant, is the registrant under whose name it is filed.

9. Would an adviser need an internal control report if "self-custody" is only attributed through pooled vehicles subject to annual audit? If it is only attributed based on the ability to deduct fees? **An internal control report is required only if a RIA or its related person serves as a QC when the use of a QC is required by the rule. Also see footnotes 65 and 130 in the adopting release for further information.**
10. If an audit of a pooled investment vehicle is not completed within the 120/180 day time frame due to unexpected issues (e.g., inability by a fund-of-funds auditor to obtain necessary confirmations within 180 days; unanticipated qualification/scope limitation on an opinion), and the adviser is thus not in compliance with the surprise examination requirement for the prior year,
 - a. Would the existing SEC Q&A "reasonable belief" standard continue to apply? **The "reasonable belief" standard was retained in Question VI.9 of the SEC staff FAQ. If repeated instances of noncompliance occur each year, SEC staff examiners may have questions whether a "reasonable belief" existed.**
 - b. If not, what, if any, remedies are available to the adviser for alternative compliance regarding the prior fiscal year? **No remedies are available, as there can be no "retroactive compliance" with the rule. If the RIA was planning to satisfy the audit provision and determined it cannot, the RIA cannot retroactively cure it - not only would it need to have had a surprise exam, it would have had to comply with the notice and**

quarterly account statements requirements; also, for a pooled investment vehicle that invests in privately offered securities and cannot meet audit provision, those privately offered securities must be held by a qualified custodian. An adviser clearly cannot go back in time to meet those requirements. The fact that there are no remedies available is no different than prior to the amendments.

11. The revised rule permits maintenance of securities balances at a qualified custodian EITHER "in a separate account for each client..." OR "in accounts that contain only your clients' funds or securities...". The latter alternative seems to imply the use of omnibus accounting at the custodian with detail recordkeeping by the adviser by individual client. In that situation, it would not be possible for anyone other than the adviser to send quarterly statements to each client, since the custodian would not have visibility to holdings or activity by individual client. Would this mean that the adviser would be a) considered to have a form of self-custody and b) thus required to have a controls examination over its omnibus procedures and a surprise examination? **Having omnibus accounts alone would not cause an adviser to obtain an IC report because the omnibus accounts would not cause the adviser to be a qualified custodian. However, this arrangement may cause problems with compliance with other aspects of the rule such as the requirement for the qualified custodian to send account statements directly to clients.**

12. Offshore funds issues:

- a. The final release states that audited financial statements are to be "in accordance with generally accepted accounting principles" (presumably US GAAP). If an offshore fund issues financial statements under something other than US GAAP, would the financials be required to include a reconciliation to US GAAP for them to qualify under the alternative compliance rule? In particular, would "unreconciled" IFRS financial statements be acceptable?

Can other forms of GAAP be used in fund financial statements as long as those financials have substantially the same disclosure and accounting provisions as US GAAP financials (specifically referring to IFRS financial statements)?

Question VI.5 of the SEC staff FAQ addresses this issue. Advisers of offshore funds which are subject to the custody rule and elect to use the audit provision to satisfy the custody rule may meet the audit provision if the offshore funds' financial statements are prepared in accordance with accounting standards other than US GAAP as long as (1) the offshore fund's financial statements contain information substantially similar to financial statements prepared in accordance with US GAAP; (2) a reconciliation of any material differences between US GAAP and the accounting standards used by the offshore fund is included in financial statements distributed to U.S. persons;

and (3) the audit of the offshore fund's financial statements is performed in accordance with US GAAS.

- b. Some offshore jurisdictions require that funds registered in that jurisdiction submit financial statements with the audit report of an auditor located in that jurisdiction. In the case of a firm with operations in the US and that offshore jurisdiction, the firm located in the offshore jurisdiction may not issue reports on any "issuers" or play a "substantial role" in the audit of an issuer and thus would not be subject to regular inspection by the PCAOB⁴, even though the US affiliate does issue reports on "issuers" and is subject to regular inspection by the PCAOB. Most of the audit procedures are performed by the US affiliate and the local auditor places reliance on that work in issuing its report. Would the report of the local auditor not meet the requirement for an accountant that is registered with, and subject to regular inspection by, the PCAOB in those circumstances?

To meet the audit provision, the auditor must be registered with, and subject to regular inspection by, the PCAOB and the report must be distributed to the investors; otherwise, the report of the local auditor would not satisfy the custody rule requirement.

- c. Do custody requirements apply to US RIAs who advise offshore funds which only contain foreign investors? **The staff clarified this point in the August 10, 2006 no-action letter to the American Bar Association.⁵ – If the US RIA is registered with the SEC but has its principal office and place of business outside of the US, and if the pool the adviser provides services to is organized and incorporated outside the US, it does not matter whether foreign or domestic investors are in the pool - the pool is not subject to the custody rule. However, if the adviser's principal office and place of business is on US territory, then the pool would be subject to the custody rule, even if all the investors are non-US.**

13. Real estate issues:

- a. When a real estate fund is managed by a registered adviser, and owns real property (e.g., a building) through LP, GP, managing member or member interests in partnerships,

The answers would depend on whether an adviser provides advice with respect to the securities or real property.

1. Are those interests in partnerships considered "securities" subject to the custody rule? **An indirect interest in real property (e.g.,**

⁴ The meaning of "subject to regular inspection" is set forth in PCAOB Rule 4003.

⁵ See <http://sec.gov/divisions/investment/noaction/aba081006.pdf>

a limited partnership that invests in real property) could be a security and therefore could have an impact on whether the custody rule applies. However, this is a legal determination that depends on facts and circumstances.

2. Are cash and other securities held within those partnerships subject to the custody rule? **If any securities are being held, then the real estate fund would be subject to the custody rule; if all the assets in the partnership are cash and direct investment in real property, the partnership is not an advisory client and thus the adviser would not be subject to the custody rule with respect to the partnership.**
 3. Would the answer vary depending on the level of control the fund/advisor has over the partnership-like structure (i.e., GP/managing member would typically have control over cash and securities; limited partners may not have "custody" but could have substantive kick-out rights which could allow them to gain custody by replacing the GP/managing member)? **The rule relates to an adviser's control over assets. By definition, a limited partner would not be an active participant in management and therefore is unlikely to be an adviser that controls the partnership - therefore, the limited partner is most likely not subject to the rule.**
 4. If the cash/securities owned by the partnership are subject to the custody rule, would an internal control report be required for the controls over the partnership's cash/securities? **An internal control report is required only when a QC is required to hold the assets and the QC is the adviser or its related person.**
14. The amended rule says that the qualified custodians of pooled investment vehicles need to send out statements to the pool's investors. Do those statements need to contain detailed information on the individual holdings of the fund or are they meant to be account statements that detail activity of investor NAV/partner capital balances? **As per question VI.2 of the SEC staff FAQ, the statements should include funds and securities held by the pool and transactions entered into by the pool.**
15. The internal control report pertains to qualified custodians who custody related person registered investment adviser (RIA) client assets. As the Custody Rule generally exempts privately offered securities from the qualified custodian requirements established, one would then expect that RIAs or their related persons with custody of only privately offered securities and who are not Qualified Custodians would not have an Internal Control Report requirement – is this correct? In addition, if a related person Qualified Custodian also had custody of privately offered securities should the Internal

Control Report to cover the privately offered securities? **An internal control report is required only if the RIA or its related person is serving in the capacity of qualified custodian. If the RIA or its related person qualified custodian hold privately offered securities but are not holding such securities in the capacity of Qualified Custodian, no internal control report is required. Also see footnotes 65 and 130 in the adopting release for further information.**

Does the RIA to a Private Equity or Hedge Fund of Funds that is relying on the audit provision for such a fund and therefore does not need a qualified custodian to maintain privately offered securities require an internal control report because it maintains possession of private investments in underlying funds (e.g., subscription documents to the underlying funds)? **No, because such securities are not required to be held by a qualified custodian.**

- 16.** Can a RIA hire a firm to perform a surprise examination after the fact to satisfy the custody rule? To clarify, if a RIA discovers in December of 2010 that it needed a count for FYE 2010, would it be able to hire an accounting firm to perform a count at any date during the 2010 calendar year in order to be in compliance with the custody rule? **This is also addressed in question/answer # 10, as the RIA may not have satisfied the notice and account statement requirements and if it was a pooled investment vehicle which holds privately offered securities and is not relying on the audit provision, such securities would have had to be held by a qualified custodian.**
- 17.** Assuming the adviser cannot meet the “reasonable belief” standard set forth in the staff FAQ, if a fund cannot meet the 120-day distribution requirement and it engages an independent public accountant to conduct a surprise examination, would the adviser ever meet the custody rule’s requirements if the qualified custodian did not send account statements? **No, see discussion above.**
- 18.** For what examinations under the Custody Rule must an accountant be registered with, and subject to regular inspection by, the PCAOB?
See Question II.8 of the SEC staff FAQ. An independent accountant registered with, and subject to regular inspection by, the PCAOB is required in the following three situations:

 - **Surprise exam where the adviser or its related person serves as the qualified custodian;**
 - **Internal control engagement - any time the IC report is issued, including when the adviser has determined that the adviser and its related person qualified custodian are operationally independent; and**
 - **Audit of a pooled investment vehicle to comply with the audit provision**

Note that registration alone is not sufficient and that the firm must also be subject to regular PCAOB inspection.

19. Liquidation Audit - is the requirement for the financial statements at the date the plan is adopted or as of the date the final funds are distributed? What is reasonable timing for distribution? **For the purposes of the liquidation audit, the financial statements should be dated as of or near the final distribution date (generally, financial statements would not be distributed prior to the final fund distribution to investors).**

Note that an audit shall occur once every 12 months, therefore, for a fund with December 31, 2010 fiscal year-end, if the liquidation process started in October 2010 but was not completed until after year-end, an audit is still needed as of December 31, 2010, followed by a liquidation audit after the distribution has been completed. The rule indicates that the financial statements should be distributed promptly, which may be interpreted “as soon as reasonably possible.”

Question whether a single set of audited financial statements could be issued to cover the period from January 1, 2010 through the date of liquidation (exceeding 12 months) if the audited financial statements for that extended period could still be delivered to investors within the 120-day period required under the rule for the annual financials. **The audited financial statements can cover a period exceeding 12 months if they are delivered to investors within 120 days of the December 31, 2010 fiscal year-end and as long as the financial statements contained the following: 2 balance sheets - 1 balance sheet as of December 31, 2010 and 1 balance sheet as of the 2011 liquidation date and 2 income statements, 2 statements of changes in partners’ capital, and 2 statements of cash flows (if applicable), for the period from January 1, 2010 – December 31, 2010 and for the period from January 1, 2011 – 2011 liquidation date.**

20. Will the Staff update their FAQ on the Custody Rule? **The staff initially updated the FAQ in March 2010 which is located at http://sec.gov/divisions/investment/custody_faq_030510.htm. The SEC staff will continue to update the FAQ as necessary.**
21. Should the Internal Control Report and Surprise Examination be conducted under US GAAS or PCAOB Standards? **The internal control report and surprise examination should be conducted under US GAAS.**
22. The panel members also discussed some other matters, including:
- Fee-only deductions – Is a registered investment adviser which has custody only as a result of its authority to deduct fees from client accounts

exempt from the Custody Rule if the qualified custodian sends out statements to the clients? **No.**

- Footnote 48 of the amended rule indicates that in order to perform an audit of a pooled investment vehicle to satisfy the audit provision, an independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period – would the fact the firm is hired subsequent to the beginning of the 2010 fiscal year preclude them for performing such engagement? **Question I.6 of the SEC staff FAQ indicates that the adviser can satisfy the requirement for exemption from the surprise examination if the accountant performing the audit of the pooled investment vehicle becomes subject to regular inspection by the PCAOB before the issuance of the audited financial statements for the pooled investment vehicle's 2010 fiscal year.**
- In a situation where a pooled investment vehicle does not rely on the audit provision exception (no audit) but the pool's qualified custodian will send quarterly account statements and the adviser will engage an accountant to perform a surprise examination – would the qualified custodian need to send statements to the limited partners? **Paragraph (a)(5) of Rule 206(4)-2 indicates that the quarterly account statements must be sent to the limited partners. As per question VI.2 of the SEC staff FAQ, the quarterly account statements need to include funds and securities held by the pool and transactions entered into by the pool.**