INVESTMENT COMPANY INSTITUTE

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October 11, 2002

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Exposure Draft of Proposed Amendments to
IAS 32 – *Financial Instruments: Disclosure and Presentation*
IAS 39 – *Financial Instruments: Recognition and Measurement*

The Investment Company Institute[1] appreciates the opportunity to comment on the IASB's exposure draft of proposed amendments to IAS 32 and IAS 39. The exposure draft addresses the financial statement presentation of shares issued by unit trusts and open-end mutual funds. The exposure draft indicates that where shares enable the holder to redeem or "put" the shares to the issuer for cash, the issuer should treat the shares as a liability. The exposure draft would cause these entities to report no equity or net assets for financial accounting purposes. In addition, the exposure draft would require these entities to report dividends paid on fund shares as "interest expense" and to recognize gains and losses related to changes in the value of fund shares in the income statement.[2]

We strongly disagree with the exposure draft's characterization of fund shares as liabilities. We believe fund shares should be characterized as equity since they represent a residual interest in funds' net assets. We are not aware of any demonstrated problems with current accounting standards that would justify the proposed change. We believe the proposed changes diminish the quality of financial information provided to shareholders, frustrate convergence of accounting standards, and fail from a cost/benefit perspective.

Fund Shares are Equity

Paragraph 22B of the exposure draft indicates that funds frequently provide their shareholders with the right to redeem their interests in the entity at any time for cash equal to

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,982 open-end investment companies ("mutual funds"), 513 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.373 trillion, accounting for approximately 95% of total industry assets, and over 87.8 million individual shareholders.

[2] The exposure draft would have no effect on U.S. registered investment companies, which are subject to U.S. generally accepted accounting principles.

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their proportionate share of the entity's net assets. The proposal indicates that even when the legal form of a puttable instrument gives the holder a right to the residual interest in the assets of an entity, the inclusion of an option for the holder to put that right back to the issuer for cash means that the puttable instrument meets the definition of a liability and must be presented as such.

We believe fund shares should be classified as equity. Paragraph 5 of the proposal defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Fund shares represent interests in the fund's underlying assets. They entitle the holder to participate in the fund's profits and losses, to receive distributions of investment income and capital gains, and to receive their *pro-rata* share of net assets in liquidation.

Furthermore, fund shares entail ownership rights typically associated with an equity investment. For example, shareholders of U.S. registered funds have the right to elect directors, approve changes in the fund's investment adviser, approve changes to advisory contracts, and approve changes in fundamental investment polices as described in the fund's prospectus. Unlike debt instruments, fund shares do not entitle shareholders to receive repayment of their initial investment or principal. For these reasons we believe fund shares most closely resemble equity.

Convergence of Accounting Standards

Fund shares entitle the holder to receive the *pro-rata* portion of the fair value of the fund's assets on demand. In this context, fund shares can be viewed as entailing a put option. While this put option could theoretically be separated from the "host contract" and treated as a liability in the fund's financial statements, we believe any such separate treatment would be both incorrect and impractical. Thus, we believe fund shares should be treated exclusively as equity.

This approach is consistent with the U.S. Financial Accounting Standards Board's recent exposure draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. Paragraphs 54 through 63 of the exposure draft describe various types of financial instruments that should be treated as equity and not obligations or liabilities of the issuer. Common stock that is puttable at its fair value (*e.g.*, fund shares) is one of the types of financial instruments that should be treated as equity. Paragraph 63 of the exposure draft states:

> "Certain entities enter into agreements with their stockholders that allow the stockholders to put shares back to the entity at the fair value of the shares. When shares are puttable at the fair value of the underlying shares at the date the put option is exercised, the effect of the put option is to add liquidity to the underlying stock—a value that traditional option pricing models cannot measure. Moreover, although adding liquidity adds value, the value added may be relatively small. Therefore, it is likely that only a small amount (if any) of the proceeds would be assigned to the liability component."

We believe the FASB model correctly characterizes fund shares as equity. FASB's current deliberations on a final standard suggest that they do not intend to modify the exposure draft's treatment of common stock issued by an open-end fund unless the shares must be redeemed on a fixed date or upon an event certain to occur. Adoption of the exposure draft as proposed is inconsistent with the objective of convergence of accounting standards. We urge the Board to adopt the FASB approach.

Income Statement Presentation

Paragraph 31 of the exposure draft indicates that dividends paid on fund shares classified as liabilities should be reported as an expense in the income statement, similar to interest paid on a bond or other borrowing. Similarly, gains and losses on redemptions of fund shares classified as liabilities should also be reported in the income statement. Paragraph A21A of the proposal indicates that the liability to repay shareholders may be presented in the balance sheet using a caption such as "net asset value available to unitholders" and that the change in the liability to repay unitholders may be presented in the income statement using a caption such as "change in net asset value available to unitholders."

Under the proposed accounting, any increase in net assets attributable to investment operations would be offset by the change in the value of the "liability" to repay shareholders. Stated differently, the income statement would net to zero as the change in value of the fund's assets attributable to investment operations would always be equal to the change in the value of the "liability" to repay fund shareholders. Even if the Board proceeds with the view that fund shares are liabilities, we do not believe it serves the interests of investors to report a bottom line result of zero, even where the fund's assets increased (decreased) due to investment gains (losses).

Cost/Benefit

We see no benefit associated with the exposure draft. Indeed, we are concerned that characterization of fund shares as liabilities could do significant harm by causing shareholders to believe that their investment in a fund is analogous to a deposit and is guaranteed against risk of loss, or that it is a debt instrument with a fixed redemption date.

We foresee substantial costs associated with the proposal. Fund offering documents typically provide that transactions in fund shares are processed at the current *net asset value.* Fund prospectuses typically include investment policies based on *net assets* (*e.g.*, the fund will invest a specified portion of its net assets in a particular type of security). Management fee rates are typically based on *net assets* (*e.g.*, 1.00% of average daily net assets). The exposure draft would require changes to these provisions, as the net assets of open-end funds would be redefined by this interpretation to equal zero. Certain of these changes may require shareholder approval and would entail costs associated with calling a special meeting of shareholders. All of these documents were originally written under the common understanding that fund shares are equity. At a minimum, these documents will need to be amended to clarify that the term net assets represents the residual interests of shareholders, regardless of any accounting literature requirement for presentation of such amounts as liabilities for financial reporting purposes.

If you have any questions on our comments or would like to discuss them further, please contact the undersigned at 202/326-5851.

Sincerely,
Gregory M. Smith
Gregory M. Smith
Director – Operations/
Compliance & Fund Accounting