INVESTMENT COMPANY INSTITUTE

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September 30, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements*; PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

The Investment Company Institute[1] appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release). The Concept Release describes four alternatives intended to enhance the information conveyed by auditors to investors in connection with the audit of financial statements. The alternatives under consideration are: 1) a supplement to the auditor's report in which the auditor would provide additional information about the audit and the company's financial statements (Auditor's Discussion and Analysis or AD&A); 2) required and expanded use of emphasis paragraphs in the auditor's report; 3) auditor reporting on information outside the financial statements (*e.g.* MD&A, earnings releases); and 4) clarification of certain concepts included in the auditor's report (*e.g.*, reasonable assurance, duty to detect fraud). Our comments below are from the perspective of SEC registered investment companies as issuers of audited financial statements.

We believe the first three alternatives described in the Concept Release would provide little, if any benefit to investors in SEC registered investment companies. We therefore recommend that the Board exclude audits of such companies from the scope of any rule-making that would implement these alternatives. We support the fourth alternative – clarification of concepts included in the auditor's report – and recommend that, for audits of SEC registered investment companies, the clarification describe the auditor's consideration of the fund's internal control over financial reporting, including controls relating to security valuation, for purposes of

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

designing audit procedures to be performed and expressing an opinion on the financial statements. We elaborate on our recommendations below.

SEC Registered Investment Companies

SEC registered investment companies pool investor funds in order to provide shareholders with professional investment management. Typically an investment company sells its capital shares to the public and invests the proceeds entirely in securities consistent with its stated investment objectives and policies.

SEC registered investment companies typically have no employees. Instead, their operations are conducted by various affiliated organizations and independent contractors, such as an investment adviser, administrator, underwriter, custodian, and transfer agent. As is the case for other types of companies, fund directors have oversight responsibility for the management of the fund's business affairs. Overlaying state law duties is the fundamental concept of the Investment Company Act of 1940 (1940 Act) that independent directors serve as watchdogs for the shareholders' interests and provide a check on the adviser and other persons closely affiliated with the fund. The 1940 Act requires that a majority of the fund's board of directors be persons who are entirely independent of the fund's investment adviser and principal underwriter.

The 1940 Act subjects publicly-offered funds to a comprehensive framework of substantive SEC regulation that goes far beyond the other federal securities laws. For example, the 1940 Act contains specific prohibitions against certain transactions between a fund and its investment adviser, underwriter, or other affiliated persons. These provisions are designed to regulate strictly the potential for affiliates to profit from the operations of the fund. In addition, the 1940 Act requires all funds to safeguard their assets by placing them in the hands of a custodian and by providing fidelity bonding of fund officers and others who may access the fund's securities.

SEC registered investment companies prepare their financial statements under the industry-specific reporting model described in FASB ASC 946. The overall objective of investment company financial statements is to present the investment portfolio, results of operations, changes in net assets, and financial highlights from investment activities. SEC registered investment company financial statements must also comply with Article 6 of Regulation S-X.

Audits of SEC Registered Investment Company Financial Statements

SEC registered investment company financial statements are inherently less complex than operating company financial statements due to the limited nature of the fund's operations (*i.e.*, issuing shares and investing the proceeds in a portfolio of investment securities). Fund financial statements entail fewer estimates and judgments than operating company financial statements. For example, SEC registered investment companies typically have no employees, employee pension plans, or post employment benefit plans. SEC registered funds typically have no intangibles, goodwill, loan loss reserves, or discontinued operations. Further, management of SEC registered investment companies has fewer choices in the application of accounting policies. For example, all securities are recognized at fair value with the change in fair value reflected in earnings (*i.e.*, no securities are classified as available for sale or held to maturity).

Finally, SEC registered investment companies typically have no items that give rise to other comprehensive income, and they generally are not required to provide a statement of cash flows.[2]

The limited nature of SEC registered investment company operations results in financial statement audits that are less complex than audits of operating company financial statements. For the reasons described above, we believe audits of SEC registered investment companies entail fewer judgments or close calls by auditors. Accordingly, we believe both an AD&A and an emphasis of matter paragraph would provide little, if any benefit to investors in SEC registered funds. In addition, given that investment company financial statements are less complex than operating companies, we are concerned that any requirement to provide an AD&A or emphasis of matter paragraph would quickly evolve into standard language, lengthening auditor reports without providing meaningful information to investors.

We note that the PCAOB has previously recognized that audits of investment companies are less complex than audits of operating companies. The Board and the FASB are funded through accounting support fees paid by public companies based on their market capitalization. Investment companies pay accounting support fees at a rate equal to 10% of the rate paid by operating companies. When adopting the 10% fee rate structure applicable to investment companies the PCAOB stated, "In recognition of the structure of investment companies and the relatively less-complex nature of investment company audits (as compared to operating company audits), investment companies would be assessed at a lower rate."[3]

Auditor Reporting on Information outside the Financial Statements

The Concept Release requests comment on requiring auditors to provide assurance on information outside the financial statements, such as MD&A, earnings releases, or non-GAAP information. SEC registered investment companies are exempt from the requirement to provide an MD&A (Item 303 of Regulation S-K) in their shareholder reports and other filings. Also, SEC registered funds do not issue earnings releases and they do not provide non-GAAP information (*e.g.*, earnings from continuing operations).

Open-end investment companies are required to provide a Management's Discussion of Fund Performance (MDFP) in their annual shareholder report.[4] MDFP requires 1) a discussion of the factors that materially affected fund performance, including relevant market conditions and investment strategies; 2) a line graph illustrating the change in value of an investment in the fund over a 10-year period; and 3) average annual total return over 1, 5, and 10 year periods. We are not aware of any concerns by investors that information provided in MDFP is inaccurate or incomplete. We see little benefit associated with auditor assurance on MDFP.

Clarification of Concepts Included in the Auditor's Opinion

The final potential enhancement to the auditor reporting model included in the Concept Release would involve clarifying concepts in the existing standard auditor's report. Such

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[2] *See* FASB ASC 230-10-15-4.

[3] *See* PCAOB Release No. 2003-003 (April 18, 2003).

[4] *See* Item 27(b)(7) of SEC Form N-1A. Money market funds are exempt from the requirement to provide MDFP.

enhancements could explain, for example, the meaning of "reasonable assurance," "material misstatement," or describe the auditor's responsibility to detect fraud. We believe such enhancements would provide investors with a better understanding of the audit of the financial statements and the auditor's responsibilities. We recommend that the Board consider an additional enhancement specific to investment companies not contemplated by the Concept Release as described below.

We believe the key audit risks for SEC registered investment companies relate to the existence and valuation of the investment portfolio. The auditor's opinion for a SEC registered investment company is unique in that it must state specifically that securities have been confirmed or physically examined to substantiate their existence.[5] The audit opinion, however, does not directly address the auditor's work with respect to confirming the value of securities at period end, or the auditor's consideration of internal controls relating to security valuation for purposes of planning the audit procedures to be performed.[6]

We believe SEC registered investment companies have well developed internal controls relating to valuation of their investment portfolios and that auditors perform extensive testing of these controls as part of the financial statement audit. We recommend that the Board consider, as part of the contemplated enhancements to the audit opinion, a more fulsome description of the auditor's work pertaining to evaluation of the internal controls for purposes of planning the audit procedures to be performed.[7] For example, the enhancements could require the opinion to indicate that the auditor considered the fund's internal control over financial reporting, including controls relating to valuation of investment securities, as a basis for designing its auditing procedures for the purpose of expressing an opinion on the financial statements.

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[5] *See* Section 30(g) of the 1940 Act and SEC Codification of Financial Reporting Policies, section 404.03a.

[6] SEC registered investment companies are exempt from the audit of internal controls over financial reporting required by Section 404 of the Sarbanes-Oxley Act of 2002.

[7] AU Section 314 requires the auditor to obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

If the Board pursues rule-making in this area, it should ensure that the benefits to fund investors exceed the related costs that will be incurred through increased audit fees. Any increase in fees billed to open-end funds will increase fund expenses and diminish fund returns. Finally, any rule-making should recognize that an AD&A or emphasis of matter paragraph may not be appropriate for all types of issuers in all instances. Please contact the undersigned at 202/326-5851 if you have any questions on our comments.

Sincerely,

/s/ Gregory M. Smith

Gregory M. Smith
Director – Operations/
Fund Accounting

cc: Jaime Eichen, Chief Accountant
Division of Investment Management
U.S. Securities and Exchange Commission