kpmg

KPMG LLP

Suite 3300 Commerce Court West
PO Box 31 Stn Commerce Court
Toronto, ON M5L 1B2

Telephone (416) 777-3500
Telefax (416) 777-8365
www.kpmg.ca

July 27, 2004

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Office of the Administrator, New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Government of the Yukon Territory
Registrar of Securities, Nunavut

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
e-mail: jstevenson@osc.gov.on.ca

Dear Sirs and Mesdames:

Re: Request for Comments – National Instrument 81-106 – Investment Fund Continuous Disclosure (the "Instrument")

We are writing to provide our comments on the proposals put forward in the above document. The primary focus of our comments is on certain accounting and reporting provisions of the proposed Instrument. While subsection 2.6(1) of the Instrument requires the financial statements of an investment fund to be prepared in accordance with Canadian GAAP, we are particularly concerned by several accounting and reporting provisions that appear to have no little or no authoritative support and potentially undermine the CICA Handbook as a primary source of Canadian GAAP.

The attached Appendix sets out our comments and recommendations for consideration by the CSA members.

Yours very truly,

Alan G. Van Weelden, Associate Partner
National Assurance and Professional Practice

APPENDIX

National Instrument 81-106

Section 1.1 Definitions: "Current Value" and "Net Asset Value"

The definition of "net asset value" requires the assets and liabilities of investment funds to be measured at current value calculated in accordance with Canadian GAAP. For the reasons outlined below ***we recommend that the definition of net asset value require only the investments of an investment fund to be measured at fair value calculated in accordance with Canadian GAAP***.

The definition of "current value" is inconsistent with the definition of fair value in Canadian GAAP. The definition in the Instrument segregates the terms "market value" and "fair value", whereas under Canadian GAAP the term market value is a subset of the broader term fair value. As it applies to the investments of investment funds the inclusion of the term "market value" in the definition of "current value" is unnecessary. It is encompassed within the definition of fair value as found in primary sources of Canadian GAAP. It is sufficient to require investments to be measured at fair value.

The CICA Accounting Guideline "Investment companies" ("AcG-18") requires the investments of an investment fund (as defined in NI 81-106) to be measured at fair value. AcG-18 defines fair value as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgable, willing parties who are under no compulsion to act". Further guidance on determining the fair value of financial instruments is provided in CICA Handbook Section 3860 "Financial instruments – disclosure and presentation". CICA 3860.82 indicates the "quoted market price" provides the best evidence of fair value when a financial instrument is traded in an active and liquid market. CICA 3860.83 provides guidance on determining the fair value where there is not an active and liquid market.

In general, assets and liabilities are measured under Canadian GAAP at historical cost, which is the amount of cash or cash equivalents paid or received or the fair value ascribed to the transactions when they took place (CICA 1000.53). Requiring all liabilities and other assets of an investment fund to be measured at fair value establishes a basis of measurement that is not in accordance with Canadian GAAP.

The comparable requirements under U.S. GAAP are found primarily in the AICPA Audit and Accounting Guide "Audits of Investment Companies" (the "AICPA Guide"), which requires only the investments of an investment company to be measured at fair value.

We do not see any compelling reason to abandon Canadian GAAP when it comes to measuring an investment fund's liabilities and other assets. CICA 3860.87 acknowledges that the historical cost carrying amount of receivables and payables subject to normal trade credit terms usually approximates fair value. We would expect the historical cost measurements of the other assets and liabilities of an investment fund (such as prepaid expenses, receivables, accounts payable and accrued expenses) to constitute an appropriate basis of measurement. One potential area where substantial differences could arise between historical cost and fair value is in the measurement of long-term liabilities. Paragraph 7.25 of the AICPA Guide states: "Notes payable to banks, including bank overdrafts, and to others, and other debt should be stated at amounts payable, net of unamortized premium or discount, and reported separately." The AICPA Guide requires disclosure in the notes to the financial statements of long-term debt maturities and the fair value of liabilities, which coincide with requirements in CICA 3210.03 and CICA 3860.78, respectively.

Subsection 2.9(3)

We recommend an amendment to this subsection to separate the requirements for a comparative interim statement of net assets from those for the other financial statements. This is necessary in order to ensure the required comparative interim financial statements include those required by Section 1751 of the CICA Handbook. Specifically, the required comparative interim statement of net assets is as of the end of the immediately preceding fiscal year (CICA 1751.16(a)).

Section 7.5 Multiple Class Investment Funds

Section 7.5 of the Instrument permits an investment fund to prepare "separate financial statements" for each class or series of securities outstanding that is referable to a single portfolio. ***We recommend that this "option" in paragraph 7.5(1)(a) be deleted.***

There is nothing unique about an entity having multiple classes of securities outstanding. We do not believe one can interpret the requirements in CICA Handbook to permit separate financial statements to be prepared in these circumstances. CICA 1000.15 indicates the objective of financial statements is to provide information about "(a) an entity's economic resources, obligations and equity/net assets; (b) changes in an entity's economic resources, obligations and equity/net assets; and (c) the economic performance of the entity." In the circumstances described in Section 7.5 the investment fund is the entity (a.k.a. the "reporting issuer") and the holder of a particular class of securities is entitled to the complete information on that entity's economic resources, obligations, and net assets.

It appears the CSA is choosing to disregard relevant guidance in the AICPA Guide, which deals with this specific issue through separate disclosure in the income statement (or the accompanying notes) of the class-specific expenses. The notes to the financial statements disclose fee arrangements, methods of allocating expenses, etc. for each class of shares/units. This is exactly how thousands of other private and public Canadian entities address this same circumstance in preparing their financial statements in accordance with Canadian GAAP.

We acknowledge the existence of a historical practice of preparing separate financial statements for a class of securities, but leaving Section 7.5 as it stands will only perpetuate a practice that appears to lack authoritative accounting support.

Companion Policy 81-106CP

Section 3.5 "Auditor's Involvement with the Annual Management Reports of Fund Performance"

The reference to section 7500 of the CICA Handbook should be updated to reflect the revisions to the name and content of the section effective November 1, 2003.

Section 4.3 "Costs of Distributions of Securities" and Section 4.4 "Trailing Commissions"

The CICA undertook the hierarchy of GAAP project in response to a variety of issues and concerns. Two of the concerns listed in the Background and Basis for Conclusions for CICA Handbook Section 1100 "Generally accepted accounting principles" were:

> "(c) Securities Commission staff members were concerned that GAAP was being developed based on the consensus of informal groups of entities and their advisors who might confer and agree on an approach to an issue. Some interpreted the previous guidance to permit GAAP to include so-called "industry practice" that did not consider other sources of GAAP.
>
> (d) Securities Commission staff members were concerned that isolated precedents were cited as justification for practices that contravene the spirit, if not the letter, of CICA Handbook – Accounting concepts and standards."

We are concerned that the CSA views in the above sections contravene the spirit and the letter of the CICA Handbook, including Section 1100.

An investment fund is continuously issuing and redeeming its securities. These two activities are clearly capital transactions. The treatment of the costs related to issuing and redeeming securities is specifically addressed in a primary source of Canadian GAAP, namely Section 3610 of the CICA Handbook "Capital transactions". In accordance with Canadian GAAP these costs should be excluded from the determination of net income and shown separately in the statement to which they relate, which for most investment funds is the statement of changes in net assets.

CICA 3240.15 recognizes that a company cannot earn a profit from the acquisition of its own shares. The converse is also true - a company cannot suffer a loss from issuing its own securities (though a loss could occur from the abandonment of a proposed issue of securities, as contemplated in EIC-94 "Accounting for corporate transactions costs").

It appears the CSA has concluded that the guidance in the CICA Handbook on distribution costs is not applicable to investment funds. If that conclusion is correct, then CICA 1100.04 requires the adopted accounting policy to be:

(a) consistent with the primary sources of GAAP; and
(b) developed through the exercise of professional judgement and the application of the concepts described in "Financial Statement Concepts", Section 1000.

The proposed treatment of distribution costs is inconsistent with Section 3240 and Section 3610. Further, the concept of an expense in CICA 1000.38 is that it results from an entity's ordinary revenue generating or service delivery activities. These "activities" are described in more detail in paragraph CICA 1000.37: "Revenues of entities normally arise from the sale of goods, the rendering of services or the use by others of entity resources yielding rent, interest, royalties or dividends." The issue and redemption of securities are not activities that generate revenues. In contrast to revenues, "gains" under CICA 1000.39 are increases in equity/net assets resulting from peripheral or incidental transactions and events affecting an entity and from all other transactions, events and circumstances affecting the entity *except those that result from revenues or equity/net assets contributions*. The concept of "losses" in CICA 1000.40 similarly excludes decreases in equity/net assets resulting from distributions of equity/net assets. The financial concepts in Section 1000 do not appear to provide support for the treatment of distribution costs as an expense or a loss.

CICA 1100.24 indicates that guidance in U.S. literature is often an important source to consult in selecting an accounting policy. Under U.S. GAAP the treatment of distribution costs and offering costs are addressed in the AICPA Guide. Many open-end investment companies finance the distribution of their shares under a plan pursuant to rule 12b-l of the Investment Company Act of 1940. Distribution expenses paid with an investment company's assets are accounted for as operating expenses. The AICPA Guide also addresses "offering costs" incurred by an investment company during its development stage. The treatment of these costs varies with the nature of the costs, the type of offering and the legal structure of the investment company, being either charges to capital (closed-end funds, investment partnerships, unit investment trusts) or deferral and amortization over a twelve month period (open-end investment companies and closed-end funds with a continuous offering period).

The adoption of a single accounting policy to cover distribution costs incurred by all investment funds in all circumstances is not supported by reference to U.S. GAAP.

The prevailing historical practice in the industry has been to expense distribution costs. This practice was supported in the 1997 CICA Research Report "Financial Reporting by Investment Funds" on pages 19 and 20. However, CICA 1100.31 indicates the relevance of a practice is demonstrated by its compliance with CICA 1100.04 and not be its use within a particular industry. The reason cited by the CSA in support of their view ("…it is important that investors fully understand the costs associated with the ownership of securities of an investment fund") falls well short of justifying the dismissal of the guidance in the CICA Handbook and demonstrating compliance with CICA 1100.04. We appreciate the CSA's sensitivity to the investment fund's MER. We submit that this issue can be addressed by: (i) requiring separate disclosure of distribution costs in the statement of net assets and (ii) requiring those costs to be included in an investment fund's MER. Rather than bending GAAP to satisfy MER calculation objectives, we support considering all of the information disclosed in GAAP financial statements as potentially available for use in calculating the costs associated with ownership of the securities of an investment fund.