



# Audit and Accounting Guide

Investment Companies

July 1, 2019



A resource of the  
Enhancing Audit  
Quality Initiative

WILEY





# Audit and Accounting Guide

Investment Companies

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# Preface

(Updated as of July 1, 2019)

This guide was prepared by the Investment Companies Special Committee.

## About AICPA Audit and Accounting Guides

This AICPA Guide has been developed by the AICPA Investment Companies Guide Task Force to assist practitioners in performing and reporting on their audit and attestation engagements, and to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (GAAP).

This guide describes operating conditions and auditing procedures unique to the investment company industry and illustrates the form and content of investment company financial statements and related disclosures.

Because many investment companies are subject to regulation under the Investment Company Act of 1940, rules under that act are discussed extensively in this guide. However, the rules, regulations, practices, and procedures of the investment company industry have changed frequently and extensively in recent years. The independent practitioner should keep abreast of those changes as they occur.

An AICPA Guide containing auditing guidance related to generally accepted auditing standards (GAAS) is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.<sup>1</sup> Interpretive publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries.

Interpretive publications are issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Throughout this guide, when appropriate, reference is made to Q&A sections in Technical Questions and Answers. A Q&A section is an "other auditing publication." AU-C section 200 indicates that in applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications. Although the auditor determines the relevance of these publications in accordance with paragraph .28 of AU-C section 200, the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate. These other auditing publications are listed in AU-C appendix F, *Other Auditing Publications*.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with existing GAAS.

Any auditing guidance in a guide appendix or exhibit (whether a chapter or back matter appendix, or an exhibit), although not authoritative, is considered an "other auditing publication." In applying such guidance, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of other auditing guidance, auditing guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the auditor may presume that it is appropriate.

An AICPA Guide containing attestation guidance is recognized as an interpretative publication as defined in AT-C section 105, *Concepts Common to All Attestation Engagements*.<sup>2</sup> Interpretative publications are recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Interpretative publications are issued under the authority of the ASB. The members of the ASB have found the attestation guidance in this guide to be consistent with existing SSAEs.

A practitioner should be aware of and consider the guidance in this AICPA guide applicable to his or her attestation engagement. If the practitioner does not apply the attestation guidance included in an applicable interpretative publication, the practitioner should document how the requirements of the SSAE were complied with in the circumstances addressed by such attestation guidance.

Any attestation guidance in a guide appendix or exhibit (whether a chapter or back matter appendix or an exhibit), although not authoritative, is considered an "other attestation publication." In applying such guidance, the practitioner should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the engagement. Although the practitioner determines the relevance of other attestation guidance, such guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the practitioner may presume that it is appropriate.

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<sup>2</sup> All AT-C sections can be found in AICPA *Professional Standards*.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to attestation. Conforming changes made to the attestation guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the attestation guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the SSAEs.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming changes made to the financial accounting and reporting guidance contained in this guide are approved by the FinREC Chair (or his or her designee). Updates made to the financial accounting and reporting guidance in this guide exceeding that of conforming changes are approved by the affirmative vote of at least two-thirds of the members of FinREC.

This guide does the following:

- Identifies certain requirements set forth in the FASB *Accounting Standards Codification*<sup>®</sup> (ASC).
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. Accounting guidance for governmental entities included in an AICPA Guide, and cleared by GASB, is a source of authoritative GAAP described in category B of the hierarchy of GAAP for state and local governmental entities, as defined in GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. AICPA members should be prepared to justify departures from GAAP, as discussed in the "Accounting Principles Rule" (ET sec. 1.320.001).<sup>3</sup>

AICPA Audit and Accounting Guides also include guidance from AICPA *Technical Questions and Answers*. These questions and answers are not sources of established authoritative accounting principles as described in FASB ASC, the

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<sup>3</sup> All ET sections can be found in AICPA *Professional Standards*.

authoritative source of GAAP for nongovernmental entities. This material is based on selected practice matters identified by the staff of the AICPA's Technical Hotline and various other bodies within the AICPA and has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

AICPA Guides may include certain content presented as "supplement," "appendix," or "exhibit." A supplement is a reproduction, in whole or in part, of authoritative guidance originally issued by a standard setting body (including regulatory bodies) and applicable to entities or engagements within the purview of that standard setter, independent of the authoritative status of the applicable AICPA Guide. Both appendixes and exhibits are included for informational purposes and have no authoritative status.

## Purpose and Applicability

### Limitations

This guide does not discuss the application of all GAAP, GAAS, and PCAOB standards that are relevant to the preparation and audit of financial statements of investment companies. This guide is directed primarily to those aspects of the preparation and audit of financial statements that are unique to investment companies or those aspects that are considered particularly significant to them.

## Recognition

### **AICPA Senior Committees**

#### **Auditing Standards Board**

Jay Brodish, *Member*  
Michael J. Santay, *Chair*

#### **Financial Reporting Executive Committee**

Angela Newell, *Chair*

The AICPA gratefully acknowledges those members of the AICPA Investment Companies Expert Panel (2017–2018) who reviewed or otherwise contributed to the development of this edition of the guide:

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Kristin Van Dask

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## **Guidance Considered in This Edition**

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued, and other revisions as deemed appropriate. Relevant guidance issued through July 1, 2019, has been considered in the development of this edition of the guide. However, this guide does not include all audit, accounting, reporting, and other requirements applicable to an entity or a particular engagement. This guide is intended to be used in conjunction with all applicable sources of authoritative guidance.

Relevant guidance that is issued and effective on or before July 1, 2019, is incorporated directly in the text of this guide. Relevant guidance issued but not yet effective as of July 1, 2019, but becoming effective on or before December 31, 2019, is also presented directly in the text of the guide, but shaded gray and accompanied by a footnote indicating the effective date of the new guidance. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader's purposes (as part of the guide's "dual guidance" treatment of applicable new guidance).

Relevant guidance issued but not yet effective as of the date of the guide and not becoming effective until after December 31, 2019, is referenced in a "guidance update" box; that is, a gray shaded box that contains summary information on the guidance issued but not yet effective.

In updating this guide, all guidance issued up to and including the following was considered, but not necessarily incorporated, as determined based on applicability:

- FASB Accounting Standards Update (ASU) No. 2019-07, *Codification Updates to SEC Sections—Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10532, Disclosure Update and Simplification, and Nos. 33-10231 and 33-10442,*

Investment Company Reporting Modernization, and Miscellaneous Updates (SEC Update)

- Statement on Auditing Standards (SAS) No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports* (AU-C sec. 720)
- SSAE No. 18, *Attestation Standards: Clarification and Recodification*
- Interpretation No. 4, "Performing and Reporting on an Attestation Engagement Under Two Sets of Attestation Standards," (AT-C sec. 9105 par. .31–.35), of AT-C section 105
- PCAOB Release No. 2018-006, *Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect, if any, on entities and engagements covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the Schedule of Changes appendix. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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## **FASB ASC Pending Content**

### ***Presentation of Pending Content in FASB ASC***

Amendments to FASB ASC (issued in the form of ASUs) are initially incorporated into FASB ASC in "pending content" boxes that follow the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends, and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes within FASB ASC until the roll-off date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended could still be applied.

### ***Presentation of FASB ASC Pending Content in AICPA Guides***

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on July 1, 2019, is referenced as "Pending Content" in this guide. Readers should be aware that "Pending Content" referenced in this guide will eventually be subjected to FASB's roll-off process and no longer be labeled as "Pending Content" in FASB ASC (as discussed in the previous paragraph).

## Terms Used to Define Professional Requirements in This AICPA Guide

Any requirements described in this guide are normally referenced to the applicable standards or regulations from which they are derived. Generally, the terms used in this guide describing the professional requirements of the referenced standard setter (for example, the ASB) are the same as those used in the applicable standards or regulations (for example, "must" or "should"). However, where the accounting requirements are derived from FASB ASC, this guide uses "should," whereas FASB uses "shall." In its resource document "About the Codification" that accompanies FASB ASC, FASB states that it considers the terms "should" and "shall" to be comparable terms and to represent the same concept — the requirement to apply a standard.

Readers should refer to the applicable standards and regulations for more information on the requirements imposed by the use of the various terms used to define professional requirements in the context of the standards and regulations in which they appear.

Certain exceptions apply to these general rules, particularly in those circumstances where the guide describes prevailing or preferred industry practices for the application of a standard or regulation. In these circumstances, the applicable senior committee responsible for reviewing the guide's content believes the guidance contained herein is appropriate for the circumstances.

## Applicability of Generally Accepted Auditing Standards and PCAOB Standards

Appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of the AICPA Code of Professional Conduct recognizes both the ASB and the PCAOB as standard setting bodies designated to promulgate auditing, attestation, and quality control standards. Paragraph .01 of the "Compliance With Standards Rule" (ET sec. 1.310.001 and 2.310.001) requires an AICPA member who performs an audit to comply with the applicable standards.

Audits of the financial statements of those entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) are to be conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget. In citing the auditing standards of the PCAOB, references generally use section numbers within the reorganized PCAOB auditing standards and not the original standard number, as appropriate.

Audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) — hereinafter referred to as *nonissuers*<sup>4</sup> — are to be conducted in accordance with GAAS as issued by the ASB.

The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure

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<sup>4</sup> See the definition of the term *nonissuer* in the AU-C Glossary.

of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in AICPA *Professional Standards*. In citing GAAS and their related interpretations, references generally use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate.

The auditing content in this guide primarily discusses GAAS issued by the ASB and is applicable to audits of nonissuers. Users of this guide may find the tool developed by the PCAOB's Office of the Chief Auditor helpful in identifying comparable PCAOB standards. The tool is available at <http://pcaobus.org/standards/auditing/pages/findanalogousstandards.aspx>.

Considerations for audits of entities in accordance with PCAOB standards may also be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. PCAOB guidance included in an AICPA Guide has not been reviewed, approved, disapproved, or otherwise acted upon by the PCAOB and has no official or authoritative status.

## Guidance for Issuers

### ***Management Assessment of Internal Control***

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted final rules requiring companies subject to the reporting requirements of the 1934 Act, other than registered investment companies and certain other entities, to include in their annual reports a report from management on the company's internal control over financial reporting. Business development companies do not fall within the scope exception contained in Section 405 and are required to include a report from management on the company's internal control over financial reporting. However, see paragraphs 1.62–.64 of this guide for discussion of the Jumpstart Our Business Startups Act of 2012, which explains that certain business development companies may be temporarily exempt from certain financial reporting disclosures and regulatory requirements, including Section 404 of the Sarbanes-Oxley Act of 2002.

The SEC rules clarify that management's assessment and report is limited to internal control over financial reporting.

As established by Rule 12b-2 of the 1934 Act, the auditor's attestation for large accelerated and accelerated filers is required. However, Section 404(c) of the Sarbanes-Oxley Act of 2002 provides that an attestation report of a registered public accounting firm on internal control over financial reporting is not required for an issuer that is neither an accelerated filer nor a large accelerated filer.

### **Applicability of Quality Control Standards**

QC section 10, *A Firm's System of Quality Control*,<sup>5</sup> addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. A system of quality control consists of policies that a firm establishes and maintains to provide it with reasonable assurance that the firm and its personnel comply with professional standards, as well as applicable legal and

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<sup>5</sup> The QC sections can be found in AICPA *Professional Standards*.



regulatory requirements. The policies also provide the firm with reasonable assurance that reports issued by the firm are appropriate in the circumstances.

QC section 10 applies to all CPA firms with respect to engagements in their accounting and auditing practice. In paragraph .06 of QC section 10, an *accounting and auditing practice* is defined as "a practice that performs engagements covered by this section, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the AICPA ASB or the AICPA Accounting and Review Services Committee under the "General Standards Rule" (ET sec.1.300.001) or the "Compliance With Standards Rule" of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*."

In addition to the provisions of QC section 10, readers should be aware of other sections within AICPA *Professional Standards* that address quality control considerations, including the following provisions that address engagement level quality control matters for various types of engagements that an accounting and auditing practice might perform:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AT-C section 105
- AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*<sup>6</sup>

Because of the importance of engagement quality, this guide includes appendix A, "Overview of Statements on Quality Control Standards," which summarizes key aspects of the quality control standard. This summarization should be read in conjunction with QC section 10, AU-C section 220, AT-C section 105, AR-C section 60, and the quality control standards issued by the PCAOB, as applicable.

## Alternatives Within U.S. Generally Accepted Accounting Principles

The Private Company Council (PCC), established by the Financial Accounting Foundation's Board of Trustees in 2012, and FASB, working jointly, will mutually agree on a set of criteria to decide whether and when alternatives within U.S. GAAP are warranted for private companies. Based on those criteria, the PCC reviews and proposes alternatives within U.S. GAAP to address the needs of users of private company financial statements. These U.S. GAAP alternatives may be applied to those entities that are not public business entities, not-for-profits, or employee benefit plans.

The FASB ASC Master Glossary defines a *public business entity* as

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

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<sup>6</sup> All AR-C sections can be found in AICPA *Professional Standards*.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a *public business entity* solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

***Considerations related to alternatives for private companies have not been discussed within this guide's chapter text as of July 1, 2019.***

## **AICPA.org Website**

The AICPA encourages you to visit the website at [aicpa.org](http://aicpa.org) and the Financial Reporting Center at [www.aicpa.org/frc](http://www.aicpa.org/frc). The Financial Reporting Center supports members in the execution of high quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process, including accounting, preparing financial statements and performing compilation, review, audit, attest or assurance and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

## **Risk Assessment — AICPA Enhancing Audit Quality (EAQ) Areas of Focus**

Identifying, assessing, and responding to risks of material misstatement are the core of every audit. However, there is evidence that a high percentage of

audit engagements do not reflect proper assessment of risk or linkage of the assessment to planned further audit procedures in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

In connection with its EAQ initiative, the AICPA has developed a webpage dedicated to risk assessment resources intended to help auditors perform more effective risk assessment and appropriately link the risk assessment to further audit procedures in compliance with professional standards. Certain resources are available at no cost, including a risk assessment template, an internal inspection aid, and staff training workshop. These and other current risk assessment resources can be accessed at <https://www.aicpa.org/content/aicpa/eaq/aicpa-risk-assessment-resources.html>.

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# TABLE OF CONTENTS

Chapter		Paragraph
1	Overview of the Investment Company Industry	.01-.66
	Introduction .....	.01-.16
	Guide Application .....	.02-.04
	Investment Companies Defined — Scope of FASB ASC 946 .....	.05-.16
	Types of Investment Companies .....	.17-.20
	History .....	.21-.22
	Definition and Classification .....	.23-.36
	Organizations Providing Services to Investment Companies .....	.37-.44
	The Investment Adviser .....	.38-.39
	The Distributor .....	.40-.41
	The Custodian .....	.42
	The Transfer Agent .....	.43
	The Administrator .....	.44
	Regulation .....	.45-.51
	Summary of Relevant SEC Registration and Reporting Forms .....	.47-.51
	Financial Reporting to Shareholders .....	.52-.53
	Accounting Rules and Policies .....	.54-.55
	Effective Date of Transactions .....	.56-.57
	Other Rules and Regulations .....	.58-.66
	Money Market Reform .....	.58
	Other Requirements .....	.59-.61
	Jumpstart Our Business Startups Act (JOBS Act) .....	.62-.64
	Regulatory Changes for Investment Companies That Invest in Commodities .....	.65-.66
2	Investment Accounts	.01-.183
	Investment Objectives and Policies .....	.02-.03
	Operations and Controls .....	.04-.18
	Recordkeeping Requirements .....	.04-.05
	Custody of Securities .....	.06-.08
	Accounting for Segregated Accounts .....	.09-.11
	Routine Investment Procedures .....	.12-.18
	Accounting .....	.19-.183
	Net Asset Value Per Share .....	.19-.24
	Basis of Recording Securities Transactions .....	.25-.30
	Valuing Investments .....	.31-.44
	Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased .....	.45-.51
	Valuation Techniques .....	.52-.60

Chapter		Paragraph
2	Investment Accounts — continued	
	Present Value Techniques .....	.61-.63
	The Fair Value Hierarchy .....	.64-.69
	Application of Fair Value Measurements .....	.70-.84
	Offsetting Positions in Market Risks or Counterparty Credit Risk .....	.85-.86
	Investments in Entities That Calculate Net Asset Value Per Share .....	.87-.99
	Money Market Funds .....	.100
	Determining Costs and Realized Gains and Losses .....	.101-.109
	Accounting for Investment Income .....	.110-.128
	Defaulted Debt Securities .....	.129-.130
	Accounting for Expenditures in Support of Defaulted Debt Securities .....	.131-.135
	Lending of Portfolio Securities and Secured Borrowings ....	.136-.144
	Accounting for Derivatives .....	.145-.148
	Accounting for Foreign Investments .....	.149-.183
3	Financial Instruments	.01-.81
	Money Market Investments .....	.02-.07
	Repurchase Agreements .....	.08-.09
	Reverse Repurchase Agreements .....	.10
	U.S. Government Securities (Treasury Bills, Notes, and Bonds) .....	.11-.12
	Municipal Notes and Bonds .....	.13-.16
	Insured Portfolios .....	.17
	To Be Announced Securities .....	.18-.22
	When-Issued Securities .....	.23-.24
	Synthetic Floaters and Inverse Floaters .....	.25-.28
	Mortgage-Backed Securities .....	.29-.31
	Adjustable Rate Mortgages .....	.32
	Collateralized Mortgage Obligations .....	.33
	Real Estate Mortgage Investment Conduits .....	.34
	High-Yield Securities .....	.35-.36
	Payment-in-Kind Bonds .....	.37-.38
	Step Bonds .....	.39-.40
	Put and Call Options .....	.41-.44
	Warrants .....	.45-.46
	Loan Commitments .....	.47-.48
	Standby Commitments .....	.49
	Commodity and Financial Futures Contracts .....	.50-.54
	Forward Contracts .....	.55
	Forward Exchange Contracts .....	.56-.57

Chapter		Paragraph
3	Financial Instruments — continued	
	Interest Rate, Currency, Credit, and Equity Swaps and Swaptions .....	.58-.64
	Centrally Cleared Swaps .....	.65-.69
	Structured Notes or Indexed Securities .....	.70-.73
	Short Positions .....	.74-.76
	Mortgage Dollar Rolls .....	.77-.81
4	Capital Accounts	.01-.56
	Operations and Controls .....	.02-.21
	Distributors .....	.02-.07
	Orders to Purchase or Redeem .....	.08-.12
	Cancellation of Orders .....	.13
	Shareholder Transactions .....	.14-.21
	Accounting for Capital Share Transactions and Distributions .....	.22-.30
	Equalization .....	.28-.30
	Auditing Procedures .....	.31-.56
	Principal Audit Objectives .....	.31
	Obtaining an Understanding of the Entity and Its Environment, Including Internal Control .....	.32-.38
	Examination of Transactions and Detail Records .....	.39-.50
	Other Auditing Matters .....	.51-.56
5	Complex Capital Structures	.01-.96
	Operational and Accounting Issues .....	.02-.30
	Multiple-Class Funds .....	.02-.17
	Master-Feeder Funds .....	.18-.21
	Funds of Funds .....	.22-.25
	Other Considerations for Investments in Nonpublicly Traded Investees .....	.26-.30
	Financial Statement Presentation .....	.31-.63
	Multiple-Class Funds .....	.32-.39
	Master-Feeder Funds .....	.40-.54
	Funds of Funds .....	.55-.63
	Audit Considerations .....	.64-.96
	Planning .....	.68-.70
	Control Environment .....	.71-.74
	Investment in Master Fund and Income-Gain Allocations ...	.75-.78
	Other Transactions .....	.79
	Prospectus Restrictions and Compliance .....	.80-.83
	Tax Qualifications and Compliance .....	.84-.87
	Financial Statements .....	.88-.90
	Funds of Funds .....	.91-.92
	Control Environment .....	.93-.96

Chapter		Paragraph
6	Taxes	.01-.134
	Overview .....	.01-.02
	Financial Statements and Other Matters .....	.03-.16
	Income Tax Expense .....	.03-.12
	Federal Income Tax Provisions Affecting Investment Accounts .....	.13
	Foreign Withholding Taxes .....	.14
	Financial Statement Presentation .....	.15
	Diversification of Assets .....	.16
	RICs .....	.17-.134
	General Discussion of the Taxation of RICs .....	.17
	Taxation of a RIC's Taxable Income and Net Capital Gains .....	.18-.24
	Taxation of Shareholder Distributions .....	.25-.43
	Excess Reported Amounts .....	.44
	Qualification Tests .....	.45-.57
	Variable Contracts .....	.58-.63
	Distribution Test .....	.64-.82
	Excise Tax on Undistributed Income .....	.83-.95
	Computation of Taxable Income and Gains .....	.96-.125
	Offshore Funds .....	.126-.130
	Small Business Investment Companies .....	.131-.134
7	Financial Statements of Investment Companies	.01-.239
	Comparative Financial Statements .....	.05-.07
	Consolidation .....	.08-.17
	Other Consolidation Considerations .....	.12-.17
	Reporting Financial Position .....	.18-.110
	Reporting of Fully Benefit-Responsive Investment Contracts .....	.23-.26
	Schedule of Investments .....	.27-.46
	Assets .....	.47-.68
	Liabilities .....	.69-.81
	Disclosures Related to Transfers of Financial Assets, Including Repurchase Agreements .....	.82-.83
	Fair Value Disclosures .....	.84-.98
	Fair Value Option .....	.99-.102
	Net Assets .....	.103-.110
	Statement of Operations .....	.111-.146
	Investment Income .....	.112-.115
	Expenses .....	.116-.129
	Net Investment Income .....	.130
	Net Realized Gain or Loss From Investments and Foreign Currency Transactions .....	.131-.134



**Table of Contents**

**xix**

Chapter		Paragraph
7	Financial Statements of Investment Companies — continued	
	Net Increase (Decrease) in Unrealized Appreciation or Depreciation on Investments and Translation of Assets and Liabilities in Foreign Currencies .....	.135-.136
	Net Increase From Payments by Affiliates and Net Gains (Losses) Realized on the Disposal of Investments in Violation of Restrictions .....	.137-.143
	Net Realized and Unrealized Gain or Loss From Investments and Foreign Currency .....	.144
	Net Increase or Decrease in Net Assets From Operations .....	.145
	Reporting of Fully Benefit-Responsive Investment Contracts .....	.146
	Statement of Changes in Net Assets .....	.147-.152
	Subsequent Events .....	.153-.158
	Statement of Cash Flows .....	.159-.172
	Financial Highlights .....	.173-.187
	Other Disclosure Requirements .....	.188-.205
	Fully Benefit-Responsive Investment Contract Disclosures ....	.190
	Offsetting Assets and Liabilities .....	.191-.205
	Interim Financial Statements .....	.206-.212
	Auditing Considerations .....	.209-.212
	Illustrative Financial Statements of Investment Companies ....	.213-.229
	Illustrations of Calculations and Disclosures When Reporting Expense and Net Investment Income Ratios .....	.230
	Illustration of Calculation and Disclosure When Reporting the Internal Rate of Return .....	.231
	Illustration of Calculation and Disclosure When Reporting the Total Return Ratio .....	.232
	Illustration of a Condensed Schedule of Investments .....	.233
	Illustrations of Nonregistered Investment Partnerships Schedule of Investments .....	.234
	Presentation of Fully Benefit-Responsive Investment Contracts .....	.235
	Disclosure — Fair Value Measurements of Investments That Are Measured at Net Asset Value per Share (or its Equivalent) as a Practical Expedient .....	.236
	Illustration of Reporting Financial Highlights, Net Asset Value Per Share, Shares Outstanding, and Share Transactions When Investors in Unitized Nonregistered Funds Are Issued Individual Classes or Series of Shares .....	.237
	Illustrative Statement of Changes in Net Assets (Changes in Partners' Capital) of a Nonregistered Investment Partnership That Includes a General Partner and One or More Limited Partners .....	.238
	Illustrative Disclosure for a Registered Fund Issuing Consolidated Financial Statements and Relying on CFTC Letter No. 13-51 .....	.239

Chapter		Paragraph
8	Other Accounts and Considerations	.01-.62
	Investment Advisory (Management) Fee Expense .....	.01-.03
	Expenses .....	.04-.13
	Distribution Expenses .....	.14-.23
	Organization and Offering Costs .....	.24-.35
	Unusual Income Items .....	.36
	Business Combinations .....	.37-.48
	Diversification of Assets .....	.49-.50
	Liquidation Basis of Accounting .....	.51-.62
	When to Apply the Liquidation Basis of Accounting .....	.52-.54
	Recognition and Measurement Provisions .....	.55-.56
	Presentation and Disclosure .....	.57-.62
9	Unit Investment Trusts	.01-.22
	Fixed-Income and Equity UITs .....	.05-.13
	Taxes .....	.14-.15
	Illustrative Financial Statements .....	.16-.22
10	Variable Contracts — Insurance Entities	.01-.63
	Separate Accounts .....	.01-.06
	History .....	.07-.10
	Product Design .....	.11-.22
	Contracts in the Payout (Annuitization) Period .....	.23-.25
	SEC Registration .....	.26-.30
	Auditing Considerations .....	.31-.37
	Taxation of Variable Contracts .....	.38-.55
	Illustrative Financial Statements .....	.56-.63
11	General Auditing Considerations	.01-.103
	Chapter Overview .....	.01-.03
	General Audit Planning Considerations .....	.04-.16
	Audit Risk .....	.04-.06
	Risk Assessment Procedures .....	.07-.12
	Risk Assessment and the Design of Further Audit Procedures .....	.13-.16
	Other General Considerations for Audits of Investment Companies .....	.17-.56
	Internal Control Considerations .....	.27-.32
	Going Concern .....	.33
	Risk Assessment Procedures and Related Activities .....	.34-.43

## Table of Contents

**xxi**

Chapter		Paragraph
11	General Auditing Considerations — continued	
	Auditor Conclusions .....	.44-.49
	Implications for the Auditor’s Report .....	.50-.55
	Documentation .....	.56
	Auditing Procedures for the Investment Portfolio Accounts ....	.57-.100
	Principal Audit Objectives .....	.57
	Examination of Transactions and Detail Records .....	.58-.100
	Appendix A — Auditor’s Responsibility for Other Information in Documents Containing Audited Financial Statements .....	.101
	Appendix B — Reports on Controls at Outside Service Organizations .....	.102
	Appendix C — Consideration of Fraud in a Financial Statement Audit .....	.103
12	Independent Auditor’s Reports and Client Representations	.01-.54
	Introduction .....	.01-.02
	Forming an Opinion on the Financial Statements .....	.03-.05
	Reports on Financial Statements of Nonregistered Investment Companies .....	.06-.19
	Unmodified Opinion .....	.06-.07
	Modified Opinions .....	.08-.18
	Review Report on Interim Financial Information .....	.19
	Reports on Financial Statements of Registered Investment Companies .....	.20-.28
	Report for a Registered Investment Company That Includes a Summary Schedule of Investments in the Financial Statements Provided to Shareholders .....	.27-.28
	Report on Internal Control Required by the SEC Under Form N-CEN .....	.29-.35
	Report on Examinations of Securities Pursuant to Rules 17f-1 and 17f-2 Under the 1940 Act .....	.36-.45
	Report on Examinations of Securities Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940 .....	.37-.45
	Reports on Processing of Transactions by a Transfer Agent .....	.46-.47
	Reporting Pursuant to the Global Investment Performance Standards .....	.48-.51
	Illustrative Representation Letter — XYZ Investment Company .....	.52-.54
	Nonregistered Investment Company Written Representation .....	.52
	Registered Investment Company Written Representation .....	.53-.54

## Appendix

- A Overview of Statements on Quality Control Standards
- B Common or Collective Trusts
- C Venture Capital, Business Development Companies, and Small Business Investment Companies
- D Computation of Tax Amortization of Original Issue Discount, Market Discount, and Premium
- E Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies
- F Illustrations for Separately Calculating and Disclosing the Foreign Currency Element of Realized and Unrealized Gains and Losses
- G References to Technical Questions and Answers
- H The New Leases Standard: FASB ASC 842
- I Schedule of Changes Made to the Text From the Previous Edition
- J Accounting for Financial Instruments
- K Asset Management
- L New Auditing Standards to Change the Auditor's Report

## Glossary

Index of Pronouncements and Other Technical Guidance

Subject Index

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## Chapter 1

# Overview of the Investment Company Industry

*Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, July 1, 2019, but becoming effective on or prior to December 31, 2019, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.*

### © Update 1-1 Accounting and Reporting: Credit Losses

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued in June 2016, is effective for fiscal years of public business entities (PBEs) that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

For all other public business entities, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960 through FASB ASC 965 on plan accounting, ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Early application is permitted for all entities as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

**Note:** At the July 17, 2019, board meeting, FASB adopted a two-bucket approach to stagger effective dates for major standards. Bucket one includes SEC filers (as defined in generally accepted auditing principles [GAAP]), excluding smaller reporting companies (SRCs) as currently defined by the SEC. Bucket two makes up all other entities, which includes the following:

- All other PBEs, including SRCs
- Private companies
- All not-for-profit organizations, including not-for-profit entities that have issues, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- All employee benefit plans, including employee benefit plans that file financial statements with the SEC

The board decided that FASB ASU No. 2016-13 will be effective for PBEs that are SEC Filers, excluding SRCs as currently defined by the SEC, for fiscal years beginning after December 15, 2019,

and interim periods within those fiscal years. The determination of whether an entity is an SRC will be based on an entity's most recent assessment in accordance with SEC regulations. For all other entities, the board decided that FASB ASU No. 2016-13 will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early adoption will continue to be permitted; that is, early adoption is allowed for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (that is, effective January 1, 2019, for calendar-year-end companies).

The FASB board's tentative decisions can be located under the "Meetings" page at [www.fasb.org](http://www.fasb.org). FASB notes that all of the conclusions reported are tentative and may be changed at future board meetings. Decisions become final only after a formal written ballot to issue an ASU or a Statement of Financial Accounting Concepts.

ASU No. 2016-13 creates FASB ASC 326, *Financial Instruments—Credit Losses*, to amend guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities.

For assets held at amortized cost basis, FASB ASC 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected.

For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP. However, FASB ASC 326 will require that credit losses be presented as an allowance rather than as a write-down.

ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. This also changed guidance in FASB ASC 325-40, which is related to initial and subsequent measurement.

Readers are encouraged to consult the full text of this ASU on FASB's website at [www.fasb.org](http://www.fasb.org).

For more information on ASU No. 2016-13, see appendix J, "Accounting for Financial Instruments," of this guide.

## Introduction

**1.01** The investment company industry is highly specialized; intensely competitive; and may be subject to specific governmental regulation, special tax treatment, and public scrutiny. Accordingly, before starting an engagement to audit an investment company's financial statements, an auditor should become familiar with the entity's business; its organization, structure, and operating characteristics and the industry's terminology; legislation; and, if applicable, relevant securities and income tax laws and regulations. This chapter provides an introductory review of these topics.

## Guide Application

**1.02 Auditing.** The auditing procedures discussed in this guide apply to most investment companies.<sup>1</sup> Fundamental considerations associated with the planning and execution of investment company financial statement audits are included in chapter 11, "General Auditing Considerations," of this guide, while auditor report considerations are provided in chapter 12, "Independent Auditor's Reports and Client Representations." When applicable, audit considerations directly associated with certain specific accounting principles are included within the respective chapters of this guide where the specific accounting principles are discussed.

**1.03 Accounting.** The accounting principles discussed in this guide apply to all investment companies within the scope of FASB ASC 946 (as discussed in the following section of this chapter).

**1.04** Consistent with FASB ASC 946-10-15-3, this guide does not apply to real estate investment trusts, which have some of the attributes of investment companies but are scoped out of FASB ASC 946.

### Investment Companies Defined — Scope of FASB ASC 946

**1.05** FASB ASC 946-10-15-5 requires an entity that is not regulated under the Investment Company Act of 1940 (1940 Act) to perform an assessment to determine whether it is an *investment company* for accounting purposes, and is, therefore, within the scope of the industry-specific guidance in FASB ASC 946.

**1.06** An entity regulated under the 1940 Act is an investment company for accounting purposes, pursuant to FASB ASC 946-10-15-4.

**1.07** Paragraphs 6–7 of FASB ASC 946-10-15 identify characteristics of an investment company. Entities that are not regulated under the 1940 Act are required to meet certain fundamental characteristics to be considered investment companies, and are also required to be assessed for other typical characteristics of investment companies. An entity's purpose and design should be considered when conducting the assessment. An entity that does not have the fundamental characteristics is not an investment company. However, failing to meet one or more of the typical characteristics does not necessarily preclude an entity from being an investment company. If an entity does not possess one or more of the typical characteristics, judgment should be applied and a determination made, considering all facts and circumstances, on whether the entity's activities are consistent (or are not consistent) with those of an investment company.

**1.08** Based on FASB ASC 946-10-15-6, an entity must have the following fundamental characteristics to be an investment company:

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<sup>1</sup> The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of nonissuers. See the section "Applicability of Generally Accepted Auditing Standards and PCAOB Standards" of the preface to this guide for a discussion of the definitions of issuer and nonissuer as used throughout this guide. Further considerations for audits of issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. PCAOB guidance included in an AICPA Guide has not been reviewed, approved, disapproved, or otherwise acted upon by the PCAOB and has no official or authoritative status.

- a. It is an entity that does both of the following:
  - i. Obtains funds from one or more investors and provides the investor(s) with investment management services
  - ii. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both
- b. The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

In addition, an entity should assess whether it has the following typical characteristics of an investment company, as identified in FASB ASC 946-10-15-7:

- a. More than one investment
- b. More than one investor
- c. Investors that are not related parties of the parent entity (if there is a parent) or the investment manager
- d. Ownership interests in the form of equity or partnership interests
- e. Substantially all of its investments are managed on a fair value basis

**1.09** Technical Questions and Answers (Q&A) section 6910.36, "Determining Whether Loan Origination Is a Substantive Activity When Assessing Whether an Entity Is an Investment Company,"<sup>2</sup> discusses how an entity determines whether loan origination activity represents a substantive activity that precludes the entity from qualifying as an investment company under FASB ASC 946-10-15-6 when such loan originations to third parties are performed for the purposes of maximizing an entity's returns from capital appreciation, investment income, or both.

**1.10** In performing the assessment, Q&A section 6910.36 states that entity should consider its design, business purpose (see paragraphs 4–7 of FASB ASC 946-10-55), and the reason for performing the activities (see FASB ASC 946-10-55-10), including how the entity is marketed and presented to current and potential investors. If an entity believes it is an investment company under FASB ASC 946 the entity's design, business purpose, and how it holds itself out to investors should be consistent with those of an investment company.

**1.11** Determining whether loan origination activity represents a substantive activity may require significant judgment. Loan origination would generally be considered inconsistent with the business purpose of capital appreciation, investment income, or both (investing income). Significance of the income generated from the entity's origination and syndication of loans as compared to the income generated through capital appreciation, investment income, or both, is an important factor for entities to consider. FASB ASC 946-10-55-4 indicates

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<sup>2</sup> *Technical Questions and Answers* is not a source of established authoritative accounting principles as described in the FASB *Accounting Standards Codification*<sup>®</sup>, the authoritative source of U.S. generally accepted accounting principles for nongovernmental entities. This nonauthoritative material is based on selected practice matters identified by the staff of the AICPA Technical Hotline and various other bodies within the AICPA and has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

All Q&A sections can be found in *Technical Questions and Answers*.



that an investment company should have no substantive activities other than its investing activities and should not have significant assets or liabilities other than those relating to investing activities. The evaluation of loan origination activities generally would include a quantitative and qualitative assessment of the significance of those activities relative to the entity's investing activities. Often, the entity's business strategy with respect to originating loans (for example, if the entity originates and holds the loans versus originating and selling the loans) would correspond to the quantitative significance of loan origination income relative to investing income.

**1.12** The fee income generated as part of loan origination activities relative to total income represents an important factor for entities to consider. An entity would generally also perform a qualitative analysis in determining whether the loan origination represents a substantive activity of the entity. Appendix A, "Factors to Consider in Determining Whether Loan Origination Represents a Substantive Activity of the Entity," to Q&A section 6910.36 provides examples of when factors may be more or less indicative of an investment company.

**1.13** Q&A section 6910.36 concludes in addressing the requirements of FASB ASC 946-10-25-1 and states that a change in the level of loan origination activity or holding period for self-originated loans that would affect its quantitative analysis, as well as changes to the qualitative factors, may indicate that the purpose and design of the entity have changed.

**1.14** Readers should consider and utilize the related implementation guidance in FASB ASC 946-10-55, which is an integral part of assessing investment company status and provides additional guidance for that assessment.

**1.15** The aforementioned definition of an investment company has similarities to the legal definition of an investment company in federal securities laws. Securities laws explain that typically, an investment company sells its capital shares to investors; invests the proceeds, mostly in securities, to achieve its investment objectives; and distributes to its shareholders the net income earned on its investments and net gains realized on the sale of its investments.

**1.16** Paragraph 1 of FASB ASC 946-10-25 states that an initial determination of whether an entity is an investment company should be made upon formation of the entity; afterwards, an entity should reassess whether it is or is not an investment company only if there is a subsequent change in the purpose and design of the entity or if the entity is no longer regulated under the 1940 Act. For information about change in status, readers should review FASB ASC 946-10-25 and the related implementation guidance and illustrative examples in FASB ASC 946-10-55.

## Types of Investment Companies

**1.17** Several types of entities may meet the aforementioned investment company scope criteria, including but not limited to the following:

- Management investment companies registered under or otherwise regulated by the 1940 Act
- Unit investment trusts (UITs)
- Common (collective) trust funds
- Investment partnerships

- Special purpose funds
- Venture capital investment companies, private equity funds, hedge funds
- Certain separate accounts of life insurance companies
- Offshore funds

See the "Definition and Classification" section of this chapter for further discussion of these and other types of entities.

#### 1.18 Management investment companies may include

- open-end funds (usually known as mutual funds), including exchange-traded funds (ETFs), and
- closed-end funds, including
  - small business investment companies (SBICs) and
  - business development companies (BDCs).

**1.19** Investment companies may be organized under various legal entity forms, including corporations (in the case of mutual funds, under the laws of certain states that authorize the issuance of common shares redeemable on demand of individual shareholders); common law trusts (sometimes called business trusts); limited partnerships, limited liability investment partnerships and companies; and other more specialized entities such as separate accounts of insurance companies that are not in themselves entities at all except in the technical definition of the 1940 Act.

**1.20** Mutual funds and closed-end investment companies registered with the SEC under the 1940 Act are common forms of investment companies and are required to follow many rules and regulations prescribed by the SEC. These rules and regulations are discussed within the "Regulation" section of this chapter and elsewhere throughout this guide.

## History

**1.21** One of the first documented concepts of investment companies originated in England in 1868 with the formation of the Foreign & Colonial Government Trust. Its purpose was to provide investors of moderate means with the same advantages as those of more affluent investors (that is, to diminish risk by spreading investments over many different securities). Massachusetts Investors Trust, the first mutual fund, was organized in 1924.

**1.22** The investment company industry has changed considerably since its origin and has attracted insurance companies, brokerage firms, conglomerates, banks, and others as sponsors to perform advisory or distribution services. Initially, the industry was characterized by one- or two-person managements, relatively simple investment techniques, and rudimentary sales practices. Today, investment techniques are more sophisticated, and selling practices are more creative and aggressive. For example, in the 1970s, tax-exempt and money market funds came into use; in the 1980s, funds entered foreign markets; in the 1990s, funds entered the derivative security markets, which necessitated new investment expertise and increasingly sophisticated data processing capability; and in the 2000s, funds expanded their derivative activity and invested in such instruments as asset-backed securities and private placement equities, which