Project **Consolidation**

Topic **Investment Companies**

Introduction

1 At the February 2010 joint Board meeting, the FASB and IASB discussed how an investment company should account for its investments in entities that it controls. The boards tentatively decided that an entity that is considered an investment company should be exempt from consolidating entities that it controls and should measure investments in such controlled entities at fair value through profit or loss. This decision is similar to the guidance currently in U.S. GAAP (FASB Accounting Standards Codification™ Topic 946, Financial Services—Investment Companies), but would be a significant change to the approach currently in IFRS and proposed in ED 10 *Consolidated Financial Statements*, which was exposed by the IASB in December 2008.

2 The boards tentatively decided that the guidance currently used to define an investment company in Topic 946 should be used as the basis for developing the attributes of an investment company as part of the joint project. However, the boards asked the staff to address a number of implementation concerns with that guidance.

3 The purpose of this paper is to define an investment company to capture the appropriate entities that will be required to measure investments in controlled entities at fair value through profit or loss. Agenda paper XX discusses the

proposed disclosure requirements that the staff believe should be required for entities that are considered investment companies.

4 This paper discusses the following:

(a) US GAAP guidance regarding the characteristics of an investment company (paragraphs 5 – 7)

(b) Staff analysis and recommendations regarding the characteristics of an investment company (paragraphs 9 – 40)

(c) Transition requirements relating to the investment company guidance (paragraphs 41 and 42).

US GAAP guidance

5 Topic 946 of the Codification (formerly the AICPA Investment Company guide) includes four criteria that need to be met in order for an entity to qualify as an investment company. The criteria are as follows:

a. *Investment activity.* The investment company's primary business activity involves investing its assets, usually in the securities of other entities not under common management, for current income, appreciation, or both.

b. *Unit ownership.* Ownership in the investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.

c. *Pooling of funds.* The funds of the investment company's owners are pooled to avail owners of professional investment management.

d. *Reporting entity.* The investment company is the primary reporting entity.

Further, an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940[1]) must be a separate legal entity to be within the scope of the Financial Services—Investment

[1] Separate accounts of insurance companies are not separate legal entities but nevertheless are considered investment companies under the scope of Topic 946.

Companies Topic. That is, the guidance in this Topic should be applied only if the investment is held by an investment company that is a separate legal entity. Though many aspects of venture capital investment companies, including small business investment companies and business development companies, differ from aspects of other types of investment companies, the provisions of this Topic generally apply.

Topic 946 further provides that real estate investment trusts (which have some of the attributes of an investment company but are covered by other generally accepted accounting principles) are specifically excluded from the guidance for investment companies.

6 In June 2007 the AICPA issued Statement of Position (SOP) 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies,* which provides guidance for determining whether (1) an entity is within the scope of Topic 946 and (2) the specialized industry accounting principles should be retained by a parent in consolidation or by an equity method investor. The SOP was indefinitely deferred with the issuance of FASB Staff Position SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, in December 2007 because of the FASB's concerns with certain implementation issues.

7 Specifically, the SOP included a requirement that in order to retain investment company accounting in the financial statements of the parent company, the consolidated group should follow established policies that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group.

Staff analysis and recommendations

8 The staff examined current US guidance and the SOP as a starting point to develop the criteria discussed below. Paragraphs 9 – 24 discuss characteristics of an investment company that are either included within established guidance or were discussed at previous Board meetings, together with the staff recommendations. The draft recommended criteria to define an investment company are set out in paragraph 40.

Scope of Other Activities Permitted

9 Topic 946 currently requires that an investment company's *primary* business activity involves investing in assets for current income, appreciation or both. One view presented by the staff at the February joint Board meeting included a requirement that an investment company should not have *substantive* activities other than its investing activities. A difference was perceived in the threshold of the other activities that would be permitted for an investment company under the two proposals and the staff considered if (a) an investment company should be permitted to be involved in other activities, and (b) to what extent an investment company could be involved in activities other than investing activities, including holding assets other than those relating to its investment activities.

10 The requirement that an investment company should not have *substantive* activities other than its investing activities is consistent with the deferred guidance in SOP 07-1.

11 The use of *primary* in US GAAP has been interpreted inconsistently with respect to the amount of non-investment activities that can be conducted by the investment company. In order to clarify the intention behind the criteria, the staff recommend that the requirement currently in Topic 946 should be changed.

12 The staff agree with the guidance that was proposed in the SOP—if a company purports to be an investment company, then the entity should not have substantive

activities other than its investing activities and it should not have any significant assets or liabilities other than those relating to investing activities. However, an investment company may undertake (or hold an investment in an entity that undertakes) operating activities that relate to services provided to its investment business (investment advisor or transfer agent services), even if that activity is substantive. If an investment company has a controlling interest in an investee that provides these services to the investment company's investment business, then the investment company should consolidate those operations. Owning such investments, however, would not prevent investment company status.

13 The staff acknowledge that this change may affect some investment companies in the United States as the scope of activities permitted under *primary* has been interpreted more widely than *substantive.* For example, Equity REITs[2] are one type of investment vehicle likely to be affected, although the staff believe that the affect on Equity REITs will depend on the outcome of the FASB's current project on Accounting for Investment Properties. That project may result in an option (or a requirement) to measure investment properties at fair value through earnings. IAS 40 *Investment Property* provides such an option.

Purpose of the Investment

Express business purpose

14 An investment company invests for the purpose of income, capital appreciation, or both. In order for an entity to be considered an investment company, that entity shall make an explicit commitment to a group of unrelated investors that the purpose of its business is to invest in assets in order to generate and distribute income, capital appreciation, or both. Evidence about the entity's express business purpose may include the manner in which the entity presents itself to other parties. For example, an entity that presents itself as a private equity investor

[2] An Equity REIT owns and operates income-producing real estate. They are usually vertically integrated property operating companies that include the leasing, maintenance and development of real property and tenant services.

with the objective of investing for capital appreciation has the express business purpose that is consistent with the business purpose of an investment company. Evidence about the entity's business purpose may include a prior history of buying and selling investments, the entity's offering memorandum, publications distributed by the entity, and other corporate or partnership documents that indicate the objectives of the entity.

15 One of the concerns raised by the boards in February was the use of 'internal' investment companies, most commonly in the form of venture capital funds. The boards were concerned that an entity that meets the definition of an investment company could be inserted in a larger corporate structure. The larger corporate could then use its 'internal' investment company subsidiary to invest in entities with loss making activities (for example research and development activities on behalf of the overall group) and would record its investments at fair value, rather than reflecting the underlying activities of the investee. Typically, in these situations, the corporate entity would hold a fixed price call option to acquire the investments of the internal investment entity if the underlying investment is successful and therefore the purpose of the investment is no longer for income or capital appreciation, or both—the investment is truly designed to benefit the corporate entity in some operating or strategic capacity.

16 Because of the potential abuse of "internal" investment companies, some Board members recommended that the staff examine the relationship between the investments and the investment company as well as between a parent of an investment company and the investments of an investment company. Some staff support including a requirement that the investment company (or its affiliates) does not obtain benefits from its investees that would be unavailable to other unrelated investors or non-investors of the investee. This requirement would be similar to the requirement proposed in the SOP. These staff believe that this factor is precisely what differentiates an investment company from an operating conglomerate. Even if an investment company holds a controlling interest in an investee, the investment company's business model is not to integrate the investee

with any of its other investees or actively manage the day-to-day activities of the investee.

17 These staff recommend that a requirement similar to that in paragraph **.18** of the SOP (included below) should be included as part of the criteria to meet the definition of an investment company. The requirement in paragraph **.18** of the SOP set out factors that, if they exist, would prevent an entity from being an investment company.

> **.18** …Investments are held for strategic operating purposes if the entity or its affiliates obtain or have the objective of obtaining benefits (other than benefits attributable to the ownership interest, such as dividends) as a result of investments in any investee, through relationships with the investee or its affiliates, that are unavailable to non-investor entities that are not related parties to the investee.[3] Examples of relationships and activities that violate this requirement include, but are not limited to, the following:
>
> *a.* The acquisition, use, exchange, or exploitation of the processes, intangible assets, or technology of the investee or its affiliates by the entity or its affiliates.
>
> *b.* Significant purchases or sales of assets (other than products or services as discussed in item *e* below) between the investee or its affiliates and the entity or its affiliates.
>
> *c.* Joint ventures or similar arrangements between the investee or its affiliates and the entity or its affiliates.
>
> *d.* Other arrangements between the investee or its affiliates and the entity or its affiliates to jointly develop, produce, market, or provide products or services.
>
> *e.* Other transactions between the investee or its affiliates and the entity or its affiliates that (1) are on terms that are unavailable to entities that are not related parties to the investee, (2) are not at a price the transaction would occur in an orderly transaction between market participants at the measurement date (and that price is objectively verifiable), or (3) represent a significant portion of the investee's or the entity's business activity, including business activities of investees or affiliates of the entity. (Transactions that (1) do not represent a significant portion of the investee's business activities and that are between the investee or its affiliates and the entity or its affiliates and (2) involve products or services of the investee or its affiliates that are available to entities or customers that are not related parties to the investee on similar terms do not violate this condition if the transactions occur at a price the transaction would occur in an orderly transaction between market participants at the measurement date and that price is objectively

[3] Affiliates of the entity in this guidance refer to entities that are controlled by the potential investment company, any parent of the potential investment company and any entities under common control (eg fellow subsidiaries of the potential investment company).

> verifiable by similar transactions between (*a*) the investee or its affiliates and entities that are not related parties to the investee or (*b*) the investor or its affiliates and entities that are not investees or affiliates of the investor or investees.)
> *f*. The entity or its affiliates have disproportionate rights, exclusive rights, or rights of first refusal to purchase or otherwise acquire assets, technology, products, or services of investees or their affiliates. (Rights of first refusal to purchase or otherwise acquire direct ownership interests would not violate this provision.)

18 In addition, some staff believe that any providers of debt to an investee of an investment company should not have direct recourse to any of the investment company's other investees. Such cross-collateralisation links the individual investments of an investment company and would seem to go against the purpose of holding an investment for income, capital appreciation, or both. The dependence of one investee on another for collateral or financing would also appear to be a benefit that other unrelated investors would be unlikely to be able to obtain.

Exit strategy

19 A number of constituents that the staff spoke with emphasised that the purpose of investing assets for income, capital appreciation, or both, is accomplished through the acquisition and *disposal* of investments. They stressed that an investment company that holds investments for this purpose will have an exit strategy included in its investment plans. The staff agree that the entity should have investments plans that include an exit strategy in order to be considered an investment company. Similar to the requirement in SOP 07-1, the staff believe that to be considered an investment company, the entity is required to have identified potential exit strategies (even though it may not have identified the specific method of exiting the investment) and a defined time at which it expects to dispose of the investment (or range of time) for each investment that it holds. An entity would not be precluded from meeting this criterion if the specific method of exiting has not been identified or if the time identified is defined by a specific set of facts and circumstances, ie achieving a milestone.

Fair Value

20 All of the staff conversations with users and preparers of financial statements of investment companies emphasised the relevance of fair value for these entities. Therefore the staff believe that this emphasis should be evident in the operations and management of an investment company. All of the investment company's investments should be managed, and their performance evaluated, on a fair value basis. Information about the investment company's investments should be provided internally on a fair value basis to the entity's key management personnel and externally on a fair value basis to its investors.

Ownership, funds and financing

21 The investment company should act on behalf of a group of unrelated investors and the funds of the investment company's owners are pooled to avail owners of professional investment management. Ownership in an investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed. An investment company can have more than one class of investor.

Other Items Considered

Composition of the investor group

22 Based on discussions with a number of constituents, many believe that the composition of the shareholder group in an entity should be a determinant of whether an entity would qualify as an investment company. Some constituents believe that there should be a requirement that an investment company has a minimum number of investors or a prescribed percentage (for example 50%) of the outstanding investors being considered passive investors. The staff are concerned that an entity could be structured to meet this requirement by issuing equity to passive investors and, in turn, writing call and put options on these investments, such that even though the investors would be considered passive,

they are non-substantive. The staff believe that it could include criteria which would need to be evaluated to determine if the passive investment is considered substantive; however, the staff believe that this would complicate the investment company criteria and the other requirements are adequate.

Level of ownership in the investments

23 The staff considered whether the level of ownership interests in investees should be considered when determining whether an entity should qualify as an investment company. SOP 07-1 included that a significant level of ownership, particularly a controlling financial interest, is an indication that the business purpose of an entity is not for income, capital appreciation, or both. The staff believes that there is not necessarily any correlation between the size of ownership interest in an investee and whether an entity should be considered an investment company.

Contractual life of the investment company

24 Some constituents have indicated that the requirements to qualify as an investment fund should include a requirement that the entity has a contractual life, which may only be amended by a super-majority vote of the investors. The staff believe that including such a requirement would result in open ended funds not qualifying as investment companies which, in their view, would be inappropriate.

Parent entity accounting

25 With regards to examining the relationship that an investment company has with a parent, some questions the boards asked the staff to consider were:

- Should an investment company be permitted to have a parent?
- Should a parent of an investment company be permitted to use fair value to measure the investment company's investments in entities that it controls when preparing its consolidated financial statements?

26 The staff do not believe that an investment company should be precluded from having a parent. Therefore, having a parent should not prevent an entity from meeting the definition of an investment company.

27 The staff have presented three options for the boards to consider with regards to accounting for the controlled investees of an investment company subsidiary by a parent in its consolidated financial statements. All three options would incorporate the requirement that a parent that is also an investment company would use fair value to measure controlled investees of an investment company subsidiary in its consolidated financial statements.

Option 1

28 Some staff support a parent not being permitted to retain fair value accounting for any controlled investees of an investment company subsidiary in the parent's consolidated financial statements (unless the parent is an investment company itself). The parent must consolidate all controlled investees of investment company subsidiaries as if the parent holds investments in those investees directly.

29 The consequences of this option is that a corporate entity that has substantive activities other than investing would be required to consolidate all controlled subsidiaries, including those investments held through an investment company subsidiary which, by definition, would not have substantive activities other than investing.

30 The benefits of choosing Option 1 are: (a) it addresses the concern expressed by Board members regarding internal investment companies, and (b) all controlled investees would be consolidated, giving consistency in measurement and presentation. However, the staff recognise that this approach may not properly reflect the nature of an investment company subsidiary's business. If fair value measurement is most relevant in the investment company's financial statements then, in the absence of a different objective for holding investment in the

investees in the group accounts, fair value would seem to continue to be relevant when included in its parent's consolidated financial statements.

Options 2 and 3

Option 2

31 Some staff support allowing a parent to retain the accounting of an investment company subsidiary if a parent has multiple separate activities in its business. They, therefore, believe that it is appropriate for a parent to report its investment activities (conducted through investment company subsidiaries) at fair value while operating activities would be consolidated. Those staff believe that the criteria proposed in paragraphs 9 – 21 are sufficient to prevent inappropriate use of the investment company criteria by a parent and recommend that the accounting principles should be retained in the consolidated financial statements of the parent when those principles are appropriate at the subsidiary level.

Option 3

32 Other staff support including specific guidance that would set out when it is appropriate for a parent to retain the accounting of an investment company subsidiary (ie to retain fair value measurement of controlled investees of an investment company subsidiary when preparing the parent's consolidated financial statements). Those staff would propose that the parent should retain the accounting of an investment company subsidiary when, from the parent's perspective, investments in controlled investees of an investment company subsidiary are held for investment purposes.

33 The difference between options 2 and 3 is best illustrated using the example set out in paragraph 15 of this paper. A corporate entity (the parent) holds a call option to acquire the investment in a controlled investee held by a subsidiary if the underlying activities of the controlled investee are successful. In this situation, we believe that the subsidiary's objective in holding the investment in the controlled investee could be for income, capital appreciation or both.

However, the existence of the option is likely to indicate that, at the parent level, the purpose of the investment is no longer for income, capital appreciation, or both—the investment is truly designed to benefit the parent in some operating or strategic capacity.

34 The staff supporting option 2 would conclude that because the group (including the parent) does not have an objective to hold the investment in the investee for income, capital appreciation, or both, the subsidiary holding the investment would not be an investment company. [Refer to the criterion in paragraph 17 of this paper that prevents an entity from being an investment company if the entity or any of its affiliates obtains benefits (or has the objective of obtaining benefits) that are unavailable to other investors or unrelated parties of the investee. The term 'affiliates' includes the entity's parent and any fellow subsidiaries.] Due to this restriction in paragraph 17 (considered together with other proposed criteria), those staff would conclude that a parent should retain the accounting of an investment company subsidiary even if the parent itself is not an investment company.

35 The staff supporting option 3 would conclude that, in the fact pattern set out in paragraph 33 of this paper, the subsidiary holding the investment in the controlled investee could be an investment company. They would make that assessment on the basis of the subsidiary's objectives for holding the investment. However, because from the group's perspective (including the parent) the objective is not to hold the investment for income, capital appreciation or both, the parent would consolidate the investment in the controlled investee when preparing its consolidated financial statements.

36 The staff supporting option 2 would argue that the approach appropriately reflects the nature of the business of an investment company subsidiary, which invests primarily for the purpose of income or capital appreciation, and would mean that the accounting is the same at the consolidated and subsidiary (investment company) level.

37 These staff believe that accounting for the investments of an investment company subsidiary should not change the parent's consolidated financial statements. Further, they would argue that potential abuse is not a valid reason for prohibiting the use of specialised industry accounting principles which would otherwise be used in accounting for an investment company subsidiary. Accordingly, these staff believe that an investment company should be appropriately defined to prevent the abuse concerns identified above.

38 The staff that support option 3 believe that an entity should be able to meet the definition of an investment company even if the group's objective (including the parent) in holding the investment in the investment company's investee is for a purpose other than for income, capital appreciation, or both. The investment company's other investors would still require fair value information to evaluate their investment if the business purpose of the investment company is to invest for income, capital appreciation, or both, regardless of the parent's objective regarding the investees of the investment company subsidiary.

39 If the boards were to chose option 3, the staff would recommend amending the guidance proposed in paragraph 17 of this paper so that it would be applied only in relation to an entity and its investees when assessing whether the entity is an investment company, ie in order to be an investment company, the entity and its other investees should not obtain benefits that are unavailable to other investors or unrelated parties of the investee.

Staff proposals

40 The following guidance is proposed in order to identify an investment company.

An investment company is an entity that meets all of the following conditions:

a. *Express Business Purpose*. The express business purpose of an investment company is investing for current income, capital appreciation, or both. The entity shall make a commitment, to a group of unrelated investors, that the purpose of the entity involves investing in assets, usually in the securities of other entities not under common management, in order to generate and distribute income, and/or capital appreciation, or both. An exit strategy must also be included in the investment plans.

b. *Investment activity*. To meet the express business purpose requirement in (a) above substantially all of the entity's activities shall be investment activities carried out for the purpose of generating current income, capital appreciation, or both. Operating activities related to services provided to the entity, as discussed in paragraph 946-810-45-3[4], do not preclude an investment company from meeting this criterion. An entity shall not obtain benefits from its investees that would be unavailable to other investors or unrelated parties of the investee.[5]

c. *Unit Ownership*. Ownership in the entity is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.

d. *Pooling of Funds* The funds of the entity's owners are pooled to avail owners of professional investment management.

e. *Fair value*. All of the investments of the entity are managed, and their performance evaluated, on a fair value basis. Information about the entity's investments is provided internally on a fair value basis to the entity's key management personnel and externally on a fair value basis to its investors.

f. *Reporting Entity*. The entity must be a separate legal entity.

g. *Debt.* Any providers of debt to the investees of the entity shall not have direct recourse to any of the entity's other investees.

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[4] 946-810-45-3 states "An exception to the general principle in the preceding paragraph occurs if the investment company has an investment in an operating entity that provides services to the investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. If an individual investment company holds a controlling interest in such an operating entity, consolidation is appropriate."

[5] The situations described in SOP 07-1 .18 will be included in application guidance.

A reporting entity that meets these requirements shall measure investments in entities that it controls at fair value, with changes in fair value recognised in profit or loss. The reporting entity shall provide the appropriate disclosures in IFRS 7 *Financial Instruments: Disclosures, Topic 820, Fair Value Measurements and Disclosures* and the disclosures proposed in Agenda Paper 4B.

Questions 1 and 2 for the boards
1. Do the boards agree with the proposed criteria to define an investment company as set out in paragraph 40? 2. Do the boards agree with Option 1 (paragraphs 28 – 30; to never allow a parent to retain investment company accounting for a qualifying subsidiary), Option 2 (paragraph 31; to always allow a parent to retain investment company accounting for a qualifying subsidiary) or Option 3 (paragraph 32; to have specific guidance to evaluate whether a parent should retain the accounting of an investment company subsidiary) when assessing the accounting to be applied by a parent of an investment company?

Transition requirements

41 The staff believe that an entity (applying US GAAP) should discontinue the application of the guidance in Topic 946 if it no longer qualifies as an investment company as a result of the amendments to the definition of an investment company. The entity should present the change in its status prospectively by accounting for its investments in conformity with applicable generally accepted accounting principles (GAAP) (other than investment company accounting in Topic 946) as from the date the revised consolidation requirements are first applied. For those investees that are required to be consolidated as a result of the entity no longer qualifying as an investment company, the staff believe that the entity should apply the transition guidance discussed in Agenda paper 4F for other entities that will be required to be consolidated as a result of the amendments to the consolidation requirements. Similarly, for those investments that are required to be accounted for using the equity method as a result of the entity no longer

qualifying as an investment company, the staff believe that the entity should apply the initial measurement requirements discussed in Agenda paper 4F for entities that are required to be deconsolidated as a result of the revised consolidation requirements. This includes the impracticability exemptions discussed in that paper. However, the staff propose that an entity should be allowed to use the fair value of the investment at the date of the change in status as the investment's initial carrying value if the investments would need to be accounted for using the equity method.

42 The staff also believe that an entity that previously was not considered an investment company, but meets the revised definition of an investment company, should report the effect of the change in status as of the date that they first apply the revised consolidation requirements as an adjustment to retained earnings in the period in which the change occurred. The adjustment to retained earnings would represent the difference between (1) the previous carrying amount of the net assets of the investee and (2) the fair value of the investee as of the date of first applying the new consolidation requirements.

Questions 3 and 4 for the boards
3. Does the FASB agree with the transition guidance proposed in paragraphs 41 and 42 above? 4. Does the IASB agree with the transition guidance proposed in paragraph 42 above? [The transition guidance proposed in paragraph 41 above is not applicable for IFRS preparers.]