THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

2 October 2009

International Accounting Standards Board Staff
30 Cannon Street
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RE: ED 10, Consolidated Financial Statements

The Investment Funds Institute of Canada ("IFIC"), British Columbia Investment Management Corporation ("bcIMC") and Caisse de dépôt et placement du Québec ("Caisse") appreciate the opportunity to provide additional comments on Exposure Draft 10, *Consolidated Financial Statements* ("ED 10"). We are responding to issues raised at the June 2009, round table meeting on investment management held in Toronto, Canada.

In our comment letter on ED 10, and subsequently at our meeting, we articulated that circumstances exist where fair value measurement provides the most relevant information about an investment that is managed on a fair value basis, irrespective of whether control exists. At the round table, we were asked to develop and propose a solution that would appropriately circumscribe these cases and that would fit within the constraints of ED 10 as drafted.

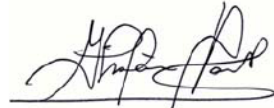
We considered various investment activities and the characteristics that distinguish those activities in circumstances where we think fair value is most relevant. Our conclusion is that fair value is most relevant when a reporting entity holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in the reporting entity based on the fair value of its net assets.

We are conscious of your concerns that any proposals need to be defined in such a manner to prevent inappropriate use. We think that we have provided sufficient guidance to achieve that objective, as illustrated by the application examples in the Appendix.

We also examined the guidance in ED 10 about agency relationships and considered whether the responsibilities of some entities would preclude control based on the proposed guidance in ED 10. As a result, we determined that we think circumstances exist in which an entity may be precluded from having power to direct the activities of another entity due to regulatory, contractual or other legal restrictions. We think that it would be useful to clarify the guidance in ED 10 on this point. However, we also think that it is not likely to address all circumstances in which fair value is the most relevant basis of accounting for financial interests held in another entity.

If you have any questions, or would like to further discuss our proposals, please do not hesitate to contact Joanne De Laurentiis at jdelaurentiis@ific.ca.

Yours truly,



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Project	**Consolidation**
Topic	**Controlled investments held by entities that hold investments only for capital appreciation, investment income, or both, and that are obliged to redeem interests in the reporting entity based on the fair value of its net assets**

Introduction

1. The purpose of this paper is to propose that controlled investments held by a reporting entity that holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in the reporting entity based on the fair value of its net assets, be measured at fair value, irrespective of whether control exists.
2. We acknowledge that this is an exception to the core principle in paragraph 1 of ED 10, *Consolidated Financial Statements.* However, we think that fair value measurement provides the most relevant information to users of financial statements in these circumstances.
3. This paper discusses:
   (a) the proposed principle [paragraphs 6 – 7] and application guidance [paragraphs 8 – 14];
   (b) accounting for parent company and equity method investors in entities that hold investments only for capital appreciation, investment income, or both and that

are obliged to redeem interests in the reporting entity based on the fair value of its net assets [paragraphs 15 -17];

(c) disclosures that may be included in circumstances where subsidiaries are accounted for at fair value [paragraphs 18 – 23];

(d) why fair value provides the most relevant information for users in these circumstances [paragraphs 24 – 29];

(e) comments received in response to ED 10 relating to investment entities [paragraphs 30 – 32];

(f) other IFRS precedents [paragraphs 33 – 35]; and

(g) the advantages of an approach that focuses on a reporting entity's activities in relation to its investments as opposed to one that focuses on the investment itself [paragraphs 36 – 43].

4. This paper also proposes that ED 10 be amended to clarify that regulations, contracts or other legal restrictions can eliminate or offset the power that a reporting entity might otherwise have as a result of its investment [paragraphs 44 – 45].

5. Appendix A applies the proposed guidance to examples of common investment structures to demonstrate that the exception provides a practical and meaningful basis just for those reporting entities that hold investments only for capital appreciation, investment income, or both and that are obliged to redeem interests in the reporting entity based on the fair value of its net assets. Appendix B compares the model proposed in this paper with that in the AICPA Audit and Accounting Guide: *Investment Companies* and SOP 07-01, *Clarification of the Scope of Audit*

and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies.

Proposed core principle

6. A reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses, and cash flows with those of the entities that it controls, except for a reporting entity that:
   - (a) holds investments only for capital appreciation, investment income, or both; and
   - (b) is obliged to redeem interests in itself based on the fair value of its net assets [paragraph 1].
7. *A reporting entity for which paragraphs 1 (a) and (b)*[1] *apply shall measure investments at fair value, with changes in fair value accounted for in profit or loss as they arise. Such an entity shall also provide the disclosures in paragraph X*[2].

Proposed application guidance

Holding investments only for capital appreciation, investment income, or both

8. A reporting entity does <u>not</u> hold investments only for capital appreciation, investment income, or both, when:
   - (a) the reporting entity is, or has been, involved either directly or indirectly in the operations of its investees (e.g., provided or assisted the investee in obtaining financing or restructuring);

[1] Refer to paragraph 6.
[2] Refer to paragraph 20.

(b) the reporting entity obtains, or has obtained, benefits from investees that would be unavailable to investors that hold non-controlling interests and are not related parties of such investees (e.g., receipt of any servicing or financing fees, tax benefits, discounts or cost savings); or

(c) personnel, information systems and other critical resources of investees are, or have been, integrated with those of the reporting entity (e.g., replacement of investee's management team by the reporting entity). Significant intercompany balances and transactions between a reporting entity and its investee typically indicate integration of the critical resources of those entities.

9. A reporting entity that holds investments only for capital appreciation, investment income, or both, evaluates performance of its investments on a fair value basis, in accordance with documented risk management or investment strategies. Information about investments that is provided to the reporting entity's key management personnel and to external users, including key performance metrics, is prepared on a fair value basis.

10. Investment income includes dividends and other equity distributions that would be available to investors that hold non-controlling interests and are not related parties of such investees.

11. Compensation arrangements with management, including a portfolio manager, that are based on the fair values of investments held may also indicate that a reporting entity holds investments only for capital appreciation.

Obliged to redeem interests in the reporting entity based on the fair value of its net assets

12. A reporting entity has an obligation to redeem interests in itself based on the fair value of its net assets when investors or other stakeholders can demand payment at any time, or under circumstances that are certain to arise. For example, a reporting entity could be committed to redeeming issued financial instruments at a specified date or upon the pre-determined windup of the reporting entity.
13. The obligation to redeem interests in the reporting entity based on the fair value of its net assets arises from contractual, regulatory, or other legal requirements, or constructive arrangements with shareholders or other stakeholders.
14. A reporting entity may also have an implicit obligation to redeem interests in the reporting entity based on the fair value of its net assets that arises as a result of related entities' obligations. For example, a parent company's obligation to redeem interests based on the fair value of its net assets may impose an implicit obligation on the reporting entity to redeem interests in itself based on the fair value of its net assets.

Accounting by parent company and equity method investors for investments in entities that hold investments only for capital appreciation, investment income, or both and are obliged to redeem interests in themselves based on the fair value of their net assets

15. The question arises as to whether or not fair value accounting should be retained by a parent company or equity method investor in an entity that holds investments only for capital appreciation, investment income, or both and that is obliged to redeem

interests in itself based on the fair value of its net assets. We propose the following guidance, adapted from Canadian Accounting Guideline 18, to address such circumstances:

16. The parent company of, or equity method investor in, another entity that is required to account for controlled investments at fair value, should retain fair value as the measurement basis for that entity's investments only if all of the following apply:
    (a) the immediate subsidiary or affiliate entity is a separate legal entity whose primary business activity for the period is to hold investments only for capital appreciation, investment income, or both;
    (b) the parent company or equity method investor is not involved in the operations of the investees;
    (c) the parent company or equity method investor does not obtain benefits that are unavailable to investors that are not related parties of the investee; and
    (d) the parent company and its subsidiaries follow established policies that effectively distinguish the nature and type of investments made by the immediate subsidiary or affiliate entity from those made by other entities within the group that do not hold investments only for capital appreciation, investment income, or both. These policies prohibit subsidiaries that hold investments only for capital appreciation, investment income, or both from making investments that are similar to investments held by the parent company, or another member of the consolidated group, and that are accounted for by the equity method or by consolidation.

17. If all of the conditions in paragraph 16 (a) – (d) are not met, the ultimate parent company or equity method investor should consolidate controlled investments held by investees that hold investments only for capital appreciation, investment income, or both and that are obliged to redeem interests in themselves based on the fair value of their net assets.

Disclosures required when investments are reported at fair value

18. We think that in circumstances where controlled investments are required to be accounted for at fair value, it may be useful for a reporting entity to provide additional disclosures in its financial statements that provide information about the subsidiary. Due consideration will need to be given to the costs and benefits associated with additional disclosures, and to determine which disclosures would be appropriate to mandate will ultimately require consultation with users of financial statements for these types of entities.
19. We have adapted the disclosures below from Canadian Accounting Guideline 18, *Investment Companies*, which we think provides a good starting point from which required disclosures can be developed.
20. A reporting entity shall disclose:
    (a) that its investments are measured and reported at fair value, including those that meet the definition of a subsidiary and those over which the investment company exercises significant influence (identifying any exceptions as outlined in the prior section);

(b) the method adopted to determine fair value and any significant assumptions made[3]; and

(c) the maximum exposure to loss and the nature of the exposure, including the risks that could give rise to that loss, when the maximum exposure to loss for any investment is greater than the carrying amount of the investment.

21. We have not proposed additional disclosures that would provide further insight into the financial position, operations and cash flows of the other entities in which the reporting entity holds a controlling interest. Based on reporting experience in North America, such information has not been needed. Users have been making capital allocation decisions based on fair value information described above. As a result, we think that the cost of providing information about the underlying activities of each controlled investee would outweigh its benefits.

22. When investments are reported at fair value in the financial statements of the parent company or equity method investor, those statements should disclose information necessary to understand the extent to which enterprises that are controlled by the reporting entity or over which it is able to exercise significant influence, are reported at fair value, including, at a minimum:

(a) the investments held by a subsidiary that carries its investment in another controlled subsidiary at fair value;

[3] Once issued, this requirement should be revised to refer to the IASB's proposed standard on Fair Value Measurement.

(b) the carrying amount of the interest in the subsidiary that carries its investment in another controlled subsidiary at fair value and the caption in the balance sheet that it is included in;

(c) the name of any investee of the subsidiary that carries its investment in another controlled subsidiary at fair value that the parent company controls as a result of its interest in that subsidiary;

(d) the parent company's percentage ownership in the investee; and

(e) the maximum disclosures to loss described above.

23. When fair value is retained by the parent company or equity method investor as the measurement basis for controlled investments held by a subsidiary or equity method investee, those statements should disclose information necessary to understand the impact on the parent company financial statements, including, at a minimum:

(a) the gross unrealized gains and losses on investments held by the subsidiary at the balance sheet date;

(b) the net realized gains and losses and the net unrealized gains and losses for each year; and

(c) the policy for distinguishing the nature and type of investments made by the subsidiary from investments made by other members of the consolidated group.

Fair value is most relevant for investors when a reporting entity holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in itself based on the fair value of its net assets

24. In the Reporting Entity phase (phase D) of the conceptual framework project, the Board confirmed its view that consolidated financial statements, in which entities are consolidated on the basis of control, are most likely to provide decision-useful information to the greatest number of capital providers. While it may be most likely, it is not always the case.
25. The ability to provide decision-useful information is important since the objective of financial statements in the Framework is to provide information that is useful to a wide range of users in making economic decisions [paragraph 12]. This is only achieved to the extent that such information is relevant [paragraph 25], which results when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations [paragraph 26]. It follows that controlled investments should not be consolidated when consolidation does not result in relevant, decision-useful information to users.
26. Financial statement users and regulators have consistently asserted, through comment letters and commentary about accounting for investments by certain types of entities, that consolidation is not relevant when a reporting entity holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in itself based on the fair value of its net assets. Acceptance of this view is evidenced by the wide-spread use of fair value in accounting for such

investments by investment entities around the world. Often, this argument is presented in the context of investment entities that issue redeemable units or shares, such that the entity has an obligation, be it contractual or constructive, to deliver capital appreciation from its investments. In many cases, private equity and similar organizations are privately-held and the investors in such entities represent the primary, or only, financial statement users. Additionally, information about the fair value of investments is often requested by and provided to investors in these types of entities, in conjunction with the financial statements, or more frequently.

27. For entities whose primary business purpose is to acquire investments for capital appreciation, investment income, or both, value realization occurs as a result of holding an investment, rather than from managing the underlying assets and operations of an investee. Investments held by such entities are like a portfolio of financial instruments held for trading by a financial institution, or investment property. Investing activities by traditional operating entities differ in that they involve activities other than holding the investment (e.g., managing the activities of the investee and its underlying assets to maximize cash flows of the consolidated entity).

28. Users of financial statements for these entities need to understand the cash flows and changes in the fair values of its investments, including subsidiaries acquired only for capital appreciation, investment income, or both, in order to understand the performance and financial condition of the entity. This results from the fact that the entity's primary objective is to maximize the fair values of its investments. These fair values are also used by financial statements users to measure the entity's

success in meeting that objective. While the investee's individual assets and operations are ultimately the source of changes in its fair value, consolidated financial statements would preclude recognition of the full changes in fair value since certain items (e.g., goodwill, some types of intangibles and deferred taxes) cannot be measured at fair value in the consolidated financial statements under existing standards. Additionally, consolidation obscures the users' ability to assess the reporting entity's financial position and results as it emphasizes the financial position, operations and cash flows of the investee, rather than those of the reporting entity.

29. Consolidating these investments also reduces users' ability to compare the different investments reported in the controlling entity's financial statements, as well as the investments held by different reporting entities of a similar nature. Commonly, these reporting entities will also hold non-controlling interests in other entities that are reported at fair value. Reporting controlling interests and non-controlling interests in other entities on a different basis hinders the ability of users to compare investments, despite the fact that both investments are held only for capital appreciation, investment income, or both. Accounting for investments consistently, and comparability between investments and the entities that hold those investments, will affect users' capital allocation decisions.

Comments received in response to ED 10

30. Comments received in response to ED 10 as it relates to entities that hold investments only for capital appreciation, investment income, or both and are

obliged to redeem interests in themselves based on the fair value of their net assets, focused primarily on the nature and characteristics of the reporting entity. For example, many responses referred to investment companies (e.g., mutual funds, venture capital and other similar organizations) that often manage investments and measure and report performance on a fair value basis. We acknowledge that the Board prefers not to develop standards that centre on specific types of reporting entities. We think that guidance intended to apply to all circumstances in which fair value is most relevant would therefore need to focus on the activities of the reporting entity in respect of the investment, rather than on the nature and characteristics of the reporting entity.

31. Respondents also noted that requirements exist in other reporting frameworks around the world that require specified entities to account for controlled investments at fair value. For example, they noted that the AICPA Audit and Accounting Guide: *Investment Companies* and SOP *07-01, 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,* issued by the American Institute of Certified Public Accountants in the U.S. and Accounting Guideline 18, *Investment Companies*, issued by the Canadian Accounting Standards Board ("the AcSB") require fair value accounting for investments held by investment companies in all but remote circumstances. Additionally, the AcSB recently issued an exposure draft on accounting by pension plans, in which it proposed that such entities would not consolidate investments. The UK's Accounting Standards Board has also proposed similar guidance in its

Discussion Paper *The Financial Reporting of Pensions,* as has the Australian Accounting Standards Board in its Exposure Draft, *Superannuation Plans and Approved Deposit Funds*.

32. Some respondents also noted that similar principles already exist in IFRS. For example, they noted that in IAS 28, *Investments in Associates,* the Board confirmed its view that equity or proportionate consolidation methods of accounting for investments held by venture capital organizations, mutual funds, unit trusts and similar entities often produces information that is not relevant to their management and investors and that fair value measurement produces more relevant information [paragraph BC5]. Therefore, these respondents think that the issue is whether an effective method to make this principle operational can be developed for subsidiaries (i.e., not whether the principle is valid).

Other IFRS precedents

33. To provide more relevant information to users, IAS 39 also permits an entity to designate upon initial recognition financial instruments at fair value when: "a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel" [paragraph 9, definition of financial asset or a financial liability at fair value through profit or loss (b)(ii)].

34. Similarly, IAS 40, *Investment Property,* requires that a reporting entity account for its investment in property that is held to earn rentals, capital appreciation, or both, at fair value. The guidance in IAS 40 recognizes that the characteristics of investment property differ significantly from those of owner-occupied property, even when the reporting entity earns rentals from the property.
35. These precedents emphasize the importance of permitting similar items to be reported differently when an entity manages them on different bases in order to provide decision-useful information to users.

Advantages of evaluating the criteria at the reporting entity level

36. We think that the advantages of evaluating the criteria at the level of the reporting entity's activities in relation to its investments outweigh those of evaluating them at the investment level for the reasons outlined below.
37. *It lessens the incentive and opportunity for abusive structuring*. Evaluating the criteria at the reporting entity level lessens the incentive for potential abusive structuring by requiring an enterprise meeting the criteria to account for all controlled investments at fair value. For example, if the evaluation is performed at the investment level, depending on the criteria, there may be opportunity for an enterprise to include non-substantive terms so that only well-performing investments meet the established criteria for fair value accounting. There would be less incentive to include such terms if all investments (both well-performing and

poorly-performing investments) were required to be accounted for at fair value if the reporting entity as a whole meets the established criteria.

38. *It provides more meaningful financial reporting from a user's perspective*. Accounting for some investments at fair value and consolidating others may not provide a clear picture of the true performance of the entity as a whole and may be confusing for users. Investors and other users of financial statements of these types of entities evaluate performance based on fair value and management compensation is driven based on fair value. Financial statements that include only selected investments at fair value would not portray the true performance of the entity as a whole.

39. *It reduces complexity and cost associated with accounting subsequent to initial recognition*. These entities often hold large inventories of investments and therefore, it would be very costly for them to evaluate whether each investment meets the criteria at each reporting date, rather than evaluating the enterprise as a whole.

40. *It is consistent with current requirements under U.S. GAAP and Canadian GAAP*. Evaluating the criteria at the reporting entity level is consistent with existing requirements under U.S. GAAP and Canadian GAAP which provide exceptions for reporting entities that manage, and measure performance, on a fair value basis. In evaluating whether an entity is an entity that should account for controlled investments at fair value, the criteria in the AICPA Audit and Accounting Guide: *Investment Companies* and Accounting Guideline 18, *Investment Companies*, is applied to the reporting entity. A consistent approach under IFRS would reduce

complexity and conversion costs for those enterprises that currently apply those standards and will transition to IFRS.

41. *It addresses the SEC's concern about lack of guidance for some entities that manage, and evaluate performance of, investments on a fair value basis*. In the SEC's proposed IFRS roadmap, it excluded investment companies because of the lack of specific guidance under IFRS. Evaluating the criteria at the reporting entity level is consistent with the current requirements under U.S. GAAP and would facilitate the SEC "scoping in" investment companies in a future roadmap. It would be unfortunate if a large number of US and possibly Canadian companies would not be able to adopt IFRS because it did not address accounting by these entities.

Advantages of evaluating the criteria at the investment level

42. *It would be consistent with the IASB's approach to other standards*. Evaluating the investment company criteria at the reporting entity level would be inconsistent with the IASB's approach of not providing specialized industry guidance that reaches across all transactions of an enterprise in a specific industry. Rather, the IASB prefers to develop guidance that is applied to specific transactions. By including criteria that focuses on the reporting entity, the Board would essentially scope out entire enterprises from the consolidation standard rather than individual investments.

43. *It is consistent with how entities are managed*. Management generally evaluates each investment separately in determining how to allocate resources to their

different investments and ultimately whether to hold or dispose of an investment. Therefore, financial reporting based on assessments made at the individual investment level would reflect how management views and manages investments.

Regulations, contracts or other legal restrictions that limit power

44. We considered whether it was possible to address circumstances where fair value is most relevant by including additional guidance or interpretations of the basic principles in ED 10 about control. For example, we considered whether regulations, contracts or other legal restrictions have the substantive effect of eliminating or offsetting the power that a reporting entity might otherwise have as a result of its investment. We think that it is useful to include such guidance; however, it is unlikely to address the circumstances described above since such circumstances may exist irrespective of whether or not control exists.

45. We recommend that additional guidance be included in the proposed consolidation standard to clarify that a reporting entity does not have the power to direct the activities of another entity, and therefore does not control that other entity, when the reporting entity has:

    (a) an irrevocable and enforceable promise to third parties not to direct the activities of that other entity; or

    (b) is prevented by regulation or law of having or exercising its power to direct the activities of that other entity.

Appendix A – application of the proposed model

A1. The first and second of the following examples illustrate situations in which a reporting entity is required to account for controlled investments at fair value because it holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in itself based on the fair value of its net assets. The third and forth examples illustrate situations in which an entity does not meet these criteria and is required to consolidate its controlled investments. The fifth example illustrates the application of the additional guidance proposed for the accounting by a parent company for investments held by entities that hold investments only for capital appreciation, investment income, or both and are obliged to redeem interests in themselves based on the fair values of their net assets. The sixth and seventh examples outline situations provided to us by IASB staff in which a subsidiary invests in a securitization entity and structured investment vehicles. These examples illustrate the application of the additional guidance for determining whether an investment is held only for capital appreciation, investment income or both and related parent company reporting.

Example 1 – mutual fund that controls another entity

Fact pattern

A2. Entity A is an open-ended mutual fund trust (i.e., an investment vehicle that allows investors to join or exit the entity at any time, based on the fair value of the entity's net assets) that holds global equity investments, including 35% of the outstanding equity of Entity B. Entity A's offering document that is provided to investors

stipulates that it has no operations, other than to hold global equity investments. Entity A's investors can withdraw from the fund at any time, based on the fair value of the entity's net assets, which is reported daily. Management of Entity A are compensated based on 2% of its net assets, calculated daily based on the fair values of its assets and liabilities. Entity B is a tire manufacturer and recent market events caused Entity B's shares to trade at a price that Entity A thought was a deep discount to their longer-term value, resulting in Entity A's 35% acquisition. The remaining shareholders of Entity B are widely disbursed. Entity A is the dominant shareholder and controls Entity B.

Analysis

A3. Entity A is not involved with the operations of Entity B because Entity A has not replaced or does not have any management in common with Entity B. Also, Entity A is entitled to receive dividends and other capital distributions from Entity B, but does not obtain any other benefits from Entity B that would be unavailable to independent non-controlling investors of Entity B. Investors in Entity A are able to withdraw from the fund based on the fair value of its net assets, which includes the investment in Entity B. Entity A compensates its management and calculates net assets daily, based on the fair value of its investments. Entity A is also restricted in its ability to continue to hold the investment in Entity B, due to the redeemable nature of its units as an open-ended mutual fund trust. As such, Entity A holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in itself based on the fair value of its net assets. Therefore, we would conclude that it should account for Entity B on a fair value basis.

Example 2 – private equity organization that controls another entity

Fact pattern

A4. Entity A is a private equity organization that holds equity instruments of entities in the mining sector, including 53% of the outstanding equity of Entity C. Entity A reports financial information to investors each quarter, which includes details about the fair values of its investments. Management of Entity A are compensated based on fixed amounts plus an incentive fee of 20% of its net assets, calculated monthly based on the fair values of its assets and liabilities, in excess of a target threshold. Incentive fees represent approximately half of the total compensation to management on average. Entity A's investment strategy is to hold the shares of Entity C until they reach a target price, at which point Entity A intends to dispose of the investment. Entity A is not involved in the operations of Entity C and has not imposed any changes to management, systems or processes at Entity C subsequent to the acquisition of control.

Analysis

A5. A major component of Entity A's compensation arrangement with its management (i.e. incentive fee), and its reporting to investors, is based on the fair value of the entity's investments, including its investment in Entity C. Entity A is not involved in the operations of Entity C and has acquired the investment with an exit strategy in place. Therefore, Entity A holds investments only for capital appreciation, investment income, or both and is obliged to redeem interests in itself based on the fair value of its net assets. Therefore, we would conclude it should account for its investment in Entity C at fair value.

Example 3 – venture capital organization that controls another entity

Fact pattern

A6. Entity A is a venture capital organization that owns 75% of outstanding equity of Entity D, a pharmaceutical company that is in the start-up phase of operations. Entity A controls Entity D. Upon acquisition of control, Entity A replaced the CEO and CFO of Entity D with members from its own management team and implemented its own reporting and control procedures. Entity A monitors its investment in Entity D by gauging the cash flows it generates against predetermined thresholds.

Analysis

A7. Entity A is involved in the operations of Entity D because its own management team is managing Entity D. Entity A imposed its own systems and processes on Entity D and focuses on the cash flows, rather than fair value, of Entity D. Therefore, we would conclude that Entity A does not hold investments only for capital appreciation, investment income, or both and, as such, Entity A should consolidate Entity D.

Example 4 – operating entity establishes new entity to acquire another operating entity

Fact pattern

A8. Entity A is a large financial institution with diverse operations, which include significant insurance operations. Entity F is a small insurance company that operates in rural areas not captured by Entity A's existing operations. Entity A establishes a new entity, Entity E, that exists only to hold its investment in Entity F. Management of Entity A and Entity F are compensated based on fixed amounts and bonuses that are based on the net income and cash flows of Entity A's operations, including those attributable to Entity E and Entity F.

Analysis

A9. Entity A is able to increase its insurance business by accessing additional areas, as a result of its acquisition of Entity F through Entity E. Entity A does not have an obligation to deliver the capital appreciation associated with its investments. Entity A does not compensate its management based on changes in the fair value of Entity F or Entity E. Therefore, Entity A does not hold investments only for capital appreciation, investment income, or both and is not obliged to redeem interests in itself based on the fair value of its net assets. As such, we would conclude that Entity A should consolidate Entity E and Entity F.

Example 5 – entity with established investment division that controls an operating entity

Fact pattern

A10. Entity A is a large financial institution with diverse operations, which include a private equity division. Entity G's only operations are to conduct private equity activities on behalf of Entity A. Entity G is 100% owned by Entity A. Entity H is a computer manufacturer that is controlled by Entity G. Entity G manages and evaluates the performance of its investments on a fair value basis and reports all investments, including its subsidiary Entity H, at fair value in its stand-alone financial statements. Entity A acquires computers for its offices from Entity H without consideration. Entity A does not have any formal policies that restrict the investing activities of any of its subsidiaries or affiliates and does not manage any of its own controlled investments on a fair value basis.

Analysis

A11. Entity A is the parent company of Entity G, which controls Entity H. Entity A obtains benefits from Entity H and Entity A does not have any policies that distinguish the investments of Entity G from those of other entities within the group. Therefore, we would conclude that Entity A should not retain fair value accounting for the investment and should consolidate Entity H.

Example 6 – subsidiary invests in a securitization vehicle with related party servicer

Fact pattern

A12. Entity A is a Bank and has two distinct and separate subsidiaries (Subsidiary I and J). Subsidiary I is a reporting entity that meets the criteria in paragraph 6 (a) and (b) of the proposed guidance and invests primarily in entities that have been established for the securitization of mortgages. Subsidiary I holds 70% of the returns of Securitization Entity K and the "kick-out rights" associated with its investment. Subsidiary J, an operating subsidiary of Entity A, has transferred receivables into the securitization entity. Subsidiary J performs the servicing function for these assets.

Analysis

A13. Subsidiary I controls its investment in Securitization Entity K as it has the power over the key activities and has returns associated with its investment. Subsidiary J is involved in the operations [paragraph 8(a)] of Securitization Entity K and it receives additional benefits (i.e., liquidity and/or capital relief) that are not available to outside investors of the entity [paragraph 8(b)]. Entity A does not meet the criteria in paragraph 16 [i.e., Subsidiary J is involved in operations] to retain fair value presentation.

Example 7 – investment in a structured investment vehicle (SIV)

Fact pattern

A14. Entity A is a Bank and has two distinct and separate subsidiaries (Subsidiary I and J) [same parties as Example 6]. Subsidiary I invests in a SIV in which it is considered the dominant shareholder by virtue of being the largest investor and having additional participating rights associated with its investment. Subsidiary J sponsored the SIV and provides the investment management services to SIV in return for a management fee. The investment management has been outsourced to a third party investment manager in return for a management fee at market rate who is acting on behalf of Subsidiary J [e.g. the third party investment manager acts as an agent for Subsidiary J].

Analysis

A15. Subsidiary I controls its investment in the SIV. To the extent that it is holding the investment only for capital appreciation and is obliged to redeem its interest in the SIV based on the fair value of the net assets of the entity, it would be required to present its investment in the SIV at fair value in its financial statements. However, Entity A would be required to prepare consolidated financial statements that include Subsidiary I and its investment in the SIV not at fair value because it would not have satisfied the criteria in paragraph 16. Specifically, Subsidiary J is responsible for the agent that is directing the activities of the SIV. Therefore Entity A, through its Subsidiary J, is involved in the operations of the SIV.

Appendix B – Comparison of the proposed model with AICPA Audit and Accounting Guide "Investment Companies" and SOP 07-01, *Clarification of the Scope of Audit and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

SOP 07-01, *Clarification of the Scope of Audit and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, was issued by the AICPA on June 11, 2007 and was initially effective for fiscal years beginning on or after December 15, 2007, with early adoption encouraged. The FASB subsequently issued FSP SOP 07-1-1 in February 2008, which indefinitely deferred the effective date of the SOP due to perceived implementation challenges with its guidance as it relates to accounting by parent companies and equity method investors. As such, guidance in the AICPA Audit and Accounting Guide continues to be applied in the US, without the clarification of scope provided by the SOP.

	Audit and Accounting Guide Investment Companies	**Proposed model**	**Comparison**
Overriding principle	"An investment company is a separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. Accordingly, investment companies do not acquire or hold investments for strategic operating purposes and do not obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to non-investor entities that are not related parties to the investee." [Paragraph 5]	A reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses, and cash flows with those of the entities that it controls, except for a reporting entity that: (a) holds controlled investments only for capital appreciation, investment income, or both, and (b) is obliged to redeem interests in the reporting entity based on the fair value of the net assets of the entity	***More restrictive*** Proposed model is more principles-based and unlike the AICPA Guide, it emphasizes an obligation to redeem interests in the reporting entity based on the fair value of an entity's net assets.
Legal entity	…is a separate legal entity…	Consistent with the Board's view on the reporting entity, the proposed model does not require that an entity be a separate legal entity in order to be a reporting entity. The principles are required to be met on a reporting entity basis.	***Similar***

Multiple investments	…whose business purpose and activity are investing in multiple substantive investments…	This criteria is implicit in the proposed model's requirement that a reporting entity hold investments only for capital appreciation, investment income, or both.	***Similar***
Capital appreciation	…for current income, capital appreciation, or both…	…for capital appreciation, investment income, or both…	***Similar***
Exit strategies	…investment plans that include exit strategies…	Having plans to exit its investments is implicitly required because in the proposed model, the reporting entity must be able to dispose of its investments in order to fulfill its obligation to redeem interests in itself.	***Similar***
Involvement with investee	…do not acquire or hold investments for strategic operating purposes…	This requirement is implied by the proposed model in paragraph 8 (a) – (c). Additionally, significant intercompany transactions or other critical resources identifies that a reporting entity does not hold investments only for capital appreciation, investment income, or both.	***More restrictive***
Benefits	…do not obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to non-investor entities that are not related parties to the investee.	This requirement is included in the proposed model in paragraph 8 (b). Principle identifies investment, versus current income to distinguish returns from holding the investment, from the operating earnings of the investee.	***Similar*** *Note: In practice current income is being interpreted as investment income.*
Obliged to redeem interests based on the fair value of net assets	Not explicitly addressed	... is obliged to redeem interests in the reporting based on the fair value of its net assets [paragraph 1].	***More restrictive***

Evaluation of investee performance	Not explicitly addressed	A reporting entity that holds investments only for capital appreciation, investment income, or both, evaluates performance of investments on a fair value basis, in accordance with documented risk management or investment strategies. Information about investments that is provided to the reporting entity's key management personnel and to external users, including key performance metrics, is prepared on a fair value basis.	***More restrictive***

Parent company and equity method investor accounting for investments in investment companies

SOP 07-01, *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*		**Proposed model**	**Comparison**
Parent company or equity method investor is also an investment company	In order to retain investment company accounting in the financial statements of the parent company or equity method investor, a subsidiary or equity method investee that is an entity regulated by the 1940 Act or similar requirements as described in paragraphs .09 - .10 of this SOP and, therefore, within the scope of the Guide for purposes of its separately issued financial statements, should also meet the definition of an investment company pursuant to the guidance in paragraphs .05 and .11 - .29 of this SOP.	A parent company that holds investments only for capital appreciation, investment income, or both, accounts for investments, including investments in entities that account for controlled investments at fair value under the proposed model.	***Similar***
Investment company subsidiary or equity method investee precluded	In order to retain investment company accounting in the financial statements of the parent company, the consolidated group (the parent company and its consolidated subsidiaries) should follow	The parent company and its subsidiaries follow established policies that effectively distinguish the nature and type of investments made by the immediate subsidiary or affiliate entity from those made by other entities within the group	***Similar***

from making investments similar to non-investment company subsidiaries or equity method investees	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 that are no investment companies. These policies should address, at a minimum, (1) the degree of influence held by the investment company and its related parties over the investees of the investment company, (2) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (3) the level of ownership interest held in the investment company by the consolidated group. The guidance in this condition is intended to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by non-investment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a non-investment company member of the consolidated group. Such policies should include sufficient details and information to distinguish investment company investments from other investments in the consolidated group.	that do not hold investments only for capital appreciation, investment income, or both. These policies prohibit subsidiaries that hold investments only for capital appreciation, investment income, or both from making investments that are similar to investments held by the parent company, or another member of the consolidated group, and that are accounted for by the equity method or by consolidation [paragraph 15 (d)].	
Parent company or equity method investor holding only for capital	In order to retain investment company accounting in the financial statements of the parent company or equity method investor, the parent company, or equity method investor (through the investment	The parent company or equity method investor is not involved in the operations of the investees [paragraph 15(b)]. The parent company or equity method investor does not obtain	***Similar***

appreciation, current income, or both	company), should be investing for current income, capital appreciation, or both, rather than for strategic operating purposes.	benefits that are unavailable to investors that are not related parties of the investee [paragraph 15 (c)].	