Project **Consolidation**

Topic **Investment companies—sweep issues relating to the accounting by a parent of an investment company**

Introduction

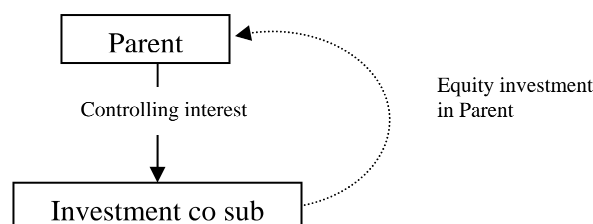
1. At the February 2010 joint board meeting, the boards tentatively decided that an investment company is required to measure investments in entities that it controls at fair value through profit or loss. At the April 2010 joint board meeting, the boards also tentatively decided that the fair value measurement basis for controlled investees applied by an investment company should be retained in the consolidated financial statements of a parent of an investment company.

2. During the boards' discussions, some board members raised questions about the accounting by a parent of an investment company when it retains fair value measurement in its consolidated financial statements. Those questions are discussed in this paper.

Investments in the parent entity

3. At the April joint board meeting, one board member raised a question regarding the treatment of equity investments that a controlled investment company holds in its parent (or in any other member of the group). The concern is whether a Parent could inflate its assets and its equity by directing an investment company that it manages to purchase Parent's equity.

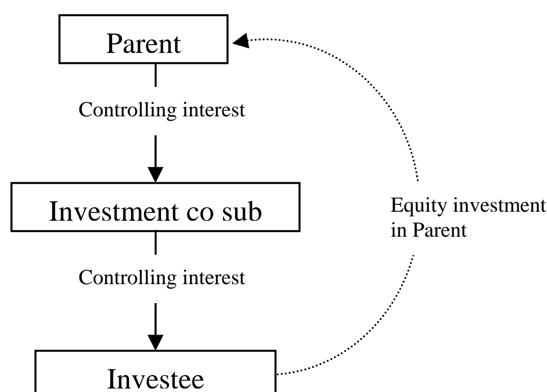
Example 1



4. In this example, the investment company subsidiary would be required to be consolidated by Parent. The staff believe that on consolidation, the equity investment in the parent entity owned by the investment company would be treated as treasury shares. Accordingly, the assets and equity recognised in the consolidated financial statements of Parent would be reduced as if those equity investments did not exist. In accordance with paragraph 505-30-45-1 of the Codification, the cost of the acquired treasury shares would be shown separately as a reduction from share holders equity, with any changes in fair value of the treasury shares reversed in consolidation. This is consistent with the requirements in IFRS.

5. An additional concern that was raised is the treatment of equity interests that a controlled investee of a consolidated investment company holds in the ultimate parent of the investment company (or in any other member of the group).

Example 2



6. Currently according to IFRS, the Investee would be consolidated by Parent and the equity investment in Parent held by Investee would be treated as treasury shares and eliminated in consolidation. However, it is unclear as to how an Investee’s interest in the Parent entity should be reflected in the consolidated financial statements of the Parent, if the Investee is measured at fair value.

7. If the boards believe that this issue needs to be addressed, we think that there are a number of ways that this could be done:

   (a) By specifically proposing that such an equity investment is treated as treasury shares in the consolidated financial statements of the parent. For example, if the fair value of the investee is $100 (including the

value of the shares held by the Investee in the Parent), in consolidation, the parent entity would be required to first calculate the fair value of its investment in the Investee as though the shares in the Parent did not exist. Assuming that the fair value of the investee excluding its investment in the parent is $70 and the cost of the treasury shares of the Parent that would need to be eliminated is $20, the difference ($10) would be allocated to the investors in the investment company.

(b) By requiring the investee to be measured at fair value, including the embedded investment in the parent, but require that the parent disclose the investment in the parent held by the investee as part of the related party disclosures. For example, assuming the identical fact pattern in bullet (a) above, the Parent entity would reflect the entire investment in the Investee of $100 in its consolidated finical statements. Although this value includes some value attributable to Investee's interest in the Parent entity, this would not be eliminated on consolidation.

(c) By including a requirement that, to meet the definition of an investment company, any controlled investees of the entity could not hold equity investments in any member of the group.

(d) By prohibiting the retention of the fair value accounting applied by an investment company subsidiary when the Parent entity prepares its consolidated financial statements, ie the parent of an investment company would consolidate all controlled investees, including those held by investment company subsidiaries.

8. Should the boards wish to specifically address the issue, some staff recommend alternative (d) set out in paragraph 7, while others recommend alternative (b). The staff believe that alternative (c) is inappropriate because they do not believe that an entity should be prevented from being an investment company simply because a controlled investee has an equity investment in the ultimate parent or another member of the group. The investee could hold a highly liquid portfolio of listed investments (that includes shares of the parent) that could result in the entity 'flipping in and out' of being considered an investment company. The

staff recommending alternative (d) would support alternative (a) should the boards not wish to proceed with alternative (d).

9. The staff supporting alternative (b) believe that the boards have tentatively decided that a parent should retain the fair value accounting applied by an investment company subsidiary when preparing its consolidated financial statements. Accordingly, those staff believe that it would *not* be appropriate to perform any intercompany eliminations for transactions between the controlled investee and other members of the group (eg if the parent receives revenue from the investee)—performing intercompany eliminations would result in measuring the investment in the controlled investee (excluding intercompany transactions) at fair value rather than measuring the entire investment in the controlled investee at fair value (ie it would result in a change in the unit-of-account). If the boards have decided that fair value measurement of investments held by investment companies provides more useful information both at the parent level as well as at the investment company level, then it is appropriate to retain that fair value measurement without adjustments.

10. The staff supporting alternative (d) agree with the board member who raised the issue set out in paragraph 5 that this could be a real concern—the potential for a parent to direct a controlled investee of an investment company subsidiary to purchase equity interests in the parent would appear to be similar to known abuses using unconsolidated special-purpose-entities (or variable interest entities) before the introduction of FIN 46(R) *Consolidation of Variable Interest Entities*. It also raises the question of whether there are other issues that we have not yet identified associated with a parent not consolidating a controlled investee.

11. Those staff believe that this issue raises the question as to whether a parent of investment company subsidiary should be permitted to retain fair value accounting in its consolidated financial statements. When a parent is permitted to retain fair value accounting for some subsidiaries in its consolidated financial statements while other subsidiaries are consolidated, examples 1 and 2 discussed in the paragraphs above emphasise that different accounting can result solely because of where, within the parent group, a transaction takes place. [ie as

shown in example 1, if the investment in the parent is held by a consolidated subsidiary, the investment is treated as treasury shares and eliminated on consolidation; as shown in example 2, if the investment in the parent is held by a subsidiary that is not consolidated, the investment is not eliminated on consolidation.] Because the parent ultimate controls both an investment company subsidiary and its controlled investees, the parent is likely to be able to decide (within certain parameters set out in the investment company criteria) where, within the group, transactions actually take place.

12. Those staff also have concerns about whether a parent of an investment company could avoid consolidating, say, a structured entity by holding a controlling investment in that structured entity via an investment company subsidiary. Rather than own 50% of the residual interest in structured entities, a special servicer could simply insert an investment company in the group structure which would own the entire residual interest in the structured entity, with the investment company then holding a 50% interest in the investment company. Because of those concerns, those staff would recommend that a parent of an investment company should consolidate all controlled investees within the group, including those controlled by investment company subsidiaries.

13. The staff supporting view (b) believe that this is not an issue as the criteria being proposed for an investment company are stricter than current US GAAP requirements. Specifically, according to the proposed criteria an entity would not be considered an investment company if transactions between the investee or its affiliates and the entity or its affiliates (affiliates include any member of the parent group) (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**. These staff believe that, in the example in paragraph 12, a significant portion of the activities of the investee are the special servicing activities, which are performed by the investment company's affiliates.

Accordingly, the investment company would not qualify for fair value measurement.

Question (1) for the boards
(1) Do the boards wish to address the issue raised in paragraph 5 of the paper regarding equity investments that a controlled investee of an investment company subsidiary holds in a member of the group? If yes, which of the alternatives set out in paragraph 7 do the boards support? [Alternative (a)—treat the equity investments as treasury shares in the parent's consolidated financial statements; alternative (b)—retain fair value accounting for the controlled investee of an investment company subsidiary, including the investments in a member of the group, and disclose the investments held; alternative (c)—to be an investment company, any controlled investees of the investment company cannot hold investments in a member of the group; alternative (d)—prohibit the retention of the fair value accounting applied by an investment company subsidiary when preparing the parent's consolidated financial statements .]

Accounting considerations when a parent (or one of its non-investment company subsidiaries) holds an investment in an investee of an investment company subsidiary

14. At the April joint board meeting, one board member asked how a parent would account for any investment that a non-investment company member of its group holds in an investee of an investment company subsidiary. The issue is best illustrated by way of an example set out in the following paragraphs.

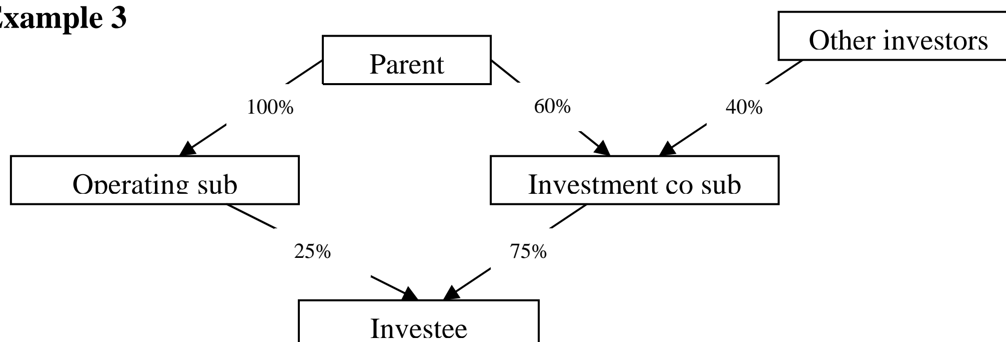
15. [Note: the discussion in this section of the paper assumes that the boards have confirmed their tentative decision that a parent retains the fair value accounting applied by an investment company subsidiary when preparing its consolidated financial statements. The accounting issues do not arise if the parent of an investment company must consolidate all controlled investees—alternative (d) discussed in paragraphs 3-13 of this paper.]

Example 3: An investee is controlled by an investment company subsidiary of the parent. Another non-investment company within the group also holds an investment in that investee.

16. Parent has a 60% controlling interest in Investment co sub, and owns 100% of Operating sub. Through subsidiary holdings, Parent controls Investee (and indirectly owns 70% of Investee). Investment co sub controls Investee on a

stand-alone basis. Looked at in isolation, Operating sub has significant influence over Investee, and accounts for its 25% investment using the equity method.

Example 3



17. Assuming that Investment co sub meets the definition of an investment company, Investment co sub would measure its 75% investment in Investee at fair value through profit or loss.[1] In addition, in its consolidated financial statements, Parent would account for the 75% investment in Investee held by Investment co sub at fair value through profit or loss.

18. The question arises as to how Parent should account for the 25% investment in Investee held by Operating Sub.

Alternative A

19. Parent first assesses its relationship with Investee at the group level—in example 3, Parent controls Investee through its subsidiary holdings. Because Parent controls Investee, it should consolidate Investee, recognising 75% non-controlling interest (NCI). [Parent recognises the 75% investment held by Investment co sub as NCI because Investment co sub is not treated as a group entity and it also recognises that 75% investment at fair value through profit or loss as noted in paragraph 17.]

[1] To meet the definition of an investment company, any member of Parent group must not obtain or have the objective of obtaining benefits (other than benefits attributable to ownership interests) from its investments in Investee that are unavailable to other unrelated parties. If Parent (or any member of Parent group) could obtain benefits from its investments in Investee that are unavailable to other unrelated parties, Investment co sub would not meet the definition of an investment company.

20. The accounting under Alternative A reflects the overall relationship between Parent and Investee—ie Parent controls Investee and therefore should consolidate it. It is also consistent with the tentative decision taken by the IASB as part of annual improvements regarding IAS 28 *Investments in Associates*—an investor first assesses whether it has significant influence over an investee (either directly or indirectly) in accordance with IAS 28. If a portion of the investor's interest in the investee is measured at fair value through profit or loss (because it is held, for example, by a venture capital subsidiary of the investor), the remaining portion of the investment in the associate is accounted for using the equity method. The IASB's tentative decision regarding IAS 28 is illustrated in the appendix to this paper.

21. However, when the ultimate parent controls the investee, Alternative A creates what some might argue is a double-counting issue—ie, in example 3 set out in paragraph 16 of this paper, Parent consolidates 100% of the assets and liabilities of Investee (and an associated 75% NCI) and also recognises a 75% investment in Investee at fair value. Alternative A also results in the 75% investment in Investee held by Investment co sub being treated as part of NCI when that investment is actually held by a controlled entity within Parent group.

22. Alternative A would lead to consolidation in situations where a non-investment company subsidiary of the group holds any investment in the investee (eg 1%). In that case, the consolidated financial statements would reflect a NCI of 99% of the Investee. However, if Operating sub sold its investment in Investee, Parent would no longer be required to consolidate the Investee even though it still controls the Investee (via the 75% investment held by Investment co sub).

Alternative B

23. The investment in Investee held by Investment co sub is treated separately from any investment in Investee held by a non-investment company subsidiary of Parent. Therefore, Parent retains the accounting of Operating sub for its 25% investment in Investee and accounts for the 25% investment using the equity method. It would also recognise the 75% investment in Investee held by Investment co sub at fair value through profit or loss.

24. Some staff support Alternative B because treating investments held by investment company subsidiaries separate from investments held by non-investment company subsidiaries is the basis for allowing a parent to retain the fair value measurement accounting used by an investment company subsidiary. A parent is not required to consolidate any controlled investees of an investment company subsidiary because the purpose of holding those investments is for investing purposes (and not for operating purposes) and the investment company criteria is such that the group cannot access 'control-type benefits' from its investments in the controlled investee that are unavailable to other unrelated investors. Alternative B mirrors that thinking by considering the investments held by investment company subsidiaries separately from investments held by non-investment company subsidiaries. Alternative B also avoids the "double-counting" and NCI issues mentioned in paragraph 21 above.

25. The staff supporting Alternative A believe that not only is it consistent with the IASB's tentative decision regarding IAS 28, but it also ensures that the IASB's decisions in IFRS 9 regarding the presentation of changes in fair value of an investment in equity instruments in other comprehensive income (OCI) are maintained.

26. For example, assume that example 3 (paragraph 16 of this paper) is changed so that Operating sub holds a 10% investment in Investee, rather than a 25% investment. Also assume that Operating sub elects to present in OCI changes in the fair value of its 10% investment in Investee. Alternative A would conclude that Parent controls Investee and therefore should consolidate Investee, recognising a 90% NCI. Alternative B would conclude that the 10% investment in Investee held by Operating sub is treated separately from the 75% investment in Investee held by Investment co sub. According to IFRS, Parent could recognise its 10% investment in Investee held by Operating sub at fair value, with changes in fair value recognised in OCI. Consequently, Parent would recognise dividends paid by Investee in profit or loss, even though Parent controls Investee and could influence its dividend policy. When discussing IFRS 9, the IASB noted that recognising dividends in profit or loss in this situation could create structuring opportunities. However, it concluded that that 'those structuring opportunities would be limited because an entity with the

ability to control or significantly influence the dividend policy of the investment would not account for those investments in accordance with IFRS 9.' [IFRS 9 paragraph BC86] Alternative B would retain those structuring opportunities. According to the proposed model for financial instruments being discussed by the FASB, all equity investments would be measured at fair value with changes in fair value recorded through profit and loss (i.e. changes in fair value on equity securities may not be included in OCI).

What if a non-investment company member of the group controls a subsidiary and an investment company subsidiary also holds an investment in that subsidiary?

27. The staff have also considered whether we need to address the accounting by a parent when a non-investment company member of a group controls a subsidiary and an investment company subsidiary also holds an investment in that subsidiary. We have concluded that this situation does not need to be addressed specifically because the investment held by the investment company subsidiary would be eliminated on consolidation—refer to the appendix of this paper for an illustration of this situation.

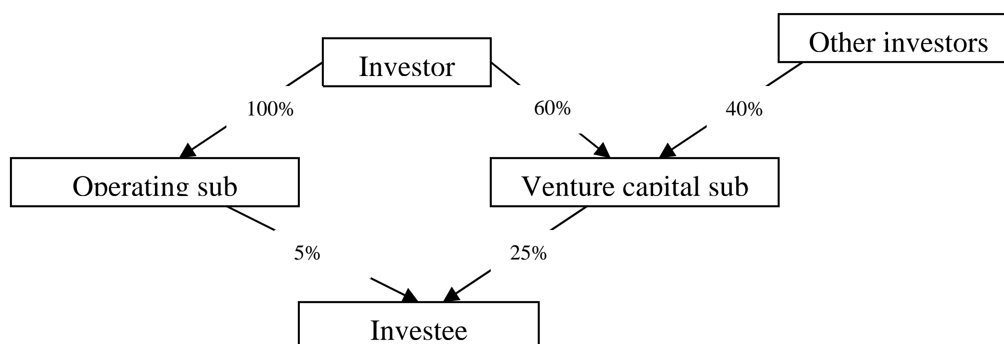
Question (2) for the boards
(2) Regarding situations in which an investment company subsidiary controls an investee (illustrated by example 3 in paragraph 16), do the boards agree with Alternative A (a parent should consolidate a controlled investee if a non-investment company subsidiary holds an investment in the investee) or with Alternative B (a parent should account for investments in a controlled investee held by investment company subsidiaries separate from investments in that investee held by a non-investment company subsidiary)?

APPENDIX

Illustration of IASB's tentative decision regarding IAS 28

28. Consider the following example. Investor has significant influence over Investee. Venture capital sub measures its 25% investment in Investee at fair value through profit or loss. Operating sub measures its 5% investment in Investee at fair value through profit or loss in its financial statements (Operating sub holds the investment in Investee for trading purposes).

Example – the IAS 28 tentative decision

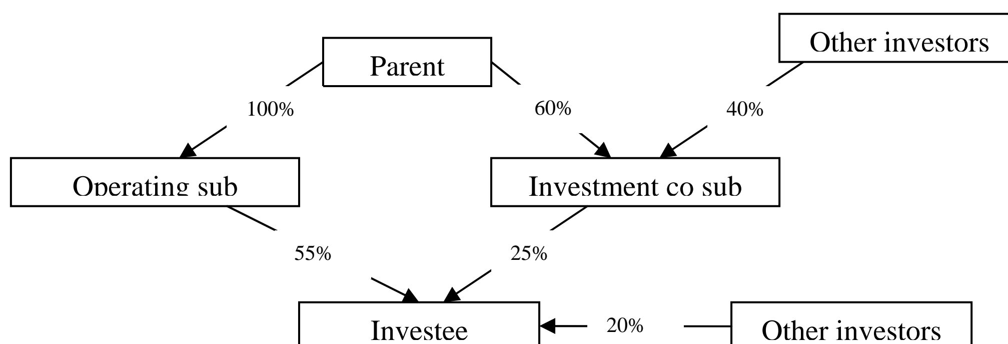


29. According to the IASB's tentative decision regarding IAS 28, in the example above, in its consolidated financial statements Investor could measure the 25% investment in Investee held by Venture capital sub at fair value through profit or loss. If so, Investor would account for the 5% investment in Investee held by Operating sub using the equity method. This is because Investor has significant influence over Investee when Investor considers its overall relationship with Investee via investments held by Operating sub and Venture capital sub.

Illustration of an example in which an investee is controlled by the group (excluding investment company subsidiaries). An investment company subsidiary of the group also holds an investment in that investee.

30. Parent has a 60% controlling interest in Investment co sub, and owns 100% of Operating sub. Through subsidiary holdings, Parent controls Investee (and indirectly owns 70% of Investee). Operating sub controls Investee and consolidates its 55% investment in Investee. Investment co sub has significant influence over Investee, and measures its 25% investment in Investee at fair

value through profit or loss (in accordance with the designation option available in paragraph 1 of IAS 28 and the requirements in Topic 946 of the FASB Accounting Standards Codification).



31. Parent consolidates Investee. In addition, in its consolidated financial statements, Parent would eliminate the 25% investment held by investment co sub similar to the conclusion reached for example 1 (paragraphs 3 and 4 of this paper). This is because the 25% investment of Investment co sub is an investment in a consolidated member of Parent group.

32. However, it should be noted that, similar to example 2 (paragraph 5 of this paper), if an investee of an investment company subsidiary held an investment in the parent (or another group company), accounting implementation issues may arise.