STAFF PAPER

FASB | IASB Meeting

Project	**Investment Entities / Investment Companies**		
Paper topic	Accounting by a non-investment entity parent for the investments of an investment entity subsidiary		

CONTACT(S)	Sarah Geisman	sgeisman@ifrs.org	+44 (0)20 7246 6464
	Rachel Knubley	rknubley@ifrs.org	+44 (0)20 7246 6904
	Upaasna Laungani	ulaungani@fasb.org	+1 203 956 5325

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Objective

1. The objective of this paper is to discuss the appropriate accounting for particular investments of a noninvestment entity, when that non-investment entity is a parent company and those investments are held by its investment entity subsidiary.

2. The questions asked of the boards are different in scope. This is because the IASB is considering a potential exception to the requirement to consolidate controlled investees if those investments are held by an investment entity. In contrast, the FASB is considering investment company accounting more broadly.

3. For the IASB, the question that this paper addresses is whether the non-investment entity parent should retain in its consolidated financial statements **the proposed exception to consolidation** that would require fair value accounting for controlled investees[1] of an investment entity[2] subsidiary. The question this paper

---

[1] This paper only discusses how a non-investment entity parent would account for the investments of an investment entity subsidiary in its consolidated financial statements. The paper assumes that a non-investment entity parent would consolidate the investment entity subsidiary and would correspondingly recognise the assets, liabilities, equity and non-controlling interest in the investment entity subsidiary in the parent's consolidated financial statements.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

addresses for the FASB is whether a non-investment entity parent should retain in its consolidated financial statements **the fair value accounting used for all investments** of an investment company under US GAAP. Hereafter these scenarios are referred to as the 'retention of specialised accounting'.

4. This paper assumes that the IASB will retain their proposal that a non-investment entity parent of an investment entity subsidiary should *retain* the fair value accounting that an investment entity subsidiary would use for its investments in associates and joint ventures. Constituents have expressed support for this proposal, confirming that it provides useful information. Additionally, the proposal is consistent with the recently confirmed requirements in IAS 28 *Investments in Associates and Joint Ventures*.

Summary of staff recommendations

5. The FASB staff recommend that a non-investment entity parent should be required to retain the specialised accounting applied by its investment entity subsidiaries in the non-investment entity parent's consolidated financial statements. This recommendation is consistent with current US GAAP and the FASB's proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement and Disclosure Requirements,* ('the FASB ED').

6. The IASB staff recommend that a non-investment entity parent should be required to consolidate all controlled investees, regardless of whether those investments are held through an investment entity subsidiary. This is consistent with the proposal in the IASB's *Investment Entities* exposure draft ('the IASB ED').

[2] For purposes of this paper, the terms 'investment entity' and 'investment company' will be used interchangeably.

Background

Exposure draft proposals

7. Under current US GAAP, a parent entity is required to retain the specialised accounting applied by a subsidiary that follows industry-specific guidance. The FASB ED retains that requirement for a non-investment company parent of an investment company subsidiary. Under this guidance, when a non-investment company parent consolidates an investment company subsidiary, it would retain the measurement attributes for assets and liabilities held by the subsidiary. Consequently, in the consolidated financial statements, the investment company subsidiary's investments (including controlled investees) would be measured at fair value and own debt would generally be measured at cost.

8. The Basis for Conclusions in the FASB ED explains that the FASB believes that, assuming the specialised investment company accounting principles are appropriate at the subsidiary level, those principles should be retained at the parent level. Moreover, the FASB believes that retaining the specialised investment company accounting at the parent level improves the visibility into the investments held by an investment company subsidiary.

9. In the IASB ED, the IASB proposed that a non-investment entity parent would not retain the specialised accounting used by an investment entity subsidiary for its controlled investees in the parent's consolidated financial statements. Consequently, the non-investment entity parent would consolidate all its controlled investees, including those held by an investment entity subsidiary.

10. The Basis for Conclusions of the IASB ED explains that the IASB made this decision because of concerns about potential accounting inconsistencies and possibilities for abuse when accounting for an investment entity in the consolidated financial statements of a group. These concerns included:

    (a) The possibility that a non-investment entity parent could selectively make investments within an investment entity in order to avoid consolidation.

(b) The possibility that a non-investment entity parent could artificially inflate its capital base by issuing equity to an investee of the investment entity subsidiary.

11. The Basis for Conclusions also stated that the IASB believed that, in most cases, investment entities would have investment entity parents.

12. However, the IASB also proposed that a non-investment entity parent would retain the exception to the equity method of accounting for an investment entity subsidiary's investments in associates and joint ventures in its consolidated financial statements. This is consistent with decisions made recently by the IASB in its deliberations that led to the revised issuance of IAS 28 *Interests in Associates and Joint Ventures* in 2011. In its deliberations, the IASB decided that a reporting entity would be able to retain the fair value accounting for the investments in associates used by venture capital organisations, mutual funds, or unit trust subsidiaries in the group consolidated financial statements, even if the total investment at the group level is only held partially by a venture capital, mutual fund or unit trust subsidiary.

Decisions made in redeliberations

13. During the May joint board meeting, the boards tentatively decided that an entity would be required to meet a definition to be an investment entity. The definitions the boards tentatively decided on are reproduced in Appendix A. In addition, the boards discussed other concepts that would be considered when making the investment entity assessment. Although the boards did not decide on the exact relationship between the definition and the other concepts to consider, judgement would be required when making the assessment of whether an entity is an investment entity.

Feedback received

14. Nearly all FASB constituents and the majority of IASB constituents (including users) were supportive of the US GAAP approach and offered the following reasons to support their view:

    (a) the specialised accounting used by an investment entity subsidiary continues to be relevant at a non-investment entity parent level because the nature of the investment entity's activities and the business purpose of the investment entity would not change just because that investment entity is controlled by a non-investment entity parent;

    (b) the cost savings and benefits of more relevant reporting would be lost in cases when an investment entity subsidiary is controlled by a non-investment entity parent; and

    (c) retention of the specialised accounting used by an investment entity subsidiary would be consistent with the IASB's proposed accounting by a non-investment entity parent for interests in associates and joint ventures held by an investment entity subsidiary (that is, the fair value used for these interests would be retained at the non-investment entity parent level).

15. Those constituents also made suggestions to address the IASB's concern about the possibilities for structuring that would arise if a non-investment entity parent were to retain the fair value accounting used by an investment entity subsidiary. Many of those constituents argued that those concerns could be addressed by strengthening the existing criteria that need to be met to qualify as an investment entity. Some constituents also believed that the IASB's concerns about abuse were somewhat overstated. They noted that there has not been a history of abuse in jurisdictions where a non-investment entity parent has been allowed to retain the specialised accounting used by an investment entity subsidiary, such as the United States, Canada and Japan. Other constituents stated that they did not believe the IASB should be setting standards on an anti-abuse basis.

16. Constituents also commented on the IASB's concern about some accounting issues that would arise if a non-investment entity parent retained the specialised accounting used by an investment entity subsidiary for controlled investees.

    (a) In the case of an investment entity subsidiary having a controlled investee that holds an investment in the non-investment entity parent, constituents suggested that the IASB could either use the same solution for own equity that they are using in the insurance project for participating contracts (that is, to recognise an investment entity subsidiary's investment in its parent as an asset in the parent's financial statements) or address the issue through additional disclosures. Moreover, constituents suggested that this case would be very rare and should not direct the IASB's decision making.

    (b) In the case of a non-investment entity parent and an investment entity subsidiary holding investments in the same entity but accounting for those investments differently, constituents suggested the issue could be solved by prohibiting an investment entity from making an investment in the same entity as its non-investment entity parent. Alternatively, the IASB could accept that a non-investment entity parent and an investing entity subsidiary are investing for different reasons and should therefore use different measurement bases to account for their investments.

17. Some constituents also disagreed with the IASB's statement that in most cases, investment entity subsidiaries would not have non-investment entity parents. These constituents offered many examples of investment entity subsidiaries controlled by non-investment entity parents, describing cases where insurance companies, asset managers, banks and government entities own investment entity subsidiaries.

18. Some constituents who supported retaining specialised accounting suggested various criteria that should be met in order for a non-investment entity parent to be able to retain the specialised accounting used by an investment entity subsidiary. These constituents mentioned that similar criteria are being used in

other local GAAPs, such as Canadian GAAP and Japanese GAAP, and might be used to allay the IASB's concerns about structuring. The suggested criteria included:

(a) prohibiting a non-investment entity parent from receiving any benefits from the investment entity subsidiary or that subsidiary's investments that are not available to other parties;

(b) prohibiting a non-investment entity parent and the investment entity subsidiary from investing in any of the same investments;

(c) prohibiting an investment entity subsidiary from investing in the non-investment entity parent;

(d) requiring that an investment entity subsidiary be managed by a professional external asset manager; and

(e) requiring that the business purposes and strategies of a non-investment entity parent and an investment entity subsidiary be clearly differentiated from each other.

19. A minority of constituents agreed with the IASB's proposal to prohibit a non-investment entity parent from retaining the specialised accounting used by an investment entity subsidiary for controlled investees. These constituents argued that the exception to consolidation proposed in the IASB ED is effectively based on an entity's business model and that, since a non-investment entity parent has a different business model than an investment entity subsidiary, it would be inappropriate for the non-investment entity parent to retain the exception.

20. These constituents were also concerned about the potential structuring that could occur from allowing a non-investment entity parent to retain the exception to consolidation used by an investment entity subsidiary. These constituents focused on the ability of a non-investment entity parent to hide leverage by moving highly leveraged investees to an investment entity subsidiary.

21. These constituents were also concerned about different measurement bases being used for the same investment depending on whether that investment is being held

at a non-investment entity parent or investment entity subsidiary level. They suggested that non-investment entity parents of investment entity subsidiaries be required to disclose fair value information about these subsidiaries to address the needs of investors.

User feedback

22. User feedback in this area was generally consistent with the rest of constituent feedback. The majority of users were supportive of the US GAAP approach and argued that retaining the specialised accounting of an investment entity subsidiary in a non-investment entity parent's financial statements resulted in more relevant information that better reflected the diverse business activities of the non-investment entity parent. These users suggested that information about an investment entity's investments, such as the leverage of those investments, be disclosed in the notes to the financial statements as an alternative to consolidating an investment entity subsidiary's controlled investees.
23. However, there were a minority of users who were supportive of the IASB approach to prohibit the proposed exception to consolidation at a non-investment entity level. These users were concerned about the ability of a non-investment entity parent to hide information about controlled investees by investing in them through an investment entity subsidiary. Some of these users also argued that, for a non-investment entity parent, the most relevant information is always consolidated information, no matter whether a controlled investee is held through an investment entity subsidiary or not.

Staff analysis and recommendations

24. The staff first analyses the advantages and disadvantages of retaining the specialised accounting used by an investment company subsidiary in the consolidated financial statements of the parent entity. The staff then presents alternatives for the boards' consideration and provides its recommendations.

25. The staff also note that many examples of investment entity subsidiaries with non-investment entity parents were provided by constituents, as noted in paragraph 17 above. Consequently, the staff think that it would be incorrect for the boards to assume that few investment entity subsidiaries have non-investment entity parents, as indicated in the IASB ED. However, the staff note that in respect of the IASB proposals, the proposed prohibition is only relevant when an investment entity has a non-investment entity parent *and* has controlled investees.

Advantages of retention of specialised accounting

26. The staff believes there are a number of advantages to retaining the specialised accounting used by an investment entity subsidiary at the non-investment entity parent level.

27. Firstly, having a non-investment entity parent does not change the activities of an investment entity. Consequently, if fair value measurement of investments is deemed appropriate due to the business activities and business purpose of an investment company, retention of that fair value measurement by the parent entity appropriately reflects the business activities of the investment entity subsidiary.

28. In addition, it would be responsive to the majority of constituents who thought that the retention of specialised accounting provides the most useful information at the non-investment entity parent level.

29. For the IASB, this alternative is also consistent with the current treatment of the fair value option in IAS 28 in a parent's financial statements. IAS 28 allows a parent to retain the fair value accounting used by certain subsidiaries (such as venture capital organisations or mutual funds) in the parent's consolidated financial statements when accounting for those subsidiaries' interests in associates. The staff has heard from many constituents that retaining this fair value accounting in a parent's consolidated financial statements works well in practice and results in information that is relevant for users.

30. It would be less onerous for a non-investment entity parent to retain the specialised accounting used by an investment entity subsidiary. The cost savings

created by the exception from consolidation would continue to be realised at the non-investment entity parent level instead of being lost through a requirement to unwind the specialised accounting. Moreover, there would generally be costs associated with the need to prepare and maintain two different sets of financial statements at the parent and subsidiary level. Further, it seems complex to require an investment company to assess consolidation guidance in order to avail itself of the exception from consolidation and then also to require the parent entity to assess consolidation guidance to consolidate controlled investees held by an investment company subsidiary.

Disadvantages of retention of specialised accounting

31. The staff have also identified a number of disadvantages to requiring that a non-investment entity parent retain the specialised accounting used by an investment entity subsidiary.

32. Firstly, the boards have stated that the accounting proposed by each board is justified because of the unique business model of an investment entity. A non-investment entity parent does not have the same business model as an investment entity. Consequently, the specialised accounting used by an investment entity is arguably less relevant for a non-investment entity parent.

33. Additionally, measuring controlled investees at fair value instead of consolidating them results in the loss of information in the non-investment entity parent's financial statements. This includes information about an investment entity's investees' assets, liabilities, revenues and expenses.

34. Moreover, as noted in the IASB ED, if the exception from consolidation were retained in a non-investment entity parent's financial statements, a non-investment entity could avoid consolidation of a controlled entity by forming an investment entity subsidiary and transferring controlled investees into that investment entity subsidiary, provided that the subsidiary meets the definition of an investment entity. The staff analyses the definition of an investment entity and possible structuring concerns in paragraphs 36-44 below.

35. Finally, the staff note that the retention of specialised accounting gives rise to certain practical issues that must be considered. The staff analyses these practical considerations in paragraphs 45-51 below.

Structuring concerns

36. As described above, part of the reason the IASB proposed to prohibit the retention of specialised accounting at a non-investment entity parent level is because the IASB was concerned that a non-investment entity parent could achieve specific accounting outcomes by transferring controlled investments into an investment entity subsidiary.

37. The staff note that many constituents stated that the definition of an investment entity should be crafted so that it would not be possible for a non-investment entity parent to avoid consolidation of its controlled investees simply by creating an investment entity subsidiary. The staff thinks that the definition the boards agreed upon in the May 2012 joint board meeting has elements that restrict the possibility of structuring.

38. The proposed definition of an investment entity the boards agreed upon in the May 2012 joint board meeting requires that an investment entity's only substantive activities be investing for capital appreciation or investment income[3]. The definition also states that an investment entity and its affiliates (which would include a non-investment entity parent) cannot obtain any returns or benefits from their investments that are other than capital appreciation or investment income, not available to other noninvestors, or are not normally attributable to ownership interests. This would prevent investment funds with non-investment entity parents from qualifying as investment entities when the non-investment entity parent receives some sort of benefit from the fund that is other than capital appreciation or investment income.

---

[3] In the May 2012 meeting, the FASB decided that an investment entity would be required to invest for 'capital appreciation, investment income, or both'. The IASB decided that an investment entity would be required to invest for 'capital appreciation or capital appreciation and investment income'.

39. The staff think that this may address many of the concerns raised about forming investment entity subsidiaries to avoid the consolidation of loss-making or highly leveraged investments. For example, the staff do not think an investment fund controlled by a pharmaceutical company and formed to invest in pharmaceutical research and development projects would qualify as an investment entity because the parent pharmaceutical company would be receiving benefits that are other than capital appreciation or investment income from those investments.

40. Moreover, the staff note that, in the May 2012 joint board meeting, the IASB also decided to require that an investment entity realise capital appreciation and have an exit strategy for substantially all of its investments. The staff think that this requirement will also limit the opportunity for a non-investment entity parent to inappropriately avoid consolidation of controlled investees.

41. However, the staff note that the definition and general approach to assessing whether an entity is an investment entity that the boards have tentatively decided on widens the population of investment entities in some senses from what was proposed in the EDs. In particular, the boards have tentatively decided that some of the criteria proposed in the EDs would no longer be mandatory but would be treated as factors to consider. This means that there is greater judgement involved in the assessment of investment entity status.

42. Some staff think that this broader population and additional judgement could make it easier for an entity to create an investment entity subsidiary for the purposes of retaining the specialised accounting used by that subsidiary. For example, the staff note that, if the fair value measurement used by investment entities was able to be retained at a non-investment entity parent level, operating companies with no connection to the financial services industry would be able to measure controlled investees at fair value instead of consolidating them.

43. Additionally, based on the decisions made by the boards at the May 2012 board meeting, an investment entity would be required to measure a controlled investee at fair value even when it is involved in the day-to-day operations of that controlled investee via an investment entity subsidiary. This means that the

investment could be actively managed rather than simply being a passive investment.

44. Based on the conversation at the May 2012 board meeting, the staff think it is likely that the boards will decide not to require an investment entity to have multiple unrelated investors. Consequently, a non-investment entity parent could wholly own of another operating company through a wholly-owned investment fund subsidiary but not be required to consolidate that wholly-owned operating company as long as the investment fund subsidiary met the definition of an investment entity. The staff note that the removal of the requirement to have multiple unrelated investors will also broaden the population of investment entities relative to the FASB and IASB EDs.

Other practical issues

45. The staff note some practical consequences of the retention of specialised accounting that they think the boards should consider. The boards considered these practical consequences when they made their decisions regarding the proposals in the IASB and FASB EDs.

46. The staff note that if an investment entity subsidiary holds a controlled investee, that investee holds an investment in the equity of the non-investment entity parent, and specialised accounting is retained at the parent level, the non-investment entity parent could appear to be over capitalised through the investee's investment in own (group) equity.

47. The staff note that the FASB ED's Basis for Conclusions stated that the FASB did not expect this issue to occur very frequently in practice and could be addressed through disclosure. After considering feedback received on the EDs, the staff generally agree with the FASB's assessment.

48. Additionally, a non-investment entity parent could hold a controlling interest in an operating company through a combination of direct investment and investment through investment entity subsidiaries. If the non-investment entity parent holds the controlling interest in an operating company through a combination of direct

investment and investment through investment entity subsidiaries (ie the non-investment parent does not directly control the operating company), the control relationship at the group level would not be reflected in the financial statements. This is because the direct investment would be accounted for as a financial asset or an investment in associate and the investment held through investment entity subsidiaries would be measured at fair value.

49. Some IASB constituents have noted this issue in their arguments against the retention of specialised accounting. They argue that consolidation of controlled operating companies at the non-investment entity parent level results in more relevant information that more accurately reflects the nature of the parent's relationship with the controlled operating company.

50. The staff note that one way to address this issue, as constituents suggested, would be to prohibit a non-investment entity parent from investing in the same investments as an investment entity subsidiary. However, the staff does not think this prohibition would be operational, particularly if another entity in the group had a trading portfolio, because a non-investment entity parent would have to track its investments, the investments held by its investment (and non-investment) entity subsidiaries and the subsidiaries' investees.

51. The staff also acknowledge that another way to address this issue would be to accept that a non-investment entity parent is directly investing for different business reasons than its investment entity subsidiary and that these differences should be reflected in the financial statements.

Alternatives for consideration

52. The staff has identified three alternatives for the boards to consider:

(a) **Alternative 1:** require all non-investment entity parents to retain specialised[4] accounting (US GAAP approach).

(b) **Alternative 2:** prohibit all non-investment entity parents from retaining specialised accounting (IASB ED approach).

(c) **Alternative 3:** require only some non-investment entity parents to retain specialised accounting.

53. The staff analysis of Alternatives 1 and 2 is contained in the discussion of the disadvantages and advantages of retaining the specialised accounting used by an investment company subsidiary in paragraphs 26 through 51. Below the staff analyses Alternative 3.

Alternative 3: Require only some non-investment entity parents to retain specialised accounting

54. Another alternative the boards could consider is to require the retention of specialised accounting only in specific circumstances. This alternative would allow specialised accounting (general investment company accounting for the FASB and an exemption from consolidation of controlled investees for the IASB) to be retained by a non-investment entity parent in cases where that results in the most relevant information, while limiting the opportunity for a non-investment entity parent to avoid consolidation by making controlling investments through an investment entity subsidiary.

55. However, this alternative would involve complexity as it would only allow the retention of specialised accounting in specific circumstances. It would place a lot of emphasis on the population of entities that would be allowed to retain the

[4] Again, the staff note that the 'retention of specialised accounting' has a different meaning for the FASB and the IASB in this paper. For the FASB, the 'retention of specialised accounting' refers to a non-investment company parent retaining the fair value accounting that an investment company subsidiary uses for **all** its investments. For the IASB, the 'retention of specialised accounting' refers to a non-investment entity parent retaining the fair value accounting that an investment entity subsidiary uses for its **controlled investees**.

specialised accounting used by an investment entity subsidiary for their subsidiaries.

56. Some constituents suggested criteria that could be required to be met to qualify for retention of specialised accounting (described in paragraph 18). However, the staff have concerns with many of these suggestions. For some of the suggestions (such as the suggestion that a non-investment entity parent be prohibited from receiving any benefits from the investment entity subsidiary or its investments that are not available to other parties), the staff think that the criteria would automatically be met given the definition of an investment entity that was decided on by the boards in the May 2012 meeting. For others (such as the suggestion that a non-investment entity parent be prohibited from investing in the same investments as its investment entity subsidiaries), the staff have concerns regarding whether the criteria are operational (as discussed in paragraph 50).

57. However, the staff have identified some types of non-investment entity parents where they believe that it is clear that the retention of specialised accounting would result in more relevant information than consolidation at a non-investment entity parent level. If the boards elect this approach, the staff think that it is more effective to define the type of non-investment entity parent that should retain specialised accounting rather than identifying certain criteria that would have to be met for any non-investment entity parent to retain specialised accounting.

58. As noted in Agenda paper 8A/FASB memo no. 46A for the May 2012 joint board meeting, many international listed private equity companies that would otherwise qualify for investment entity status are disqualified because they have substantive asset management subsidiaries that provide asset management services to third parties in exchange for fee income. Those asset management subsidiaries invest external funds in the private equity funds controlled by the parent. The staff notes that some of these funds are required to follow IFRSs and are concerned that they would have to start consolidating investees that were previously measured at fair value because of the implementation of IFRS 10 *Consolidated Financial Statements* and its agent-principal guidance.

59. As noted in Agenda paper 8A for the May 2012 joint board meeting, the staff did not recommend that these entities should qualify as investment entities because they are not only receiving capital appreciation or investment income from their investments. They are also receiving fee income from investing third parties' funds.

60. However, the staff believe that retaining the specialised accounting used by the parent company investment entity subsidiary funds in these cases would result in the most relevant information. The business model of the parent is very similar to the business model of an investment entity—the difference is that private equity companies with asset management subsidiaries also invest third parties' funds (for a fee) as well as their own funds. However, these companies, through their investment entity subsidiaries, still have controlled investees in multiple unrelated industries and argue that consolidated information involves significant time and effort to prepare while providing little to no useful information.

61. The staff has confirmed through discussions with users of these companies' financial statements that the presence of substantive asset management activities does not change the fact that they still view fair value information as much more relevant than consolidation of each private equity fund's controlled investees.

62. Such parent entities would not be able to retain the specialised accounting used by their investment entity subsidiaries although they are very similar to investment entities and are acknowledged as such by the users of these entity's financial statements.

63. To address this, if the boards elect Alternative 3, the boards could decide that a non-investment entity parent would be able to retain the specialised accounting used by an investment entity subsidiary *if the non-investment entity parent would meet the proposed definition of an investment entity except that it provides substantive investment-related services to external parties*. The staff think this approach would capture those parents who mainly engage in investing activities while also having asset management subsidiaries. The approach would also exclude non-investment entity parents whose business models at the parent level

include activities that are more than investing or investment management and thus have business models that are very different from those of investment entities.

64. If the boards elect Alternative 3, the line could be drawn as described above in order to allow entities whose business model at a parent level is very similar to that of an investment entity to be able to retain the specialised accounting used by investment entity subsidiaries. However, the staff would also like to note that the separate accounts of insurance companies and private equity funds held by banks and asset managers would also represent instances where some of the staff think there is a strong argument that fair value measurement for the controlled investees held by these funds would result in more relevant information than consolidated information.

65. In all of these cases, arguably the non-investment entity parent is investing to obtain returns from capital appreciation or interest income. Additionally, many of the same arguments that are used for justifying an exception from consolidation for investment entities can also apply in these cases. Consolidation of controlled investees involves considerable time and would obscure the financial statements.

66. While the staff think that drawing the line as described in paragraph 63 would solve the issue of private equity companies who provide asset management services, the staff acknowledge that such an approach would not result in fair value accounting for indirectly held subsidiaries in other instances where fair value accounting is considered by many to provide more relevant information, as described above. If the boards were to elect Alternative 3, the staff would need to do additional work to define the entities that would qualify for the ability to retain the specialised accounting.

Staff recommendations

FASB staff recommendation

67. The FASB staff recommend requiring a non-investment entity parent to retain the specialised accounting used by an investment company subsidiary for its investments (the US GAAP approach). The FASB staff believe that a parent entity

should be required to carry over the measurement attributes used by the investment company subsidiary in the parent entity's consolidated financial statements.

68. The FASB staff believes that if the definition of an investment company identifies the appropriate population of entities that should measure their investments at fair value, fair value measurement should be retained at the parent entity level because the business activities that generated the investments have not changed.

69. The FASB staff highlight that almost all FASB user constituents and the majority of IASB user constituents stated that retaining the investment company subsidiary's accounting in the consolidated financial statements of the parent entity results in the most useful information. Further, the FASB staff believes that not retaining the specialised accounting at a non-investment entity parent level results in increased complexity and agrees with the cost-benefit and operational concerns raised by nonuser constituents.

70. The FASB staff also note that under US GAAP, a parent entity is required to retain the specialised accounting applied by a subsidiary that is subject to industry-specific guidance. Consequently, the guidance is not unique to investment company subsidiaries. The FASB staff believe that if the boards decide that a non-investment entity parent is prohibited from retaining the specialised accounting applied by an investment company subsidiary for its investments, the FASB also should prohibit the retention of specialised accounting applied by subsidiaries following all other industry-specific guidance.

IASB staff recommendation

71. The IASB staff recommend that a non-investment entity parent consolidate all controlled investees, regardless of whether those investees are held through an investment entity subsidiary.

72. The IASB staff acknowledges that the majority of both U.S. GAAP and IFRS constituents have opposed this approach. Moreover, the IASB staff think that fair

value measurement does result in more relevant information in a number of cases where investment entity subsidiaries have non-investment entity parents.

73. However, the IASB has decided to provide an exception from consolidation, and the FASB provides investment company accounting guidance, because of the unique business models of investment entities. Non-investment entity parents do not have these business models; they do not invest solely for capital appreciation or investment income and they do not have investors who are entitled to a portion of that capital appreciation or investment income. The argument for fair value measurement requirement is weakened at a non-investment entity parent level.

74. The IASB staff does think that the definition of an investment entity decided on at the May 2012 joint board meeting addresses many of the boards' concerns about a non-investment entity parent's ability to avoid consolidation by holding a controlled investee through an investment entity subsidiary. However, the IASB staff does have concerns that broadening the definition of an investment entity from what was proposed in the EDs as tentatively agreed in the redeliberations to date, especially by allowing single investors and day-to-day management, would still provide non-investment entity parents with the ability to avoid consolidation.

75. Additionally, the IASB staff note the practical difficulties around retaining the specialised accounting used by an investment entity subsidiary for controlled investees when a non-investment entity parent and an investment entity subsidiary invest in the same investment or when an investment entity subsidiary holds a controlled investee that invests in equity of a non-investment entity parent.

76. IFRSs are different from US GAAP in the sense that US GAAP has industry-specific guidance for a number of different industries, and that industry-specific guidance is required to be retained by a parent entity, regardless of whether that parent entity is part of that industry. In its investment entities project, the IASB is not proposing comprehensive industry-specific guidance for all investment entities. Instead, it is proposing exceptions from IFRS 10 and IAS 28 for investment entities. Given the different objectives of the IASB and FASB projects and the history of retention of specialised accounting under US GAAP, the staff

think that the argument for retention of specialised accounting for controlled investees is weakened for the IASB.

77. Moreover, the IASB staff note that the United States has had regulatory and accounting requirements for investment companies for many years, including a national understanding of the investment company industry. The IASB cannot rely on such an environment in all of its constituencies.

78. While the IASB staff recognize the merits of Alternative 3, the IASB staff do not recommend Alternative 3 because they are concerned that allowing the retention of specialized accounting for the controlled investees of an investment entity subsidiary only in certain cases would be overly complex, would place too much pressure on the 'line' that would be drawn to allow the retention of specialised accounting and would not address all arguments against the retention of specialised accounting.

79. Finally, the IASB staff acknowledge this approach is inconsistent with the fact that IFRSs allow the fair value accounting used by certain entities for investments in associates in IAS 28 to be retained at a parent level. However, the IASB staff notes that the difference between the information provided by consolidation and fair value measurement is much larger than the difference between the information provided by the use of the equity method and fair value measurement.

Questions to the Boards

Does the FASB think that a non-investment company parent should retain the specialized accounting used for all investments held by an investment company subsidiary? If no, does the FASB think that specialized accounting should be retained for any subsidiaries subject to industry-specific guidance?

Does the IASB think that a non-investment entity parent should retain the exception from consolidation used for the controlled investees of an investment entity subsidiary?

Appendix A

A1. The IASB tentatively decided that the definition of an investment entity would be as follows:

> An investment entity does all of the following:
>
> a) obtains funds from an investor or investors and provides the investor(s) with professional investment management services;
>
> b) commits to its investor(s) that its business purpose and only substantive activities are investing the funds for returns from capital appreciation or capital appreciation and investment income; and
>
> c) manages and evaluates the performance of substantially all of its investments on a fair value basis.
>
> An investment entity and its affiliates do not obtain, or have the objective of obtaining, returns or benefits from their investments that are either of the following:
>
> a) other than capital appreciation or capital appreciation and investment income; or
>
> b) not available to other noninvestors or are not normally attributable to ownership interests.

A2. The FASB tentatively decided that the definition of an investment company would be as follows:

> An investment company is an entity that does both of the following
>
> a) Obtains funds from an investor or investors and provides the investor(s) with professional investment management services
>
> b) Commits to its investor(s) that its business purpose and only substantive activities are investing the funds

for returns from capital appreciation, investment income, or both.

An investment company and its affiliates do not obtain, or have the objective of obtaining, returns or benefits from their investments that are either of the following:

a) Other than capital appreciation or investment income

b) Not available to other noninvestors or are not normally attributable to ownership interests.