

# STAFF PAPER

**21 May – 24 May 2012**

## REG FASB | IASB Meeting

| Project     | Investment Entities / Investment Companies |  |                     |
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| Paper topic | Criteria to be an investment entity        |  |                     |
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### Purpose

1. In light of feedback received, this paper discusses potential changes to the investment entity criteria proposed in the IASB Exposure Draft, *Investment Entities* (IASB ED), and the proposed FASB Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement and Disclosure Requirements* (FASB ED).
2. The following issues will be discussed at future Board meetings and, therefore, this paper does not specifically discuss feedback received regarding:
  - (a) real estate entities, including real estate investment trusts and real estate funds.
  - (b) the explicit inclusion of entities that are investment companies under regulatory rules as investment companies for accounting purposes.
3. The staff recommendations in this paper assume that the Boards would continue to *require* an entity to meet a series of criteria to be an investment entity. However, the staff believes that some constituent concerns are better addressed by applying a different approach to assessing the criteria, which involves providing a definition of

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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](http://www.fasb.org)

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an investment entity along with factors to consider to determine whether an entity is an investment entity. The staff states that view where applicable in the staff recommendations in this paper. This paper does not discuss alternatives for the overall approach to provide entity-based investment entity guidance but the analysis about each proposed criterion in this paper is integral when deciding on the overall approach to assessing the criteria. Alternative approaches to assessing the criteria are discussed in Agenda Paper 8B/FASB Memo No. 46B.

4. This paper does not ask the Boards to make any decisions regarding changes to be made to the criteria. All the questions to the Boards are in Agenda Paper 8C/FASB Memo No. 46C. Agenda Paper 8C/FASB Memo No. 46C also contains a summary of the staff recommendations in this paper.

## **Background**

5. The EDs propose that six criteria must be met to qualify as an investment entity. The criteria are mainly converged under the EDs. However, there are some wording differences regarding how the criteria are described and some differences in application guidance under the EDs. This memo uses the criteria as worded in the IASB ED for discussion purposes. All proposed criteria as worded in the IASB ED and FASB ED are reproduced in Appendix A.
6. In the feedback received on the EDs, many constituents expressed various criticisms of the proposed criteria, stating that the criteria as proposed would inappropriately include or exclude various structures from the scope of the investment entity guidance. Many of those constituents offered suggestions on how to change the proposed criteria.
7. For each of the six criteria proposed in the EDs, this paper describes:
  - (a) The feedback received regarding the criterion or related application guidance
  - (b) A staff analysis of the potential changes that could be made to the criterion or application guidance, along with a staff recommendation of whether or not to make those potential changes.

8. This paper discusses significant concerns raised by constituents regarding each of the proposed criteria. The staff may identify other issues or points of clarification during the redeliberations and drafting process to be discussed at a future meeting.

### **Nature of the investment activity criterion**

9. The nature of the investment activity criterion is phrased in the IASB ED as follows:

The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both.

10. The discussion about the nature of the investment activities criterion is organized as follows:
- (a) Substantive activities and permitted activities (paragraphs 11-20)
  - (b) Day-to-day management (paragraphs 21-24)
  - (c) Inter-investee activities (paragraphs 25-27)
  - (d) Multiple investments (paragraphs 28-40).

### ***Substantive activities and permitted activities***

11. The EDs require that an investment entity's only substantive activities are investing for capital appreciation, investment income or both. The EDs also propose that an investment entity could still meet the substantive activities requirement if it provides investment-related services only related to the investment entity's own investing activities. In addition, the FASB ED explicitly permits an investment company to provide services to third parties if those activities are not substantive.
12. The staff thinks that this criterion was meant to capture an investment entity's business model of investing for capital appreciation, investment income, or both and to ensure that an investment entity performed only those activities.
13. The Basis for Conclusions in the FASB ED state that the Boards decided to use the term *only substantive activities* when describing the nature of activities of an investment entity, because having other substantive activities would call into question

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whether the entity exists for reasons other than to invest for capital appreciation, investment income, or both.

*Feedback received*

14. Most FASB constituents agreed with the FASB proposals in this area, although some requested that the term *substantive* be clarified or defined. Some IASB constituents were confused about whether or not investment-related services provided to third parties would be prohibited regardless of the significance of those services because the IASB ED did not explicitly state whether investment-related services provided to third parties would be prohibited for investment entities. Most IASB constituents agreed with the IASB ED’s proposal that an investment entity should be able to provide services related to its own investing activities.
15. Feedback from IASB constituents was more mixed, however, on whether an investment entity should be allowed to provide investment-related services to third parties. Some IASB constituents believe that any provision of services to third parties should be prohibited because those services would constitute activities that are other than investing. Other IASB constituents argue that the provision of external services should be allowed only if those activities are minor ancillary activities, such as IT or recordkeeping services.
16. Some IASB constituents argued that the provision of investment management services to third parties should be allowed. Those constituents argued that many investment entities, such as private equity entities, have investment management subsidiaries that provide investment management services both for the reporting entity and for third parties. Those constituents did not think that providing such services to third parties should disqualify a reporting entity from investment entity status. Those constituents argued that it should not matter whether investment management services are related to an investment entity’s own investments or the investments of a third party; either way, the investment entity’s business purpose is investing for capital appreciation, investment income, or both. Those constituents argue that the provision of investment-related services do not change the entity’s substantive activities or business purpose.

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*Staff analysis and recommendation*

17. The staff thinks it would be useful to clarify in the final IASB guidance that an investment entity can provide investment-related services to external parties, so long as those services are not substantive, similar to the FASB ED. However, the staff notes that this would not totally address some constituents' requests to allow an investment entity to provide investment-related services to external parties, regardless of how 'substantive' those services are. This is a significant issue for some large listed private equity companies. Those private equity companies provide significant investment management services to external parties while running multiple private equity funds.
18. However, the staff does not think that an investment entity should be able to provide substantive investment-related services to third parties, such as investment management services, and still assert that its business model is only investing for capital appreciation, investment income, or both. An entity that provides substantive investment management services has (at least) two business models: investing and asset management. Such an entity would be investing for capital appreciation, investment income, or both while simultaneously earning fee income.
19. The staff recommends that an entity that provides significant investment management services to external parties should not qualify as an investment entity. The staff notes that the Boards will consider whether noninvestment entity parents (including asset managers) should retain the fair value accounting used by investment entity subsidiaries at a later date.
20. Finally, the staff acknowledges constituents' requests for a definition of *substantive* or more guidance on this term. The staff does not recommend providing a definition of *substantive* because it is concerned that this will place too much pressure on the definition and lead to structuring. The staff thinks that entities should be able to use professional judgement when making the *substantive* assessment.

***Day-to-day management***

21. The IASB ED does not provide guidance on whether active involvement in the day-to-day management activities of an investee would constitute an allowable investing

activity, and many IASB constituents requested clarification in that area. Paragraph BC18 of the FASB ED specifically discusses this issue and permits an investment company to be involved in the day-to-day management activities of an investee:

The Boards concluded that an investment company may be involved in the day-to-day management activities of its investees for purposes of maximizing the overall value of an investment (rather than generating strategic benefits). The Boards considered such involvement to be consistent with the activities of an investment company. In addition, the Boards noted that focusing on the involvement in the day-to-day activities (or the ability to be involved in the day-to-day activities) may create an inconsistency with the control principle under both U.S. GAAP and IFRS when the investment company has a controlling financial interest in the investee. The concern is that a limitation on active management is counterintuitive to controlling another entity; one cannot claim to control another entity without being involved, or having the ability to be involved, in the day-to-day management of that entity. Finally, the Boards were concerned that diversity may evolve when an investment company is only involved in the day-to-day management for some of its investees or only on a temporary basis.

#### *Feedback received*

22. Some IASB constituents agree with the FASB ED and recommend that the IASB include similar language in its Basis for Conclusions. Other IASB constituents argued that the Boards should prohibit active involvement in the day-to-day management activities of an investee, stating that this type of involvement should not be considered an ‘investing activity’ because engaging in the day-to-day management activities of an investee indicates that an entity is actively managing its controlled entity rather than simply investing in that entity. Those IASB constituents felt that, when an entity is actively involved in the day-to-day management of an investee, consolidating that controlled investee would result in more relevant information.

#### *Staff analysis and recommendation*

23. The staff can understand certain constituents’ requests to prohibit active involvement in the day-to-day management activities of an investee. It can be argued that such involvement means that consolidation is more appropriate because consolidated information will better depict the results of the operations of the investee than an investment entity is involved in.

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24. However, the staff agrees with the rationale in the FASB Basis for Conclusions and does not think that an investment entity should be prohibited from involvement in the activities of its investees. The staff understands that, in private equity and venture capital funds that hold controlled investees, those entities will at times exercise their control by, for example, placing individuals in management positions or providing operational and strategic assistance during initial public offerings or acquisitions. The staff understands that for those entities those activities are meant to increase the fair value of the investee and the ultimate capital appreciation of the investment and are not meant to result in any additional benefits to the investor beyond increasing the value of its investment. The staff also thinks that it would be difficult to distinguish different ‘types’ of involvement in the activities of the investee (that is, involvement in operations vs. management, temporary vs. nontemporary involvement, etc.) and appreciate the practical difficulties of such a prohibition. Therefore, the staff recommends that the IASB include language similar to the language in the FASB’s Basis for Conclusions.

### ***Inter-investee activities***

25. The EDs include a paragraph (paragraph B6 in the IASB ED and paragraph 946-10-55-7 in the FASB ED) that provides examples of activities and relationships between (a) an investment entity and its affiliates and (b) an investee and its affiliates that would be inconsistent with an investment entity’s activities and business purpose of investing for returns from capital appreciation, investment income or both. The language in the paragraph differs slightly between the IASB ED and the FASB ED. Those paragraphs are reproduced in Appendix B.

### ***Feedback received***

26. Many constituents agreed with paragraph B6 in the IASB ED and paragraph 946-10-55-7 in the FASB ED. However, some IASB constituents requested that the paragraph be clarified to allow transactions and synergies between controlled investees. Those constituents stated that such transactions are common in the private equity business. For example, a private equity fund could invest in multiple controlled investees in the same industry. Those investees could transact with each

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other and also could gain synergies by participating in activities such as co-marketing. Those constituents still thought that all of the examples should be prohibited for the investment entity and its parent (including the parent’s subsidiaries), but should not be prohibited for transactions between controlled investees of the investment entity.

*Staff analysis and recommendation*

27. The staff recommends that application guidance should indicate that transactions between controlled investees would not be prohibited. The staff agrees with the arguments made by constituents regarding transactions between controlled investees. The staff believes that such transactions are consistent with investing activities because neither the investment entity or its parent will not gain any benefits from synergies between investees beyond an increased fair value and capital appreciation.

***Multiple investments***

28. In both the IASB ED and the FASB ED, the nature of the investment activity criterion requires an investment entity to hold multiple investments. However, at some times during the investment company’s life, such as during the initial offering period and liquidation, the guidance in the EDs would permit an investment company to hold a single investment. The guidance in the EDs also permits an investment company to hold a single investment when the investment company is formed in conjunction with another investment company that holds multiple investments.
29. The Basis for Conclusions in both EDs explains that the Boards would require an investment entity to hold multiple investments because investment entities typically invest in multiple investees as a means of diversifying their portfolio and maximizing their returns. Consequently, investing in multiple investees is an important characteristic of an entity that invests for capital appreciation, investment income, or both.

*Feedback received*

30. Some IASB and many FASB constituents commented that this criterion was overly strict, stating that there are entities that hold a single investment for capital appreciation investment income, or both that would meet the other proposed criteria to



be an investment entity. Those constituents provided specific examples of entities that they believed should be investment entities but only hold a single investment. Those examples included single investment funds set up to pool investors' funds to invest in a single entity because the required minimum investment is too high for an individual investor, or the investment is unobtainable by individual investors.

31. Those constituents argued that the requirement to hold multiple investments should be removed or that application guidance should be added to permit an investment entity to hold a single investment in the above circumstances.

*Staff analysis and recommendation*

32. The staff thinks that the examples described in paragraph 30 are good examples of cases where an entity could meet all of the other proposed criteria to be an investment entity but not qualify because of the proposed requirement to hold multiple investments.
33. The staff understand that, in most cases, investment entities will have multiple investments. The staff continues to think that holding multiple investments is an important indicator of investment entity status because the business model of typical investment entities involves holding multiple investments to diversify their portfolio and gain the maximum amount of capital appreciation and investment income from those investments.
34. Holding multiple investments is also part of the explanation for why consolidation does not result in the most relevant information for investment entities; that is, consolidation obscures the financial statements and involves unnecessary time and effort when an investment entity holds multiple unrelated investments.
35. If an investment fund has a single controlled investment, some staff members think that consolidated information about that investment would provide useful information as the consolidated financial statements would only contain information about the single investment. Moreover, the fair value of that single investment could be disclosed in the footnotes to the financial statements.
36. Other staff members believe that in the examples provided in paragraph 30, the investors are still only interested in fair value information and consolidated

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information about the one controlled entity would not provide useful information and would clutter the financial statements. As described in those examples, the reason that the investor did not purchase the investment directly is because the required minimum investment was too high for the investor or the investment is unobtainable directly by the investor. However, those staff members believe that the investor’s objective, whether purchasing the investment directly or through the investment company, was to obtain returns only from capital appreciation investment income, or both.

37. All staff members believe that concerns raised regarding the proposed multiple investments requirement are best handled by applying a different approach to assessing the criteria to be an investment company as discussed in Agenda Paper 8B/FASB Memo No. 46B. Under that approach, holding multiple investments would be a factor to consider when assessing investment entity status, in which an investment company would be expected to hold multiple investments, but not all investment entities would be required to hold multiple investments. The staff thinks that this approach would capture the fact that typical investment entities hold multiple investments while ensuring that an entity that otherwise satisfies the criteria is not excluded without further consideration simply because it holds a single investment.
38. If the Boards decide to continue with the criteria approach proposed in the EDs, some staff members would recommend that the requirement to hold multiple investments be retained. Those staff members think that, if the Boards continue with the strict criteria approach proposed in the EDs, it is important to retain the multiple investments concept to emphasize the fact that most investment entities will have multiple investments and that holding multiple investments is part of the reason for fair value measurement. Those staff members also think that the arguments for fair value measurement are weakened when an investment fund only holds a single investment.
39. Moreover, those staff members think it is important that the criteria do not allow an entity with a single investor holding a single investment to be an investment entity, and the staff is recommending loosening the proposed multiple investor requirement, as discussed in paragraphs 79-83. However, those staff members acknowledge that retaining the requirement for investment entities to hold multiple investments would result in the examples mentioned in paragraph 30 failing to qualify as investment entities.

40. Other staff members share the concerns that under a strict criteria approach, the staff recommendations could potentially permit an entity (a) with a single investor and (b) holding a single investment from being an investment company. However, those staff members believe that an investment company should not be required to hold multiple investments only to avoid that particular type of structure from being an investment company. Those staff members believe that if a single investment fund is investing for returns only from capital appreciation or investment income, it should be an investment company provided it meets the other criteria to be an investment company.

### **Business purpose criterion**

41. The business purpose criterion is phrased in the IASB ED as follows:

The entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income (such as dividends or interest), or both.

42. Most constituents generally agreed with the inclusion of this criterion. The majority of the feedback received on this criterion focused on the exit strategy requirements included in the application guidance for the criterion.

### ***Exit strategy requirements***

43. The IASB ED proposes that an investment entity should have an exit strategy for its investments. The FASB ED proposes that an investment company whose express business purpose includes realizing returns from capital appreciation should have an exit strategy for how it plans to realize the capital appreciation of its investments. The FASB ED states that an investment company does not require an exit strategy for its investments if the investment company's express business purpose is only to invest for returns from investment income.
44. The IASB Basis for Conclusions states that an investment exit strategy is "essential to the business purpose of an investment entity" because it is one of the important ways to distinguish between an investment entity and an operating entity that would own and operate its subsidiaries indefinitely to realize returns from those operations.

45. The FASB Basis for Conclusions explains that an exit strategy is important for investment companies that plan to realize returns from capital appreciation because the investment company must have a plan to ultimately dispose of its investments to realize the capital appreciation. However, an exit strategy is not necessary for investments that are held for returns from investment income because the investment company does not plan to realize changes in the price of the investments through disposal. Further, provided that the investment company meets the other criteria, fair value is still the most relevant measurement attribute in those circumstances because investors transact on the basis of net asset value per share, which is calculated using the fair value of the investment company's underlying investments.

*Feedback received*

46. Some IASB constituents stated that the requirement to have an exit strategy was very important and should form its own criteria. However, other IASB constituents stated that, at times, private equity funds hold corporate debt instruments only for investment income. These funds may be held, for example, to diversify the investment fund's portfolio or to provide an alternative source of investing when attractive equity investments are not available. Those constituents requested that an exit strategy not be required for those investments that are only held to collect investment income similar to the guidance provided in the FASB ED.
47. Many IASB constituents also requested that clarifications be made to the exit strategy guidance. IASB constituents questioned the following:
- (a) Whether an exit strategy would be required to be assessed for each individual investment held by an investment entity or could be assessed at a portfolio level
  - (b) Whether there should be timing limits around exit strategy
  - (c) Whether feeder funds in master-feeder structures would require exit strategies.
48. Some FASB constituents expressed concern with an exit strategy requirement in general, stating that an exit strategy would inappropriately exclude certain investment companies and may create structuring opportunities in which an entity could opt in

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and out of investment company status. Those constituents added that the exit strategy notion should be an indicator that an entity is an investment company rather than a requirement.

49. Other FASB constituents generally agreed with the exit strategy requirements in the FASB ED but requested clarification of the application of the exit strategy requirement to specific types of entities, such as:
- (a) Index funds and exchange-traded funds that would sell an investment only to reflect changes in asset allocation strategies or the composition of the index
  - (b) Tax-managed funds that pursue capital appreciation with the intent of minimizing taxable capital gains distributions to shareholders
  - (c) Limited-life entities in which investments are disposed of only when the entity is liquidated.

*Staff analysis and recommendation*

50. The staff acknowledges constituent concerns that the exit strategy guidance could inappropriately exclude certain investment companies and may create structuring opportunities in which an entity could opt in and out of investment company status. One alternative for the Boards would be to remove the exit strategy requirements entirely to address those concerns. However, the staff does not recommend that alternative. The staff continues to think that having an exit strategy is an important demonstration of a business purpose that includes realizing capital appreciation.
51. All staff members agree that an exit strategy should be required when an investment entity has a business purpose that includes realizing capital appreciation from its investments. However, the staff have mixed views on whether an investment entity should be required to have an exit strategy when its business purpose includes earning returns from investment income.
52. **T**he IASB staff thinks that an exit strategy should continue to be required for all investment entities as an illustration of the business purpose. The exit strategy guidance was cited frequently by IASB constituents as differentiating an investment

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entity from an investment holding company that holds various investments in different industries for the long term.

53. The IASB staff thinks that an investment entity must ultimately hold a controlled investment for capital appreciation with an exit strategy rather than holding it indefinitely only to collect investment income, because the staff thinks that in those cases the entity would be more like a conglomerate or other operating company. Because any investment entity under IFRS would have at least one controlled investment, that means that an investment entity must realize at least some of its returns through capital appreciation.
54. Moreover, the IASB staff thinks that an investment entity should not hold a significant amount of its portfolio only for returns from investment income. The IASB staff recommends clarifying language to be added in application guidance. The staff think that measuring investments only held for investment income at fair value would be inconsistent with IFRS 9 *Financial Instruments*, which requires that debt instruments that are held within a business model whose objective is to hold assets to collect contractual cash flows be measured at amortized cost. Therefore, the staff thinks that an investment entity should have an exit strategy for substantially all of the investments in its portfolio.
55. With that said, the staff does understand the IASB constituents' concerns about investment entities holding a few debt investments to diversify their portfolio. The staff thinks that, if debt investments that are held to collect contractual cash flows do not constitute a significant portion of the investment portfolio, an entity should not be disqualified from investment entity status only for holding those investments. The IASB staff recommends that the guidance regarding exit strategy should be modified to state that an investment entity should have an exit strategy for substantially all of its investments. The IASB staff would further recommend that guidance should be added to state that an investment entity would not be required to have an exit strategy for debt instruments held only for investment income if those debt instruments do not form a significant part of its portfolio and only if the entity is still considered to manage on a fair value basis.

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56. The FASB staff agrees with the FASB’s decisions and basis in the FASB ED. The FASB staff believes that an investment company should be required to have an exit strategy for investments that the investment company’s business purpose includes realizing capital appreciation but should not be required to have an exit strategy for investments that the investment company’s business purpose is only to invest for returns from investment income. The FASB staff believes that requiring an exit strategy for all investments, including those held for investment income only, would exclude very common investment structures, such as municipal bond funds, because they generally hold their debt securities to maturity. In addition, the FASB staff believes that the clarifications requested by FASB constituents should be included in implementation guidance. The FASB staff believes that the examples provided in paragraph 49 could be viewed as investment companies holding investments for returns only from investment income.

**Exit strategy: other clarifications requested by IASB constituents**

57. The staff does not think that it is necessary to specify whether the exit strategy should be assessed at either an investment or a portfolio level (as requested in paragraph 47(a)), because the most relevant level will depend on the size and structure of an investment entity. However, the staff recommends that the final guidance explicitly state that an entity would be allowed to have an exit strategy for a portfolio of investments rather than individual investments.
58. The staff does not recommend setting a maximum amount of time for an exit strategy as requested in paragraph 47(b) because that could lead to structuring and would be an arbitrary bright line. The staff thinks that entities should be able to use professional judgment together with the examples already in the application guidance when assessing whether an entity has a reasonable exit strategy.
59. Finally, to address the concern in paragraph 47(c), the staff recommends stating that feeder funds in master-feeder structures should look through to the master fund to see if it has an exit strategy for its investments because the feeder fund investors are essentially investing in the investments of a master fund.

## Unit ownership criterion

60. The unit ownership criterion is phrased in the IASB ED as follows:

Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed.

61. The discussion about this criterion is organized as follows:

- (a) Need for the criterion and form of units (paragraphs 62-70)
- (b) Proportionate shares vs. a portion of net assets (paragraphs 71-73)

### ***Need for the criterion and form of units***

62. The staff thinks that the Boards included this criterion because unit ownership is typical of most investment entities. Further, the staff thinks that the criterion is important because it describes part of the reason for why fair value is more relevant to investment entity investors; they are entitled to a portion of the net assets of the investment entity and the net assets are based on the fair value of investment assets. Also, many investment funds transact with their investors based on the net asset value of an ownership unit.

63. The FASB ED specifically requires the ownership units of an investment company to be in the form of equity or partnership interests, while the IASB ED is less prescriptive but implies that the same was required.

### ***Feedback received***

64. Several constituents stated that this requirement introduces complexity, including determining whether units in the legal form of equity are considered debt for accounting purposes. Those constituents stated that the proposed guidance put too much pressure on the legal form of ownership units and that the analysis of whether an entity is an investment entity should focus on whether or not ownership units participate in the risks and rewards of an entity and provide an investor with a portion of the net assets of an investment entity.

65. Constituents described examples of investment funds in which ownership would be classified as debt rather than equity in accordance with U.S. GAAP and IFRS, such as



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funds formed with profit-participating loans and limited-life funds with ownership units that are mandatorily redeemable upon termination of the fund. Additionally, many U.S. constituents stated that collateralized debt obligations and collateralized loan obligations currently follow investment company accounting and reporting guidance under U.S. GAAP, but do not have substantive equity interests.

66. Some constituents questioned whether the unit ownership criterion was necessary, stating that the other criteria proposed in the IASB ED and the FASB ED would appropriately identify investment entities. Moreover, some constituents criticized the criterion for excluding certain investment funds, such as investment funds wholly-owned by pension plans and sovereign wealth funds, stating that those funds should be investment entities but that they do not provide unitised ownership interests directly to their shareholders.

*Staff analysis and recommendation*

67. The staff does not think the guidance about unit ownership should be removed completely. The staff continues to think the concept that the net assets of an investment entity are divided into ownership interests that are held by investors is an important one that justifies why fair value information is more relevant for investors in investment entities. Investors evaluate the performance of an interest in an investment entity by evaluating how changes to the net assets (which are based on fair value) affect their ownership interests.
68. The staff does not think it is appropriate for investment funds to be excluded from the scope of the proposed guidance only because they do not provide units of ownership to direct investors. For example, investment funds wholly owned by pension plans have beneficiaries that are entitled to a portion of the net assets of the investment fund; however, those beneficiaries are entitled to the net assets because of contracts with the pension plan rather than the fund itself. Additionally, the staff does not think it is clear how the unit ownership concept would apply to other wholly-owned funds, such as sovereign wealth funds, because they only have one investor.
69. The staff understands that most investment funds are structured so that ownership units are provided in the form of equity or partnership interests. However, the staff does not think it is appropriate for an investment fund to fail to be an investment

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entity simply because ownership interests in the entity are in the form of debt interests. The staff recommends that IASB and FASB guidance be amended to remove any references to required ‘forms’ of ownership interest. The staff also recommends that the wording be changed from ‘ownership units’ to ‘ownership interest.’

70. The staff believes that concerns raised regarding the unit ownership criterion are best handled by applying a different approach to assessing the criteria to be an investment company as discussed in IASB Agenda Paper 8B/FASB Memo No. 46B in which the unit ownership guidance would be a factor to consider rather than a determinative requirement.

***Proportionate shares vs. a portion of net assets***

71. The EDs contain slightly different wording in the unit ownership criterion when discussing how the net assets of an investment entity are attributed to ownership units. The IASB ED states that the ownership units represent “proportionate shares” of the net assets of an investment entity, while the FASB ED states that ownership units represent “a portion of” the net assets of an investment entity.

*Feedback received*

72. Most FASB constituents agreed with the wording proposed in the FASB ED. Many IASB constituents, however, disagreed with the proposed wording in the IASB ED. Those constituents stated that some investment funds, such as funds in which different share classes had different rights or funds where investors have discretion to invest in individual assets within the fund, would be disqualified as a result of this wording and recommended that the IASB adopt the wording in the FASB ED.

*Staff analysis and recommendation*

73. The staff recommends that the IASB adopt the FASB language, which states that ownership units represent “a portion of” the net assets of an investment entity. The staff does not think it was the IASB’s intention to exclude investment funds with preferential asset classes and thinks that the FASB ED wording is more flexible but still captures the idea that ownership units should entitle an investor to a portion of the

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net assets of an investment entity. The staff further recommends that both the FASB and the IASB criterion add that those ownership units represent a *specifically identifiable* portion of the net assets of an investment entity. The EDs included the notion of *specifically identifiable* in application guidance rather than in the criterion itself. Adding the *specifically identifiable* language will add robustness to this criterion and be consistent with the fact that investors are interested in fair value because it directly relates to the value of their ownership shares, which they are able to determine by having this specifically identifiable portion of net assets.

### **Pooling of funds criterion**

74. The pooling of funds criterion is phrased in the IASB ED as follows:

The funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity.

75. This discussion regarding the pooling of funds criterion is organized as follows:

- (a) multiple investors (paragraphs 76-83)
- (b) related party investors (paragraphs 84-90)

### **Multiple investors**

76. The Boards proposed that an investment entity would be required to have multiple investors. The guidance in the EDs permits an investment company to have a single investor when the investment company is formed in conjunction with another investment company that has multiple investors. In addition, the FASB ED contains implementation guidance that allows an investment company to have a single investor at certain times during the investment company's life, such as during the initial offering and liquidation.

77. The EDs' Basis for Conclusions explains that the Boards included this requirement because a typical investment entity would have significant external investors. Also, the Basis for Conclusions explains that having multiple investors would help to

address the Boards' concern that an investment entity could be inserted into a larger corporate structure to achieve a particular accounting outcome.

*Feedback received*

78. Many constituents disagreed with this requirement, arguing that investment funds with a single investor should not be excluded from being investment entities. Those constituents provided the following examples of investment funds with single investors that they thought should be investment entities:

- (a) Funds that have a single investor during start up or wind down
- (b) Government-related entities, such as sovereign wealth funds
- (c) Funds wholly owned by pension plans<sup>1</sup> and endowments<sup>2</sup>
- (d) Private equity funds wholly owned by corporations or financial services firms or high-net-worth individuals
- (e) Charities<sup>2</sup> or individual trusts
- (f) Funds set up by an asset manager for an unrelated single investor with a unique investment strategy (separate accounts or managed accounts).

*Staff analysis and recommendation*

79. While the staff thinks that the majority of investment entities will have multiple investors, the staff understands the arguments and examples of single investor funds described above. The staff thinks that there are three basic categories of single investor investment funds:

- (a) Funds that have a single investor temporarily (funds that have a single investor during start up or wind down)

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<sup>1</sup> Under U.S. GAAP, pension plans would follow the guidance in Topic 960, Plan Accounting—Defined Benefit Pension Plans, Topic 962, Plan Accounting—Defined Contribution Pension Plans, and Topic 965, Plan Accounting—Health and Welfare Benefit Plans. Under IFRS, pension plans would follow the guidance in IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.

<sup>2</sup> Endowments and charities would follow the guidance in Topic 958, Not-for-Profit Entities, under U.S. GAAP. There is no specific guidance for not-for-profit entities in IFRSs.

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- (b) Funds that have a single investor that is required to measure its investments at fair value. (investment funds wholly owned by pension plans or endowments)
  - (c) funds that are formed for the investment strategy of a particular investor (sovereign wealth funds, managed or separate accounts, wholly-owned private equity funds, charities, individual trusts)
80. The staff recommends that IASB guidance include guidance similar to that in the FASB ED regarding funds that have single investors temporarily during certain times in the investment company’s life, such as at during the initial offering and liquidation, to address the concern in paragraph 79(a).
81. For the concerns mentioned in paragraph 79(b), the staff considered providing an exemption from the pooling of funds and the unit ownership criterion similar to the guidance in the proposed FASB Accounting Standards Update, *Real Estate—Investment Property Entities (Topic 973)*, which provides an exemption from those criteria if the parent entity is required to measure its investments at fair value under U.S. GAAP or is a not-for-profit entity under Topic 958, Not-for-Profit Entities, that measures its investments at fair value. However, the staff does not recommend such an exemption because it would not address the concerns in paragraph 79(c) that in the staff’s view are legitimate single investor structures.
82. The staff thinks that the majority of the investment funds listed in paragraph 79(c) would meet all of the other criteria to be an investment entity. Therefore, the staff recommends that the requirement to have multiple investors be removed. The staff thinks that the Boards’ concern with single investor funds, that is, a wholly owned investment entity could be inserted into a corporate structure to achieve a particular accounting outcome, still has merit. However, the staff believes that the structures that are troublesome to the Boards would not meet the nature of the investment activities and business purpose criteria to be an investment entity because those structures would be obtaining benefits beyond only returns from capital appreciation and investment income.
83. However, the staff believes that concerns raised regarding the multiple investors requirement are best handled by applying a different approach to assessing the criteria

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to be an investment company as discussed in Agenda Paper 8B/FASB Memo No. 46B in which the multiple investors guidance would be a factor to consider rather than a requirement.

### ***Related party investors***

84. The Boards proposed in their EDs that an investment entity would need to have investors that are unrelated to the investment entity's parent (if the investment entity had a parent). This proposal was made for similar reasons as the proposal that an investment entity would need to have multiple investors and was made in part to prevent entities from structuring around the requirement to have multiple investors.

### ***Feedback received***

85. Similar to the concerns listed regarding the multiple investors requirement, many constituents did not feel that it was appropriate for an investment entity to fail to be an investment entity simply because of the types of investors an investment entity has and whether or not those investors are related to each other. The most frequently mentioned investment fund that constituents thought would inappropriately fail to be an investment entity as a result of this requirement was employee side-by-side funds. Employees and their families are offered the chance to invest in the same investments as other investment funds offered by the asset manager but those employee side-by-side funds are kept separate from the main fund.

### **Staff analysis and recommendation**

86. The staff thinks this issue is very similar to the multiple investors issue. Moreover, if the Boards remove the requirement for an investment entity to have multiple investors, this issue is no longer relevant (the Boards cannot require that an investment entity have unrelated investors if there is no requirement for multiple investors).
87. The staff understands that in most cases an investment entity would have unrelated investors. The staff also thinks that the notion of independence is important. That is, the staff does not think, in most cases, that an investment fund could assert that it is

only investing for capital appreciation, investment income, or both if it did not have unrelated investors or it did not have an unrelated asset manager.

88. However, the staff does not think that an investment fund should fail to qualify as an investment entity simply due to the makeup of its investors. The staff understands the concerns regarding the employee side-by-side funds described above, especially because they are formed to invest in the same investments as the main investment fund which would qualify as an investment entity.
89. If the Boards decide to follow the proposed criteria approach and continue to require that an investment entity have multiple investors, the staff recommends that the requirement to have unrelated investors remain in the final guidance but that guidance should be introduced to explain that in certain cases when an investment fund with only related investors is set up in connection with an investment fund with unrelated investors (such as employee side-by-side funds), this requirement would not need to be met.
90. The staff believes that concerns raised regarding related party investors are best handled by applying a different approach to assessing the criteria to be an investment company (as discussed in Agenda Paper 8B/FASB Memo No. 46B) in which the related party investors guidance would be a factor to consider rather than a requirement.

### **Fair value management criterion**

91. The fair value management criterion is phrased in the IASB ED as follows:

Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.

92. Paragraph BC26 of the FASB ED explains that the Boards included this criterion because of the following:

The most useful information for users of investment company financial statements is the fair value of its investments, including an understanding of how the investment company calculates fair value. Fair value is the critical component of the information used for analyzing the performance of investments made by investment companies.

93. The discussion regarding the fair value management criterion is organized as follows:

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| IASB Agenda ref | <b>8A</b>  |
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- (a) Definition of fair value management (paragraphs 94-104)
- (b) Fair value measurement of investment entity financial liabilities (paragraphs 105-106)

***Definition of fair value management***

- 94. The EDs contain application guidance that states that the evaluation of fair value management is based on how an investment entity manages and evaluates the performance of its investments and that fair value must be the primary measurement attribute used to make decisions about the financial performance of those investments.
- 95. The FASB ED Basis for Conclusions also contains language stating that an entity should consider that following to determine whether the entity meets the fair value management criterion:
  - (a) How it transacts with its investors. For example, some open-end funds transact with investors on the basis of a net asset value per share, which is calculated using the fair value of the entity’s investments.
  - (b) How asset-based fees are calculated and whether those fees are based on the fair value of the entity’s net assets.
- 96. The FASB ED Basis for Conclusions also concludes that money market funds would meet the fair value management criterion because they are managed to minimize the difference between the carrying value and the fair value of their investments to maintain a constant net asset value.

***Feedback received***

- 97. Constituents requested that the Boards provide the same guidance relating to fair value management. Constituents also questioned whether the following scenarios would meet the criterion:
  - (a) Investments managed and their performance evaluated primarily on a yield (income) basis such as investments held in money market funds and fixed-income funds and debt securities held to maturity



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- (b) Investments managed and evaluated based on another metric (such as internal rate of return), which constituents noted is common in the private equity industry (FASB constituents only)
  - (c) Stable value funds that currently measure investments at fair value but transact with investors at contract value. (FASB constituents only)
98. IASB constituents questioned the scenario in paragraph 97(a) in the context of an investment fund holding some debt investments only to collect investment income (as described in the exit strategy issue in paragraph 46). FASB constituents raised the concern in that paragraph in the context of funds that manage all of their investments on a yield basis, such as money market funds and fixed-income funds. Constituents stated that for those investments, fair value may be a measurement attribute considered by management, but amortized cost which mainly focuses on yield (income) may be the primary measurement attribute used to make decisions about the financial performance of the investment. However, because yield affects the fair value of the investment and is a key component used in determining fair value, it is unclear whether the entity would meet the fair value management criterion.

*Staff analysis and recommendation*

99. The FASB staff recommends that the additional guidance related to the fair value management criterion that was included in the FASB’s Basis for Conclusions (see paragraphs 95 and 96) should be included in implementation guidance rather than in the Basis for Conclusions. The staff believes that this guidance would address the concern raised in paragraph 97(a) and paragraph 97(b) because although investments are managed using another metric, those funds would generally calculate some asset-based fees using fair value information or transact with investors based on the fair value of investments held.
100. Regarding the concerns in paragraph 97(c), the FASB staff believes stable value funds manage and evaluate the performance of their investments on a fair value basis to ensure that the fund provides a constant net asset value to its investors. In addition, the FASB staff believes that the additional guidance regarding how asset-based fees are calculated would allow stable value funds to meet the fair value management criterion.

101. However, the FASB staff believes that the concerns raised regarding the fair value management criterion are best handled by applying a different approach to assessing the criteria to be an investment company as discussed in Agenda Paper 8B/FASB Memo No. 46B. Because of the various operational and definitional concerns raised by constituents regarding the fair value management criterion, the FASB staff believes that the fair value management criterion should be a factor to consider rather than a determinative requirement when assessing whether an entity is an investment company.
102. In regards to this issue, the IASB staff would not recommend including the additional language in the FASB ED regarding fair value management in the IASB investment entities guidance. Firstly, the primary focus of the project for the IASB is to determine the appropriate accounting for controlled entities rather than determining the accounting for debt investments. While entities being evaluated may also hold debt investments the notion of fair value management for debt investments is not directly relevant.
103. The IASB staff also recommends that the final IASB guidance does not include the FASB guidance described in paragraphs 95 and 96 because adding such guidance would expand the definition of managing on a fair value basis and would be inconsistent with similar guidance in IFRS 9. The notion of fair value management is already used in IFRS 9, both in the fair value option for financial liabilities and the business model assessment for the classification and measurement of financial assets. Under IFRS 9, an entity measures its eligible financial assets at amortized cost if the assets are held within a business model in which the objective is to hold to collect contractual cash flows from those assets. IFRS 9 also states that managing on a fair value basis is inconsistent with a 'hold to collect' business model and requires assets held in such a model to be measured at fair value through profit & loss<sup>3</sup>. Simply monitoring fair values to ensure that a particular investment amount is maintained while focussing on maximizing the income from contractual yield would not in the staff's view be considered managing on a fair value basis for IFRS 9 purposes. The intended outcome is thus different to that proposed by the FASB staff above.

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<sup>3</sup> IFRS 9 B4.1.6

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104. In addition, as also noted in Agenda Paper 8B/FASB Memo No. 46B, the IASB staff thinks that retaining the fair value management criterion as a requirement for investment entities is important because it would ensure that those entities that the IASB considers manage their assets on a fair value basis will be more likely to achieve accounting outcomes that are more aligned with the broader investment company accounting model under U.S. GAAP.

***Fair value measurement of investment entity financial liabilities***

Feedback received

105. Some IASB constituents questioned if an investment entity would be required to measure its financial liabilities on a fair value basis to meet the fair value management criterion.

Staff analysis and recommendation

106. The staff does not think that the final standard necessarily needs to specify that an investment entity must measure its financial liabilities on a fair value basis. The relevant feature of the fair value management criterion is that the investment entity manages its *investments* on a fair value basis—this feature is what makes the fair value measurement attribute for its investments relevant, and does not have anything to do with the measurement of the investment entity’s financial liabilities. Further, the staff thinks that an investment entity should not be required to manage its financial liabilities on a fair value basis to meet the fair value management criterion.
107. Also, under U.S. GAAP, investment companies generally measure their own debt at cost. Therefore, requiring an investment entity to measure its own debt at fair value to meet the fair value management criterion under IFRS would be a point of divergence between U.S. GAAP and IFRS.

**Reporting entity criterion**

108. The reporting entity criterion was phrased in the IASB ED as follows:

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The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.

109. The EDs' Basis for Conclusions explains that U.S. GAAP had previously required that the reporting entity must be the primary reporting entity. The meaning of that requirement was unclear, and the Boards wanted to clarify that an investment entity can, but need not be, a separate legal entity to include trusts and partnerships that may not be considered legal entities.
110. Constituents had few specific comments on this criterion. However, several constituents questioned whether this criterion was really necessary. Those constituents argued that the requirement that an investment entity provide financial information about its investment activities to its investors was self-explanatory and did not add anything of substance to the criteria.

*Staff analysis and recommendation*

111. The staff agrees with the constituents' comments described above and recommend that the criterion be removed from the final guidance. However, the staff does think that the statement that an investment entity does not need to be a legal entity is an important one and should be retained in the application guidance because the staff believes that it is necessary to ensure that separate accounts would be investment companies even though they are not separate legal structures.

***'In conjunction with' guidance***

112. The EDs contain guidance stating that the requirement to hold multiple investments and the requirement to have multiple investors do not need to be met if two investment entities are formed in conjunction with each other. That guidance was meant to capture structures such as blocker funds or master-feeder funds that are structured so that a single investment entity with multiple investors and multiple investments is broken up into multiple investment entities (parent investment entities and subsidiary investment entities) for tax, legal, regulatory, or other business reasons.

*Feedback received*

113. Many constituents agreed with this guidance but were confused as to whether “in conjunction with” referred to investment entities set up at the same time or could encompass additional structures that were added after the main structure’s formation. For example, feeder funds are frequently established after the formation of the original master and feeder funds in a master-feeder structure. Blocker funds also can be established after the formation of a main fund.
114. Additionally, constituents were unsure whether the ‘in conjunction with’ guidance would apply when funds with a single investment or a single investor were set up alongside a main fund for various economic reasons, such as:
- (a) An overflow fund set up to hold a single investment alongside a main fund holding multiple investments
  - (b) A co-investment fund is set up alongside a main fund with a single investor investing in the same investments as the main fund.

Those types of funds also are frequently established after the formation of the main fund.

*Staff analysis and recommendation*

115. The staff thinks that the Board did not intend the ‘in conjunction with’ guidance to apply only to investment funds that are formed at the same time. The staff thinks it is appropriate that the exemption from meeting the multiple investment and multiple investor requirements should be extended to investment entities that are formed in conjunction with other investment entities, but after the original formation of those investment entities. The staff recommends that explanatory language should be added in the application guidance to clarify this point.
116. The staff also recommends that application guidance should be clarified to allow single investor or single investment funds set up alongside a main fund for various business reasons to be investment entities provided that they meet the other criteria to be an investment entity.

## Appendix A: Investment entity criteria

A1. The following table contains the six investment entity criteria as they were proposed in the IASB ED and FASB ED, respectively:

| Criterion                                | IASB ED   | FASB ED   |
|--|---|---|
| <b>Nature of the investment activity</b> | The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both.  | The investment company's only substantive activities are investing in multiple investments for returns from capital appreciation, investment income (such as dividends or interest), or both.   |
| <b>Business purpose</b>                  | The entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income (such as dividends or interest), or both.  | The express business purpose of the investment company is investing to provide returns from capital appreciation, investment income (such as dividends or interest), or both.   |
| <b>Unit ownership</b>                    | Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed.  | Ownership in the investment company is represented by units of investments, in the form of equity or partnership interests, to which a portion of the net assets are attributed.  |
| <b>Pooling of funds</b>                  | The funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity. | The funds of the investment company's investors are pooled to avail investors of professional investment management. The entity has investors that are not related to the parent (if there is a parent) and those investors, in aggregate, hold a significant ownership interest in the entity. |
| <b>Fair value management</b>             | Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.  | Substantially all of the investment company's investments are managed, and their performance evaluated, on a fair value basis.  |
| <b>Reporting entity</b>                  | The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a   | The investment company provides financial results about its investment activities to its investors. The entity can be but   |

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| legal entity. | does not need to be a legal entity. |
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## Appendix B: ‘Prohibited activities’ paragraph

B1. Both the IASB ED and the FASB ED include a paragraph that provides examples of activities and relationships between (a) an investment entity and its affiliates and (b) an investee and its affiliates that would be inconsistent with an investment entity’s activities and business purpose of investing for returns from capital appreciation or investment income. The language in the paragraphs differ slightly between the IASB ED and the FASB ED. The paragraphs in each ED are reproduced below.

| IASB ED   | FASB ED  |
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| <p><b>B6</b> An entity’s activities are considered to be other than investing for the purpose of capital appreciation, investment income (such as dividends or interest), or both, if the entity or its affiliates obtain, or have the objective of obtaining, benefits from its investments in any investee in which the benefits are not capital appreciation, investment income (such as dividends or interest), or both. Examples of relationships or activities that demonstrate that an entity is investing other than for capital appreciation, investment income (such as dividends or interest), or both, include but are not limited to the following:</p> <ul style="list-style-type: none"> <li>(a) The acquisition, use, exchange or exploitation of the processes, intangible assets or technology of the investee or its affiliates by the entity or its affiliates.</li> <li>(b) Joint arrangements between the investee or its affiliates and the entity or its affiliates.</li> <li>(c) The investee or its affiliates and the entity or its affiliates enter into other arrangements to jointly develop, produce, market or provide products or services.</li> <li>(d) The investee or its affiliates and the entity or its affiliates enter into transactions that: <ul style="list-style-type: none"> <li>(i) are on terms that are</li> </ul> </li> </ul> | <p><b>946-10-55-7</b> An entity would not meet the nature-of-the-investment-activities criterion if the entity or its <b>affiliates</b> obtain or have the objective of obtaining returns from its investments other than capital appreciation or investment income in entities other than an investment company or an investment property entity as defined in Topic 973. Examples of relationships and activities between (1) the entity or its affiliates and (2) an investee or its affiliates (other than an investment company or an investment property entity as defined in Topic 973) that demonstrate that an entity is investing for other than capital appreciation or investment income include the following:</p> <ul style="list-style-type: none"> <li>(a) The entity or its affiliates acquire, use, exchange, or exploit the processes, intangible assets, or technology of the investee or its affiliates.</li> <li>(b) There are other arrangements to jointly develop, produce, market, or provide products or services.</li> <li>(c) There are transactions that meet any of the following: <ol style="list-style-type: none"> <li>1. They are on terms that are unavailable to entities that are not affiliates of the investee;</li> <li>2. They are not at fair value at the measurement date or are not conducted at arm’s length.</li> <li>3. They represent a significant portion of the investee’s or the entity’s</li> </ol> </li> </ul> |



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| <p>unavailable to entities that are not related parties of the investee;</p> <p>(ii) are not at a price that would be paid or received in an orderly transaction between market participants at the measurement date; or</p> <p>(iii) represent a significant portion of the investee's or the entity's business activity, including business activities of affiliates of the investee or affiliates of the entity.</p> <p>(e) The entity or its affiliates have disproportionate rights, or exclusive rights, to purchase or otherwise acquire assets, technology, products or services of the investee or its affiliates; for example, if an entity or its affiliates hold an option to purchase an asset from an investee if the asset's development is deemed successful.</p> <p>(f) The investee or its affiliates provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity or its affiliates. (However, an entity would still be able to use the investments in its investees as collateral of any of its borrowings.)</p> <p>(g) An affiliate of the entity holds an option to purchase from the entity ownership interests in an investee.</p> | <p>business activity, including business activities of affiliates of the entity or affiliates of the investee.</p> <p>(d) The entity or its affiliates have disproportionate rights, or exclusive rights, to purchase or otherwise acquire assets, technology, products, or services of an investee or its affiliates (for example, an affiliate of the entity holds an option to purchase an asset from an investee of the entity if the asset's development is deemed successful).</p> <p>(e) The investee or its affiliates provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity or its affiliates to provide returns or with the objective of providing returns other than capital appreciation or investment income. This paragraph does not prohibit an investment company from using its investments in its investees as collateral for any of its borrowings.</p> <p>(f) An affiliate of the entity holds an option to purchase ownership interests in the entity's investees from the entity at an amount other than fair value.</p> |
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