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Project	**Investment Entities / Investment Companies**		
Paper topic	Approach to Assessing the Criteria		

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Purpose of This Memorandum

1. Both the FASB proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements,* (FASB ED), and the IASB Exposure Draft, *Investment Entities*, (IASB ED) require an entity to meet all six proposed criteria to be an investment company[1]. The proposed criteria, including feedback received on each proposed criterion, are outlined in IASB Agenda Paper 8A/FASB Memo No. 46A.

2. Many constituents that provided feedback on the FASB and the IASB proposals expressed concern that requiring an entity to meet all six criteria to be an investment company is too prescriptive and does not allow for sufficient professional judgment. In addition, U.S. constituents stated that the proposed approach would cause some entities that currently follow investment company accounting under U.S. GAAP to lose investment company status. In light of the feedback received from constituents, this paper discusses possible alternative approaches to assessing whether an entity

[1] This paper uses the terms *investment entity* and *investment company* interchangeably.

qualifies as an investment company. The paper also discusses whether the IASB should develop an asset-based approach rather than the entity-based approach proposed in the IASB ED. This paper does not have questions for the Boards. The questions for the Boards, including a summary of staff recommendations, are in IASB Agenda Paper 8C/FASB Memo No. 46C.

3. This memo is organized as follows:

   (a) Summary of feedback

   (b) Asset-based versus entity-based guidance (IASB-only consideration)

   (c) Approaches to assessing entity-based criteria.

Summary of Feedback

4. Some constituents agreed that requiring an entity to meet all six proposed criteria would capture the appropriate population of investment companies. However, many constituents expressed concern that requiring an entity to meet all six criteria to be an investment company is too prescriptive and that a more flexible approach to assessing the criteria would result in more consistent reporting by entities with similar business activities. Those constituents emphasized the application of judgment when assessing whether an entity is an investment company. Users generally did not comment on that aspect of the proposals.

5. Additionally, many IASB constituents argued that the six proposed criteria in the IASB ED did not provide a general description of an investment entity and an explanation of why fair value measurement is more relevant for the controlled investments of an investment entity. Because the concept of an 'investment entity' is new to IFRSs, those constituents argued that the guidance should include a more general description of an investment entity (rather than just criteria to be an investment entity) and a justification for the exception from consolidation so

constituents can understand the types of structures that the IASB thinks the exception from consolidation would apply to.

6. A few IASB constituents suggested that an entity that meets the criteria to be an investment company should have an option either to consolidate controlled investees or measure controlled investees at fair value. Those constituents believe that an explicit option should be provided because an entity could simply choose to meet or not meet specific criteria, therefore creating an implicit option. Additionally, some of those constituents believe that the scope of the proposed guidance in the IASB ED is unclear and providing an option would address the concerns of some entities (such as real estate investment trusts or holding companies) that believe that they may inappropriately qualify as investment entities.

7. Some IASB constituents recommended that the IASB follow an asset-based approach to the exception to consolidation. Under that approach, an entity would focus on the specific characteristics of the investment (that is, an individual asset) to determine if fair value measurement is more appropriate rather than determine the accounting treatment based on the type of entity that owns the investment/asset. Constituents supporting an asset-based approach recommended using elements of the nature of investment activities, business purpose, and fair value management criteria to come up with the appropriate criteria for an asset-based approach. Those constituents argued that such an approach:

    (a) Is more principled and more consistent with the asset- or transaction-based guidance in IFRSs

    (b) Would address the needs of entities that would not qualify as investment entities but hold some of their controlled investments only for capital appreciation or investment income

    (c) Would avoid some concerns raised regarding an entity-based approach, such as:

        (i) Creating industry-specific guidance

(ii) Trying to capture particular structures in the proposed criteria

(iii) The question of noninvestment entity parent accounting for the controlled investments of investment entity subsidiaries.

Asset-based versus entity-based guidance (IASB only consideration)

8. As described in paragraph 7 above, some IASB constituents suggested that the IASB should provide more transaction-based rather than entity-based guidance for fair value measurement of controlled investees. The IASB has generally sought to avoid accounting guidance that is entity specific, focusing instead on accounting for transactions. Paragraphs BC3 through BC6 of the IASB ED describe the feedback received from respondents to ED 10, *Consolidated Financial Statements*, in relation to investment entities, which drove the IASB to propose an entity-based approach for the proposed exception to consolidation. Paragraph BC4 states that respondents indicated that "consolidated financial statements of an investment entity may impede users' ability to assess an investment entity's financial position and results because it emphasises the financial position, operation and cash flows of the investee, rather than those of the investment entity." Users of investment entity financial statements that responded to ED 10 indicated that for those types of entities, fair value measurement and how the entity measures fair value of its investments provides the most useful information.

9. If the IASB decides to pursue developing an asset-based approach, the IASB staff would need to perform additional research to recommend criteria for an asset-level assessment that would be deliberated at a future Board meeting.

10. The FASB staff believes this issue is not relevant for the FASB because U.S. GAAP for investment companies historically has been entity based and has required investment companies to measure all their investments at fair value. An asset-based approach would be outside the scope of the FASB's investment companies project.

Staff analysis and recommendation

11. The staff recommends that the Boards continue to deliberate an entity-based approach rather than pursuing an asset-based approach.

12. The proposed asset-based approach would represent a significant change from the proposals in the IASB ED. The approach would allow more entities to measure investments at fair value and would be consistent with the IASB's transaction-based accounting guidance. However, the staff has serious reservations about this approach. This approach would significantly broaden an exception to consolidation guidance by making the exception available to any entity. That would represent a significant conceptual change to the consolidation model the IASB has developed in IFRS 10, *Consolidated Financial Statements*, by essentially providing any entity an opportunity to measure controlled investees at fair value rather than consolidate those entities. The staff continue to think that the entity-based approach in the IASB ED is more appropriate because of the unique business model of investment entities.

13. In addition, if the IASB were to decide to pursue an asset-based approach, it would create a point of divergence between the two boards. Finally, if the IASB were to pursue an asset-based approach, the additional analysis and probable re-exposure required by that approach would mean that any amendments to IFRS 10 would not be finalised by the 1 January 2013 effective date of IFRS 10.

Approaches to assessing entity-based criteria

14. The following discussion on a joint basis is relevant only if the IASB agrees to continue with an entity-based approach for investment entities. If the IASB decides to develop an asset-level approach, the FASB would discuss issues relevant to investment companies separately. Assuming that the boards agree to pursue an entity-based approach, the remainder of this paper discusses three alternatives to the overall approach to providing entity-based investment company guidance. Each

alternative identifies a population of entities that would be investment companies for purposes of following investment company guidance in U.S. GAAP and would be investment entities for purposes of being eligible for the exception to consolidation under IFRSs. The alternatives discussed in this paper are as follows:

(a) **Alternative 1:** All six criteria are required to be met—the ED approach.

(b) **Alternative 2:** A qualitative assessment—an entity would consider the six criteria in totality to determine if it is an investment company.

(c) **Alternative 3:** A definition and factors to consider—an entity would be required to meet a definition and consider other factors to determine if it is an investment company.

15. This paper does not discuss specific criteria but, rather, focuses on the overall approach to providing entity-based investment company guidance. That is, the paper discusses how the criteria work together to determine whether an entity is an investment company. The staff analyzes each of the alternatives to determine which alternative would most likely identify the appropriate population of investment companies. IASB Agenda Paper 8A/FASB Memo No. 46A discusses each proposed criterion in the EDs and recommends changes to each criterion in light of feedback received. The staff did, however, consider feedback received on specific criteria to develop alternatives and provide a recommendation in this paper. Therefore, IASB Agenda Paper 8A/FASB Memo No. 46A is integral to the discussion in this paper.

Option to measure controlled investees at fair value

16. As described in paragraph 6, a few IASB constituents suggested that an entity that meets the criteria to be an investment company should have an option either to consolidate controlled investees or measure controlled investees at fair value. This paper does not address that suggestion further because the staff believes that the boards generally do not support giving entities an *option* to be investment companies. Providing an option would be inconsistent with the basis of the project

which is that fair value information, even for controlled entities, is most relevant for particular types of entities (investment companies) and would also reduce comparability between reporting entities. Moreover, the staff thinks that the concerns raised by those IASB constituents can be addressed by developing more robust guidance that captures the appropriate population of investment entities.

Alternative 1: All six criteria are required to be met (the ED approach)

17. Alternative 1 is the approach proposed in the EDs that requires an entity to meet all six criteria (outlined in IASB Agenda Paper 8A/FASB Memo No. 46A) to be an investment company. If an entity fails to meet one or more criteria, the entity would be prohibited from applying investment company accounting under U.S. GAAP and from qualifying for an exception to the IASB's consolidation guidance. The boards proposed this approach because they believed that it would result in more consistent application of the guidance and would not result in some entities inappropriately qualifying for investment company accounting. Moreover, the boards believed that all of the proposed criteria were important to be met to define the appropriate population of investment entities.

18. As explained in paragraph BC7 of the IASB ED, because the criteria for an investment entity would determine whether the entity qualifies for an exception to the principle of consolidation under the IASB ED, it was essential to define carefully the appropriate population of entities that qualify for that exception. Additionally, paragraph BC9 of the IASB ED explains that the Boards believe that the assessment of whether or not an entity is an investment entity should be based on an overall consideration of the nature of the entity's transactions and relationships and that the criteria are a way to make that assessment.

19. As described in the feedback section of this paper, many constituents disagreed with the approach proposed in the EDs stating that the approach is too strict and does not provide flexibility in assessing the criteria. This would result in many entities that currently present financial statements under investment company guidance in the

U.S. to lose investment company accounting under the ED approach (Alternative 1) and would result in inappropriately excluding some entities that should qualify as investment entities under IFRSs.

20. The requirement to meet all six criteria means whether an entity is an investment company is completely determined by the criteria. That is, there is no flexibility to make the assessment in any other way. Thus, some are of the view that the approach proposed in the EDs may encourage an entity to specifically structure itself to qualify as, or to avoid qualifying as, an investment company.

21. Further, an entity may not meet all of the six proposed criteria throughout its life. A strict criteria approach (Alternative 1) could require an entity to more frequently reassess whether it meets all of the criteria to be an investment company. Some are concerned that this can be the case when in their view the change is relatively immaterial so the economic substance of the entity has not changed substantially. Transitioning in and out of investment company guidance would result in a lack of financial reporting comparability and would confuse users because the entity could apply different accounting/consolidation guidance during different periods of its life.

22. The staff notes that the reassessment requirements in the IASB ED and the FASB ED are different. The FASB ED would require an entity to reassess investment company status when there is a change in the purpose and design of the entity whereas under the IASB ED, an entity would reassess whether the criteria are met if facts and circumstances indicate that there are changes to one or more of the criteria. Reassessment guidance will be discussed at a future meeting.

23. The staff note that some of the concerns expressed by constituents regarding the approach proposed in the EDs stem from concerns about specific criteria rather than the approach itself. For example, some have commented that many of the criteria proposed in the EDs are too prescriptive and focused on the structure (or form) of an investment company rather than its business model (or substance). Many constituents described scenarios involving single investments and/or single

investors that would inappropriately exclude an entity from being an investment company. Therefore, the Board could address constituent concerns by making changes to each criterion as discussed in IASB Agenda Paper 8A/FASB Memo No. 46A while still requiring an entity to meet all criteria to be an investment company.

Alternative 2: A qualitative assessment

24. Under Alternative 2, an entity's management (and its auditor) would use judgment to consider the six criteria in totality to determine if the entity is an investment company. None of the criteria would be considered as a strict requirement and an entity that does not meet one or more criteria would not necessarily be prohibited from being an investment company. The criteria would be treated as indicators to determine whether an entity is an investment company.

25. By allowing the use of judgment, this alternative is more flexible because it permits an entity to consider the total body of evidence when making a determination as to whether it is an investment company. This alternative would address constituent concerns about the proposed criteria in the EDs being too strict and focused on the structure of an entity.

26. This alternative would permit certain investment structures that have historically qualified as investment companies in the United States but currently do not meet all six of the proposed criteria to continue to qualify as investment companies (for example, employee parallel funds, small business investment companies [SBICs], and certain single investment or single investor funds). The flexibility inherent in this alternative would address IFRS constituents' concerns about the proposed criteria inappropriately excluding certain entities they believe should be investment entities. Specific types of entities are discussed in Agenda Paper 8A/FASB Memo No. 45A.

27. Additionally, this alternative has the benefit of alleviating constituents' concerns about changes to investment company status for entities that may fail the criteria to

be an investment company at different times in their life, but in which the entity's economic substance has not changed significantly.

28. The FASB considered this approach in its deliberations, but rejected the approach due to concerns that its flexibility could result in inconsistent application of investment company guidance and would allow for the inappropriate inclusion of entities that should not be investment companies (see paragraph BC10 of the FASB ED).

29. If the boards select this alternative, which allows for the use of judgment, the boards would need to provide additional application guidance or requirements. For example, a requirement could be added for an entity to justify its conclusion that it qualifies as an investment company even though it does not meet one or more of the six criteria. The purpose of such a requirement would be to prevent potential abuse of the flexibility permitted under this approach.

Alternative 3: A definition and factors to consider to be an investment company

30. Alternative 3 would require an entity to meet a definition of an investment company comprised of specific aspects of some of the proposed criteria. The remaining proposed criteria would not be required to be met but would be treated as factors that an entity must consider to determine whether it is an investment company.

31. Under Alternative 3, if the entity does not meet the definition of an investment company, it would not be required to assess the factors. If the entity meets the definition of an investment company, it would also be required to consider the accompanying factors before it determines that it is an investment company. Therefore, this alternative is a middle ground between Alternative 1 and Alternative 2 because an entity would be required to meet the definition as well as required to qualitatively assess the additional factors.

32. This alternative is similar to the approach in AICPA Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment*

Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. (The FASB has indefinitely deferred the effective date of SOP 07-1 because of some implementation issues.) SOP 07-1 defines an investment company but also requires an entity to consider other factors to determine whether it is an investment company.

33. Many constituents recommended this approach as part of their feedback on the EDs. Most of those constituents suggested that the definition of an investment company should incorporate the nature of investment activities criterion and the express business purpose criterion because those criteria are fundamental to determine whether an entity is an investment company. The nature of investment activities and business purpose of investment companies are the key characteristics that differentiate investment companies from other entities and, therefore, justify the use of fair value accounting. Focusing the definition of an investment company on those criteria would allow an entity to assess its business model rather than its legal form when determining whether it is an investment company. To supplement those criteria, some constituents added that the definition of an investment company should state that an investment company does not obtain, or have the objective of obtaining, returns or benefits from its investment activities other than investment income or capital appreciation. Those constituents believe that emphasizing that concept would reduce opportunities for structuring, especially in the case of corporations setting up 'investment entity' subsidiaries to achieve a particular accounting outcome.

34. Some constituents believe that certain aspects of the pooling of funds criterion also are essential to determine whether an entity is an investment company. Those constituents believe it is important to emphasize that the business model of an investment company is to act as a conduit to facilitate professional investment management advice for unrelated third-party investors as opposed to acting as an investment vehicle for a parent company.

35. Some constituents believe that the definition of an investment company should include the fair value management criterion. Requiring entities to meet the fair value management criterion helps ensure that fair value is truly the most relevant measure for the entity's investments.

36. The benefits of this alternative are that the definition of an investment company would be a more structured and disciplined assessment of the key criteria to be an investment company, but at the same time the other factors to consider would allow for the use of professional judgment. This would help prevent the exclusion of some entities that historically have qualified as investment companies under U.S. GAAP (or other national GAAPs) and would also address requests from IFRS constituents that we describe more clearly the nature of an investment entity and set out factors to be considered, in the most appropriate way, to determine whether an entity has that nature. Therefore, this alternative would reduce the concerns regarding structuring under Alternative 1 and also result in more consistent reporting than Alternative 2 (the qualitative assessment), which is important for users of investment company financial statements.

37. A disadvantage of this alternative is that it could be viewed as more complex than requiring an entity to meet strict criteria or a qualitative assessment. Further, in practice an entity may inappropriately interpret the approach to mean that the entity needs to ensure that it meets the definition of an investment company and less emphasis could be placed on the additional factors given that they are not a part of the definition that is required to be met.

Staff recommendation

38. The staff does not recommend Alternative 1 (the ED approach of a requirement to meet all six criteria) because it believes that it is too prescriptive and may inappropriately exclude investment structures that currently qualify for investment company accounting under U.S. GAAP (or other national GAAPs). The staff also agrees with some IASB constituents' concerns that Alternative 1 does not provide a

description of an investment entity. It is therefore unclear why fair value accounting is appropriate for investment entities based on the criteria as set out. Further, the staff believes that many of the constituents' concerns relate to aspects of the proposed criteria rather than the overall approach to assessing the criteria. Therefore, Alternative 1 would require the Boards to address all of the concerns raised by constituents regarding each criterion as described in IASB Agenda paper 8A/FASB Memo No. 46A. The staff would recommend providing some flexibility in assessing the criteria rather than attempting to change each criterion to address constituent concerns.

39. The staff also does not recommend Alternative 2 (qualitative assessment) because it believes that alternative is too flexible, would not clearly define the population to be treated as investment companies, and would not result in a consistent application of the accounting guidance developed. Moreover, Alternative 2 would not address IASB constituents' request for a general definition or description of an investment entity because it would continue using criteria to determine whether an entity is an investment entity without an overarching description or principle. A qualitative assessment is also inconsistent with the fact that the investment entity definition is from the IASB's perspective the basis for an exception from the general principle that controlled entities should be consolidated. Being an exception its scope needs to be clear.

40. The staff recommends Alternative 3 (the definition and factors to consider approach). In the staff's view, this approach achieves the appropriate balance between creating discipline with a clear scope and allowing entities to make an assessment based on relevant factors to identify those entities for which fair value measurement of assets is most relevant and useful. As described in paragraphs 31 and 32 of this paper, the staff believes that this approach combines the benefits of Alternative 1 and Alternative 2 while also addressing constituent concerns.

41. The staff acknowledges that Alternative 3 would allow a broader range of entities to be investment entities than the ED approach as some factors that were mandatory

criteria in the EDs would now only be *considered* in assessing whether an entity is an investment entity rather than being determinative. However, the staff believes that Alternative 3 would capture a more appropriate population of investment entities than the population of entities that would have been captured by the ED approach, while at the same time providing an overarching definition of an investment entity indicating why fair value is more relevant for investment entities.

42. The staff also believes that Alternative 3 would not inappropriately include entities that should not be investment entities because the definition of the investment entity would require an entity to meet some key criteria that are focused on the business model of an investment entity.

43. The staff expects that if the entity does not meet the definition of an investment company, it would be precluded from assessing the factors. However, the staff believes that the guidance should be clear that if the entity meets the definition to be an investment company, it also must consider the factors. That would further ensure that entities are not inappropriately included within the scope of investment company guidance. In addition, the staff recommends that an entity be required to consider its purpose and design when assessing both the definition and additional factors to determine whether it is an investment company.

44. The staff further recommends that both the definition and the factors incorporate key aspects of the criteria proposed in the EDs rather than developing new guidance. The remainder of this paper provides the staff's recommendations on specific components of the definition and factors under Alternative 3.

Staff recommendation for the definition of an investment company

45. All staff members recommend that the definition of an investment company include aspects of the following criteria proposed in the EDs:

    (a) Nature of the investment activities

    (b) Express business purpose

(c) Pooling of funds.

46. Some staff members also recommend that the definition of an investment company include the fair value management criterion proposed in the EDs. However, other staff members believe that the fair value management guidance should be included as a factor to consider. The different staff member views regarding the fair value management criterion are discussed in paragraphs 59 through 63.

47. The staff recommends that an entity consider its purpose and design when assessing the definition to determine whether it is an investment company. All staff members recommend that the definition of an investment company generally be described as follows:

> An investment company is an entity that does both of the following:
>
> a. Pools 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 and investment income
>
> b. Not available to other noninvestors or are not normally attributable to ownership interests.

48. The staff believes that the most important and traditional function of an investment company is pooling funds and providing professional investment management services to its investors. Therefore, the staff believes that this concept should be part of the definition of an investment company. Because of concerns raised regarding single investor funds, the staff recommends that the language in the definition

should not necessarily disqualify single investor funds. Rather, the number of investors should be a factor to consider as described later in this paper.

49. The staff also believes that it is important to define what an investment company does with the funds it receives from its investor(s) and finally, that an investment company is committed to providing returns from those activities to its investors. Therefore, the staff believes that an entity's activities and business purpose are critical in determining whether the entity is an investment company. The staff believes that an investment company's only substantive activities of investing for capital appreciation, investment income, or both and that an investment company communicates to its investor(s) that such activities are their business purpose, are the concepts that distinguish investment companies from other operating entities.

50. To strengthen the definition and to address board member concerns about investment companies being inserted into larger corporate structures, the staff believes it is necessary that the definition state that an investment company or its affiliates do not obtain returns or benefits from its investing activities other than capital appreciation or investment income, or are not available to other noninvestors or are not normally attributable to ownership interests. For example, the staff believes that including this statement in the definition will prevent a pharmaceutical or technology company from creating an investment company subsidiary to perform research and development activities because the parent company would be directly benefiting from the operations of the subsidiary and those benefits clearly go beyond obtaining returns only from capital appreciation or investment income.

51. The staff believes some of the structures described by constituents should not necessarily be disqualified from being investment companies. For the reasons set out in Agenda Paper 8A/FASB Memo No. 46A, the staff's recommended definition does not include some aspects of nature of investment activities, express business purpose, and pooling of funds criteria proposed in the ED and other criteria proposed in the ED. Instead, as discussed below, the staff recommends that many of the concepts proposed in the ED that are not included in the definition should be

factors that an entity consider before it determines that it is an investment company. Constituent concerns regarding each proposed criterion are discussed in Agenda Paper 46A/FASB Memo No. 8A.

Staff recommendation for the factors to consider to be an investment company

52. The staff recommends that an entity that meets the definition of an investment company described in paragraph 47 also should consider the additional factors to determine whether it is an investment company. The staff recommends that an entity consider its purpose and design when assessing the following factors to determine whether it is an investment company:

    (a) *Number of investments and investors*: Investment companies typically have multiple investors and hold multiple investments. However, an entity is not precluded from being an investment company because it has a single investor or holds a single investment, provided it demonstrates how it meets the definition of an investment company. It would be rare for an investment company to have both a single investor and hold a single investment because it would be very difficult but not necessarily impossible for such an entity to meet the definition of an investment company.

    (b) *Related investors*: Typically investment companies have multiple investors with a significant ownership interest held by an investor or investors that are not related to the parent (if there is a parent). However, an entity is not precluded from being an investment company because it has multiple related investors provided it demonstrates how it meets the definition of an investment company. For this assessment, investors related to the parent should be combined and treated as a single investor, along with the parent.

    (c) *Ownership interests*: Ownership interests in an investment company are typically in the form of equity or partnership interests to which a specifically identifiable portion of the net assets are attributed. However, an entity that has significant debt ownership may still qualify as an investment company provided that it demonstrates that its ownership interests represent a specifically identifiable portion of the net assets.

53. The staff believes that the three factors to consider described above should be treated as additional considerations, that are not required to be overcome but must

be assessed when the definition is met, to determine whether an entity is an investment company. In the staff's view, there are structures in practice where one or more of these factors are not met and yet the entity should be considered an investment company if it meets the definition of an investment company. The three factors above would accommodate legitimate exceptions to how typical investment companies operate and the required justification about how the entity considered each of the three factors should help ensure that the nature of the entity is consistent with the scope of investment entities as intended by the boards.

54. Many constituents commented that the application guidance in the EDs provided some exceptions to the strict criteria. Those constituents believe that the exceptions should be better integrated into the standard. The staff believes that including the three factors described in paragraph 52 would address this concern. The three factors to consider would allow the guidance to stand on its own with application guidance providing clarification rather than exceptions to the guidance.

55. The following paragraphs summarize the staff's reasons for including each of the components in paragraph 52 as factors to consider rather than requirements as part of the definition of an investment company.

56. Agenda Paper 8A/FASB Memo No. 46A describes many examples of structures with single investors or single investments that the staff believes should not be excluded from being investment companies solely because of the number of investments or investors. During deliberations, the boards' concerns regarding investment companies holding a single investment or being wholly owned by a large corporate entity related to scenarios in which the entity or its affiliates obtain benefits that are more than returns from capital appreciation or investment income and are not available to other noninvestors or are not normally attributable to ownership interests. The staff believes that the definition of an investment company addresses those concerns as described in paragraph 50. However, the staff believes that the Boards' concerns would be elevated if the entity has one investor and holds one investment because the staff thinks it would be highly unlikely that an entity

would set up an intermediary investment company to invest in a single investment rather than directly purchase that investment if the parent entity did not intend to obtain benefits other than returns from capital appreciation or investment income from that investment. Therefore, the 'number of investments and investors' factor indicates that it would be rare that an investment company has one investor and also holds only one investment.

57. Agenda Paper 8A/FASB Memo No. 46A describes concerns that many constituents raised about employee funds being excluded from being investment companies because the pooling of funds criterion in the EDs would have required an investment company to have a significant ownership interest held by investors unrelated to the parent (if there is a parent) such as employee funds. The staff believes that by including the related party investors concept as a factor rather than as part of the definition of an investment company, employee funds could be investment companies as long as they *demonstrate* how the definition of an investment company is met. The staff did not eliminate the consideration of related party investors when assessing whether an entity is an investment company because there are some circumstances, such as when all the investors are related to the asset manager, that the staff believes the entity should not be an investment company.

58. The staff believes that the form of ownership interests in an entity should not determine whether it is an investment company. As described in Agenda Paper 8A/FASB Memo No. 46A, constituents have raised many concerns with the 'unit ownership' criterion proposed in the EDs, highlighting instances where the form of an ownership interest in an entity would disqualify it from investment entity status. While the staff believes that most investment companies are formed to have only ownership interests in the form of equity or partnership interests, it believes that alternative structures should not necessarily be disqualified from investment entity status. Moreover, the staff believes that it is important that the primary assessment of whether an entity is an investment entity should focus on the economic substance, rather than the form of interests in the entity. However, the staff believe

it is helpful to include some guidance about the form of interests in the entity because in some cases a deviation from the typical form ownership interests will indicate that an entity is not an investment entity.

Staff views regarding the fair value management criterion in the EDs

59. The staff has split views regarding whether the fair value management criterion proposed in the EDs should be included as part of the definition of an investment company or whether managing on a fair value basis should be a factor to consider when determining whether the entity is an investment company. IASB staff recommends that the definition of an investment company include the fair value management criterion proposed in the IASB ED. The FASB staff believes that the fair value management criterion should be a factor to consider rather than a requirement.

60. IASB staff members believe it is necessary that an entity manage and evaluate the performance of its investments on a fair value basis in order for the entity to be required to measure its controlled investments at fair value. The IASB staff view this as a fundamental feature of an investment entity. In the development of the IASB ED, the staff had heard that fair value directly impacts the decision-making processes of both management of the investment entity and investors in the investment entity. Feedback to the EDs has confirmed this; many constituents have stated that both management and investors evaluate the performance of an investment entity by reference to the fair value of its investments. This makes fair value information the most relevant information. IASB staff members think that including the 'fair value management' concept in the investment entity definition is an important means of capturing the importance of fair value to an investment entity.

61. Moreover, for the IASB, this concept and the related application guidance also can be used to ensure that an investment entity will measure all of its investments at fair value, not just its controlled investments (for example, debt investments would be

measured at fair value through profit or loss in accordance with IFRS 9 if managed on a fair value basis). This would assist in aligning the fair value accounting for investments held by investment entities with the scope of investment entity guidance under IFRS and investment company guidance under U.S. GAAP despite differences in the scope of our guidance.

62. FASB staff members believe that fair value management should be a factor to consider but should not be required for an entity to be an investment company because of the many concerns raised regarding what it means to manage on a fair value basis and the application of the criterion to common investment fund structures (as described in IASB Agenda Paper 8A/FASB Memo No 46A). Further, (also described in paragraphs 94-104 of IASB Agenda Paper 8A/FASB Memo No. 46A) the proposed meaning of managing on a fair value basis is different under the FASB ED and the IASB ED, and the FASB staff members believe it would be inappropriate to include the fair value management criterion as a requirement without converged application guidance describing what it means to manage on a fair value basis.

63. In addition, FASB staff members believe that the business model of an investment company (as described by the other criteria included in the definition) warrants fair value measurement of all investments held regardless of how the entity is managing those investments. For example, those staff members believe that a money market fund should be an investment company although management of the fund evaluates the performance of its investments on a yield basis. Money market funds are managed in such a way that differences between the carrying amount and fair value are minimized to maintain a constant net asset value. Those staff members believe that including the fair value management criterion as a factor to consider would allow flexibility and would not exclude entities that are clearly investment companies, such as money market funds.

Additional guidance recommended

64. In addition to the definition and factors to consider, the staff recommends that the Boards include relevant implementation guidance that was included in the EDs and relevant implementation guidance that was recommended in IASB Agenda Paper 8A/FASB Memo No. 46A to assist entities in determining whether they are investment companies. For example, the staff believes that it is important to carry forward implementation guidance in the proposals that describes permissible business activities, exit strategy requirements, and indicates the times during the life of an entity in which the entity would be permitted to hold a single investment and have a single investor. Also, the staff believes it is important to provide examples of entities that would be investment companies and those that would not.

65. In addition, the staff believes the reporting entity criterion proposed in the EDs should not be part of the definition nor should it be a factor to consider. Rather, the staff believes that application guidance should indicate that an entity does not need to be a legal entity to qualify for investment company guidance. The staff would not eliminate the reporting entity concept altogether 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.