



**Board Meeting Handout**

**Investment Companies**

**January 23, 2013**

**PURPOSE OF THIS MEETING**

1. The purpose of this meeting is to discuss the following issues:
  - a. **Issue 1:** IASB Changes to the Jointly Discussed Investment Company Assessment
  - b. **Issue 2:** Disclosures
  - c. **Issue 3:** Need for Exposure of Disclosures about Investments in Another Investment Company
  - d. **Issue 4:** Transition and Effective Date.

**ISSUE 1: IASB CHANGES TO JOINTLY DISCUSSED INVESTMENT COMPANY ASSESSMENT**

2. On October 31, 2012, the IASB issued its final document, *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*. Before issuing its final standard, the IASB made a few changes to the jointly discussed assessment of investment company status because of comments received by the IASB from external reviewers.
3. The IASB revised the following aspects of the investment company assessment:
  - a. Exit strategy requirement
  - b. Fair value management
  - c. Investment-related services to third parties.

4. The FASB would need to decide whether any changes are needed to its tentative decisions regarding the investment company assessment in light of the IASB's changes.

**Question for the Board**

1. Does the Board believe changes are necessary to the FASB's tentative decisions regarding the investment company assessment because of the IASB's changes to the assessment after joint redeliberations?

## **ISSUE 2: DISCLOSURES**

5. This issue discusses the disclosures that an investment company should provide in the notes to its financial statements. Issue 2 is organized as follows:
  - a. **Part 1:** Financial Support
  - b. **Part 2:** Transfer Restrictions
  - c. **Part 3:** Investment Company Status
  - d. **Part 4:** Threshold for Disclosures about Investments in Another Investment Company.

### **Part 1: Financial Support**

6. The following paragraph from the proposed FASB Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*, would require an investment company to disclose financial support provided to investees that is explicit or implicit:

**946-20-50-15** An investment company shall disclose whether it has provided financial support during the periods presented to any of its investments that it was not previously contractually required to provide support to or whether it intends to provide such support, including the following:

- a. The type and amount of support provided, including situations in which the investment company assisted the investee in obtaining financial support
  - b. The primary reasons for providing the support.
7. International Financial Reporting Standards (IFRS) require a similar disclosure for controlled investees and interests in structured entities. The Boards decided to require that disclosure because they noted that the information would help users understand an investment company's exposure to risk.

#### **Feedback Received**

8. Users did not provide feedback on this proposed disclosure requirement. Many nonuser constituents disagreed with the requirement to provide disclosures about financial support that the investment company *intends* to provide and that is not contractually required. Those constituents recommended that the disclosure be limited to contractual obligations. Some noted that if the disclosure were limited to contractual obligations, it may be redundant with other requirements under current U.S. generally accepted accounting principles (GAAP).
9. Constituents in the private equity and venture capital industry stated that plans to provide financial support are confidential and could disadvantage the fund in negotiations with investees or open the fund to litigation risk. In addition, those constituents are concerned that these disclosures may be viewed as binding commitments.
10. Some constituents requested clarification about the definition of financial support. Constituents were unclear whether capital infusions or expenditures related to restructurings by funds invested in high-yield securities or defaulted securities would be considered financial support.

## Alternatives for Consideration

11. The staff has identified the following alternatives for the Board to consider regarding disclosure of financial support:
- a. **Alternative 1:** Retain the disclosure in the proposed Update on investment companies.
  - b. **Alternative 2:** Limit the disclosure requirement as follows:
    1. **Alternative 2a:** Require the disclosure only for controlled investees
    2. **Alternative 2b:** Require disclosure of (a) contractually required support and (b) support that was provided or committed to be provided (for support that is not contractually required).
    3. **Alternative 2c:** Require disclosure of (a) support that was provided during the reporting period, disaggregated by support contractually required and support not contractually required and (b) support contractually required but that has not been provided.
  - c. **Alternative 3:** Remove the disclosure requirement.

### Question for the Board

2. Which alternative does the Board prefer for the disclosure about financial support?

## Part 2: Transfer Restrictions

12. The guidance in the proposed Update on investment companies would require an investment company to provide disclosures about restrictions on an investee's ability to transfer funds as follows:

**946-20-50-16** An investment company shall disclose the nature and extent of any significant restrictions on the ability of investees to transfer funds to the investment

company in the form of cash dividends, or interest, or repayment of loans or advances.

13. IFRSs require a similar disclosure for controlled investees and interests in joint arrangements and associates. The Boards considered this disclosure useful for investors because restrictions on the transfer of funds could potentially affect distributions to the investment company's investors.

#### **Feedback Received**

14. Users did not provide feedback on this proposed disclosure requirement. Many nonuser constituents stated that this disclosure requirement would not be practical and would not increase the usefulness of information provided to users of financial statements. Some constituents stated that most private equity investments have restrictions on distributions and so this disclosure requirement would not provide additional useful information. Some constituents stated that this disclosure is unnecessary because transfer restrictions and any associated risks would be reflected in the fair values of the assets from which the potential of such transfer arises.
15. Constituents are particularly concerned about the burden and cost of the disclosure for an investment fund that holds hundreds of investments because this disclosure requirement would require an investment company to search financial statements, debt covenants, and other agreements issued by each investee to determine if any restrictions exist. Those constituents said that the disclosure should be limited to investees that represent a significant portion of the investment company's net assets.
16. Some stated that it is unclear whether the Board intended to include only formal restrictions or implied restrictions such as a going concern scenario. Some constituents noted that investment companies regulated under the 1940 Act are currently required to provide disclosures about nonincome producing and defaulted securities.

### Alternatives for Consideration

17. The staff has identified the following alternatives for the Board's consideration regarding disclosure of restrictions on the ability of an investee to transfer funds to the investment company:
- a. **Alternative 1:** Retain the disclosure requirement.
  - b. **Alternative 2:** Require investment companies to disclose which investments are nonincome producing.
  - c. **Alternative 3:** Remove the disclosure requirement.

#### Question for the Board

3. Which alternative does the Board prefer for the disclosure about restrictions on the ability of an investee to transfer funds to the investment company?

### Part 3: Investment Company Status

18. The IASB standard on investment entities requires an investment company to disclose the following about its status as an investment company:
- a. That it meets the definition of an investment entity.
  - b. The fact that it is required to apply the exception to consolidation and account for its investment in a subsidiary at fair value through profit or loss.
  - c. Information about significant judgments and assumptions it has made in determining that it is an investment entity. If the investment entity does not have one or more of the typical characteristics of an investment entity, it shall disclose its reasons for concluding that it is nevertheless an investment entity.
19. The FASB would need to decide whether an investment company should be required to provide similar disclosures under U.S. GAAP.

#### Question for the Board

4. Does the Board believe that an investment company should be required to disclose any of the following:
- a. That it is an investment company?
  - b. That it has not consolidated controlled investees?
  - c. Information about how the investment company assessed the typical characteristics?

#### **Part 4: Threshold for Disclosures about Investments in Another Investment Company**

20. At its August 29, 2012, meeting, the Board decided that, for **significant** investments in another investment company (the investee fund), an investment company should disclose certain items about the investee fund. To be consistent with the new disclosures, the Board also decided to amend the threshold in paragraph 946-210-50-9 to require all investment companies to disclose each investment owned by an investee fund that represents a **significant** portion of the reporting investment company's net assets at the reporting date rather than those that exceed 5 percent of the reporting investment company's net assets at the reporting date.
21. The Board decided that it would not set a bright line for disclosures about an investment in another investment company, but the Board expected practice to interpret **significant** as 5 percent of net assets, consistent with other requirements in Topic 946 and U.S. Commodity Futures Trading Commission disclosure requirements.
22. The staff has concerns that practice may interpret **significant** as 20 to 25 percent because of current industry practice for attaching financial statements of investee funds. Therefore, a threshold based on **significant** rather than 5 percent of net assets could result in a loss of transparency and create structuring opportunities.

23. To alleviate concerns about voluminous disclosures when the investee fund's financial statements are publicly available, the Board could consider permitting the reporting investment company to state that fact to satisfy the disclosure requirements.

**Questions for the Board**

5. Does the Board believe that disclosures about investments in another investment company should be required when the investment in the investee fund exceeds 5 percent of the reporting investment company's net assets at the reporting date?
6. Does the Board believe that for an investee fund whose financial statements are publicly available, the reporting investment company should be permitted to state that fact to satisfy the disclosure requirements?

**ISSUE 3: NEED FOR EXPOSURE OF DISCLOSURES ABOUT INVESTMENTS IN ANOTHER INVESTMENT COMPANY**

24. Due process requires the Board to consider whether decisions reached during redeliberations of an Exposure Draft require re-exposure. The staff notes that the only item that could be considered a substantive change from the amendments in the proposed Update on investment companies is the Board's decision to require disclosures about investments in another investment company. The staff adds that all other decisions reached during redeliberations can be issued as final guidance. The Board would need to decide whether the required disclosures about an investment in another investment company need to be exposed for public comment.

**Question for the Board**

7. Does the Board believe that the decisions requiring disclosures about an investment in another investment company should be exposed?

**Comment Period**

25. If the Board decides that an Exposure Draft is necessary for the tentative disclosure requirements about an investment in another investment company, the Board would need to decide on the comment period for that Exposure Draft. The staff recommends a 90-day comment period to allow adequate time for constituents to respond to the document.

**Question for the Board**

8. Does the Board agree with the staff recommendation of a 90-day comment period for an Exposure Draft on disclosure requirements for investments in another investment company?

**ISSUE 4: TRANSITION AND EFFECTIVE DATE**

**Transition Requirements**

26. The transition requirements in the proposed Update on investment companies differed depending on whether (a) the entity no longer met the criteria of an investment company or (b) the entity became an investment company as a result of the proposed amendments.

**Entities That No Longer Meet the Requirements to Be Investment Companies**

27. For an entity that no longer meets the requirements to be an investment company as a result of the proposed guidance, the amendments in the proposed Update on investment companies would require the entity to record a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption for the difference between the net assets required to be recognized and the amount previously recognized.

28. Under the proposed amendments, the initial carrying amount of assets, liabilities, and noncontrolling interests of a subsidiary and an equity method investment should be calculated by the entity that no longer is an investment company as though it had always accounted for its investments in conformity with other applicable U.S. GAAP, unless it is not practicable. If determining the carrying amounts is not practicable, the proposed guidance would permit an entity to use the fair value of the investment at the date the amendments become effective.
29. For all other investments that are required to be accounted for under other U.S. GAAP as a result of the entity no longer being an investment company, the proposed guidance would require the initial measurement of those investments to be the fair value at the date of adoption.
30. If an entity is required to consolidate a subsidiary or apply the equity method of accounting for an investment because the entity no longer is an investment company, the proposed guidance provides a fair value option at the date of adoption for all the financial assets and financial liabilities of the subsidiary and for the measurement of the equity method investment.

#### **Feedback Received**

31. Users did not provide feedback on this aspect of the guidance in the proposed Update. Most nonuser constituents agreed with the transition guidance for entities that would no longer qualify as investment companies. Some constituents specifically noted support for the practicability exception stating that moving from an unconsolidated environment to a consolidated one is difficult and there may be circumstances in which it may be impracticable to determine historical carrying values accurately, particularly when interests have been held for long periods of time.

32. Other constituents argued that the guidance should be applied prospectively using the fair value amount of investments at the date the provisions become effective. Those constituents questioned the benefit of requiring preparers to spend time and resources to demonstrate that obtaining the historical carrying amounts was impracticable to be able to apply the practicability exception.

**Question for the Board**

9. Does the Board believe the transition requirements in the proposed Update for an entity that no longer meets the requirements to be an investment company should be retained for the final guidance issued?

**Entities That Become Investment Companies**

33. The proposed amendments require prospective application for an entity that becomes an investment company as a result of the guidance. The IASB's standard on investment entities requires retrospective application but provides a practicability exception when it is impracticable to apply the guidance retrospectively.

**Feedback Received**

34. Users did not provide feedback on this aspect of the proposed Update. Almost all constituents agreed with the proposed guidance. Constituents noted that retrospective application would be impracticable because an entity that was not an investment company may not have access to the historical fair value information. In addition, constituents stated that investment company presentation is most appropriate only for the periods in which an entity is an investment company.

#### Questions for the Board

10. Does the Board believe the transition requirements in the proposed Update for an entity that becomes an investment company should be retained for the final guidance issued?

11. Does the Board believe that the disclosures about an investment in another investment company should be provided prospectively as of the period of adoption?

#### Effective Date

35. The amendments in the proposed Update would be effective for an entity's interim and annual reporting periods in fiscal years that begin after the effective date. Earlier application would be prohibited.
36. The IASB's standard has an effective date of January 1, 2014, with early adoption permitted to allow companies the option to implement the guidance simultaneously with the guidance in IFRS 10, *Consolidated Financial Statements*.

#### Feedback Received

37. Users did not provide feedback on the effective date. Most nonuser constituents stated that at least one year and up to two years would be necessary to implement the proposed amendments. Constituents that requested a time to implement of 18 months or more stated that additional time would be necessary to implement the requirement to consolidate controlling financial interests in a fund-of-funds structure to allow for systems upgrades and implementation of additional control procedures.
38. Almost all constituents agreed that the proposed amendments should apply equally to both public and nonpublic entities, including the effective date. Many constituents stated that the core investment activities and business purpose of a public investment company and a nonpublic investment company do not differ and, therefore, subjecting nonpublic entities to the

same guidance is critical to achieve comparable financial reporting. A few constituents suggested that nonpublic investment companies be given additional time to implement the proposed standards (such as one additional year).

39. Many constituents agreed that early adoption should be prohibited because of comparability concerns. Some constituents stated that early adoption should be permitted when management determines that adoption would improve the information provided to users of their financial statements.

#### Questions for the Board

12. Does the Board believe that the final guidance issued should be effective for an entity's interim and annual reporting periods in fiscal years that begin on or after January 1, 2014?

13. Does the Board believe that nonpublic investment companies should be provided with a deferred effective date?

14. Does the Board believe that early adoption should be prohibited?