MINUTES

Financial Accounting Standards Board

To: Board Members

From: Bennett, Ext. 229

Subject: Minutes of the September 13, 2006 Board Meeting—AcSEC / FSP FIN 46(R)-d **Date:** September 20, 2006

cc: Leisenring, Bielstein, Smith, MacDonald, Golden, J. Johnson, Fanzini, Roberge, Jacobs, Glotzer, Vernuccio, Swift, Polley, Gabriele, Sutay, Carney, Allen, FASB Intranet; Outside: D. Noll (AICPA)

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topics:

1. Final clearance of the AICPA Statement of Position, *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*
2. Issuance of Proposed FASB Staff Position (FSP) FIN 46(R)-d, "Application of FASB Interpretation No. 46(R) to Investment Companies"

Basis for Discussion: Board Memorandums dated August 31, 2006 and September 7, 2006

Length of Discussion: 9:10 to 10:20 a.m.

Attendance:

Board members present: FASB: Batavick, Crooch, Herz, Linsmeier, Seidman, Trott, and Young
IASB: Leisenring

Staff in charge of topic: J. Johnson

Other staff at Board table: Smith, Golden, and Bennett

Outside participants:	Ben Neuhausen, Chair, AcSEC; Mark Bielstein, Former Chair, AcSEC; Joel Tanenbaum, AICPA; Dan Noll, AICPA; Brian Gallagher, AICPA Investment Companies Task Force; Paul Laurenzano, KPMG (Former FASB Fellow)

Summary of Decisions Reached:

The Board met with representatives of the AICPA's Accounting Standards Executive Committee (AcSEC) and discussed final clearance of the AICPA Statement of Position (SOP), *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 Board did not object to issuance of that final SOP. The Board also discussed the issuance of a proposed FSP on the application of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* to investment companies, to amend paragraphs 4(e) and 36 of that Interpretation. The Board deferred making a decision on the issuance of a proposed FSP and requested that the staff perform further analysis on the issue. That analysis will be presented at a future Board meeting.

Objectives of Meeting:

The first objective of the meeting was to discuss final clearance of the AICPA Statement of Position, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. The second objective of the meeting was for the Board to discuss a proposed FSP that would address the application of Interpretation 46(R) to investment companies. Those objectives were met.

Matters Discussed and Decisions Reached:

AICPA STATEMENT OF POSITION

1. Mr. Johnson stated that at the June 15, 2004 Board meeting, the Board cleared the proposed SOP subject to the AICPA's Accounting Standards Executive Committee (AcSEC) making certain editorial changes requested by the Board. At that time, Ms. Katherine A. Schipper, who left the Board on June 30, 2006, objected to the clearance of the SOP and Messrs. Linsmeier and Young were not yet members of the Board. Since the Board did clear the proposed

SOP at the June 2004 Board meeting, the staff will not revisit any objections raised at that meeting. At today's meeting, the staff will only present the changes that have taken place since that meeting. Three new concerns have arisen since the June 2004 meeting:

a. Reexposure of the proposed SOP. AcSEC received comment letters expressing concerns about the length of time that has passed since the proposed SOP was exposed for public comment and requested that AcSEC consider reexposing the proposed SOP. AcSEC decided that because no significant changes have been made to the proposed SOP, there is no reason to reexpose the document for public comment. The FASB staff concurs with that decision.

b. The tainting provisions in paragraph 30 of the proposed SOP. Practitioners in the industry are concerned that those provisions are overly strict and would prohibit a company from using investment company accounting if it has an investment through an investment company and simultaneously has a direct investment in that same or similar investment. The FASB staff discussed that concern with some of those constituents. The staff believes that the proposed SOP is operational as written.

c. The interaction between the proposed SOP and the proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. Some constituents expressed concern that the proposed Statement on fair value option will undermine one of the SOP's primary intents, which is to prevent a company from using the investment company guide to avail itself of the fair value accounting metric. Other constituents believe that that objective is no longer necessary because the proposed Statement on fair value option would allow companies to elect the use of fair value on an item-by-item basis. The FASB staff acknowledges that the accounting environment has changed but believes it is still important to clear the proposed SOP for three reasons:

(1) The proposed SOP, unlike the proposed Statement on fair value option, would allow an investment company to carry investments, in which the company has a controlling financial interest, at fair value rather than consolidating those investments.

(2) The proposed Statement on fair value option would not allow companies to elect the use of fair value for nonfinancial investments. However, if the company could apply the investment company guide (that is, it is an investment company), it would be allowed to carry those investments at fair value.

(3) The proposed SOP provides guidance for when a company is prohibited from applying investment company accounting and also for when a company must apply investment company accounting, and, therefore, must use fair value. The proposed Statement on fair value option would not require the use of fair value.

2. Mr. Johnson announced that the AcSEC representatives made a decision late yesterday afternoon to recommend that the effective date of the proposed SOP be changed to fiscal years beginning after December 15, 2007. This effective date would accomplish two objectives:

a. Allow companies to avoid having two transition events

b. Allow companies adequate time to make the investment company assessment before they have to apply the SOP.

3. Mr. Bielstein stated that AcSEC reviewed all the comment letters received on the proposed SOP and did not find any arguments that had not been considered during the development of the document. However, AcSEC noted

that it did not address the interaction of the proposed SOP with the proposed Statement on fair value option because that proposed Statement did not exist at the time AcSEC drafted the proposed SOP. He noted that the proposed effective date of the SOP should allow companies adequate time for implementation and should not be before the effective date of the proposed Statement on fair value option. The proposed effective date would provide companies that could no longer apply the investment company guide with the option to fair value those investments that qualify under the proposed Statement on fair value option.

4. Ms. Seidman questioned the reasons for setting an effective date of December 15, 2007, rather than continuing with the original proposal of linking the effective date of the proposed SOP with the proposed Statement on fair value option. Mr. Bielstein responded that by setting an effective date, the American Institute of Certified Public Accountants (AICPA) could issue the SOP and allow constituents adequate time to determine the effects of implementing the SOP without having to wait for the finalization of the proposed Statement on fair value option. He stated that if there is a delay in issuing the proposed Statement on fair value option, AcSEC would amend the effective date of the SOP such that the SOP does not become effective before that proposed Statement. Mr. Johnson added that because the SOP would be operationally challenging for entities to adopt, a longer period of time between issuance and effective date is desirable. Conversely, the optional nature of the proposed Statement on fair value option makes the amount of time between issuance and effective date less of a concern.

5. Mr. Trott stated that another benefit of having a delayed effective date for the SOP would be to allow entities to simultaneously adopt the SOP after the effective date of the proposed FASB Statement, *Fair Value Measurements*, as investment companies are not scoped out of that proposed Statement. This would ensure that investment companies are using the definition of fair value in the proposed Statement on fair value measurements.

6. Mr. Leisenring stated that he believes that the Board should not clear the proposed SOP because he believes that it is unconscionable that the investment company guide should preclude an investment company from consolidating an entity that it controls. Additionally, the decision to clear the investment company guide would result in divergence from International Financial Reporting Standards (IFRS). He expressed concerns that the Board is not addressing an egregious loophole in both the investment company guide and the proposed FSP that allows investment companies to avoid consolidation of other investment companies that it controls, especially given the diversity in practice. Mr. Johnson pointed out that Mr. Leisenring's concerns relate to a section of the Audit and Accounting Guide, *Investment Companies*, that is not being amended by the proposed SOP. Mr. Johnson further stated that since investment companies carry their assets at fair value and present their financial statements at net asset value, whether or not an investment company consolidates another investment company that it controls is only a matter of presentation. The consolidation issue is not as critical within investment companies as it is outside of investment companies.

7. Ms. Seidman asked the Board if it intends to restrict the application of fair value accounting for those companies that have been disqualified from applying the investment company guide, given the broad scope of the proposed Statement on fair value option relating to financial instruments, including equity method investments. She expressed concerns about the operationality of the tainting provisions in paragraph 30 of the proposed SOP. Ms. Seidman stated that AcSEC and the staff should consider a proposal advanced by a constituent in a comment letter. That constituent stated that the SOP should employ the principle that if an entity has an investment that would be subject to consolidation if the entity controlled it, that entity cannot avoid consolidation by carrying some of it's interest in that investment through an investment company.

8. Mr. Bielstein stated that for an investment company the financial statement presentation and disclosures are different than they would be for a

non-investment company employing the fair value option. When AcSEC dealt with the consolidation issue, it attempted to determine whether an entity qualifies as an investment company and whether investment company accounting for that entity should be retained in consolidation by the investment company's parent company. AcSEC was not attempting to determine the appropriate accounting for a single investment within the investment company. AcSEC did not consider the proposed Statement on fair value option when developing the proposed SOP because that project did not exist at that time. AcSEC believes that investment company accounting should be applied on an entity-wide basis and not on an individual investment basis. In addressing what investments are considered similar investments, AcSEC believed that companies should develop their own internal policy to identify and categorize investments that it considers similar. Those similar investments should either be accounted for using investment company accounting, if the entity qualifies as an investment company, or be accounted for using other GAAP (that is, there should be no mixed attribute accounting for similar investments).

9. Ms. Seidman stated that in the case of financial instruments, it would seem that the proposed Statement on fair value option significantly undermines the restrictions AcSEC had attempted to put in place with respect to retaining investment company accounting in consolidation. Mr. Trott disagreed with Ms. Seidman and stated that AcSEC developed the proposed SOP to identify the accounting for an activity and entities should not be accounting for those activities on an optional basis.

10. Messrs. Trott and Bielstein and Ms. Seidman discussed whether accounting guidance should be provided in the proposed SOP for transfers of financial and nonfinancial assets out of virtual investment companies prior to the adoption of the SOP, such that upon adoption, a company would only consider the assets held at that point in time in the activity to determine if it qualifies as an investment company. Mr. Bielstein stated that providing guidance for transfers of assets is not only beyond the scope of the investment company guide, but it

would also affect various other accounting literature, which AcSEC could not specifically address in the proposed SOP. Ms. Seidman noted that if the proposed SOP does not provide that guidance, the proposed Statement on fair value option would have to address that issue because it seems pointless to coordinate the proposed SOP with the proposed Statement on fair value option, if entities could not elect the fair value option for the items that have been moved out of the investment company.

11. The Board agreed to clear the proposed SOP (four Board members agreed; three did not (LFS, TJL, DMY)). Mr. Herz requested that the staff perform an analysis of Ms. Seidman's concern about the interaction of the proposed SOP with the proposed Statement on fair value option, specifically regarding the transfers of financial and nonfinancial assets.

ISSUANCE OF PROPOSED FASB STAFF POSITION

12. Mr. Johnson stated that since the Board has cleared the proposed SOP, the Board should address the application of Interpretation 46(R) to investment companies.

Background

13. When the Board issued Interpretation 46(R), paragraph 4(e) of that Interpretation exempted a registered investment company from consolidating an investee that is not also a registered investment company. At that time, the Board did not provide a permanent exemption for unregistered investment companies due to the ambiguity of the scope of the Investment Company Audit Guide. Instead, the Board provided a temporary deferral for unregistered investment companies in paragraph 36 of Interpretation 46(R) until AcSEC clarifies the scope of the Audit Guide by issuing the final SOP. Paragraph 36 states that "Following AICPA issuance of the final SOP, the Board will consider modifying paragraph 4(e) to provide an exception for companies that apply the

Audit Guide as revised by the SOP." Since the Board has cleared the proposed SOP, the Board should address paragraph 36 of Interpretation 46(R).

14. The staff presented the Technical Application and Implementation Committee (the Committee) with a draft of the proposed FSP on June 26, 2006, and the Committee supported the proposal for a permanent exemption from Interpretation 46(R) for unregistered investment companies. The Committee requested that the staff draft the FSP to accomplish the following:

a. Both registered and unregistered investment companies should receive the same treatment, and

b. Current practice in the industry should be preserved.

15. The staff drafted the proposed FSP using the words from paragraph 36 of Interpretation 46(R) to state that unregistered investment companies should not consolidate those investments which it accounts for at fair value under the investment company guide.

Discussion of the Proposed FSP

16. Ms. Seidman stated that the original practice by registered investment companies to not consolidate an investee that is not also a registered investment company was brought about through regulation. If the Board issues the proposed FSP, it would extend that practice to unregistered investment companies.

17. Mr. Crooch asked if the proposed FSP will change current practice. Mr. Johnson replied that the proposed FSP will not change current practice; the proposed FSP would just allow unregistered investment companies to continue current practice, which the staff admits is diverse due to the ambiguity of the guidance for investment companies in Securities and Exchange Commission (SEC) guidance and in the investment company guide.

18. Mr. Herz asked the staff whether the proposed FSP creates the opportunity to create wholly-owned or substantially wholly-owned internal investment companies that the company does not have to consolidate. He understands that although the proposed SOP creates that opportunity, he stated that registered investment companies are regulated by the SEC but unregistered investment companies do not have to follow those same regulations. Mr. Herz expressed concerns that unregistered investment companies are able to create a variable interest entity, call it an investment company, and avoid having to consolidate under Interpretation 46(R).

19. Mr. Johnson stated that the proposed SOP is intended to draw a distinction between what is an investment company, by activity, and what is not. The proposed SOP would not allow a company to create a wholly-owned investment company to house a variable interest entity and avoid the consolidation rules unless that wholly-owned investment company meets the criteria in the proposed SOP to qualify as an investment company.

20. Mr. Herz questioned whether the Board is inadvertently creating a loophole via the proposed FSP that would allow companies to completely circumvent Interpretation 46(R). Mr. Golden replied that if the Board does not issue the proposed FSP, the Board would have effectively amended the proposed SOP that it had cleared earlier. He stated that companies that apply the investment company guide follow a different accounting model than the one in Interpretation 46(R) and are not currently within the scope of that Interpretation. If the Board does not issue the proposed FSP, it would create a disparity between registered and unregistered investment companies, both of which apply the investment company guide. Mr. Johnson stated that the purpose of the SOP was to clearly define whether an activity qualifies as an investment company, and thus, whether an investment company is “registered” or “unregistered” should be unimportant for accounting purposes.

21. The Board deferred making a decision on the issuance of a proposed FSP. Mr. Herz requested that the staff perform an analysis of whether there are any possible scenarios in which entities could circumvent Interpretation 46(R) by applying the proposed FSP. Mr. Linsmeier also requested that the staff perform an analysis of a two-tiered structure scenario, whereby a company owns an unregistered investment company, and that unregistered investment company invests in a variable interest entity. He asked that the staff analyze and explain the resolution of the consolidation issue in that scenario.

Follow-Up Items:

AICPA Statement of Position

22. The staff will perform an analysis on the interaction of the proposed SOP with the proposed Statement on fair value option, specifically regarding the transfers of financial and nonfinancial assets.

Proposed FSP

23. The staff will perform an analysis of whether there are any possible scenarios in which an entity could circumvent Interpretation 46(R) by applying the proposed FSP. Additionally, the staff will analyze the consolidation issue in a two-tiered structure scenario. Those analyses will be presented at a future Board meeting.

General Announcements:

None.