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Proposed Accounting Standards Update: Financial Services—Investment Companies (Topic 946) Amendments to the Scope, Measurement, and Disclosure Requirements

The Accounting Principles and Auditing Standards Committee (“the Committee” or “We”) of the California Society of Certified Public Accountants (“CalCPA”) is grateful for the opportunity to comment on the Proposed Accounting Standards Update referenced above. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 35,000 members. The Committee is comprised of 43 members, of whom 56 percent are from local or regional firms, 12 percent are sole practitioners in public practice, 9 percent are in academia and 2 percent are in an international firm.

The Committee generally supports the changes in this Proposed Accounting Standards Update, but some members of the Committee take issue with some of the proposed changes, as indicated in our responses to the specific questions below.

Scope

Question 1: The proposed amendments would require an entity to meet all six of the criteria in paragraph 946-10-15-2 to qualify as an investment company. Should an entity be required to meet all six criteria, and do the criteria appropriately identify those entities that should be within the scope of Topic 946 for investment companies? If not, what changes or additional criteria would you propose and why?

A majority of the members of the Committee agree that an entity should meet all six criteria to qualify as an investment company. However, a significant number of members think that the accounting for an economic activity or a transaction should be based on the economic activity or transaction – not on such criteria as the legal form of the entity or the number of investors. These members think that, if fair value is the appropriate

accounting for investments made for investment returns, then that accounting should be available for any entity involved in that activity regardless of whether it is an individual, a partnership, a commercial or finance (bank) company or an investment company.

Also, as a separate issue to the one discussed in the preceding paragraph, limiting the exemption in paragraph 946-10-15-2 from the six criteria for qualifying as an investment company to those entities regulated under the Investment Company Act of 1940 seems too narrow. If the Board decides that such an exemption is necessary, then the exemption should not be limited to just those entities registered under the Investment Company Act of 1940 in the United States. There may be entities that are subject to U. S. GAAP that have subsidiaries that are regulated as investment companies in other jurisdictions that should have the same exemption. We suggest adding words in proposed paragraph 946-10-15-2 such as “an entity that is regulated under the Investment Company Act of 1940 or similar regulation in other jurisdictions.”

Question 2: The definition of an investment company in the proposed amendments includes entities that are regulated under the SEC’s Investment Company Act of 1940. Are you aware of any entities that are investment companies under U.S. regulatory requirements that would not meet all of the proposed criteria in paragraph 946-10-15-2? If so, please identify those types of entities and which of the criteria they would not meet.

The Committee is not aware of any entities that are investment companies under U.S. regulatory requirements that would not meet all of the proposed criteria in paragraph 946-10-15-2. However, even if an investment company under U.S. regulatory requirements failed to meet all the criteria, we agree that it should still be accounted for as an investment company.

We also suggest that, if an entity considered an investment property entity under the companion Proposed Accounting Standards Update would otherwise be excluded from the definition of an investment company but is regulated under the Investment Company Act of 1940, it should be accounted for as an investment company. This should be made explicit in paragraph 946-10-15-2.

Question 3: The proposed amendments would remove the scope exception in Topic 946 for real estate investment trusts. Instead, a real estate investment trust that meets the criteria to be an investment property entity under the proposed Update on investment property entities would be excluded from the scope of Topic 946. Do you agree that the scope exception in Topic 946 for real estate investment trusts should be removed? In addition, do the amendments in the proposed Updates on investment companies and investment property entities appropriately identify the population of real estate entities that should be investment companies and investment property entities?

The Committee agrees that the scope exception in Topic 946 for real estate investment trusts should be removed and, except as noted in the answer to Question 2, the amendments in the proposed Updates on investment companies and investment property

entities appropriately identify the population of real estate entities that should be investment companies and investment property entities.

Question 4: The proposed amendments would require an entity to reassess whether it is an investment company if there is a change in the purpose and design of the entity. Is this proposed requirement appropriate and operational? If not, why?

The Committee is not aware of any circumstances under which the proposed requirement to reassess whether an entity is an investment company would not be appropriate and operational.

Nature of the Investment Activities

Question 5: An entity may be an investment company when it performs activities that support its investing activities. As a result, a real estate fund or real estate investment trust (that is not an investment property entity) could be an investment company if the entity (directly or indirectly through an agent) manages only its own properties. However, the entity would be precluded from being an investment company if the other activities were considered more than supporting the entity's investment activities (for example, construction). Is this requirement operational, and could it be consistently applied?

The Committee is not aware of any circumstances under which this requirement would not be operational nor could be consistently applied.

Question 6: The proposed implementation guidance includes examples of relationships or activities that would indicate that an entity obtains or has the objective of obtaining returns from its investments that are not capital appreciation or investment income. Do you agree with these examples? If not, how would you modify the examples while still addressing the Board's concerns identified in paragraphs BC15 and BC16? 7

The Committee agrees with the proposed examples and has no suggestions for modification.

Unit Ownership and Pooling of Funds

Question 7: To be an investment company, the proposed amendments would require an entity to have investors that are not related to the entity's parent (if there is a parent) and those investors, in aggregate, must hold a significant ownership interest in the entity. Is this criterion appropriate? If not, why?

As discussed in our answer to Question 1 above, some members think this criterion is appropriate, but some do not.

Question 8: The proposed unit-ownership criterion would require an entity to have ownership interests in the form of equity or partnership interests to be an investment company. The entity would consider only those interests in determining whether it meets

the proposed pooling-of-funds criterion. Therefore, a securitization vehicle, such as a collateralized debt obligation, may not qualify as an investment company under the proposed amendments because it may not meet the unit-ownership or the pooling-of-funds criterion. The entity would not consider interests held by its debt holders when evaluating these criteria to be an investment company. For entities that do not have substantive equity interests (for example, those considered variable interest entities under Subtopic 810-10), should the unit-ownership and pooling-of-funds criteria to be an investment company consider interests held by debt holders? Please explain.

The Committee, except as discussed above, agrees with the proposed criteria and believes that the criteria should not consider interests held by debt holders.

Question 9: Certain entities may meet all of the other criteria to be an investment company but have only a single investor (for example, a pension plan). The amendments in FASB's proposed Update on investment property entities provides that if the parent of an entity is required to measure its investments at fair value under U.S. GAAP or the parent entity is a not-for-profit entity under Topic 958 that measures its investments at fair value, the entity would not need to meet the unit-ownership and pooling-of-funds criteria to be an investment property entity. Considering the Board's concerns identified in paragraph BC24, should the criteria in this proposed Update be amended to address situations in which the entity has a single investor?

Consistent with the response to Question 1, a majority of the Committee does not believe that the proposed criteria should be amended to address situations in which the entity has a single investor, but a minority of the Committee believes that the criterion should be eliminated entirely.

Question 10: The unit-ownership and pooling-of-funds criteria in the proposed amendments do not consider the nature of the entity's investors for evaluating if an entity is an investment company. That is, the criteria do not differentiate between passive investors and other types of investors. Do you agree that the nature of the investors should not be considered in evaluating the unit-ownership and pooling-of-funds criteria?

The Committee, except as discussed above, agrees that the nature of the investors should not be considered in evaluating the unit-ownership and pooling-of-funds criteria.

Fair Value Management

Question 11: The proposed amendments would require that substantially all of an investment company's investments are managed, and their performance evaluated, on a fair value basis. Do you agree with this proposal? If not, why? Is this proposed amendment operational and could it be consistently applied? If not, why?

The Committee agrees that substantially all of an investment company's investments should be managed, and their performance evaluated, on a fair value basis. The

Committee is not aware of any circumstances under which this requirement would not be operational nor could be consistently applied.

Interests in Other Entities

Question 12: The proposed amendments would retain the requirement that an investment company should not consolidate or apply the equity method for an interest in an operating company unless the operating entity provides services to the investment company. However, the proposed amendments would require an investment company to consolidate controlling financial interests in another investment company in a fund-of-funds structure. An investment company would not consolidate controlling financial interests in a master-feeder structure. Do you agree with this proposed requirement for fund-of-funds structures? If not, what method of accounting should be applied and why? Should a feeder fund also consolidate a controlling financial interest in a master fund? Please explain.

The Committee agrees that an investment company should consolidate controlling financial interests in another investment company in a fund-of-funds structure and that an investment company would not consolidate controlling financial interests in a master-feeder structure. We found the Board's reasoning for not consolidating the master fund in a master-feeder structure in paragraph BC37 was persuasive.

Question 13: The proposed amendments would require an investment company to consolidate a controlling financial interest in an investment property entity. Should an investment company be subject to the consolidation requirements for controlling financial interests in an investment property entity? If not, what method of accounting should be applied and why?

The Committee agrees that an investment company should be subject to the consolidation requirements for controlling financial interests in an investment property entity.

Question 14: The proposed amendments would prohibit an investment company from applying the equity method of accounting in Topic 323 to interests in other investment companies and investment property entities. Rather, such interests would be measured at fair value. Do you agree with this proposal? If not, why?

The Committee agrees that an investment company should be prohibited from applying the equity method of accounting in Topic 323 to interests in other investment companies and investment property entities but would measure such interests at fair value.

Presentation and Disclosure

Question 15: An investment company with a controlling financial interest in a less-than-wholly-owned investment company subsidiary or an investment property entity subsidiary would exclude in its financial highlights amounts attributable to the

noncontrolling interest. Do you agree that the amounts attributable to the noncontrolling interest should be excluded from the calculation of the financial highlights? If not, why?

The Committee agrees that the amounts attributable to the noncontrolling interest should be excluded from the calculation of the financial highlights.

Question 16: If an investment company consolidates an investment property entity, the proposed amendments require the investment company to disclose an additional expense ratio that excludes the effects of consolidating its investment property entity subsidiaries from the calculation. Do you agree? If not, why?

The Committee agrees that, if an investment company consolidates an investment property entity, the investment company should disclose an additional expense ratio that excludes the effects of consolidating its investment property entity subsidiaries from the calculation.

Question 17: Do you agree with the additional proposed disclosures for an investment company? If not, which disclosures do you disagree with, and why? Would you require any additional disclosures and why?

The Committee agrees with the additional proposed disclosures for an investment company and has identified no additional disclosures that should be required.

Retention of Specialized Accounting

Question 18: The proposed amendments would retain the current requirement in U.S. GAAP that a noninvestment company parent should retain the specialized accounting of an investment company subsidiary in consolidation. Do you agree that this requirement should be retained? If not, why?

The Committee agrees the current requirement in U.S. GAAP that a noninvestment company parent should retain the specialized accounting of an investment company subsidiary in consolidation should be retained.

Effective Date and Transition

Question 19: An entity that no longer meets the criteria to be an investment company would apply the proposed amendments as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption by calculating the carrying amounts of its investees as though it had always accounted for its investments in conformity with other applicable U.S. GAAP, unless it is not practicable. If not practicable, the entity would apply the proposed amendments as of the beginning of the period of adoption. Do you agree with this proposal? If not, why?

The Committee agrees with this proposal.

Question 20: How much time would be necessary to implement the proposed amendments?

The Committee thinks this question would best be answered by those directly involved in investment company accounting and reporting.

Question 21: The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why?

The Committee thinks early adoption should be prohibited.

Nonpublic Entities

Question 22: The proposed amendments would apply to both public and nonpublic entities. Should the proposed amendments apply to nonpublic entities? If not, how should the proposed amendments differ for nonpublic entities and why?

The Committee believes the proposed amendments should apply, but with a transition period at least two years longer than for other entities because of the steep learning curve and costs that these entities may incur.

We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

A handwritten signature in black ink that reads "Howard Sibel". The signature is written in a cursive, flowing style.

Howard Sibelman
Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants