Financial Accounting Standards Board

IFRS™

Investment Companies / Investment Property Entities
Joint Public Roundtable Meeting
March 16, 2012
Norwalk, CT, USA
9:00 a.m.–12:30 p.m. EDT

AGENDA

Time (EDT)	Topic
9:00 a.m.	Introductions (5 minutes)
9:05 a.m.	*Issue 1:* Assessment of the criteria to be an investment company (15 minutes)
9:20 a.m.	*Issue 2:* Criteria to be an investment company (35 minutes)
9:55 a.m.	*Issue 3:* Application of the criteria to mortgage real estate investment trusts (15 minutes)
10:10 a.m.	*Issue 4:* Investment company accounting for controlled investees and related disclosure (35 minutes)
10:45 a.m.	*Issue 5:* Accounting by a noninvestment company parent of an investment company subsidiary (15 minutes)
11:00 a.m.	Break (10 minutes)
11:10 a.m.	*Issue 6:* The investment property entity concept and fair value measurement of investment property (40 minutes)
11:50 a.m.	*Issue 7:* Criteria to be an investment property entity (20 minutes)
12:10 p.m.	*Issue 8:* Presentation of investment property related items (20 minutes)

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Participants

Pat Bailey	CRE Finance Council
Thomas Conway	GE Asset Management
Robert Fabio	AICPA
Brad Farrell	Two Harbors Investment Corp.
Craig Goodman	New York State Society of CPAs
Michael Hedden	Appraisal Institute
Robert Hitchings	Bank of New York Mellon Corporation
Mark Mahar	Ernst & Young
Paul Nungester	Health Care REIT
Judith O'Dell	Private Company Financial Reporting Committee
Melanie Pinto	SIFMA
Mohini Singh	CFA Institute
Kathleen Skero	Blackstone Group
Israel Snow	Goldman Sachs
Annette Spicker	PricewaterhouseCoopers
Jim Strezewski	REIS / NCREIF
Austin Wachter	TIAA-CREF
David Wolff	Taubman Centers, Inc.
George Yungmann	NAREIT

Participating Observers

Paul Beswick	U.S. Securities and Exchange Commission
Jaime Eichen	U.S. Securities and Exchange Commission

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FASB Participants

Leslie Seidman	Chairman
Daryl Buck	Board Member
Russ Golden	Board Member
Hal Schroeder	Board Member
Marc Siegel	Board Member
Larry Smith	Board Member
Susan Cosper	Technical Director
Kevin Stoklosa	Assistant Director
Upaasna Laungani	Project Manager
Chandy Smith	Senior Investor Liaison

IASB Participants

Patrick Finnegan	Board Member
Darrel Scott	Board Member
Alan Teixeira	Senior Director, Technical Activities
Michael Stewart	Director of Implementation Activities
Sarah Geisman	Assistant Technical Manager

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This public roundtable meeting will discuss the joint investment companies project and the FASB's investment property entities project.

The investment companies project[1] is a joint effort between the FASB and the IASB to converge the financial reporting by investment companies. The objective of this project is to provide consistent and comprehensive guidance for assessing whether an entity is an investment company. The project was added to the Boards' agendas to develop a converged definition of an investment company and to address the views of many investors that fair value is the most relevant measurement attribute for their investments in entities that are in the business of pooling funds and providing professional investment management services.

In October 2011, the FASB issued proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*, which proposes amendments to the existing guidance in U.S. generally accepted accounting principles (GAAP) for investment companies. The comment period for the FASB's Exposure Draft ended on February 15, 2012.

In August 2011, the IASB published the Exposure Draft, *Investment Entities*, with the objective of proposing an exception to the consolidation principle in IFRS 10, *Consolidated Financial Statements*, for a particular class of entities—investment companies. In addition to providing criteria for determining whether an entity is an investment company, the IASB Exposure Draft also provides accounting and disclosure guidance for those entities. The comment period for the IASB's Exposure Draft ended on January 5, 2012.

In October 2011, the FASB also issued proposed Accounting Standards Update, *Real Estate—Investment Property Entities (Topic 973)*, which proposes accounting guidance for a company focused on investing in real estate properties. That proposal is a result of the FASB's efforts to address the diversity in practice about the accounting by real estate entities and to align the scope of entities that would apply the proposed lessor accounting model under U.S. GAAP and International Financial Reporting Standards (IFRS). The comment period for the Exposure Draft ended on February 15, 2012.

During the comment periods, the Boards and staff engaged in outreach to obtain feedback on the proposals from constituents including investors, preparers, auditors, and regulators.

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[1] The investment companies project is called the investment entities project on the IASB agenda. For the purpose of these roundtable materials, the terms *investment entity* and *investment company* are used interchangeably.

Constituents have provided feedback through multiple channels including public comment letters, in-person meetings, and conference calls.

This public roundtable meeting is not only another way for the Boards and staff to receive feedback on the proposals, but it also provides an opportunity for constituents to interact with each other and discuss their views on the proposals.

The staff will provide a summary of feedback to the Boards, including feedback received from this public roundtable meeting, which will be used to guide the Boards in their redeliberations.

Today's discussion focuses on the most commented upon areas of the proposals, and it is organized as follows:

<u>Investment Companies</u>

- Issue 1. Assessment of the criteria to be an investment company
- Issue 2. Criteria to be an investment company
- Issue 3. Application of the criteria to mortgage real estate investment trusts
- Issue 4. Investment company accounting for controlled investees and related disclosure
- Issue 5. Accounting by a noninvestment company parent of an investment company subsidiary.

<u>Investment Property Entities</u>

- Issue 6. The investment property entity concept and fair value measurement of investment property
- Issue 7. Criteria to be an investment property entity
- Issue 8. Presentation of investment property related items.

Issue 1: Assessment of the Criteria to Be an Investment Company

The concept of an investment company is not new to U.S. GAAP; accounting and reporting guidance for investment companies has existed in U.S. GAAP for many years. Current U.S. GAAP prohibits an investment company from consolidating a controlling financial interest in a noninvestment company.

The IASB's Exposure Draft represents the first time that an exception from the consolidation principle in IFRS 10 (and its predecessor, IAS 27, *Consolidated and Separate Financial Statements*) has been proposed for investment companies. The IASB's Exposure Draft would require an investment company to measure its controlled investees at fair value rather than apply consolidation guidance.

The guidance in both Exposure Drafts would require an entity to meet six criteria to be an investment company. Many constituents have commented that the criteria in the Exposure Drafts are too strict and rules based. Some constituents have suggested that an entity should be permitted to perform a qualitative assessment to determine if it is an investment company.

Other constituents have suggested that a principle be developed to define an investment company accompanied by a set of indicators.

Question 1. How do you believe the criteria to be an investment company should be structured and why?

a. A set of criteria that must be met to be an investment company?
b. A set of criteria to be an investment company permitting a qualitative assessment, rather than a requirement to meet all criteria?
c. A general principle that defines an investment company that must be met and an accompanying set of indicators?

Issue 2: Criteria to Be an Investment Company

The six criteria to be an investment company are similar under both Exposure Drafts. For purposes of these roundtable materials, the criteria under the FASB's Exposure Draft are listed below.

Nature of the investment activities: The investment company's only substantive activities are investing in multiple investments for returns from capital appreciation, investment income (such as dividends or interest), or both.

Express business purpose: The express business purpose of the investment company is investing to provide returns from capital appreciation, investment income (such as dividends or interest), or both.

Unit ownership: Ownership in the investment company is represented by units of investments, in the form of equity or partnership interests, to which a portion of the net assets are attributed.

Pooling of funds: The funds of the investment company's investors are pooled to avail investors of professional investment management. The entity has investors that are not related to the parent (if there is a parent) and those investors, in aggregate, hold a significant ownership interest in the entity.

Fair value management: Substantially all of the investment company's investments are managed, and their performance evaluated, on a fair value basis.

Reporting entity: The investment company provides financial results about its investment activities to its investors. The entity can be but does not need to be a legal entity.

In addition, under the guidance in the FASB's Exposure Draft, an entity that is regulated under the Securities and Exchange Commission's (SEC) Investment Company Act of 1940 would be an investment company for accounting purposes.

Some constituents have commented that the criteria proposed would capture the appropriate population of investment companies. Other constituents have raised concerns about aspects of the proposed criteria, because they think that the criteria may inappropriately include or exclude certain entities from the scope of the guidance in the Exposure Drafts.

The questions below focus first on some of the most frequently expressed concerns about specific criteria and then request feedback on general considerations regarding the criteria.

Nature of the Investment Activities and Express Business Purpose

Common concerns raised by constituents regarding the *nature of the investment activities* and *express business purpose* criteria include the following:

1. Additional guidance for the *nature of the investment activities* criterion should be provided to clearly identify which business activities and services an investment company would be able to provide. For example, constituents questioned whether participating in the operations of a controlled investee would constitute a permissible activity for an investment company.
2. The requirement to hold multiple investments would inappropriately exclude certain entities from being investment companies.
3. Additional guidance regarding the *exit strategy* component of the *express business purpose* criterion should be provided, and the *exit strategy* component should be included in the main criteria rather than in implementation guidance.

<u>Question 2.</u> Do you believe that the *nature of investment activities* criterion clearly articulates permissible business activities and services? What other business activities or services should be permitted, if any?

<u>Question 3.</u> Do you believe that an investment company should be permitted to hold only a single investment? Why or why not?

<u>Question 4.</u> Do you believe that the *exit strategy* component is clearly articulated? Should it be given greater prominence? Why or why not?

Unit Ownership and Pooling of Funds

Common concerns raised by constituents regarding the *unit ownership* and *pooling of funds* criteria include the following:

1. The requirement that an investment company must have multiple investors not related to the fund manager is too strict and is focused on the legal structure of an entity rather than on the economics of the entity. That requirement would inappropriately exclude sovereign wealth funds, certain pension funds, certain insurance investment funds, and other wholly owned funds from being investment companies.
2. The criteria do not permit consideration of interests held by debt holders and would therefore exclude certain securitization vehicles such as collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) from being investment companies.

Question 5. Do you believe that an entity with a single investor not related to the fund manager should be an investment company?

a. If the requirement that an investment company must have multiple investors was removed, how would you address the Boards' concern that an entity could be inappropriately inserted into a larger corporate structure to achieve a particular accounting outcome?
b. Do you believe that an entity with a single investor and holding a single investment should be permitted to be an investment company?

Question 6. Do you believe that CDOs and CLOs are entities that pool investor funds to avail investors of professional investment management with investors that focus on assessing the fair-value-based performance of the structure as a whole (and therefore should be investment companies), or do you believe that CDOs and CLOs are pass-through entities with debt holders that are focused simply on earning interest income?

Other Concerns

Question 7. Do you have any other comments or suggestions to improve the criteria to capture the appropriate set of entities that should be investment companies? Do you believe that any specific criterion should be added or removed and why?

Question 8. Are you aware of any entities that are investment companies under existing regulatory requirements but would not be investment companies for accounting purposes solely based on the six proposed criteria? If so, how could the proposed criteria be amended to include those entities?

Issue 3: Application of the Criteria to Mortgage Real Estate Investment Trusts

Under current U.S. GAAP, real estate investment trusts (REITs) are specifically excluded from being investment companies. The FASB's Exposure Draft would eliminate the REIT exception in current U.S. GAAP. The IASB's Exposure Draft also does not provide that exception.

Under the FASB's proposal, REITs that meet the criteria to be investment companies would be required to follow investment company guidance. That would require REITs to measure their investments at fair value with all changes in fair value recognized in net income and to follow specific presentation and disclosure requirements (such as a schedule of investments and financial highlights).

Most constituents stated that equity REITs would not be investment companies under the proposed criteria. However, some constituents have raised concerns that mortgage REITs could be investment companies under the proposed criteria. Those constituents stated that the business model of a mortgage REIT is not consistent with the business model of an investment company. Some of those constituents also requested additional guidance to determine whether a mortgage REIT would meet the *fair value management* criterion.

Question 9. Do you believe that mortgage REITs should be specifically excluded from being investment companies? If yes, what are the distinguishing business or economic factors between mortgage REITs and mortgage securities funds?

Question 10. Do you believe mortgage REITs manage their business and/or investments on a fair value basis?

Question 11. Do you agree that a mortgage REIT that meets the criteria to be an investment company also should be required to measure its investments at fair value with all changes in fair value recognized in net income and follow specific presentation and disclosure requirements for investment companies? Why or why not?

Issue 4: Investment Company Accounting for Controlled Investees and Related Disclosure

The FASB's and the IASB's proposals to account for controlled investees of an investment company are broadly similar but do contain differences, especially for fund-of-fund structures. The proposals are presented in the following table:

Type of Subsidiary	FASB Proposed Accounting	IASB Proposed Accounting
Operating entity	Fair value*	Fair value*
Investment company	Consolidate (fund-of-funds only)	Fair value

* Consolidation required if the investment is in an operating entity that provides services to the investment company.

Some constituents stated that it is inappropriate to provide an industry-specific exception or an entity-specific exception from consolidation requirements. Those constituents commented that controlled investees should be consolidated, regardless of the nature of the parent entity or the subsidiary entity, because they think that consolidation of controlled investees results in more relevant information that is consistent with the Boards' conceptual frameworks. Those constituents also are concerned about possible structuring opportunities that could result from providing an exception from consolidation guidance to a particular group of entities.

Other constituents commented that fair value measurement provides the most useful information to investors, whether or not the investment company controls an investee. Most constituents agree with the proposals regarding an investment company's measurement of controlling financial interests in operating entities. However, feedback is mixed regarding an investment company's controlling financial interest in another investment company. Some constituents stated that consolidation provides the appropriate level of transparency to underlying assets, liabilities, income, and expenses of the investment company subsidiary, while other constituents stated that fair value is the most relevant measurement attribute for all investments, regardless of the nature of the subsidiary's business activities.

<u>Question 12</u>. Do you believe that an investment company should be required to measure controlling financial interests in an operating entity at fair value, unless the operating entity provides services to the investment company parent? Why or why not?

<u>Question 13.</u> Do you believe that an investment company should be required to measure controlling financial interests in another investment company at fair value? Why or why not? Does your answer change depending on the structure of the investment company (a fund-of-funds structure versus a master-feeder structure) or the business purpose for the controlled investment company (such as a blocker fund set up to invest in a particular type of asset)?

Question 14. If you believe that consolidation should not be required for an investment company, do you believe that specific disclosures about assets, liabilities, income, and expenses held by the investee should be required? If so, what should those disclosure requirements be? Should those disclosures be limited to controlled investees or should they be provided for significant investments held by the investment company?

Issue 5: Accounting by a Noninvestment Company Parent of an Investment Company Subsidiary

Currently, both U.S. GAAP and IFRSs require a noninvestment company parent to consolidate controlled investees. However, the IASB's Exposure Draft has proposed different guidance from the guidance in U.S. GAAP about whether the specialized accounting used by an investment company subsidiary would be retained by a noninvestment company parent in consolidation. Under both current and proposed U.S. GAAP, a noninvestment company parent retains the specialized accounting used by the investment company subsidiary in its consolidated financial statements. Therefore, the noninvestment company parent would retain fair value measurement of investment assets in its consolidated financial statements. The IASB's Exposure Draft would not permit a noninvestment company parent to retain the specialized fair value accounting used by an investment company subsidiary, and the noninvestment company parent would consolidate controlled investees held by the investment company subsidiary.

Some constituents stated that retaining the specialized fair value accounting used by the investment company subsidiary in the consolidated financial statements of a noninvestment company parent is not appropriate. Those constituents are concerned that a noninvestment company parent could avoid consolidation of a controlled investee by holding the controlled investee in an intermediary investment company subsidiary. Some of those constituents also stated that fair value measurement of controlled investees is relevant for investment company financial statements but may not always be relevant for the financial statements of a noninvestment company parent.

Other constituents stated that fair value measurement for the investment company subsidiary's controlled investees will result in more relevant information, even in the financial statements of a noninvestment company parent. Those constituents also stated that the proposed criteria to be an investment company are adequate to address the concerns about the noninvestment company parent avoiding consolidation of controlled investees because fair value accounting would be used by a subsidiary only when it is appropriate. Some of those constituents are concerned that any cost savings gained by providing an exception to consolidation guidance for investment company subsidiaries would be removed if the fair value accounting was not retained by the noninvestment company parent.

Question 15. Do you believe that a noninvestment company parent should retain the specialized fair value accounting used by an investment company subsidiary in its consolidated financial statements? Why or why not?

Question 16. If you believe that a noninvestment company parent should retain the specialized fair value accounting used by an investment company subsidiary, how would you propose to address the IASB's concerns about structuring opportunities for a noninvestment company parent? Please respond considering any changes suggested for the criteria to be an investment company.

Issue 6: The Investment Property Entity Concept and Fair Value Measurement of Investment Property

The FASB's investment property entities proposal would require all entities that meet the criteria to be investment property entities to measure their investment properties at fair value with all changes in fair value recognized in net income. In contrast, IAS 40, *Investment Property*, provides an entity with an option to measure all of its investment properties at either fair value or cost. Due to concerns that providing an option would reduce comparability, the FASB decided that entities that meet certain criteria should be required to measure their investment properties at fair value. That approach would result in comparable financial reporting for entities in which substantially all of their business activities are investing in investment properties. It also would not be burdensome for entities that may hold investment properties but whose business activities are not focused on investing in real estate properties. In addition, in the FASB's opinion, the entities that would be investment property entities under the proposal are generally the types of companies that currently elect the fair value model under IAS 40.

Under the FASB's investment property entities proposal, an entity would first determine whether it is an investment property entity. An entity that is not an investment property entity would then determine whether it is an investment company. Companies that do not meet either definition would follow other applicable U.S. GAAP.

Many constituents do not support the FASB's investment property entities proposal in its current form. Those constituents stated that a separate investment property entity concept should not be developed. Rather, many of those constituents stated that all entities should either be required to or provided an option to measure investment properties at fair value with all changes in fair value recognized in net income. Further, some of those constituents commented that an entity that focuses on investing in real estate properties should be assessed under the criteria to be an investment company. If the entity is an investment company, those constituents stated that the entity should measure its investments (including real estate properties) at fair value with all changes in fair value recognized in net income. Some constituents agree with the FASB and support a separate investment property entity concept in addition to the concept of an investment company.

Question 17. Should the investment property entity concept be retained? If not, when should an entity be required to measure its investment properties at fair value and why?

Question 18. If the investment property entity concept is not retained, do you believe equity REITs and real estate funds should be investment companies? If yes, do you believe they meet the criteria to be an investment company in the FASB's investment companies proposal? Please identify the proposed investment company criterion or criteria that the equity REITs and real estate funds would not meet and why.

Issue 7: Criteria to Be an Investment Property Entity

The criteria to be an investment property entity in the FASB's investment property entities proposal are listed below.

> *Nature of the business activities:* Substantially all of the entity's business activities are investing in a real estate property or properties.
>
> *Express business purpose:* The express business purpose of the entity is to invest in a real estate property or properties for total return including an objective to realize capital appreciation, for example, through disposal of its real estate property or properties. Real estate properties held by an entity for either of the following purposes do not meet this criterion:
> 1. The entity's own use in the production or supply of goods or services or for administrative purposes
> 2. Development for sale in the ordinary course of business upon completion.
>
> *Unit ownership:* Ownership in the entity is represented by units of investments, in the form of equity or partnership interests, to which a portion of the net assets are attributed.
>
> *Pooling of funds:* The funds of the entity's investors are pooled to avail the investors of professional investment management. The entity has investors that are not related to the parent (if there is a parent) and those investors, in aggregate, hold a significant ownership interest in the entity.
>
> *Reporting entity:* The entity provides financial results about its investing activities to its investors. The entity can be but does not need to be a legal entity.

In addition, a subsidiary entity whose parent entity (1) is required to account for its investments at fair value in accordance with U.S. GAAP or (2) is a not-for-profit entity under Topic 958, Not-for-Profit Entities, that measures its investments at fair value is not subject to the unit-ownership and pooling-of-funds criteria.

Some constituents have commented that the criteria proposed would capture the appropriate population of investment property entities. Other constituents have raised concerns about aspects of the proposed criteria, because they state that the criteria may inappropriately include or exclude certain entities from the scope of the guidance in the FASB's investment property entities proposal.

Question 19. If the FASB decides to retain the concept of an investment property entity, do you have any comments or suggestions regarding the criteria to capture the appropriate set of entities that should be investment property entities? Do you believe that any specific criterion should be added or removed?

Issue 8: Presentation of Investment Property Related Items

The FASB's investment property entities proposal would require investment property entities to separately present the following items in their financial statements:

1. Balance Sheet—The fair value of investment properties would be presented separately from the debt associated with those properties.
2. Income Statement—Rental revenue and rental operating expenses from investment properties would be presented as separate line items. All other fair value changes (realized and unrealized) would be presented as an aggregate amount, at a minimum.

The FASB's investment companies proposal also requires an investment company to separately present these items for real estate properties held by the investment company.

Constituents have mixed views on whether these items should be separately presented on the financial statements of both investment property entities and investment companies.

Question 20. Do you believe that an investment property entity and an investment company should separately present the debt associated with investment properties? Why or why not? If yes, do you believe that debt associated with investment properties also should be measured at fair value?

Question 21. Do you believe that an investment property entity and investment company should separately present rental revenue and rental operating expenses from investment properties? Why or why not?