Investment Companies — Background Information and Basis for Conclusions

AcG-18

Foreword

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard and, since that standard was fully converged with Part II of the Handbook, it remains relevant.

Background Information and Basis for Conclusions documents are primary sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100. These documents are intended to help readers understand how the Accounting Standards Board reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Handbook Section or Accounting Guideline.

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TABLE OF CONTENTS	Paragraph

INTRODUCTION

1 This document summarizes considerations that were deemed significant by the Accounting Standards Board (AcSB) members in reaching the conclusions in ACCOUNTING GUIDELINE AcG-18, Investment Companies. It sets out the reasons the AcSB undertook the project to develop the Guideline, the process of research and deliberation, the key decisions made and the principal reasons for accepting certain approaches and rejecting others. Individual AcSB members gave greater weight to some factors than to others.

2 Nothing in this document is to be taken as overriding the content of AcG-18; however, the discussion may assist Handbook users in understanding the accounting requirements in AcG-18 and the AcSB's intent with respect to the Guideline's interpretation and application.

BACKGROUND

3 Investment companies have accounted for their investments at fair value, even though these investments may meet the criteria for consolidation (see SUBSIDIARIES, Section 1590) or for equity method accounting (see LONG-TERM INVESTMENTS, Section 3050). The Board was informed that prior to its withdrawal, paragraph 1590.12 had often been relied upon to support this accounting. Paragraph 1590.12 stated: "An enterprise acquired with the clearly demonstrated intention that it be disposed of in the foreseeable future is a temporary investment."

4 DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475, was issued in December 2002 with an effective date of May 2003. At the same time, paragraph 1590.12 was withdrawn, with the result that enterprises acquired with the intention of being disposed of in the foreseeable future are now to be accounted for in accordance with Section 3475.

5 Investment companies have also relied to some extent on industry practice to support accounting for all investments at fair value. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, which is effective for fiscal years beginning on or after October 1, 2003, does not include industry practice as a primary source of GAAP. Industry practice is a relevant consideration only when it satisfies the requirements of paragraph 1100.04, namely, that it is consistent with the primary sources of GAAP and is developed through the exercise of professional judgment and the application of the concepts described in FINANCIAL STATEMENTS CONCEPTS, Section 1000. Industry practice cannot be used to justify an accounting practice that does not meet these two criteria.

6 One consequence of these changes was that GAAP would not support investment companies using fair value to account for investments that they controlled, exercised joint control over, or over which they were able to exercise significant influence.

7 Investors, potential investors and other users of financial statements of an investment company are primarily interested in the fair (market) value of an investment company and its investments. Transactions to buy and sell shares in an investment company are typically based on the fair value of the investment company's investments. AcSB members concluded that fair value generally provides more useful information for these investors and other users than do methods of accounting based on historical cost, including consolidation and the equity method. They also noted that securities regulators require investment companies to measure all investments at fair value for purposes of regulatory filings, and that US GAAP requires investment companies to account for all investments at fair value.

8 Setting the accounting requirements for investment companies requires defining what qualifies as an investment company. The AcSB concluded that it would not be appropriate for enterprises other than investment companies to rely on this Guideline to avoid accounting for their investments in accordance with SUBSIDIARIES, Section 1590, LONG-TERM INVESTMENTS, Section 3050, and INTERESTS IN JOINT VENTURES, Section 3055. A second issue was how the parent or an equity method investor in an investment company should account for their investment — specifically, whether they should use the same method of accounting as the investment company or the accounting required by Sections 1590, 3050 and 3055.

9 US GAAP requires investment companies to account for investments at fair value (see AICPA Audit and Accounting Guide "Audits of Investment Companies"). However, the definition of an investment company under US GAAP was unclear, and the issue of parent and equity method investor accounting for an investment in an investment company was not adequately addressed. In 2002, the AICPA issued a draft 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" that addressed these two topics. The AcSB reviewed the Statement of Position (SOP) and agreed to use it as the basis for the development of the Guideline. However, the AcSB decided that the Guideline should focus on the key principles to be followed and that it should not include all the detail that is in the SOP. The AcSB's intention is that the definition of an investment company is harmonized with the SOP, 1 as are the requirements for when a parent company or an equity method investor in an investment company should account for the investments of the investment company in the same way as the investment company does. (As noted below, there are differences in accounting for some interests in variable interest entities and in some of the disclosure requirements.) The SOP includes a detailed analysis of the AICPA's deliberations and conclusions, which might also be of value to Handbook users.

ACCOUNTING BY AN INVESTMENT COMPANY FOR ITS INVESTMENTS

10 The AcSB determined that investment companies should account for their investments at fair value. This includes investments that meet the definition of a subsidiary and those over which the investment company has the ability to exercise significant influence. It also includes interests in variable interest entities (VIEs). The AcSB noted that, under US GAAP, only regulated investment companies account for interests in VIEs at fair value. Interests in VIEs held by other investment companies are not excluded from the scope of FIN 46, "Consolidation of Variable Interest Entities," and must be consolidated. (The SEC has regulatory jurisdiction over regulated investment companies and requires these companies to account for all investments at fair value. FIN 46 consequently scopes out regulated investment companies, but not other investment companies.) The AcSB could not find any conceptual reason for different types of investment companies to account for interests in VIEs differently. Respondents to the draft Guideline agreed that all investment companies should account for their investments, including interests in VIEs, at fair value.

DETERMINATION OF WHETHER AN ENTERPRISE IS AN INVESTMENT COMPANY

11 Canadian securities regulatory authorities expect to issue National Instrument 81-106, "Investment Fund Continuous Disclosure," in final form in 2004. While the AcSB does not automatically converge with requirements of regulatory authorities (as these may be based on objectives that are not consistent with FINANCIAL STATEMENTS CONCEPTS, Section 1000), it does seek to minimize instances when GAAP and regulatory or legislative requirements conflict. The AcSB agreed that any enterprise that meets the definition of an investment fund in NI 81-106 should be considered an investment company for purposes of this Guideline. Respondents to the draft Guideline supported this.

12 However, the AcSB agreed that enterprises that were not regulated under NI 81-106 (for instance, because they are private companies) might also qualify as an investment company.

13 The AcSB reasoned that for such an enterprise to be an investment company, its primary business activity must be investing — buying, holding and selling investments for current income, capital appreciation or both. Many enterprises

purchase interests in other enterprises with the intent of being involved in the operating decisions of those enterprises. This active involvement in the business of the investee is inconsistent with the activities of an investment company. Enterprises that have such an involvement with their investees should account for them in accordance with Sections 1590, 3050 and 3055. As noted in CONSOLIDATED FINANCIAL STATEMENTS, Section 1600, "Consolidated financial statements recognize that the separate legal entities are components of one economic unit."

14 The AcSB recognized that an enterprise that owns a substantial portion of an investee may need to have some involvement in the activities of that investee in order to protect the value of its investment, and that such involvement can be consistent with acting as an investor. Representation on the investee's board of directors is not, in itself, inconsistent with the relationship between an investor and an investee. However, ongoing participation by the investor in the management of the investee indicates that the investor is actively involved in the operations of the investee, which is inconsistent with an investment company. In some cases the investee may have urgent need for certain limited support (for example, if a key employee leaves the investee). The investor may provide temporary support while the investee puts a permanent solution in place. Although such assistance by the investor may involve the operations of the investee, it does not preclude the enterprise from being an investment company, provided the assistance is of limited scope and for a period of time limited to that necessary for the investee to resolve the specific problem (for example, the loan of an employee to fill the position while an active search for a permanent replacement takes place).

15 Respondents to the draft Guideline generally agreed with the criteria. Some respondents were unclear about the application of the requirement for an exit strategy for each investment. An exit strategy includes one or more methods that would be used to exit the investment as well as criteria for when this would occur. These criteria may be based on different factors, including time, certain events happening or certain targets being met. For example, one possible exit strategy for an investment in a debt security would be to hold it to maturity. The discussion on exit strategies in the Guideline was expanded to respond to these respondents' concerns.

16 The AcSB discussed whether an enterprise with one or more interests in a joint venture could meet the criteria to be an investment company under paragraph 8(b) of the Guideline. A joint venture is an economic activity resulting from a contractual arrangement whereby two or more venturers jointly control the economic activity. Joint control of an economic activity is the contractually agreed sharing of the continuing power to determine its strategic operating, investing and financing policies. The involvement in operating, investing and financing decisions of the investee is inconsistent with an investment company. An enterprise with an interest in a joint venture will therefore not normally meet the criteria, unless the joint venture is itself an investment company. Real estate investment trusts and income trusts are normally directly involved in the operations of some or all of their investees and will also not normally meet the criteria.

17 Some respondents to the draft Guideline were unclear as to whether an enterprise had to meet the requirements of paragraph 8 each year to use investment company accounting for that year or whether, once the enterprise qualified as an investment company, it could continue to account for its investments at fair value whether it continued to meet the criteria or not. The AcSB confirmed that the determination is an annual one and modified paragraph 8 to clarify this.

ACCOUNTING BY PARENT COMPANIES AND EQUITY METHOD INVESTORS FOR INVESTMENTS IN INVESTMENT COMPANIES

18 When an enterprise qualifies as an investment company, it accounts for its investments at fair value. The investment company may have a parent company or equity method investor. The AcSB considered whether the parent company should use the fair value of the investment company's investments (consistent with the accounting by the investment company) or whether it should consolidate the investment companys investees without using the investment company's accounting basis. The AcSB also considered similar issues related to the accounting by an equity method investor in an investment company.

19 Paragraph 10 of the Guideline sets out conditions that, when met, require the parent company or equity method investor to account for the investment company's investments at fair value. If these conditions are not met, the parent company or equity method investor should account for them as if the investment company had not qualified as an investment company. Respondents to the draft Guideline agreed with these conditions.

20 It is possible that a parent company or equity method investor in an investment company might itself be involved in the operations of an investee of the investment company, even though the investment company was not. Retention of investment company accounting by the parent company or equity method investor is only appropriate if the parent company or equity method investor views its relationship with the investment company's investees as an investment relationship, consistent with the relationship between the investment company and the investee.

21 The AcSB considered it important that the consolidated group does not selectively make investments within an investment company subsidiary that are similar to investments held by non-investment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation or at cost if the investment were made by a non-investment company member of the consolidated group. The Guideline therefore requires that the group follows established policies that prevent this from occurring.

CHANGE IN STATUS

22 An enterprise that meets the criteria for an investment company in paragraphs 8 and 9 of the Guideline in one year may not meet them in a subsequent year and in that subsequent year the enterprise will not be able to account for its

investments under AcG-18. Similarly, an enterprise that does not qualify as an investment company one year may meet the criteria in a subsequent year and would then apply AcG-18. The AcSB discussed whether this should be considered a change in accounting policy, which would require restatement of prior periods. The AcSB determined that this would be inappropriate, since this would result in using investment company accounting in a prior period when the enterprise was not an investment company, or vice versa. The change is a change in facts and circumstances and should be accounted for as such. Prior periods would not be restated.

DISCLOSURE

23 The AcSB decided that an investment company should disclose the fact that its investments are measured at fair value. Investments are the major asset class for investment companies and the basis of accounting for them is critical information to users of the financial statements.

24 AcG-18 addresses the accounting by investment companies for their investments, including interests in variable interest entities (VIEs). Investment companies have therefore been excluded from the scope of ACCOUNTING GUIDELINE AcG-15, Consolidation of Variable Interest Entities. The AcSB noted that, under US GAAP, regulated investment companies are excluded from the scope of FIN 46 and do not have to make the disclosures that FIN 46 requires. However, they did not see any reason why the disclosures required by AcG-15 for interests in VIEs that are not consolidated should not be required of all investment companies with interests in VIEs. These disclosures from AcG-15 have therefore been included in the disclosure requirements of AcG-18.

25 The measurement of the investments of an investment company subsidiary at fair value may have a significant impact on the financial statements of the investment company's parent. Disclosure of the carrying amount of the investment company and the realized and unrealized gains and losses provide transparency about this impact.

TRANSITIONAL PROVISIONS

26 Some companies may have to change their accounting to comply with the Guideline. In order to provide sufficient time for them to make this change, the AcSB decided that the Guideline should be effective for fiscal years beginning on or after July 1, 2004.

27 However, many investment companies have already been accounting for their investments at fair value. To permit enterprises that meet the definition of an investment company in AcG-18 to continue to measure their investments at fair value, the AcSB agreed to permit early adoption of the Guideline. For example, this would permit investment companies with a December 31 year end to apply AcG-18 to its 2003 financial statements.

Footnotes

1. "Harmonized" means that an enterprise following the more detailed guidance in the SOP will comply with Canadian GAAP on these two issues. Since AcG-18 focuses on the key principles, it is possible that an enterprise following AcG-18 might not comply with the SOP.
