

## Section 10,930

# **Statement of Position 07-1 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**

June 11, 2007

### NOTES

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

### FASB Defers Effective Date of SOP 07-1

On February 14, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 07-1-1, *Effective Date of AICPA Statement of Position 07-1*. The FSP delays indefinitely the effective date of this Statement of Position (SOP). Entities that early adopted SOP 07-1 before December 15, 2007, are permitted but not required to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the following exception: If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity's adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements. For the full text of the FSP, visit the FASB's Web site at [www.fasb.org/pdf/fsp\\_sop07-1-1.pdf](http://www.fasb.org/pdf/fsp_sop07-1-1.pdf).

## Summary

This Statement of Position (SOP) provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide). For those entities that are investment companies under this SOP, this SOP also addresses whether the specialized industry accounting principles of the Guide (referred to as *investment company accounting*) should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (referred to as an *equity method investor*). In addition, this SOP includes certain disclosure requirements for parent companies and equity

method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor.

For purposes of the separate financial statements of an entity, the Guide is applicable to (1) entities regulated by the Investment Company Act of 1940 or similar requirements (as defined in paragraph .09 of this SOP) and (2) separate legal entities whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. This SOP includes guidance on the application of that definition and other factors to consider in determining whether the entity is investing for (1) current income, capital appreciation, or both or (2) strategic operating purposes.

Entities that are investment companies are required to apply the provisions of the Guide in presenting their financial statements. Entities that are not investment companies should not apply the provisions of the Guide.

This SOP also provides guidance for determining whether investment company accounting applied by a subsidiary or equity method investee should be retained in the financial statements of the parent company or an equity method investor. That guidance should be used to evaluate relationships between (1) the parent company or equity method investor and (2) investees to determine, among other matters, whether the parent company or equity method investor (through the investment company) is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. If the application of that guidance leads to the conclusion that investment company accounting should not be retained in the financial statements of the parent company or equity method investor, the financial information of the investment company should be adjusted as if investment company accounting had not been applied by the subsidiary or equity method investee for purposes of the consolidated financial statements of the parent company or the application of the equity method of accounting by an equity method investor.

The provisions of this SOP are effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. Entities that previously applied the provisions of the Guide but that, pursuant to paragraphs .05-.29 of this SOP, do not meet the provisions of this SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of paragraphs .30-.45 of this SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting this SOP prospectively by accounting for their investments in conformity with applicable generally accepted accounting principles (GAAP) other than investment company accounting, beginning as of the date of the adoption using fair value in conformity with investment company accounting at the date of adoption as the carrying amount of investments at the date of adoption. Entities that are investment companies within the scope of the Guide (or meet the provisions of paragraphs .30-.45 to retain investment company accounting in the financial statements of a parent company or equity method investor), but that previously had not followed the provisions of the Guide (or previously did not retain investment company accounting in the financial statements of a parent company or equity method investor), should report the cumulative effect of adopting this SOP as an adjustment to opening retained earnings as of the beginning of the year that this SOP is adopted.

## **Foreword**

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed



exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project,<sup>1</sup> issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

## Introduction and Background

.01 The purpose of this Statement of Position (SOP) is to clarify the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide) to assist preparers and auditors in determining whether the provisions of the Guide should be applied. This SOP clarifies the scope of the Guide by amending the Guide to provide specific guidance for determining whether an entity is within its scope. In addition, this SOP provides guidance for determining whether the specialized industry accounting principles of the Guide (referred to as *investment company accounting*) should be retained in the financial statements of a parent company of an investment company or an equity method investor in an investment company, and includes certain disclosure requirements.

## Conclusions

.02 Paragraphs 1.01 to 1.06 in Chapter 1 of the Guide, including related footnotes, are deleted and replaced with the following paragraphs .03–.29 and paragraph .48 of this SOP. Other paragraph numbers in Chapter 1 of the Guide, starting with paragraph 1.07, are renumbered accordingly.<sup>2</sup> Paragraphs .30 to .47 and paragraph .49 of this SOP, including related footnotes,

---

<sup>1</sup> At the time AcSEC undertook this project, at least five of the seven FASB members were required to not object to AcSEC undertaking the project.

<sup>2</sup> For practical purposes, paragraphs .03–.53 of this SOP include the conclusions in this SOP that are amendments to the Guide, rather than including those amendments to the Guide in a separate section of the SOP. In addition, certain wording in this SOP may undergo minor editorial revision to conform it to inclusion in the Guide. For example, in certain circumstances the sections of this SOP that are amendments to the Guide refer to the Guide as “this Guide,” to reflect wording that will be included in the amended Guide. In other circumstances, however, such as circumstances in which paragraph numbers within this SOP are cited, the sections of this SOP that are amendments to the Guide refer to “paragraph XX of this SOP,” rather than “paragraph XX of this Guide,” in order to help readers of this SOP more easily refer to those paragraphs as they are numbered within this SOP. When including the provisions of this SOP in the Guide, references to paragraphs as they are numbered within this SOP will be changed to refer to the paragraph numbers as they will be numbered within the Guide, and those references will refer to the Guide, rather than to the SOP.

will be inserted as a separate chapter of the Guide. The disclosure requirements included in paragraphs .50, .51, and .53 of this SOP will be included in that new chapter. The disclosure requirements included in paragraph .52 of this SOP will be inserted before paragraph 7.79 in Chapter 7 of the Guide. The illustrations in Appendix B [paragraph .60], “Illustrations,” of this SOP will be included as an appendix of the Guide. Appendix C [paragraph .61], “Applying the Provisions of This SOP to Entities That Hold Investments in Real Estate,” of this SOP will be included as an appendix of the Guide. Appendix E [paragraph .63], “Schedule of Paragraph Numbers in This SOP and How They Will Be Reflected in the Revised Guide,” of this SOP provides a schedule of paragraph numbers in this SOP and how they will be reflected in the Guide, as amended by this SOP.

## Background

**.03** (*Replaces paragraph 1.01 of the Guide*) The business activity of an **investment company**,<sup>3</sup> as defined in paragraph .05 of this SOP, is investing for current income, capital appreciation, or both. Those investments typically consist of securities of other entities, but may also include commodities, securities based on indices, derivatives, real estate, and other forms of investments. An investment company sells its capital shares to an investor(s), invests the proceeds to achieve its investment objectives, and distributes to its investor(s), in the form of cash or distributions of ownership interests in investees, income earned on investments, and proceeds realized on the disposition of investments, net of expenses of the investment company. Investment companies, other than certain separate accounts of insurance companies, which are discussed in paragraph .09 of this SOP, are organized as separate legal entities, such as corporations (in the case of mutual funds, under the laws of certain states that authorize the issuance of common shares redeemable on demand of individual shareholders), common law trusts (sometimes referred to as *business trusts*), limited partnerships, limited liability investment partnerships and companies, and other specialized entities.

**.04** (*Replaces paragraph 1.02 of the Guide*) The investment company industry is highly specialized and certain entities may be subject to specific governmental regulation and special tax treatment. Accordingly, before starting an engagement to audit an investment company’s financial statements, an auditor should become familiar with the entity’s business, organization, and operating characteristics; the industry’s terminology; and pertinent legislation, as well as any applicable securities and income tax rules and regulations.

## Scope

### Overview

**.05** (*Replaces paragraph 1.03 of the Guide*) An investment company is a separate legal entity<sup>4</sup> whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. Accordingly, investment companies do not acquire or hold investments for strategic operating purposes and do not obtain benefits (other than current income, capital appreciation,

---

<sup>3</sup> Terms defined in the “glossary” of the Guide are set in **boldface** type the first time they appear in this SOP.

<sup>4</sup> Separate accounts of insurance companies as defined in the “glossary” of the Guide, which are discussed in paragraph .09 of this SOP, are not separate legal entities but nevertheless are investment companies under the scope of the Guide.

or both) from investees that are unavailable to noninvestor entities that are not related parties to the investee.<sup>5</sup>

**.06** (*Replaces paragraph 1.04 of the Guide*) The initial determination of whether an entity is an investment company within the scope of the Guide should be made upon formation of the entity and that determination should be reconsidered each reporting period.<sup>6</sup>

**.07** (*Replaces paragraph 1.05 of the Guide*) Entities that meet the definition of an *investment company* in paragraph .05 of this SOP and entities regulated by the Investment Company Act of 1940 (the 1940 Act) or similar requirements as described in paragraphs .09 and .10 of this SOP should apply the accounting principles and reporting requirements in the Guide (investment company accounting) to their separate financial statements.<sup>7</sup> Entities that are neither entities regulated by the 1940 Act or similar requirements as described in paragraphs .09 and .10 nor an *investment company* under the definition in paragraph .05 should not apply investment company accounting.

**.08** (*Replaces paragraph 1.06 of the Guide*) Entities other than entities regulated by the 1940 Act or similar requirements as described in paragraphs .09 and .10 of this SOP should apply the guidance in paragraphs .11–.29 of this SOP to determine whether the entity meets the definition of an *investment company* in paragraph .05 of this SOP. In addition, paragraphs .11–.18 of this SOP elaborate on certain requirements and terms used in the definition in paragraph .05. Paragraphs .19–.29 of this SOP discuss factors that provide evidence about whether an entity meets the definition of an *investment company*. Appendix B [paragraph .60] of this SOP includes illustrations of the application of that guidance to specific fact patterns. In considering the factors discussed in paragraphs .19–.29 and their effect on the conclusion about whether an entity is an investment company, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether an entity is an investment company. No single factor discussed in paragraphs .19–.29, however, is necessarily determinative of whether the entity is an investment company.

### **Entities Regulated by the 1940 Act or Similar Requirements**

**.09** (*Added as paragraph 1.07 of the Guide*) Entities, including entities in foreign jurisdictions, that are regulated or registered in such a manner that

<sup>5</sup> FASB Statement No. 57, *Related Party Disclosures*, defines *related parties* as follows:

Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

<sup>6</sup> Paragraph .48 of this SOP provides guidance pertaining to circumstances in which the conclusion about whether an entity is within the scope of the Guide changes in a subsequent period.

<sup>7</sup> Entities are not within the scope of the Guide if pronouncements in categories (a) or (b) of Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended, provide measurement guidance for their investments. For example, entities that are within the scope of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, are not within the scope of the Guide. Similarly, entities that are within the scope of the AICPA Audit and Accounting Guide, *Employee Benefit Plans*, are not within the scope of the Guide.

they are subject to the requirements of the 1940 Act, the Small Business Investment Company Act of 1958, or similar requirements are within the scope of the Guide (referred to herein as *entities regulated by the 1940 Act or similar requirements*). Examples of entities regulated by the 1940 Act or similar requirements include management investment companies and unit investment trusts (UITs) registered under the 1940 Act (which may be open-end mutual funds or closed-end funds), small business investment companies (SBICs), business development companies (BDCs), and certain offshore funds. Also, for purposes of applying the guidance in this Guide, the separate accounts of insurance companies as defined in the glossary of the Guide and common (collective) trust funds are considered entities regulated by the 1940 Act or similar requirements.<sup>8</sup>

**.10** (*Added as paragraph 1.08 of the Guide*) To be an entity regulated by the 1940 Act or similar requirements, the entity should be subject to regulations or similar rules that require the entity to report its investments at fair value for regulatory or similar reporting purposes. In addition, regulations or similar rules regarding the following should be considered in determining whether the entity is subject to certain reporting and other requirements sufficiently similar to the regulations of the 1940 Act or the Small Business Investment Company Act of 1958:

- a. Registration requirements
- b. Reporting and disclosures to investor(s)
- c. Fiduciary duties of the investment manager and related entities
- d. Diversification of investments
- e. Recordkeeping and internal controls
- f. Purchases and redemptions of shares at fair value

### **Express Business Purpose**

**.11** (*Added as paragraph 1.09 of the Guide*) The definition of an *investment company* in paragraph .05 of this SOP requires that the business purpose of an investment company is investing for current income, capital appreciation, or both. In determining whether that requirement is met, the express business purpose of the entity should be considered. Evidence about the entity's express business purpose may include the manner in which the entity presents itself to other parties (including potential investor(s), if any, and potential investees). For example, an entity that presents itself as a *private equity investor* with the objective of investing for capital appreciation has an express business purpose that is consistent with the business purpose of an investment company. Alternatively, an entity that presents itself as an investor whose objective is to invest for strategic operating purposes has an express business purpose that is inconsistent with the business purpose of an investment company.

---

<sup>8</sup> This Guide addresses explicitly the financial statements of separate accounts of insurance companies as defined in the glossary of the Guide. This Guide does not address an insurance enterprise's accounting for its proportionate interest in a separate account. Paragraph .13 of SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, provides that an insurance enterprise's proportionate interest in the assets of a separate account does not qualify for separate account treatment, as it does not represent contract holder funds. Consequently, the assets underlying the insurance enterprise's proportionate interest should be classified and measured as general account assets in conformity with paragraphs 45–51 of FASB Statement No. 60, *Accounting and Reporting by Insurance Companies*, as amended.

Other evidence about the entity's express business purpose may include a prior history of purchasing and selling investments, the entity's offering memorandum, publications distributed by the entity, and other corporate or partnership documents that indicate the investment objectives of the entity. Entities that have express business purposes other than investing for current income, capital appreciation, or both do not meet the definition of an *investment company* in paragraph .05.

### ***The Entity's Activities, Assets, and Liabilities are Limited to Investment Activities, Assets, and Liabilities***

**.12** (*Added as paragraph 1.10 of the Guide*) The definition of an *investment company* in paragraph .05 of this SOP requires that the business purpose and activity of an investment company is investing for current income, capital appreciation, or both. To meet that requirement, the entity should have no substantive activities other than its investment activities and have no significant assets or liabilities other than those related to its investment activities, subject to the exceptions in paragraph .13 of this SOP. Entities that have substantive activities other than investment activities or have significant assets or liabilities unrelated to investment activities do not meet the definition of an *investment company* in paragraph .05, subject to the exceptions in paragraph .13.

**.13** (*Added as paragraph 1.11 of the Guide*) Undertaking the following activities and having the following assets or liabilities does not lead to the conclusion that the business purpose and activity of the entity is other than investing for current income, capital appreciation, or both:

- Operating activities related to services provided to investment companies, as discussed in paragraph 7.05 of the Guide.
- Investment companies sometimes make investments in securities that are collateralized by noninvestment assets. If the investment company takes control of the collateral as a result of defaults related to the investments, holding such assets (and related liabilities) on a temporary basis does not affect the status of the entity as an investment company, provided that the entity did not acquire those investments with the intention of taking control of the collateral.

### ***Multiple Substantive Investments***

**.14** (*Added as paragraph 1.12 of the Guide*) The definition of an *investment company* in paragraph .05 of this SOP requires that the investment company invest in multiple substantive investments. That requirement contemplates that the entity should hold multiple substantive investments directly or through another investment company. For equity investments in other entities, those investees should be organized as separate legal entities, except for temporary investments resulting from the foreclosure or liquidation of the original investment, as discussed in the second bullet of paragraph .13 of this SOP. Paragraphs .15 and .16 of this SOP discuss other applications of that guidance.

**.15** (*Added as paragraph 1.13 of the Guide*) The provisions of the definition of an *investment company* pertaining to multiple substantive investments do not require that an investment company hold multiple substantive investments at all times throughout its existence. For example, entities that have not yet completed their initial offering period, or have not yet identified suitable investments, may have not yet executed their investment plan to acquire

multiple substantive investments. Also, entities sometimes have less than multiple substantive investments during their liquidation stage. The definition of an *investment company* is not intended to exclude entities merely because those entities at times do not hold multiple substantive investments. However, the business purpose of the entity should include plans to hold multiple substantive investments simultaneously to meet the definition of an *investment company*.

**.16** (*Added as paragraph 1.14 of the Guide*) Investment companies sometimes have less than multiple substantive investments in circumstances in which they are formed (for legal, regulatory, tax, or other reasons) in conjunction with another investment company that holds multiple substantive investments (directly or indirectly) or by investors in that other investment company in order to hold certain investments. For example, investment companies sometimes establish subsidiary investment companies to hold certain individual investments for legal reasons. Also, certain investors in an investment company sometimes, for regulatory or other reasons, form a separate legal entity to hold certain investments that cannot be owned directly by the investment company or indirectly by certain investors in the investment company for regulatory or other reasons. The provisions of the definition of an *investment company* pertaining to multiple substantive investments do not preclude treatment of such related entities as investment companies if such entities otherwise meet the definition of an *investment company*.

### **Exit Strategies**

**.17** (*Added as paragraph 1.15 of the Guide*) The definition of an *investment company* in paragraph .05 of this SOP requires that the investment company have investment plans that include exit strategies. That requirement contemplates that, for each investment, both of the following exist:

- a. The entity has identified potential exit strategies even though it may not yet have determined the specific method of exiting the investment; for example, whether the investment may be exited through the sale of securities in a public market, an initial public offering of equity securities, a private placement of equity securities, distributions to investors of ownership interests in investees (typically in the form of marketable equity securities), sales of assets (including the sale of an investee's assets followed by a liquidation of the investee), or holding a debt security to maturity.
- b. The entity has defined the time at which it expects to exit the investment, which may be either an expected date or range of dates; a time defined by specific facts and circumstances, such as achieving certain milestones; the limited life of the entity; or the investment objectives of the entity.

### **Not for Strategic Operating Purposes**

**.18** (*Added as paragraph 1.16 of the Guide*) The definition of an *investment company* in paragraph .05 of this SOP prohibits investment companies from holding investments for strategic operating purposes. Investments are held for strategic operating purposes if the entity or its affiliates<sup>9</sup> obtain or have the objective of obtaining benefits (other than benefits attributable to the

---

<sup>9</sup> FASB Statement No. 57 defines an *affiliate* as "a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise."

ownership interest, such as dividends) as a result of investments in any investee, through relationships with the investee or its affiliates, that are unavailable to noninvestor entities that are not related parties to the investee. Examples of relationships and activities that violate this requirement include, but are not limited to, the following:

- a. The acquisition, use, exchange, or exploitation of the processes, intangible assets, or technology of the investee or its affiliates by the entity or its affiliates.
- b. Significant purchases or sales of assets (other than products or services as discussed in item e below) between the investee or its affiliates and the entity or its affiliates.
- c. Joint ventures or similar arrangements between the investee or its affiliates and the entity or its affiliates.
- d. Other arrangements between the investee or its affiliates and the entity or its affiliates to jointly develop, produce, market, or provide products or services.
- e. Other transactions between the investee or its affiliates and the entity or its affiliates that (1) are on terms that are unavailable to entities that are not related parties to the investee, (2) are not at a price the transaction would occur in an orderly transaction between market participants at the measurement date (and that price is objectively verifiable), or (3) represent a significant portion of the investee's or the entity's business activity, including business activities of investees or affiliates of the entity. (Transactions that (1) do not represent a significant portion of the investee's business activities and that are between the investee or its affiliates and the entity or its affiliates and (2) involve products or services of the investee or its affiliates that are available to entities or customers that are not related parties to the investee on similar terms do not violate this condition if the transactions occur at a price the transaction would occur in an orderly transaction between market participants at the measurement date and that price is objectively verifiable by similar transactions between (a) the investee or its affiliates and entities that are not related parties to the investee or (b) the investor or its affiliates and entities that are not investees or affiliates of the investor or investees.)
- f. The entity or its affiliates have disproportionate rights, exclusive rights, or rights of first refusal to purchase or otherwise acquire assets, technology, products, or services of investees or their affiliates, subject to the exception in the second bullet of paragraph .13 of this SOP. (Rights of first refusal to purchase or otherwise acquire direct ownership interests would not violate this provision.)

Entities that hold investments for strategic operating purposes as demonstrated by relationships with investees or their affiliates, such as those described above, do not meet the definition of an *investment company*.

### **Factors to Consider**

**.19** (*Added as paragraph 1.17 of the Guide*) All relevant facts and circumstances should be considered in applying the definition of an *investment company* in paragraph .05 of this SOP. In particular, the factors in paragraphs .20–.29 of this SOP should be considered in applying that definition. In

considering the factors discussed in paragraphs .20–.29 and their effect on the conclusion about whether an entity is an investment company, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether an entity is an investment company. The factors in paragraph .20 of this SOP, pertaining to the number of substantive investors in the entity (pooling of funds), and paragraph .21 of this SOP, pertaining to the level of ownership interests held in investees, typically are more significant and therefore typically provide more persuasive evidence than other factors. Accordingly, as the (a) extent of pooling of funds increases, or (b) level of ownership interests held in investees decreases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically decreases. Conversely, as the (a) extent of pooling of funds decreases or (b) level of ownership interests held in investees increases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically increases. No single factor discussed in paragraphs .20–.29, however, is necessarily determinative of whether the entity is an investment company.

**.20** (*Added as paragraph 1.18 of the Guide*) *Number of substantive investors in the entity (pooling of funds).* Pooling of funds from numerous investors to avail owners of professional investment management provides significant evidence about the business purpose of the entity. The more extensive the pooling of funds (more investors and smaller ownership interests by the investors) to avail owners of professional investment management, the greater the evidence that the entity is investing for current income, capital appreciation, or both.<sup>10</sup> (Investments of investors that are related parties as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, should be combined and treated as a single investor for purposes of considering this factor.)

**.21** (*Added as paragraph 1.19 of the Guide*) *Level of ownership interests in investees.* The level of ownership interests held in investees provides significant evidence about the business purpose of the entity. Significant levels of ownership interests in investees, particularly in circumstances in which the entity has controlling financial interests in investees, provide significant evidence that the entity is investing for strategic operating purposes. Conversely, relatively minor levels of ownership interests in investees may provide significant evidence that the entity is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. In considering this factor, entities should consider the level of ownership interests in investees and the significance of those investees in relation to the total investment portfolio.<sup>11</sup>

**.22** (*Added as paragraph 1.20 of the Guide*) *Substantial ownership by passive investors.* Substantial ownership by passive investors, as opposed to

---

<sup>10</sup> An investment company that is formed (for legal, regulatory, tax, or other reasons) in conjunction with another investment company that holds multiple substantive investments (directly or indirectly), as discussed in paragraph .14 of this SOP, may be wholly owned without providing evidence that it is investing for strategic operating purposes. For example, the primary investment company's documents may provide that the general partner is required to invest in all the same investments as the primary investment company, but must do so through a separate wholly-owned entity. In circumstances in which the wholly-owned entity is formed in conjunction with another investment company, the fact that the entity is wholly owned would not necessarily provide evidence that it is investing for strategic operating purposes.

<sup>11</sup> In considering the level of ownership interests in investees and the significance of those investees in relation to the total investment portfolio, entities should consider the remaining amount of committed capital to be invested and the investment plans for those future capital contributions.

substantial ownership by principal investors who determine the strategic direction or run the day-to-day operations of the entity, in an entity with the express business purpose of investing for current income, capital appreciation, or both provides evidence that supports that express business purpose. The more substantial the ownership by passive investors, the greater the evidence supporting the express business purpose.

**.23** (Added as paragraph 1.21 of the Guide) *Substantial ownership by employee benefit plans.* Substantial ownership by employee benefit plans provides evidence that the entity is investing for current income, capital appreciation, or both. The more substantial the ownership by employee benefit plans, the greater the evidence that the entity is investing for current income, capital appreciation, or both.

**.24** (Added as paragraph 1.22 of the Guide) *Involvement in the day-to-day management of investees, their affiliates, or other investment assets.* Involvement in the day-to-day management of investees, their affiliates, or other investment assets by the entity or its affiliates provides evidence that the entity is investing for strategic operating purposes. The more extensive the involvement in the day-to-day management of investees, their affiliates, or other investment assets, the greater the evidence that the entity is investing for strategic operating purposes. For investment companies, such involvement sometimes is initiated in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. In such circumstances, the period of involvement typically is limited to the period of time necessary to address the concern, rather than being open-ended or permanent. As the reasons for and extent of involvement in the day-to-day management of investees, their affiliates, or other investment assets go beyond that described in the previous two sentences, the evidence that the entity is investing for strategic operating purposes becomes greater. Participation on the boards of directors of investees or their affiliates or providing limited temporary assistance to management of investees or their affiliates is not necessarily inconsistent with the definition of an *investment company*. (Assistance to investees or their affiliates is not considered temporary or occasional if it is provided on a continuous or repeated basis to multiple investees or their affiliates that represent a significant portion of the investment portfolio of the entity, or if the entity and its affiliates do not have plans to discontinue such assistance to each investee or investee affiliate).

**.25** (Added as paragraph 1.23 of the Guide) *Significant administrative or support services provided to investees or their affiliates.* Investees or their affiliates sometimes utilize significant administrative or support services provided by the entity or its affiliates. Examples of such administrative or support services include legal advice, centralized cash management, or other administrative services that typically are provided by a parent to its subsidiaries or its operating divisions. In some circumstances, investees may be required to utilize such services, while in other circumstances investees have the option of utilizing such services. Such involvement provides evidence that the entity is investing for strategic operating purposes. The greater the level of such administrative or support services, particularly on a required, continuous, or repeated basis to multiple investees or their affiliates, the greater the evidence that the entity is investing for strategic operating purposes.

**.26** (Added as paragraph 1.24 of the Guide) *Financing guarantees or assets to serve as collateral provided by investees for borrowing arrangements of the entity or its affiliates.* At the entity's request, investees or their affiliates

sometimes provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity or the entity's affiliates. Such arrangements provide evidence that the entity is investing for strategic operating purposes. The more extensive such financing guarantees or assets serving as collateral, the greater the evidence that the entity is investing for strategic operating purposes. Arrangements in which the entity's ownership interest in an investee serves as collateral for borrowing arrangements of the entity or the entity's affiliates, however, are not inconsistent with the definition of an *investment company*. Also, arrangements in which the entity or its affiliates guarantee debt of an investee or its affiliates are not necessarily inconsistent with the definition of an *investment company*.

**.27** (Added as paragraph 1.25 of the Guide) *Provision of loans by noninvestment company affiliates of the entity to investees or their affiliates.* Noninvestment company affiliates of the entity sometimes provide loans to investees or their affiliates. Depending on the terms of the loans and other factors, such arrangements may provide evidence that the entity is investing for strategic operating purposes. However, such loans are not inconsistent with the definition of an *investment company* if all of the following exist:

- The terms of the loans are at fair value.
- The loans are not required as a condition of the investment.
- The loans are not made to most of the investees or their affiliates.
- Making the loans is part of the usual business activity of the noninvestment company affiliate.

**.28** (Added as paragraph 1.26 of the Guide) *Compensation of management or employees of investees or their affiliates is dependent on the financial results of the entity or the entity's affiliates.* Compensation of management or employees of investees or their affiliates sometimes is dependent on the financial results of the entity or the entity's affiliates. An example of compensation of management or employees of investees or their affiliates being dependent on the financial results of the entity is the granting of options to acquire stock in the entity or its affiliates to management or employees of an investee or its affiliates. Such compensation arrangements provide evidence that the entity is investing for strategic operating purposes. The more extensive such compensation arrangements, the greater the evidence that the entity is investing for strategic operating purposes.

**.29** (Added as paragraph 1.27 of the Guide) *Directing the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates.* The entity or its affiliates sometimes direct the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates. Such relationships may include joint ventures or other arrangements between investees, significant purchases or sales of assets or other transactions between investees, investees' participation with other investees in administrative arrangements, investees providing financing to other investees, or investees providing guarantees or collateral for borrowing arrangements of other investees. Directing the integration of operations of investees or their affiliates or establishing business relationships between investees or their affiliates provides evidence that the entity is investing for strategic operating purposes. The more extensive the direction of the integration of operations or establishment of business relationships, the greater the evidence that the entity is investing for strategic operating purposes.

## Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies<sup>12, 13</sup>

### Overview

**.30** (*Added as paragraph 9.01 of the Guide*) An investment company that is within the scope of the Guide may be (a) a subsidiary of another entity or (b) an investment of an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (referred to collectively as *parent company* or *equity method investor*).<sup>14, 15</sup> If so, investment company accounting should be retained in the financial statements of the parent company or equity method investor only if the applicable conditions in items a through c below exist:

- a. In order to retain investment company accounting in the financial statements of the parent company or equity method investor, a subsidiary or equity method investee that is an entity regulated by the 1940 Act or similar requirements as described in paragraphs .09–.10 of this SOP and, therefore, within the scope of the Guide for purposes of its separately issued financial statements, should also meet the definition of an *investment company* pursuant to the guidance in paragraphs .05 and .11–.29 of this SOP.
- b. In order to retain investment company accounting in the financial statements of the parent company, the consolidated group (the parent company and its consolidated subsidiaries) should follow established policies that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies.<sup>16</sup> Those policies should address, at a minimum, (1) the degree of influence held by the investment company

---

<sup>12</sup> *Note to Readers: The following paragraphs .30–.47, and paragraphs .49–.51 and .53 of this SOP, including related footnotes, will be inserted as a separate chapter of the Guide. That new chapter will be Chapter 9, “Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies.” Other chapter numbers of the Guide are renumbered accordingly.*

<sup>13</sup> Investors in investment companies that are other than parent companies or equity method investors should refer to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which applies to investments in equity securities that have readily determinable fair values and to all investments in debt securities, for guidance on accounting for investments in investment companies that have readily determinable fair values. Not-for-profit organizations that are investors in investment companies that are other than parent companies or equity method investors should refer to FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, which applies to not-for-profit organizations’ investments in equity securities that have readily determinable fair values and to all investments in debt securities, for guidance on accounting for investments in investment companies that have readily determinable fair values.

<sup>14</sup> If an investor applies the equity method of accounting under Emerging Issues Task Force (EITF) Topic D-46, *Accounting for Limited Partnership Investments*, EITF Issue No. 03-16, *Accounting for Investments in Limited Liability Companies*, or the provisions of SOP 78-9, *Accounting for Investments in Real Estate Ventures*, to an investment in an investment company, in circumstances in which the investor does not have the ability to exercise significant influence over the investee, that investor should retain investment company accounting in the application of the equity method, as discussed in paragraph .47 of this SOP.

<sup>15</sup> As discussed in footnote 8, this Guide does not address an insurance enterprise’s accounting for its proportionate interest in a separate account.

<sup>16</sup> The consolidated group need not follow those policies in order to retain investment company accounting in circumstances in which the investments and the effects of holding the investments would be reported the same in the consolidated financial statements regardless of whether they are held by the parent company or the investment company. For purposes of applying the guidance in the previous sentence, reporting an item in other comprehensive income rather than in income from operations is not considered “the same in the consolidated financial statements.”

and its related parties over the investees of the investment company, (2) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (3) the level of ownership interest held in the investment company by the consolidated group. The guidance in this condition is intended to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment 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 noninvestment company member of the consolidated group.<sup>17</sup> Such policies should include sufficient details and information to distinguish investment company investments from other investments in the consolidated group.

- c. In order to retain investment company accounting in the financial statements of the parent company or equity method investor, the parent company, or equity method investor (through the investment company), should be investing for current income, capital appreciation, or both, rather than for strategic operating purposes. (Paragraphs .34 to .45 of this SOP discuss this condition further.)

**.31** (*Added as paragraph 9.02 of the Guide*) The parent company should, at the inception of acquiring its interest in a particular investment company subsidiary or upon formation of an investment company subsidiary, make a determination about whether, pursuant to the provisions of this Guide, the subsidiary is an investment company for which investment company accounting should be retained in the consolidated financial statements. If any of the applicable conditions in paragraph .30 of this SOP do not exist in relation to any investment company subsidiary for which it was previously concluded that investment company accounting should be retained in the consolidated financial statements of the parent company, investment company accounting should not be retained in the consolidated financial statements of the parent company, and the financial information of all investment company subsidiaries should be adjusted (as if the investment company subsidiary(ies) had not applied the Guide) in applying consolidation accounting to all investment company subsidiaries. The parent company may, at the inception of acquiring its interest in a particular investment company or upon formation of an investment company subsidiary, reach a conclusion that, pursuant to the provisions of this Guide, investment company accounting for that particular subsidiary should not be retained in the consolidated financial statements of the parent company.<sup>18</sup> In those circumstances in which investment company accounting has never been retained in the consolidated financial statements of the parent company for a particular investment company subsidiary (that subsidiary has never been considered an investment company for purposes of the consolidated financial

---

<sup>17</sup> Equity investments are discussed in this paragraph for purposes of illustrating how the guidance would be applied to those investments. The same guidance would apply, however, to investments other than equity investments, such as investments in commodities, real estate, securities based on indices, derivatives, and other forms of investments.

<sup>18</sup> As discussed in paragraph .57 of this SOP, the parent company should make a similar determination at adoption of this SOP for all investment company subsidiaries. Accordingly, if it is determined at adoption of this SOP that, pursuant to the provisions of this SOP, investment company accounting for a particular investment company subsidiary should not be retained in the consolidated financial statements of the parent company, the fact that the conditions to retain investment company accounting in consolidation for that particular subsidiary are not met has no effect on whether the parent company should retain investment company accounting in its consolidated financial statements for other investment company subsidiary(ies).

statements of the parent company), the fact that the conditions to retain investment company accounting in consolidation for that particular subsidiary are not met has no effect on whether the parent company should retain investment company accounting in its consolidated financial statements for other investment company subsidiary(ies).

**.32** (*Added as paragraph 9.03 of the Guide*) The equity method investor should, at the inception of acquiring its interest in a particular investment company, make a determination about whether, pursuant to the provisions of this Guide, the equity method investee is an investment company for which investment company accounting should be retained in the financial statements of the equity method investor. If any of the applicable conditions in paragraph .30 of this SOP do not exist in relation to an investment in an investment company by an equity method investor for an investment company investee for which it was previously concluded that investment company accounting should be retained in the financial statements of the equity method investor, investment company accounting should not be retained in the financial statements of the equity method investor in reporting its investment in the investment company for which the applicable conditions in paragraph .30 do not exist. In addition, investment company accounting should not be retained in the financial statements of the equity method investor in reporting its investment in other investment companies that are both:

- a. Subject to the equity method investor's ability to exercise significant influence, and
- b. Managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment advisor, or functional equivalent of the entity for which the applicable conditions in paragraph .30 do not exist.

If investment company accounting is not retained in the financial statements of an equity method investor pursuant to the previous two sentences, the investment company's(ies') financial information should be adjusted (as if the investment company(ies) had not applied the Guide) in applying equity method accounting to investment companies for which investment company accounting is not retained. In some circumstances, an equity method investor may have equity method investments in other investment companies that are (a) subject to the equity method investor's ability to exercise significant influence but (b) not managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the entity for which it was previously concluded that investment company accounting should be retained in the financial statements of the equity method investor entity and for which the applicable conditions in paragraph .30 are not met. In those circumstances, that equity method investor should consider whether the (a) facts and circumstances that cause the equity method investor not to meet the applicable conditions in paragraph .30 for investments in certain investment companies affect (b) the determination about whether investment company accounting should be retained for investments in other investment companies over which the investor has the ability to exercise significant influence but that are not managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the entity for which the applicable conditions in paragraph .30 are not met. The equity method investor may, at the inception of acquiring its interest in a particular investment company or upon formation of an investment company investee, reach a conclusion that, pursuant to the provisions of this Guide, investment company accounting for that particular equity method investee

should not be retained in the financial statements of the equity method investor.<sup>19</sup> In those circumstances in which investment company accounting has never been retained in the financial statements of the equity method investor for a particular investment company equity method investee (that equity method investee has never been considered an investment company for purposes of the financial statements of the equity method investor), the fact that the conditions to retain investment company accounting in the financial statements of the equity method investor for that particular equity method investee are not met has no effect on whether the equity method investor should retain investment company accounting in its financial statements for other investment company equity method investees.

**.33** (*Added as paragraph 9.04 of the Guide*) As discussed in paragraph .30c of this SOP, in order to retain investment company accounting in the financial statements of the parent company or equity method investor, the parent company or equity method investor (through the investment company) should be investing for current income, capital appreciation, or both, rather than for strategic operating purposes. In determining whether investment company accounting should be retained, parent companies and equity method investors should consider:

- a. The degree of influence held by the investment company and its related parties over the investees of the investment company or affiliates of investees.
- b. The significance of the investments of the investment company that represent controlling financial interests.
- c. The significance of services provided and activities engaged in between and among the parent company, equity method investor, the investment company, or related parties of the parent company, equity method investor, or the investment company and investees or affiliates of investees.
- d. The level of ownership interest held in the investment company by the parent company or equity method investor.
- e. The extent to which investees of the investment company or their affiliates are in the same line of business as the parent company, equity method investor, or related parties of the parent company or equity method investor (referred to herein as *their related parties*).

As the extent of items *a* through *e* in the previous sentence becomes more significant, it becomes less likely that the parent company or equity method investor would retain investment company accounting.<sup>20</sup>

---

<sup>19</sup> As discussed in paragraph .57 of this SOP, the equity method investor should make a similar determination at adoption of this SOP for all investment company equity method investees. Accordingly, if it is determined at adoption of this SOP that, pursuant to the provisions of this SOP, investment company accounting for a particular investment company equity method investee should not be retained in the financial statements of the equity method investor, the fact that the conditions to retain investment company accounting for that particular equity method investee are not met has no effect on whether the equity method investor should retain investment company accounting in its financial statements for other investment company equity method investees.

<sup>20</sup> For parent companies, the guidance in paragraphs .30–.45 of this SOP should be applied for each consolidated financial statement presented. For example, assume entity *A* is an investment company under the provisions of this Guide. Assume entity *B* owns 100 percent of entity *A* in addition to other assets, and that entity *C* owns 100 percent of entity *B* in addition to other assets. Entity *B* should consider the guidance in paragraphs .30–.45 in accounting for its investment in entity *A* and entity *C* should consider the guidance in paragraphs .30–.45 in accounting for its indirect investment in entity *A*. However, in circumstances in which entity *B* does not qualify to retain investment company accounting in reporting its investment in entity *A*, entity *C* would not qualify to retain investment company accounting in reporting its indirect investment in entity *A*.

**The Parent Company or Equity Method Investor (Through the Investment Company) Is Investing for Current Income, Capital Appreciation, or Both, Rather Than for Strategic Operating Purposes**

**.34** (*Added as paragraph 9.05 of the Guide*) Paragraph .30c of this SOP requires that to retain investment company accounting in the financial statements of the parent company or equity method investor, investees of the investment company should be held by the parent company or equity method investor (through the investment company) for current income, capital appreciation, or both, rather than for strategic operating purposes. That requirement is not met if the (a) conditions in paragraphs .35–.37 of this SOP are not met or (b) factors in paragraphs .38–.45 of this SOP lead to the conclusion that the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In considering the factors discussed in paragraphs .38–.45 and their effect on the conclusion about whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. No single factor discussed in paragraphs .38–.45, however, is necessarily determinative of whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes.

**.35** (*Added as paragraph 9.06 of the Guide*) The parent company or equity method investor (through the investment company) is investing for strategic operating purposes if the parent company, equity method investor, or their related parties have obtained or have the objective of obtaining benefits (other than benefits attributable to the ownership interest, such as dividends) as a result of an investment in an investee of the investment company through relationships with the investee or its affiliates that are unavailable to noninvestor entities that are not related parties to the investee. Examples of relationships and activities that violate this include, but are not limited to, the following:

- a. The acquisition, use, exchange, or exploitation of the processes, intangible assets, or technology of the investee or its affiliates by the parent company, equity method investor, or their related parties.
- b. Significant purchases or sales of assets (other than products or services as discussed in item e below) between the investee or its affiliates and the parent company, equity method investor, or their related parties.
- c. Joint ventures or similar arrangements between an investee or its affiliates and the parent company, equity method investor, or their related parties.
- d. Other arrangements between the investee or its affiliates and the parent company, equity method investor, or their related parties to jointly develop, produce, market, or provide products or services.
- e. Other transactions between the investee or its affiliates and the parent company, equity method investor, or their related parties that (1) are on terms that are unavailable to entities that are not related parties to the investee, (2) are not at a price the transaction would occur in an orderly transaction between market participants at the

measurement date (and that price is objectively verifiable), or (3) represent a significant portion of the investee's or their affiliates' business activities, or the business activities of the parent company or equity method investor, including their related parties' business activities. (Transactions between investees or their affiliates and the parent company, equity method investor, or their related parties that (1) do not represent a significant portion of the investee's or their affiliates' business activities, or the business activities of the parent company or equity method investor, including their related parties' business activities and (2) involve products or services of investees or their affiliates that are available to entities or customers that are not related parties to the investee on similar terms do not violate this condition if the transactions occur at a price the transaction would occur in an orderly transaction between market participants at the measurement date and that price is objectively verifiable by similar transactions between (1) the investee or its affiliates and entities that are not related parties to the investee or (2) the parent company, equity method investor, or their related parties and entities that are not investees or affiliates of investees or related parties of the parent company or equity method investor.)

- f. The equity method investor or its related parties [excluding separate accounts of insurance companies as defined in the glossary of the Guide, common (collective) trust funds, and other investments held by trust departments of financial institutions, and pension and profit-sharing trusts], have a direct investment in an investee or an affiliate of an investee (other than investments that are clearly insignificant) and the equity method investor has the ability to exercise significant influence over the investee or affiliate of the investee as a result of that direct investment.
- g. The parent company, equity method investor, or their related parties have disproportionate rights, exclusive rights, or rights of first refusal to purchase or otherwise acquire direct ownership interests, assets, technology, products, or services of investees or affiliates of investees.
- h. The parent company, equity method investor, or their related parties obtain tax benefits as a result of an ownership interest in the investment company and obtaining the tax benefits was a significant reason for making the investment. For example, some investors make investments to obtain low-income housing credits that pass through partnerships. If obtaining those credits was a significant reason for the parent company or equity method investor making the investment, the parent company or equity method investor has obtained or has the objective of obtaining benefits as a result of the investment through relationships with the investee that are unavailable to noninvestor entities that are not related parties to the investee. [Obtaining tax benefits is not inconsistent with investees of the investment company being held by the parent company or equity method investor (through the investment company) for other than strategic operating purposes if persuasive evidence exists that obtaining the tax benefits was not a significant reason for making the investment.]

**.36** (*Added as paragraph 9.07 of the Guide*) Subject to the exceptions in paragraph .37 of this SOP, investees of the investment company are considered

to be held by the parent company or equity method investor (through the investment company) for strategic operating purposes if transfers of investments, including, but not limited to, transfers made in exchange for cash or other consideration, are made (a) from an investment company to the parent company, equity method investor, or their related parties that are not investment companies or (b) from the parent company, equity method investor, or their related parties that are not investment companies to the investment company. Accordingly, any such transfers (other than the exceptions in paragraph .37) result in a change in status to be accounted for in conformity with paragraph .49 of this SOP.

**.37** (*Added as paragraph 9.08 of the Guide*) The following transfers do not lead to the conclusion that the parent company or equity method investor (through the investment company) is investing for strategic operating purposes:

- a. Transfers in circumstances in which the investments and the effects of holding the investments would be reported the same in the financial statements, regardless of whether they are held by the transferor or the transferee.<sup>21</sup>
- b. Transfers that are pro-rata distributions to equity method investors in the investment company of shares of investees in circumstances in which (1) the equity method investor does not have the ability to initiate the distribution and (2) the shares are distributed in a final liquidation of the investment company or are publicly traded securities.
- c. In rare situations, transfers between an investment company and a parent company, equity method investor, or their related parties in circumstances in which there have been (1) significant changes in facts and circumstances related to the nature of the parent company's, equity method investor's, or their related parties' business activities unrelated to the investee or its affiliates or (2) significant changes in the investee's or its affiliates' business activities in circumstances in which such change was not initiated or directed by the parent company, equity method investor, or their related parties such that retaining the investment in the investment company, parent company, equity method investor, or their related parties would result in the conclusion that the investment company would otherwise no longer be within the scope of the Guide. (Given the nature of investments held by investment companies, such transfers should be rare.)<sup>22</sup>

---

<sup>21</sup> For purposes of applying the guidance in this Guide, reporting an item at fair value with changes in fair value reported in other comprehensive income rather than in income from operations is not considered "the same in the financial statements."

<sup>22</sup> An example of circumstances in which there have been significant changes in facts and circumstances related to the nature of the parent company's, equity method investor's, or their related parties' business activities unrelated to the investee or its affiliates could be as follows. Assume that Investor A holds a 25 percent interest in Investment Company A; Investment Company A holds a 20 percent interest in Investee A; Acquisition Target B holds a 5 percent interest in Investee A. Investor A acquires Acquisition Target B. The absence of a transfer of Acquisition Target B's interest in Investee A to Investment Company A (or the absence of a transfer of Investment Company A's investment in Investee A out of Investment Company A) would result in the conclusion that Investor A would no longer be able to retain investment company accounting, under the provisions of paragraph .30b of this SOP. Accordingly, such a transfer could occur without leading to the conclusion that Investor A (through the investment company) is investing for strategic operating purposes.

- d. Transfers that are insignificant and immaterial in all relevant respects, such as in relation to (1) the parent company's or equity method investor's financial statements, (2) the parent company's or equity method investor's interest in the investment company, and (3) the aggregate investment portfolio of investment company subsidiaries and investment company investees reported using the equity method.

## Factors to Consider

**.38** (*Added as paragraph 9.09 of the Guide*) All relevant facts and circumstances should be considered in totality in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In addition to the conditions discussed in paragraphs .35–.37 of this SOP, the factors discussed in paragraphs .39–.45 of this SOP also should be considered in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In considering the factors discussed in paragraphs .39–.45, some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes. In addition, parent companies and equity method investors should consider the factors in paragraph .33 of this SOP. As the extent of items in paragraph .33 becomes more significant, it becomes less likely that the parent company or equity method investor would retain investment company accounting. No single factor discussed in paragraphs .39–.45, however, is necessarily determinative of whether the parent company or equity method investor (through the investment company) is investing for strategic operating purposes.

**.39** (*Added as paragraph 9.10 of the Guide*) *Involvement in the day-to-day management of investees, their affiliates, or other investment assets.* Involvement in the day-to-day management of investees, their affiliates, or other investment assets by the parent company, equity method investor, or their related parties provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive the involvement in the day-to-day management of investees, their affiliates, or other investment assets, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes. Such involvement sometimes is initiated in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. In such circumstances, the period of involvement typically is limited to the period of time necessary to address the concern, rather than being open-ended or permanent. As the involvement in the day-to-day management of investees, their affiliates, or other investment assets goes beyond that described in the previous two sentences, the evidence that the parent company or equity method investor (through the investment company) is investing for strategic operating purposes becomes greater. Investees of the investment company may, however, be held by the parent company or equity method investor (through the investment company) for current income, capital appreciation, or both, even though the parent company, equity method investor, or their related parties are represented on the boards of directors of investees or their affiliates, or if management or employees of the parent company, equity method investor, or their related parties occasionally provide limited temporary assistance to the management of investees or their affiliates. (Assistance

to investees or their affiliates is not considered temporary or occasional if it is provided on a continuous or repeated basis to multiple investees or their affiliates that represent a significant portion of the investment portfolio of the entity, or if the parent company, equity method investor, or their related parties do not have plans to discontinue the assistance to each investee or investee affiliate.)

**.40** *(Added as paragraph 9.11 of the Guide)* Significant administrative or support services provided by the parent company, equity method investor, or their related parties. Investees or their affiliates sometimes utilize significant administrative or support services provided by the parent company, equity method investor, or their related parties. Examples of such administrative or support services include legal advice, centralized cash management, or other administrative services that typically are provided by a parent to its subsidiaries or its operating divisions. In some circumstances, investees may be required to utilize such services, while in other circumstances investees may have the option of utilizing such services. Such involvement provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The greater the level of such administrative or support services, particularly on a required, continuous, or repeated basis to multiple investees or their affiliates, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

**.41** *(Added as paragraph 9.12 of the Guide)* Financing guarantees or assets to serve as collateral provided by investees or their affiliates for borrowing arrangements of the parent company, equity method investor, or their related parties. At the parent company's or an equity method investor's request, investees or their affiliates sometimes provide financing guarantees or assets to serve as collateral for borrowing arrangements of the parent company, equity method investor, or their related parties. Such arrangements, resulting from the parent company's or an equity method investor's request, provide evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive such financing guarantees or assets serving as collateral, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes. Arrangements in which the parent company's, equity method investor's, or their related parties' ownership interest in the investment company, or a wholly-owned investment company's ownership interest in an investee serves as collateral for borrowing arrangements of the parent company, equity method investor, or their related parties, however, are not inconsistent with investees of the investment company being held by the parent company or equity method investor (through the investment company) for other than strategic operating purposes. Also, arrangements in which the parent company, equity method investor, or their related parties guarantee debt of an investee or its affiliates are not inconsistent with investees of the investment company being held by the parent company or equity method investor (through the investment company) for other than strategic operating purposes.

**.42** *(Added as paragraph 9.13 of the Guide)* Compensation of management or employees of investees or their affiliates is dependent on the financial results of the parent company, equity method investor, or their related parties. Compensation of management or employees of investees or their affiliates sometimes is dependent on the financial results of the parent company, equity method investor, or their related parties. An example of compensation of management or employees of investees or their affiliates being dependent on the financial results of the parent company, equity method investor, or their related parties

is the granting of options to acquire stock in the parent company, equity method investor, or their related parties to management or employees of an investee or its affiliates. Such compensation arrangements provide evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive such compensation arrangements, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

**.43** *(Added as paragraph 9.14 of the Guide) Directing the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates.* The parent company, equity method investor, or their related parties sometimes direct the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates. Such relationships may include joint ventures or other arrangements between investees, significant purchases or sales of assets, or other transactions between investees, investees' participation with other investees in administrative arrangements, investees providing financing to other investees, or investees providing guarantees or collateral for borrowing arrangements of other investees. Directing the integration of the operations of investees or their affiliates or establishing business relationships between investees or their affiliates provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive the direction of the integration of operations or establishment of business relationships, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

**.44** *(Added as paragraph 9.15 of the Guide) Active participation in the organization and formation of an investee or its affiliates.* The parent company, equity method investor, or their related parties sometimes actively participate in the organization and formation of an investee or its affiliates. Such participation provides evidence that the parent company or equity method investor is investing for strategic operating purposes. The more extensive such participation, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

**.45** *(Added as paragraph 9.16 of the Guide) Acquiring equity interests in the investment company in exchange for interests in investees.* Investors in the investment company sometimes contribute interests in investees (that were obtained by the investor in exchange for other than cash, such as in exchange for services) to the investment company in exchange for equity interests in the investment company. Such arrangements provide evidence that the investor may be investing for strategic operating purposes. The more extensive such contributed interests in investees or equity interests in the investment company received in exchange for contributed interests in investees, the greater the evidence that the parent company or equity method investor is investing for strategic operating purposes.

### **Applying the Guidance in Paragraphs .30 to .45 to Equity Method Investors**

**.46** *(Added as paragraph 9.17 of the Guide) Each equity method investor should apply the guidance in paragraphs .30–.45 of this SOP based on its own facts and circumstances without considering relationships or activities of other investors (that are not related parties to the equity method investor) in the investment company. Accordingly, an investment company may have multiple equity method investors and the determination about whether investment*

company accounting should be retained for purposes of applying the equity method in the financial statements of equity method investors should be determined individually by each of those equity method investors. Accordingly, investment company accounting may be retained for purposes of applying the equity method in the financial statements of certain equity method investors, but not retained for purposes of applying the equity method in the financial statements of other equity method investors.

**.47** (*Added as paragraph 9.18 of the Guide*) As discussed in SOP 78-9, Emerging Issues Task Force (EITF) Topic D-46, and EITF Issue No. 03-16, certain investors should apply the equity method in situations in which they do not have the ability to exercise significant influence over the investee. The conditions discussed in paragraphs .30–.45 of this SOP do not apply to equity method investors that do not have the ability to exercise significant influence over the investment company. Those investors should retain investment company accounting in applying the equity method to investment in such investment companies.

## Changes in Status

**.48** (*Added as paragraph 1.28 of the Guide*) The initial determination of whether an entity is an investment company within the scope of the Guide should be made upon formation of the entity. In addition, the provisions of paragraphs .05–.29 of this SOP should be reconsidered each reporting period. Reconsideration of the provisions of paragraphs .05–.29 may result in changes in status. For example, under the provisions of paragraphs .05–.29, some entities may no longer be investment companies within the scope of the Guide, after an initial determination that the entity was an investment company. Similarly, under the provisions of paragraphs .05–.29, some entities may be investment companies within the scope of the Guide, after an initial determination that the entity was not an investment company. Entities with such changes in status should change to the appropriate accounting as of the date of the change in status (as opposed to the reporting date). If an entity no longer meets the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the entity was an investment company, that entity should discontinue application of the Guide and report the change in status prospectively by accounting for its investments in conformity with applicable generally accepted accounting principles (GAAP) other than investment company accounting, beginning as of the date of the change using fair value in conformity with investment company accounting at the date of the change (as opposed to the reporting date) as the carrying amount of investments at the date of the change. If an entity that previously was not an investment company under the applicable provisions of paragraphs .05–.29 becomes an investment company under those paragraphs, the entity should report the effect of the change in status as of that date (as opposed to the reporting date) as an adjustment to retained earnings in the period in which the change occurred. The effect of the change in status reported as an adjustment to retained earnings represents the difference between the carrying amounts of the investments in conformity with the provisions of the Guide and the carrying amounts of the investments (or assets minus liabilities for consolidated investments) in conformity with GAAP other than the provisions of the Guide. All entities with changes in status should disclose the fact that a change in status occurred. In addition, an entity that previously was not an investment company under the applicable provisions of paragraphs .05–.29 and becomes an investment company under those paragraphs should disclose the effect of

the change in status on the financial statements of the period of the change, including the effect of the change on the reported amounts of investments as of the date of the change in status and the related effects on net income, change in net assets from operations (for investment companies) or change in net assets (for not-for-profit organizations), and related per share amounts.

**.49** (*Added as paragraph 9.19 of the Guide*) The initial determination about whether investment company accounting should be retained in the financial statements of a parent company or equity method investor in an investment company should be made upon the initial investment by the parent company or equity method investor. In addition, the provisions of paragraphs .30–.45 of this SOP should be reconsidered each reporting period. Reconsideration of the provisions of paragraphs .30–.45 may result in changes in status. If a parent company no longer meets the provisions of paragraphs .30–.45 to retain investment company accounting for any investment company subsidiary after an initial determination that investment company accounting should be retained in the financial statements of the parent company for that subsidiary (or if a subsidiary that previously was an investment company no longer meets the applicable investment company conditions in paragraphs .05–.29 of this SOP after an initial determination that the subsidiary was an investment company and investment company accounting was retained in consolidation for that investment company subsidiary), that parent company should discontinue the retention of investment company accounting for all subsidiaries. If an equity method investor in an investment company no longer retains investment company accounting under the provisions of paragraphs .30–.45 for an investment in an investment company after an initial determination that investment company accounting should be retained in the financial statements of the equity method investor for that investee (or if an equity method investee that previously was an investment company no longer meets the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the equity method investee was an investment company and investment company accounting was retained by the investor for that investee), that equity method investor should discontinue retention of investment company accounting in reporting its investment in that investment company and in reporting its equity method investments in other investment companies that are both (a) subject to the equity method investor's ability to exercise significant influence and (b) managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the investment company for which investment company accounting is no longer retained. In addition, paragraph .32 of this SOP provides that the equity method investor should consider whether it should discontinue retention of investment company accounting in reporting its equity method investments in other investment companies that are (a) subject to the equity method investor's ability to exercise significant influence but (b) not managed by the same general partner, investment adviser, or functional equivalent or related party of that general partner, investment adviser, or functional equivalent of the entity for which investment company accounting is disallowed. If a parent company or equity method investor no longer retains investment company accounting under the conditions in paragraphs .30–.45 for any investment company subsidiary or an investment of an equity method investor after an initial determination that investment company accounting should be retained in the financial statements of the parent company or equity method investor, that parent company or equity method investor should report the change in status prospectively by accounting for its investments in conformity with applicable GAAP other than

investment company accounting, beginning as of the date of the change using fair value in conformity with investment company accounting at the date of the change (as opposed to the reporting date) as the carrying amount of investments at the date of the change. Also, a change in circumstances may lead to the conclusion that investment company accounting should be retained in the financial statements of a parent company or equity method investor under the provisions of paragraphs .30–.45 in circumstances in which investment company accounting previously was not retained in the financial statements of the parent company or an equity method investor. If a parent company or equity method investor previously did not retain investment company accounting in the financial statements under the provisions of paragraphs .30–.45 and, subsequently, due to a change in circumstances, retains investment company accounting, the parent or equity method investor should change to the appropriate accounting as of the date of the change in status (as opposed to the reporting date) and report the effect of the change in status as an adjustment to retained earnings in the period in which the change occurred. The effect of the change in status represents the difference between the carrying amounts of the investments in conformity with the provisions of the Guide and the carrying amounts of the investments (or assets minus liabilities for consolidated investments) in conformity with GAAP other than the provisions of the Guide. All entities with changes in status should disclose the fact that a change in status occurred. In addition, a parent company or equity method investor that previously did not retain investment company accounting in the financial statements under the provisions of paragraphs .30–.45, subsequently, due to a change in circumstances, retains investment company accounting, should disclose the effect of the change in status on the financial statements of the period of the change, including the effect of the change on the reported amounts of investments as of the date of the change in status and the related effects on net income, change in net assets from operations (for investment companies) or change in net assets (for not-for-profit organizations), and related per share amounts.

## Disclosures

**.50** (*Added as paragraph 9.20 of the Guide*) If investment company accounting is retained in the consolidated financial statements for investment company subsidiaries, the following should be disclosed:

- a. The fact that investment company accounting is retained in the consolidated financial statements.
- b. The carrying amount (fair value) as reported in the consolidated financial statements and cost of the portfolio of investment company subsidiaries for which investment company accounting has been retained as of each balance sheet date.
- c. Disclosures about significant transactions between the parent company or its related parties and the investees of the investment company or their affiliates:
  - (1) The nature of the relationship(s) involved.
  - (2) A description of the transactions for each of the periods for which income statements are presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements, such as the amount of gross profit (or similar measure) from the transactions.
  - (3) The dollar amounts of transactions, such as sales and similar revenues, for each of the periods for which income statements

are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.

- (4) Amounts due from or to investees or their affiliates as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.
- d. Gross unrealized aggregate appreciation and aggregate depreciation of investments in the investment company's(ies') investment portfolio as of each balance sheet date.
- e. Net realized gains or losses from investments in the investment portfolio of investment company subsidiaries for which investment company accounting has been retained for each year an income statement is presented.
- f. Net increase (decrease) in unrealized appreciation (or depreciation) of the investment portfolio (change in unrealized amounts during the year) for each year an income statement is presented.
- g. The policy for distinguishing the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies.

**.51** (*Added as paragraph 9.21 of the Guide*) If investment company accounting is retained in the financial statements of an equity method investor in an investment company, the following should be disclosed:

- a. The fact that investment company accounting is retained in the financial statements of the equity method investor in an investment company.
- b. The carrying amount (fair value) and cost of the portfolio of equity method investees for which investment company accounting has been retained as of each balance sheet date. The amounts disclosed should represent the equity method investor's reported interest in the portfolio of equity method investees. Accordingly, for equity method investees for which investment company accounting has been retained, the amounts disclosed should represent the equity method investor's proportionate interest in the equity method investee's investment portfolio.
- c. Disclosures about significant transactions between the equity method investor, or its related parties and the investees of the investment company or their affiliates:
  - (1) The nature of the relationship(s) involved.
  - (2) A description of the transactions for each of the periods for which income statements are presented, and such other information deemed necessary to understand the effects of the transactions on the financial statements, such as the amount of gross profit (or similar measure) from the transactions.
  - (3) The dollar amounts of transactions, such as sales and similar revenues, for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.
  - (4) Amounts due from or to investees or their affiliates as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

**.52** (*Added as paragraph 7.79 of the Guide*) If changes in status are reported pursuant to paragraph .48 of this SOP, entities should disclose the following:

- The nature of and justification for the change in status
- Disclosures required by paragraph .48

**.53** (*Added as paragraph 9.22 of the Guide*) If changes in status are reported pursuant to paragraph .49 of this SOP, entities should disclose the following:

- The nature of and justification for the change in status
- Disclosures required by paragraph .49

## **Amendments to Other Sections of the Guide**

**.54** Appendix A [paragraph .59] of the Guide “Venture Capital and Small Business Investment Companies,” is revised to read as follows:

### **Venture Capital and Small Business Investment Companies**

Venture capital investment companies, including most small business investment companies (SBICs), and business development companies may differ from other types of investment companies. The typical open-end or closed-end company is a more passive investor than is a venture capital investment company. A venture capital investment company typically is more actively involved with its investees, while still meeting the definition of an *investment company*. In addition to providing funds, whether in the form of loans or equity, the venture capital investment company often provides technical and management assistance to its investees. Such assistance typically is initiated in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. In such circumstances, the period of involvement typically is limited to the period of time necessary to address the concern, rather than being open-ended or permanent.

The portfolio of a venture capital investment company may be illiquid by the very nature of the investments, which are typically securities with no public market. Often, gains and losses on those investments are realized over a relatively long holding period. The nature of the investments, therefore, requires valuation procedures that differ markedly from those used by the typical investment company primarily addressed by this Guide.

Venture capital investment companies may incur liabilities not generally found in other investment companies. Leverage opportunities available to the owners of those companies are not available to open-end companies and are not often found in closed-end companies. SBICs, by statute, may borrow from the Small Business Administration (SBA), often at advantageous rates, up to two or three times their paid-in capital.

Though all venture capital investment companies should prepare their financial statements in conformity with GAAP and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in a manner most meaningful to their particular group of investors. For example, if debt is a significant item, a balance sheet might be more appropriate than a statement of net assets. Also, different regulatory procedures may apply. Publicly owned SBICs are subject to the provisions of article 5 of Regulation S-X, whereas other publicly owned venture capital investment companies are subject to article 6.

The unique features (primarily the existence of significant debt) of SBICs often make it desirable that their financial statements be presented in a conventional balance sheet format. SBICs are regulated by the SBA and accordingly are required to comply with part 107 of the SBA rules and regulations. Appendixes I and II of part 107 address specific aspects of SBA regulation, such as the specific audit procedures and reporting requirements (for example, on Form 468) of the SBA for SBICs, the system of account classification, and guidance on proper techniques and standards to be followed in valuing portfolios. The auditor of an SBIC should be familiar with those publications and aware of changes in SBA regulations.

The format for reporting the results of SBIC operations varies from that presented in this Guide for other types of investment companies.

**.55** The glossary of the Guide is revised to read as follows:

**venture capital investment company.** A closed-end investment company whose primary investment objective is capital growth and whose capital typically is invested wholly or largely in restricted securities of entities with new ideas, products, or processes.

## Effective Date and Transition

### EDITOR'S NOTE

On February 14, 2008, the FASB issued FASB Staff Position (FSP) 07-1-1, *Effective Date of AICPA Statement of Position 07-1*. The FSP delays indefinitely the effective date of this SOP. Entities that early adopted SOP 07-1 before December 15, 2007, are permitted but not required to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the following exception: If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity's adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements. For the full text of the FSP, visit the FASB's Web site at [http://www.fasb.org/pdf/fsp\\_sop07-1-1.pdf](http://www.fasb.org/pdf/fsp_sop07-1-1.pdf).

**.56** The provisions of this SOP are effective for fiscal years beginning on or after December 15, 2007. Earlier application is encouraged.

**.57** The consideration of the provisions of paragraphs .05–.29 of this SOP to determine whether an entity is an investment company within the scope of the Guide and in paragraphs .30–.45 of this SOP to determine whether investment company accounting should be retained in the financial statements of a parent company or an equity method investor should be made initially as of the beginning of the fiscal year for which this SOP is first applied. If a decision to initially apply this SOP is made in other than the first interim period of the year of change, the change should be reported by retrospective application to the previous interim periods of that year. If an entity that previously applied the provisions of the Guide meets the provisions of paragraphs .05–.29 (or meets the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of a parent company or equity method investor) as of the date of initial application of this SOP, the entity should continue to apply the provisions of the Guide upon initial application of this SOP, even if the entity did not meet those provisions in all periods prior to the initial application of this SOP.

**.58** Entities that previously applied the provisions of the Guide but that, pursuant to paragraphs .05–.29 of this SOP, do not meet the provisions of this

SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of paragraphs .30–.45 of this SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting this SOP prospectively by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of adoption using fair value in conformity with investment company accounting at the date of adoption as the carrying amount of investments at the date of adoption. Entities that, pursuant to paragraphs .05–.29, are investment companies within the scope of the Guide (or parent companies or equity method investors that meet the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor), should report the cumulative effect of adopting this SOP as an adjustment to opening retained earnings as of the beginning of the year that this SOP is adopted. The cumulative effect of the change represents the difference between the carrying amount of the investments in conformity with the provisions of the Guide and the carrying amount of the investments (or assets minus liabilities for consolidated investments) in conformity with GAAP other than the provisions of the Guide. All entities with changes in accounting as a result of adopting this SOP should disclose the effect of adopting this SOP on the financial statements of the period of the change, including any changes in accounting for investments as a result of adopting this SOP, the effect of any changes on the reported amounts of investments as of the date of adoption and any related effects on net income, change in net assets from operations (for investment companies), or change in net assets (for not-for-profit organizations) and related per share amounts.<sup>23</sup>

**The provisions of this Statement of Position need not be applied to immaterial items.**

---

<sup>23</sup> The FASB *Action Alert* reporting the FASB's actions at its March 27, 2002, discussion of a document leading to the exposure draft of this SOP provides as follows:

The Board expressed its view that an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940) must be a separate legal entity to be within the scope of the [Investment Companies] Guide. Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments.

AcSEC notes that entities that are not separate legal entities, except for separate accounts of insurance companies as discussed in footnote 4, would not retain the specialized accounting practices in the Guide upon adoption of this SOP.

## Appendix A

# Background Information and Basis for Conclusions

### Introduction

**A-1.** This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

### Background

**A-2.** The AICPA Audit and Accounting Guide *Investment Companies* (the Guide) requires specialized industry accounting guidance (referred to as *investment company accounting*) for entities within its scope. Entities that are not within the scope of the Guide or other specialized industry practice generally account for investments in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*; FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*; and Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and as interpreted by FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003), among other pronouncements.

**A-3.** During the development of the Guide in the late 1990s, the FASB expressed concern that the scope of the Guide may be unclear, particularly as it pertains to certain venture capital investment companies. Though AcSEC previously had a project on its agenda to develop an SOP on accounting for venture capital investment companies, that project was terminated. Representatives of the AICPA informally surveyed preparers and auditors, who shared the FASB's concerns that the scope of the Guide may be unclear.

**A-4.** In addition, in Emerging Issues Task Force (EITF) Issue No. 85-12, *Retention of Specialized Accounting for Investments in Consolidation*, the EITF discussed whether consolidated financial statements should retain specialized industry accounting principles applicable to wholly-owned small business development company subsidiaries or venture capital investment company subsidiaries. The EITF reached a consensus that, assuming the specialized industry accounting principles are appropriate at the subsidiary level, those principles should be retained in consolidation.

**A-5.** If an investment company is (a) a subsidiary of another entity or (b) an investment of an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the investment company (referred to collectively as *parent company* or *equity method investor*) and investment company accounting is carried over to the parent company's or equity method investor's financial statements, differences in accounting for the same investment could result

depending on which entity within the consolidated group holds the investment. AcSEC concluded that in light of its reconsideration of the scope of the Guide, it should also provide guidance about whether investment company accounting should be retained in the financial statements of a parent company of an investment company or an equity method investor in an investment company.

**A-6.** In December 2002, AcSEC released for public comment an exposure draft of a proposed SOP, *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*. Forty-one comment letters were received and subsequently considered by AcSEC.

**A-7.** The exposure draft proposed guidance for determining whether an entity is within the scope of the Guide and for determining whether investment company accounting should be retained by a parent company in consolidation or by an equity method investor. That guidance was based primarily on the nature of the entity's activities and relationships with investees, as well as the organizational structure of the entity.

### **Basis for Conclusions**

#### ***Overall Model***

**A-8.** In practice, some perceive investment company accounting as more desirable to the reporting entity than accounting in conformity with generally accepted accounting principles (GAAP) other than investment company accounting. Further, some believe an entity should be prohibited from applying investment company accounting (or retaining investment company accounting in the financial statements of a parent company or equity method investor) unless the entity can demonstrate that it is an investment company (or that investment company accounting should be retained in the financial statements of a parent company or equity method investor). They believe, therefore, that the model in this SOP should include a bias against investment company accounting; a presumption that an entity is not an investment company (or that investment company accounting should not be retained in the financial statement of a parent company or equity method investor) unless it can demonstrate that it is an investment company (or that investment company accounting should be retained in the financial statements of a parent company or equity method investor). AcSEC does not support that view. AcSEC believes, and the model in this SOP reflects, that whether an entity is an investment company (and whether investment company accounting should be retained in the financial statements of a parent company or equity method investor) should be based on consideration of all relevant facts and circumstances without a bias for or against investment company accounting.

#### ***Separate Financial Statements of an Investment Company***

**A-9.** For purposes of the separate financial statements of an entity, the exposure draft proposed that the Guide should be applicable to entities that are (a) regulated as investment companies; (b) separate legal entities owned by multiple investors (referred to as entities with *pooled funds*) meeting certain conditions leading to the conclusion that their business activity involves investing for current income, capital appreciation, or both; and (c) other separate legal entities meeting certain incremental conditions leading to the conclusion that their business activity is investing for current income, capital appreciation, or both in separate autonomous businesses. (The conditions for the third category of investment company entities were more extensive than those for the first

two categories.) The exposure draft proposed guidance for determining whether an entity has pooled funds and provided specific conditions that should be met to conclude that the entity's business activity involves investment activity and that investees are separate autonomous businesses.

**A-10.** The majority of respondents who commented on the December 2002 exposure draft opposed the guidance on the specific conditions proposed in the exposure draft pertaining to the separate financial statements of the entity. Though many respondents agreed with the general description of the purpose and activities of an investment company as discussed in the exposure draft, many of those respondents believed the detailed requirements of the proposal might exclude from the scope of the Guide certain entities that typically have followed, and, in their view, should continue to follow investment company accounting. In addition, some respondents interpreted certain provisions of the exposure draft as bright line rules and believed that the SOP should instead establish general principles. Many such respondents also expressed concern that, based on the specific requirements in the exposure draft, certain entities may have frequent changes in status to and from investment company status.

**A-11.** AcSEC noted from the comment letters that there may be more diversity in activities of current investment companies and their relationships with investees than AcSEC anticipated. Though such activities and relationships may be consistent with the definition of an *investment company*, certain entities may have been excluded from the scope of the Guide by the specific nature of the provisions in the exposure draft. AcSEC believes that determinations about whether an entity is an investment company should be based on an overall consideration of the nature of the entity's activities and relationships with investees, as well as the organizational structure of the entity. In addition, AcSEC believes entities should consider all existing evidence in determining whether the entity is an investment company, and that judgment should be applied in making that determination, with less bright lines than some readers believed existed in the exposure draft. Accordingly, AcSEC concluded that the SOP should be revised to (a) simplify the application of the SOP, particularly pertaining to the determination about whether an entity is within the scope of the Guide, (b) change or eliminate certain provisions of the SOP that may be viewed as bright lines, and (c) provide illustrations of the application of the provisions of the SOP. AcSEC has therefore revised the SOP to incorporate the following model:

- A definition of an *investment company*. (The definition is derived from certain conditions in the exposure draft.)
- Guidance to apply the definition, including explanations of terms used in the definition.
- Factors that provide evidence about whether an entity meets the definition of an *investment company*. (Many of the factors are derived from the conditions in the exposure draft. Depending on the facts and circumstances, some factors may be more significant than others. Entities should weigh all existing evidence in determining whether the entity meets the definition of an *investment company*.)
- Illustrations demonstrating the application of the guidance in the SOP to various fact patterns.

**A-12.** AcSEC believes this approach generally is consistent with the original intent of the exposure draft and will not significantly change the intended scope of the Guide. In addition, AcSEC believes the benefits of this approach include:

- Making the SOP more understandable and simplifying the determination of whether an entity is within the scope of the Guide.
- Avoiding excluding from the scope of the Guide certain entities that typically have followed and should continue to follow investment company accounting.
- Retaining requirements that AcSEC believes are essential, such as investing for current income, capital appreciation, or both, rather than for strategic operating purposes.
- Retaining factors that AcSEC believes are important while permitting those factors to be considered in the totality of all relevant facts and circumstances, rather than in isolation.

### ***Discussion of Relevant Accounting Issues<sup>24</sup>***

**A-13.** As noted in paragraph .05 of this SOP, an investment company's business activity involves investing (typically by purchasing securities of other entities) for current income, capital appreciation, or both. Values and changes in values of investments held by investment companies may be as important to an investor(s) as the investment income earned. Transactions to buy and sell shares or units in an investment company are typically based on the fair value of the investment company's investments. Investment companies, therefore, report investments at fair value. Paragraphs 7.04 and 7.05 of the Guide provide that investment companies do not consolidate or apply the equity method of accounting to noninvestment company investees (except for investments in operating subsidiaries that provide services to the investment company and other investment companies) because investment companies carry their assets at fair value.

**A-14.** FASB Statement No. 115; FASB Statement No. 124; APB Opinion No. 18, as interpreted by FASB Interpretation No. 46 (revised December 2003); and ARB 51, as amended by FASB Statements No. 94 and No. 144, among other pronouncements, provide guidance on accounting for investments in investees. ARB 51 provides that all majority-owned subsidiaries shall be consolidated unless control does not rest with the majority owner. Entities that are not within the scope of the Guide are required to consolidate certain investees and apply the equity method of accounting to certain investments based on the provisions of those standards rather than account for such investments at fair value. As indicated in paragraph A-13 above, entities that are within the scope of the Guide do not consolidate or apply the equity method to their investments, except as discussed in paragraph 7.05 of the Guide.

**A-15.** APB Opinion No. 18, paragraph 2, provides that the Opinion does not apply to investments in common stock held by "investment companies registered under the Investment Company Act of 1940 or investment companies which would be included under the Act (including small business investment companies) except that the number of stockholders is limited and the securities are not offered publicly." Paragraph 53 of FASB Statement No. 94

---

<sup>24</sup> In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115*. Measurement of certain investments by some entities affected by this SOP also may be affected by Statement No. 159. Specifically, for entities other than investment companies, Statement No. 159 permits certain investments currently reported at other than fair value to be reported at fair value. AcSEC's deliberations, and the discussion in this "Basis for Conclusions," predate Statement No. 159, and therefore do not reflect the fair value options permitted by Statement No. 159.

acknowledges the specialized industry practices for investment companies and that those practices are unaffected by FASB Statement No. 94.

**A-16.** This SOP does not address the valuation of investments by venture capital investment companies or similar entities that are within the scope of the Guide. If those entities are within the scope of the Guide, they should follow the provisions of the Guide for valuing their investments. If those entities are outside the scope of the Guide, they should follow the provisions of APB Opinion No. 18; ARB 51, as amended by FASB Statements No. 94 and No. 144 and as interpreted by FASB Interpretation No. 46 (revised December 2003); or FASB Statements No. 115 or No. 124, as applicable in the circumstances.

**A-17.** If an entity is within the scope of the Guide, all of the entity's investments and activities should be accounted for and reported in conformity with the provisions of the Guide. The provisions of this SOP prohibit any of those investments from being exempted from the provisions of the Guide. If an entity is outside the scope of the Guide, the Guide does not apply to any of the entity's investments or activities.

### ***Financial Statements of Parent Companies and Equity Method Investors***

**A-18.** AcSEC considered the accounting by parent companies and equity method investors for investments in investment companies. That is, should investment company accounting be retained in the financial statements of a parent company or equity method investor? As discussed in paragraph A-4 above, the EITF had concluded in Issue No. 85-12 that, assuming the specialized accounting principles applicable to wholly-owned small business development company subsidiaries or venture capital investment company subsidiaries are appropriate at the subsidiary level, those principles should be retained in consolidation. In practice, that conclusion has been applied also by equity method investors, as well as investors other than parent companies or equity method investors. AcSEC concluded that the guidance in EITF Issue No. 85-12 should no longer be applied in determining whether investment company accounting should be retained in the financial statements of parent companies and equity method investors for investments in investment companies. AcSEC observes that EITF Issue No. 85-12 did not address whether the activities of the investment company and the relationship of the parent company to the investment company and its investees (and, in practice, the relationship of equity method investors to the investment company and its investees) should be considered in determining whether investment company accounting should be retained in the financial statements of those parent companies and equity method investors. AcSEC believes that whether investment company accounting should be retained in the financial statements of the parent company or equity method investor should be based on the activities of the investment company and relationships between the parent company or equity method investor and the investees of the investment company. AcSEC believes, however, that investors other than parent company or equity method investors in investment companies should not be prohibited from retaining investment company accounting merely because of relationships between and among other investors, the investment company, or investees, because those investors other than parent company or equity method investors typically neither have influence over nor derive any benefits from relationships between and among other investors, the investment company, or investees. Accordingly, AcSEC developed a model under which investment company accounting may be retained in the financial statements of certain investors in an investment company, but not retained in the financial statements of other investors in the same investment company.

**A-19.** Some respondents to the exposure draft commented that the SOP should not nullify the guidance in EITF Issue No. 85-12 as it applies to investments in investment companies while others supported nullifying that guidance. Some believe that the guidance included in EITF Issue No. 85-12 is sound. Others believe that the guidance in EITF Issue No. 85-12 should apply unless the parent company or equity method investor clearly obtains benefits indicative of a strategic investor. Others believe it is internally inconsistent to establish criteria at the investment company level and then impose substantial barriers and restrictions that create a presumption that investment company accounting can exist at the separate company level, but not carry over to consolidation. Still others supported the guidance in the exposure draft. AcSEC continues to believe that the SOP should include guidance for determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor. AcSEC believes that retaining investment company accounting in the financial statements of a parent company or equity method investor without consideration beyond the appropriate accounting at the investment company level could lead to unintended consequences and potential abuses. In particular, AcSEC believes circumstances exist in which an entity may meet the definition of an *investment company* on a stand-alone basis, but the entity's parent or equity method investor holds interests in the investees of the investment company (through its interest in the investment company) for strategic operating purposes. In addition, without further guidance, AcSEC believes circumstances may exist in which the accounting by the entity's parent company may differ as a result of the parent company selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment 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 noninvestment company member of the consolidated group.

**A-20.** AcSEC considered whether the conditions for determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor with an investment in an entity regulated by the Investment Company Act of 1940 (the 1940 Act) or similar requirements should be the same as the conditions for investment companies, as opposed to retaining investment company accounting in the financial statements of a parent company or equity method investor in all circumstances in which the investment company is an entity regulated by the 1940 Act or similar requirements. AcSEC believes that the reporting in the consolidated financial statements of a parent company or the financial statements of an equity method investor in an investment company should not depend on whether the investment company is an entity regulated by the 1940 Act or similar requirements. Accordingly, AcSEC concluded that investment company accounting should not be retained in the financial statements of the parent company or equity method investor in circumstances in which the investment company does not meet all of the investment company conditions applicable to entities in paragraphs .05 and .11–.29 of this SOP.

**A-21.** The guidance for determining whether investment company accounting should be retained in the financial statements of investors in the entity is similar to the guidance for determining whether an entity is an investment company, with some additional guidance. The following paragraphs discuss the basis for those conclusions from two perspectives, namely, determining whether (a) an entity is an investment company and (b) investment company accounting should be retained in the financial statements of an investor in the entity.

### **Definition of an Investment Company**

**A-22.** AcSEC concluded that the SOP's conditions for inclusion or exclusion of entities from the scope of the Guide should be based on the nature of the entity's activities. Further, AcSEC concluded that certain entities subject to regulatory requirements should automatically be within the scope of the Guide.

**A-23.** The definition of an *investment company* included in this SOP is based on characteristics that AcSEC believes distinguish investment companies from entities that benefit from the operations of investees in ways other than through current income, capital appreciation, or both.

**A-24.** For purposes of the separate financial statements of an entity, AcSEC concluded that an investment company is a separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies. Also, AcSEC believes that entities regulated under the 1940 Act or the Small Business Investment Company Act of 1958, common (collective) trust funds, and the separate accounts of insurance companies as defined in the glossary of the Guide, that are required to report investments at fair value for regulatory reporting purposes and are subject to other requirements similar those of the 1940 Act or the Small Business Investment Company Act of 1958, should be included within the scope of the Guide without further consideration.<sup>25</sup> (These entities are referred to in this SOP as *entities regulated by the 1940 Act or similar requirements*.) AcSEC believes entities regulated by the 1940 Act or similar requirements should not be required to meet additional conditions to be an investment company within the scope of the Guide for purposes of their separate financial statements because the regulations and regulatory reporting requirements provide sufficient evidence that the entity's business activity is investment activity and because requiring those entities to report investments at amounts other than fair value for financial reporting purposes would create unjustified conflicts with regulatory reporting requirements.<sup>26</sup> As discussed in paragraph A-20 above, however, AcSEC believes that the conditions for determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor with an investment in an entity regulated by the 1940 Act or similar requirements should be the same as the conditions for investments in investment companies. Accordingly, AcSEC concluded that investment company accounting should be retained in the financial statements of a parent company or equity method investor in an entity regulated by the 1940 Act or similar requirements only if that entity regulated by the 1940 Act or similar requirements otherwise meets the definition of an *investment company* in this SOP.

---

<sup>25</sup> For example, for foreign jurisdictions, AcSEC understands that as of the publication date of this SOP, Canada, the United Kingdom, the Bermuda Monetary Authority, the Cayman Island Monetary Authority, and countries in the European Union that are subject to the provisions of the Undertakings for Collective Investment in Transferable Securities are examples of foreign jurisdictions with regulations similar to the 1940 Act. Those regulations include provisions that require fair value reporting and are consistent with the concepts identified in paragraphs .11–.18 of this SOP. Also, responsibility for monitoring compliance with those regulations rests with a regulatory organization.

<sup>26</sup> Because entities regulated by the 1940 Act or similar requirements are not required to meet additional conditions to be an investment company within the scope of the Guide for purposes of their separate financial statements, this *Basis for Conclusions* discusses certain conclusions, conditions, and other factors as they pertain to entities other than entities regulated by the 1940 Act or similar requirements, without specifically mentioning each time that such discussions do not apply to entities regulated by the 1940 Act or similar requirements.

**A-25.** Footnote 3 to paragraph 1.04 of the existing Guide provides that “this Guide does not apply to [real estate investment trusts, or REITs], which have some of the attributes of investment companies but are covered by other generally accepted accounting principles.” The exposure draft proposed retaining that guidance. Some respondents commented that REITs may or may not be investment companies, depending on their activities. AcSEC concluded that this SOP should not provide specific requirements for REITs and that REITs should be subject to the same provisions of this SOP as other entities. AcSEC observes, however, that REITs typically would not meet the definition of an *investment company* because REITs typically are involved in the day-to-day management of investees in ways that are inconsistent with the activities of an investment company. For example, REITs typically develop and operate real estate.

**A-26.** Some respondents commented that enterprise funds should be considered investment companies. They describe enterprise funds as not-for-profit organizations established and funded by the U.S. Government, in part to assist in the development of the economies of certain parts of the world by investing funds in small- and medium-sized enterprises and, if appropriate, to provide technical assistance to help those enterprises grow. They describe the grant agreements for particular enterprise funds as providing that the funds have been established to promote private sector development in designated countries through loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, guarantees, and other measures. Also, they describe the activities of the enterprise fund as nevertheless being aimed at increasing current income, capital appreciation, or both. FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, defines a *not-for-profit organization* as follows:

An entity that possesses the following characteristics that distinguish it from a business enterprise: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (FASB Concepts Statement No. 4, paragraph 7).

Though AcSEC concluded that this SOP should not include special provisions for not-for-profit organizations and that not-for-profit organizations should apply the provisions of this SOP in the same manner as other entities, AcSEC observes that the objectives of an investment company, whose definition includes a business purpose of investing for current income, capital appreciation, or both, and implicitly exists to return the economic benefits of that current income, capital appreciation, or both to its investors, generally would be inconsistent with the objectives of a *not-for-profit organization* as defined above. AcSEC observes, however, that not-for-profit organizations may be investors in investment companies. Accordingly, Appendix D [paragraph .62], “Effects on Other Pronouncements,” of this SOP includes amendments to SOP 94–3, *Reporting of Related Entities by Not-for-Profit Organizations* [section 10,610], to reflect the view that not-for-profit organizations may be investors in investment companies.

**A-27.** For purposes of determining whether an entity is an investment company,<sup>27</sup> AcSEC developed guidance based on the activities of the reporting entity, the relationships between the entity and investees, and the relationships between investors and the entity. AcSEC believes that approach is sound because those attributes provide evidence about the nature of the entity, including its activities, and, therefore, whether the entity is an investment company.

**A-28.** The definition of an *investment company* provides that entities should be organized as a separate legal entity. AcSEC considered permitting or requiring investment company accounting for operating segments, divisions, departments, branches, reporting units that are otherwise separately identifiable, pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity, aggregations of assets within an entity, or other components of an entity that are not separate legal entities that meet the investment company conditions. AcSEC concluded that an investment company should be a separate legal entity to (a) clearly and objectively distinguish and segregate investment company activities from other activities, (b) present itself as an investment company to other parties under the provisions of paragraph .11 of this SOP, and (c) allow investors to purchase or sell direct ownership interests in the entity. AcSEC believes that examples of such separate legal entities include corporations, partnerships, limited liability companies, grantor trusts, and other trusts, which AcSEC believes is consistent with the term *entity* as used in FASB Interpretation No. 46. Accordingly, AcSEC concluded that operating segments, divisions, departments, branches, reporting units that are otherwise separately identifiable, pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity, aggregations of assets within an entity, or other components of an entity that are not separate legal entities, are not investment companies for purposes of their separate financial statements, if any, or for purposes of the parent company's financial statements.

**A-29.** Paragraph .12 of this SOP provides that to be an investment company, an entity should have no substantive activities other than its investment activities. Operations other than investing activities, such as holding investments in operating subsidiaries, are not undertaken by investors that hold investments for the purpose of current income, capital appreciation, or both. AcSEC considered whether investment company accounting should be permitted to be applied to selective activities within an entity, but concluded that it should not, because by definition an investment company has one activity—investing for current income, capital appreciation, or both. Having other substantive operations calls into question whether the entity exists for reasons other than to invest for current income, capital appreciation, or both.

---

<sup>27</sup> As discussed in paragraph A-24 above, AcSEC concluded that regulated investment companies should be included within the scope of the Guide without further consideration. Also as discussed in paragraph A-24 above, however, AcSEC concluded that investment company accounting should be retained in the financial statements of a parent company or equity method investor in a regulated investment company only if that regulated investment company otherwise meets the definition of an *investment company* in this SOP. In addition, as discussed in paragraph A-21 above, this “Basis for Conclusions” discusses the conclusions from the perspective of both determining whether an entity is an investment company and determining whether investment company accounting should be retained in the financial statements of an investor in the entity. Accordingly, this “Basis for Conclusions” sometimes refers to conclusions that are applicable to nonregulated entities (as opposed to regulated entities) for purposes of the entities' separate financial statements and that are applicable to both nonregulated entities and regulated entities in considering whether investment company accounting should be retained by parent companies and equity method investors in investment companies.

**A-30.** Paragraph .14 of this SOP provides that to be an investment company, an entity should hold or plan to hold substantive investments in multiple investees. Investment companies make investments in multiple investees as a means of diversifying their portfolio and maximizing their returns. AcSEC believes that investing in multiple investees, therefore, is an important characteristic of an entity that invests for current income, capital appreciation, or both.

**A-31.** AcSEC considered whether specific guidance should be provided on the number of investments that should be held to meet the condition that the entity holds multiple investments. AcSEC concluded that it was unnecessary to provide a specific definition of *multiple investments*, but it should be more than one investment (either directly or through another investment company). AcSEC believes that entities will be able to apply judgment in determining whether the number of investments made by an entity is sufficient to lead to the conclusion that the entity is investing for current income, capital appreciation, or both.

**A-32.** The exposure draft proposed that an entity be required to hold multiple substantive investments in order to conclude that it is investing for current income, capital appreciation, or both. Further, the exposure draft proposed that to meet that requirement, the entity should hold multiple substantive investments directly or through another investment company or, for entities that have not yet completed their initial offering period, the entity should have an investment plan to acquire multiple substantive investments and it is anticipated that those multiple investments will be acquired within one year. Some respondents commented that this requirement should be revised or eliminated. Some commented that it is arbitrary and does not allow sufficient time for the research, due diligence, negotiation, and patience that is often required by difficult market conditions in making investment decisions. Some commented that the SOP should provide an exception for entities that have not yet completed their initial offering period but which have an investment plan to acquire more than one substantive investment within one year of the end of the marketing period. Some commented that the SOP should be revised to provide an exception for alternative investment vehicles, which may make only one investment, to be considered part of a larger fund to which they are in effect a part. Some commented that the requirement should be less restrictive in the liquidation stage of the entity's life, because at some point in the liquidation process, the entity may hold an investment in only one investee. AcSEC agrees that the guidance proposed in the exposure draft pertaining to multiple substantive investments was too restrictive and did not recognize various facts and circumstances under which investment companies might hold fewer than multiple investments. Accordingly, AcSEC revised the provisions of the SOP to recognize various facts and circumstances under which investment companies might hold fewer than multiple investments.

**A-33.** Paragraph .14 of this SOP provides that for equity investments made by investment companies in other entities, as opposed to investments in commodities, securities based on indices, derivatives, and other forms of investments, those other entities should be organized as separate legal entities, except in cases of foreclosure or liquidation of the original investment that are intended to be temporary. AcSEC believes that requiring those investees to maintain a separate legal status to be an investment company (a) distinguishes investments by investment companies for current income, capital appreciation, or both from investments by other entities in operating assets and (b) requires an appropriate level of autonomy between the investment company and those investees.

**A-34.** As discussed in paragraph A-24 above, the definition of an *investment company* contemplates that the entity's investment plans include exit strategies. AcSEC believes that parent companies with operating subsidiaries sometimes plan to own and operate those subsidiaries indefinitely to realize the benefits of the subsidiaries through operations. However, investment companies that hold investments plan to ultimately dispose of their investments after earning current income, capital appreciation, or both. AcSEC observes that the exit strategy of an investment company for investments in private equity securities typically is a limited period, such as three to seven years or may be based on the life of the entity. Though the exit strategy may vary depending on the nature and objectives of the investment, the maturity or development of the investee, market conditions, or other circumstances, potential exit strategies should be identified in order to meet the definition of an *investment company*. Also, in order to meet the definition of an *investment company*, the entity should have plans that address the time at which it expects to exit the investment, which may be either an expected date or range of dates, or a time defined by specific facts and circumstances, such as achieving certain milestones, the limited life of the entity, or the investment objectives of the entity. For investments in shares of public companies, temporary cash equivalents, commodities, securities based on indices, and derivatives, the time at which the entity expects to exit the investment may be a function of the entity's assessment of market conditions, cash flow needs, and other factors, such as the investment objectives of the entity.

**A-35.** Various exit strategies exist. For investments in private equity securities, examples of exit strategies include an initial public offering (IPO) of equity securities, a private placement of equity securities, distributions (to investors) of ownership interests in investees (typically in the form of marketable equity securities), and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee). For investments in assets, such as real estate, an example of an exit strategy includes the sale of the real estate. For investments in debt securities, examples of exit strategies include holding the debt to maturity, selling the debt in a private placement, converting the debt to equity securities and selling those equity securities in a private placement, an IPO, or on the market, if publicly traded. For investments in ownership interests in shares of public companies, temporary cash equivalents, commodities, securities based on indices, and derivatives, examples of exit strategies include selling the investment in a private placement or on the market, if publicly traded.

**A-36.** As noted in paragraph .05 of this SOP, an investment company does not hold investments for strategic operating purposes. AcSEC believes that in order to conclude that investments are not held for strategic operating purposes, the benefits obtained from the investment should be limited to the typical benefits of passive ownership, such as rights to dividends or other distributions. Accordingly, the SOP requires that entities not obtain benefits (other than current income, capital appreciation, or both) that are unavailable to noninvestor entities that are not related parties to the investee. For example, investment companies and major investors in investment companies do not make investments for the purpose of using technological research or development of investees in their own operations. Joint venture arrangements, significant transactions between the entity or its major investor(s) and investees, agreements or plans regarding the use of research or development between the investor entity and the investee entity, or other business relationships demonstrate that the entity or its major investor(s) are holding investments for strategic operating purposes, rather than for current income, capital

appreciation, or both. Those provisions do not, however, prohibit investment company accounting in circumstances in which one investee acquires another investee in a purchase business combination, provided that the acquisition was not directed by the investment company or its affiliates.

**A-37.** The exposure draft proposed guidance that included various conditions that should be met in order to conclude that an entity is an investment company. Some of those conditions were characterized as required to be met in order to conclude that the entity's business activity is investing for current income, capital appreciation, or both. Other conditions, which were incremental conditions for entities without pooled funds, were characterized as required to be met in order to conclude that "investees are separate autonomous businesses from the entity." AcSEC reconsidered the characterization of those conditions (some of which were revised in the SOP to be factors to consider rather than conditions) in light of the revised definition of an *investment company* and overall model in the SOP. AcSEC concluded that they should be characterized as conditions or factors that provide evidence about whether the investments are held for strategic operating purposes. AcSEC reached that conclusion because it believes that "held for strategic operating purposes" more succinctly and explicitly articulates what those conditions or factors provide evidence about than does "investing for current income, capital appreciation, or both" and "separate autonomous businesses from the entity." AcSEC reached that conclusion in part because the overall model in the SOP no longer requires incremental conditions for entities without pooled funds, and, therefore, it is unnecessary to have a separate category of conditions, that is separately characterized, for entities without pooled funds.

**A-38.** In addition to the requirements of and terms in the definition of an *investment company*, AcSEC believes other factors provide evidence about whether an entity meets the definition of an *investment company*. AcSEC believes that due to the diversity in the activities of investment companies and the relationships of investors in investment companies to the investment company and to the investment companies' investees, some factors may be more or less significant than others, depending on the facts and circumstances, and, therefore, more or less heavily weighted in determining whether an entity is an investment company.

**A-39.** AcSEC believes that the extent of influence over and ownership interests in the entity by investors (and indirectly over investees of the entity) are important factors in considering whether an entity's business purpose and activity are investing for current income, capital appreciation, or both. AcSEC believes that entities in which no single investor has the ability to exercise significant influence or control (as evidenced by substantial ownership interests) over the entity are more likely to be investing for current income, capital appreciation, or both, rather than for strategic operating purposes than are entities in which a single investor has the ability to exercise significant influence or control over the entity. Conversely, AcSEC believes that in circumstances in which a single investor has the ability to exercise significant influence or control over the entity, that investor may have the ability to, and objective of, managing those investments for strategic operating purposes, rather than for current income, capital appreciation, or both. AcSEC acknowledges, however, that entities in which a single investor has the ability to exercise significant influence or control may be investing for current income, capital appreciation, or both. Accordingly, AcSEC concluded that whether an entity has pooled funds (the extent to which numerous parties invest in the entity) is a significant factor that should be considered in determining whether

the entity is investing for current income, capital appreciation, or both, but should not be a condition that is necessarily determinative of whether the entity is an investment company. Accordingly, paragraph .19 of this SOP provides that the extent of pooling of funds typically should be more significant and provide more persuasive evidence than certain other factors. Also, as the extent of pooling of funds increases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically decreases. Conversely, as the extent of pooling of funds decreases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically increases.

**A-40.** As noted in paragraph A-9 above, the exposure draft proposed that entities without pooled funds meet certain incremental conditions in order to conclude that their business activity is investing for current income, capital appreciation, or both in separate autonomous businesses. AcSEC reached that conclusion in developing the exposure draft because AcSEC believed that meeting those incremental conditions provided additional evidence that the entity is investing for current income, capital appreciation, or both, rather than for the operating purposes of the investor with significant influence or control. Though few comments were received disagreeing with the requirement to have incremental conditions for entities without pooled funds, some respondents commented that a 20 percent financial interest (the exposure draft threshold for pooled funds) does not necessarily indicate the ability to exercise significant influence or control over the entity. Some commented, for example, that ownership percentage is irrelevant in circumstances in which limited partners are required to be passive investors. Also, some commented that the definition of *pooled funds* is unclear and not operational, for various reasons. In developing this SOP, AcSEC concluded that in light of the revised model in the SOP, the SOP should not include incremental conditions that entities without pooled funds are required to meet in order to be an investment company. Consistent with the overall intent of the exposure draft, however, AcSEC concluded that the extent of pooling of funds is an important factor that should be considered in determining whether an entity meets the definition of an *investment company*. Also, AcSEC concluded that because, under the revised model, pooling of funds is one of several factors to be considered and weighed, rather than an absolute condition, and because of the difficulties encountered in trying to develop a clear and operational definition of *pooled funds*, a specific definition of *pooled funds* is unnecessary and might result in unintended consequences.

**A-41.** AcSEC considered whether the level of ownership interests held in investees should be a factor in determining whether an entity's business purpose and activity are investing for current income, capital appreciation, or both. AcSEC believes that entities that do not hold significant levels of ownership interests in investees are more likely to be investing for current income, capital appreciation, or both, rather than for strategic operating purposes, than are entities that do hold significant levels of ownership interests in investees. AcSEC, therefore, concluded that the level of ownership interests held in investees is a significant factor that should be considered in determining whether the entity is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. Accordingly, paragraph .19 of this SOP provides that the level of ownership interests held in investees typically should be more significant and should provide more persuasive evidence than certain other factors. Also, as the level of ownership interests held in investees decreases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically decreases.

Conversely, as the level of ownership interests held in investees increases, the weight of other factors providing evidence that the entity is investing for strategic operating purposes typically increases.

**A-42.** AcSEC considered whether an entity that owns a controlling financial interest in an investee should be precluded from being an investment company within the scope of the Guide, because owning a controlling financial interest provides evidence that the entity has the ability to and, perhaps, the objective of managing that investment for strategic operating purposes, rather than for current income, capital appreciation, or both. AcSEC concluded, however, that owning a controlling financial interest in an investee should not preclude an entity from being an investment company within the scope of the Guide because such ownership does not necessarily demonstrate that the entity's objective is managing that investment for strategic operating purposes, rather than for current income, capital appreciation, or both. AcSEC believes that circumstances exist in which entities own a controlling financial interest in an investee for current income, capital appreciation, or both. AcSEC believes, however, that owning a controlling financial interest provides evidence that the entity may be investing for strategic operating purposes, and such evidence should be considered with other evidence to determine whether the entity meets the definition of an *investment company*.

**A-43.** AcSEC considered the nature of the entity's investors and whether that should be a factor in determining whether the entity is investing for current income, capital appreciation, or both. AcSEC concluded that substantial ownership by passive investors who pool their funds to avail themselves of professional investment management is a factor pointing toward the conclusion that the entity is an investment company, investing for current income, capital appreciation, or both, while substantial ownership by investors who determine the strategic direction or run the day-to-day operations of the entity is a factor pointing toward the conclusion that the entity is not an investment company, but rather is investing for strategic operating purposes. In addition, AcSEC concluded that substantial ownership by employee benefit plans is a factor pointing toward the conclusion that the entity is an investment company, investing for current income, capital appreciation, or both. AcSEC reached that conclusion pertaining to substantial ownership by employee benefit plans in part because employee benefit plans tend to be passive investors and in part because employee benefit plans are required to report their investments at fair value.

**A-44.** AcSEC believes that the management of investees of an investment company should be separate from the management of the investment company or affiliates of the investment company. Accordingly, paragraph .24 of this SOP provides that involvement in the day-to-day management of investees by management of an entity or its affiliates provides evidence of a parent-subsidiary relationship for strategic operating purposes that is contrary to the nature of an investment company investment. For example, the entity's board of directors serving as the management of the investee is inconsistent with relationships between an investment company and its investees. Representation on the boards of directors of investees, however, is not inconsistent with relationships between an investment company and its investees. In addition, an investment company providing temporary support services to investees is not inconsistent with relationships between an investment company and its investees if such support is provided in order to address a particular concern pertaining to a particular investee to maximize the value of the investment. Such services demonstrate a parent-subsidiary relationship,

however, if they are not limited to the period of time necessary to address that concern. In addition, paragraph .29 of this SOP provides that if the entity or its affiliates direct the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates, that provides evidence that the entity is investing for strategic operating purposes.

**A-45.** The exposure draft proposed that entities are not investment companies if they or their affiliates are involved in the day-to-day management of investees, their affiliates, or other investment assets. That requirement could be met, however, if management of the entity or its affiliates is represented on the boards of directors of investees or their affiliates or provides limited temporary assistance to management of investees or their affiliates. (The exposure draft also proposed that to be considered temporary, such assistance should be limited to a relatively short period, such as an aggregate of approximately six months for any investee or its affiliates for which such assistance is provided, and specific plans should exist to discontinue such assistance.) Some respondents commented that such guidance is not appropriate or operational. They agree that relationships and activities, such as having seats on an investee's board of directors, acting as temporary executives, having veto rights over budgets, hiring and firing management, or having veto power over other operating decisions, are not inconsistent with characteristics of investment companies. They believe the SOP should be more flexible in allowing such activities for investment companies, and that the SOP should not impose a six-month time limit. Some commented that the existence of a limited life of the entity, or limited holding periods for investments, mitigates any evidence that such day-to-day management is undertaken for strategic operating purposes rather than for current income, capital appreciation, or both. AcSEC acknowledges that investment companies may undertake such activities for purposes of current income, capital appreciation, or both. Accordingly, AcSEC concluded that though involvement in the day-to-day management of investees, their affiliates, or other investment assets provides evidence that the entity is investing for strategic operating purposes, that factor should be considered with other evidence to determine whether the entity meets the definition of an *investment company*. In addition, AcSEC acknowledges that such activities, if undertaken by an investment company, may be undertaken in order to address a particular concern pertaining to a particular investee to maximize the value of that investment. Accordingly, AcSEC revised the guidance to eliminate the reference to a six-month time period and instead provide that such activities should be limited to the period of time necessary to address the concern.

**A-46.** AcSEC understands that some entities currently using investment company accounting may own direct interests in real estate. AcSEC considered whether the SOP should provide specific conclusions applicable to entities that own direct interests in real estate. AcSEC concluded that the SOP should not provide specific conclusions applicable to entities that own direct interests in real estate because AcSEC is unaware of reasons why real estate investments should be treated differently than other investments for financial reporting purposes. Entities with direct interests in real estate should consider whether the entity's activities pertaining to those investments would result in the entity not meeting the definition of an *investment company*. For example, entities with direct interests in real estate should consider the extent of their involvement in the day-to-day management of investees, their affiliates, or other investment assets, as discussed in paragraph .24 of this SOP. Appendix C [paragraph .61], "Applying the Provisions of This SOP to Entities That Hold Investments in Real Estate," provides additional discussion about applying the provisions of

this SOP to entities that hold investments in real estate. Also, Appendix C [paragraph .61] includes examples specifically applicable to entities that invest in real estate and activities that they typically undertake.

**A-47.** Some respondents commented that the guidance in the exposure draft should be revised so that typical investment company activities pertaining to real estate are permitted. Some commented, among other things, that the guidance should be revised to consider the substance of the involvement pertaining to advisory and property management arrangements for investments in real estate, which they believe are consistent with board representation as discussed in paragraph .24 of this SOP. They note the distinction between fee-for-service property managers frequently used in real estate and management of operating companies. AcSEC acknowledges the challenges of applying the guidance in this SOP to investments in real estate. AcSEC observes that in contrast to investment companies that invest in other than real estate, the activities of real estate investment companies preceding exiting the investment are focused more on generating operating income and maintaining the property and focused less on capital appreciation through the maturation and development of the investment property or entity. The capital appreciation of real estate held by a real estate investment company tends to be more a function of overall market conditions than a function of the maturation and development of the investment property. Nevertheless, AcSEC believes that, conceptually, the guidance in this SOP should be applicable to investments in real estate.

### ***Other Guidance Specific to Parent Companies and Equity Method Investors***

**A-48.** AcSEC believes that if an investment company is a member of a consolidated group, policies should exist and be followed within the consolidated group that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies. AcSEC believes those policies should address, at a minimum, (a) the degree of influence held by the investment company and its related parties over the investees of the investment company, (b) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (c) the level of ownership interest held in the investment company by the consolidated group. AcSEC believes this condition is necessary to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment 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 noninvestment company member of the consolidated group. AcSEC believes that in order to be effective, such policies should include sufficient details and information to distinguish investment company investments from other investments in the consolidated group. The nature and detail of such policies will affect which investments are to be made by investment company subsidiaries and noninvestment company members of the consolidated group.

**A-49.** Paragraph .30 of this SOP includes certain conditions that should be considered in determining whether to retain investment company accounting in the financial statements of a parent company or equity method investor, including whether a subsidiary or equity method investee that is an entity regulated by the 1940 Act or similar requirements also meets the definition of

an *investment company* pursuant to the guidance in paragraphs .05 and .11–.29 of this SOP, as well as whether the parent company or equity method investor (through the investment company) is investing for current income, capital appreciation, or both, rather than for strategic operating purposes. In determining whether those conditions are met, paragraph .33 of this SOP provides that parent companies and equity method investors should consider various factors, such as:

- a. The degree of influence held by the investment company and its related parties over the investees of the investment company or affiliates of investees.
- b. The significance of the investments of the investment company that represent controlling financial interests.
- c. The significance of services provided and activities engaged in between and among the parent company, equity method investor, the investment company, or related parties of the parent company, equity method investor, or the investment company and investees or affiliates of investees.
- d. The level of ownership interest held in the investment company by the parent company or equity method investor.
- e. The extent to which investees of the investment company or their affiliates are in the same line of business as the parent company, equity method investor, or related parties of the parent company or equity method investor.

Due to the diversity in the activities of investment companies and the relationships of investors in investment companies to the investment company and to investees, all relevant facts and circumstances should be considered in determining whether to retain investment company accounting in the financial statements of a parent company or equity method investor. Accordingly, the factors in items *a* through *e* (above) should be considered in totality. Some factors may be more or less significant than others, depending on the facts and circumstances, and therefore more or less heavily weighted in determining whether an entity is an investment company. As the extent of items *a* through *e* becomes more significant, however, it becomes less likely that the parent company or equity method investor would retain investment company accounting.

**A-50.** AcSEC believes circumstances in which the parent company has a majority-owned investment company and the investment company consists substantially of majority-owned investments in investees provide significant evidence that the parent company is investing for strategic operating purposes. Also, AcSEC believes that in circumstances in which the investment company consists substantially of majority-owned investments in investees, it would be less likely for a parent of the investment company to retain investment company accounting than for an equity method investor in the investment company, because a parent would presumably be able to exert more influence than would an equity method investor.

**A-51.** The exposure draft proposed that if an investment company holds significant investments in investees or their affiliates that represent controlling financial interests, a rebuttable presumption exists that the parent company, equity method investor, or their related parties obtain or have the objective of obtaining benefits through relationships with investees or their affiliates that are unavailable to noninvestor entities and that investment company accounting, therefore, should not be retained in the financial statements

of the parent company or equity method investor. The exposure draft included factors that could overcome that presumption. Some respondents commented that that presumption was inappropriate, while others supported it. Some commented that the SOP should require that transactions with investees or their affiliates be conducted at arm's length in order to retain investment company accounting. Others commented that if the investment company conditions are satisfied at the entity level, investment company accounting should be retained at the parent level. Some commented that ownership levels are relatively unimportant in determining the business activity of the entity if the entity and its investees operate with a significant degree of autonomy. AcSEC continues to believe that whether an investment company holds significant investments in investees or their affiliates that represent controlling financial interests is a significant factor that should be considered in determining whether investment company accounting should be retained in the financial statements of a parent company or equity method investor. AcSEC believes, however, that providing a rebuttable presumption that investment company accounting should not be retained in the financial statements of the parent company or equity method investor if the investment company holds significant investments that represent controlling financial interests is unnecessary under the revised approach in the SOP. Accordingly, AcSEC concluded that whether and the extent to which the investment company and its related parties have influence over the investees of the investment company and the significance of the investments of the investment company that represent controlling financial interests are significant factors in considering whether investment company accounting should be retained in the financial statements of a parent company or equity method investor.

**A-52.** Paragraph .31 of this SOP provides that if a parent company no longer meets the provisions of paragraph .30 of this SOP to retain investment company accounting for any investment company subsidiary after an initial determination that investment company accounting should be retained in the financial statements of the parent company, the parent company should discontinue retention of investment company accounting for all subsidiaries. AcSEC considered whether retention of investment company accounting should be discontinued for all investment company subsidiaries or discontinued merely for those subsidiaries that no longer meet the conditions to retain investment company accounting. AcSEC concluded that the parent company's accounting (and financial statements) should be identical, regardless of how many investment companies it has. AcSEC reached this conclusion, in part, to prevent potential abuses. For example, if the revised Guide provided that retention of investment company accounting should be discontinued merely for those investment company subsidiaries that no longer meet the conditions to retain investment company accounting, rather than for all investment company subsidiaries, a parent company might establish multiple investment company subsidiaries to minimize the financial reporting effects of anticipated future violations of the conditions to retain investment company accounting. By establishing multiple investment company subsidiaries, the parent company could avoid discontinuing retention of investment company accounting for some or most of its investment company subsidiaries (and by extension, therefore, avoid discontinuing retention of investment company accounting for some or most of its investees) by merely distributing its investees among several investment company subsidiary entities, rather than including all investees in the same investment company subsidiary entity.

**A-53.** Paragraph .32 of this SOP provides that if an equity method investor no longer meets the provisions of paragraph .30 of this SOP to retain investment

company accounting for an investment in an investment company, after an initial determination that investment company accounting should be retained in the financial statements of the equity method investor, the equity method investor should discontinue retention of investment company accounting in reporting its investment in that investment company. In addition, that equity method investor should discontinue retention of investment company accounting in reporting its equity method investment in other investment companies (a) over which it has the ability to exercise significant influence and (b) that are managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment adviser, or functional equivalent of the entity for which investment company accounting is discontinued. For example, assume the following facts:

- Equity Method Investor A owns a 20 percent interest in Investment Companies B, C, D, and E. Investment Companies B, C, D, and E are, therefore, related parties to Equity Method Investor A.
- Equity Method Investor A has the ability to exercise significant influence over Investment Companies B, C, D, and E.
- Entity X is the General Partner of Investment Companies B and C.
- Entity Y is the General Partner of Investment Company D.
- Entity Z is the General Partner of Investment Company E.
- Entity X is a related party to Entity Y.
- Equity Method Investor A no longer meets the provisions of paragraph .30 to retain investment company accounting for its investment in Investment Company B, after an initial determination that Equity Method Investor A should retain investment company accounting in reporting its investment in Investment Company B.

Equity Method Investor A should discontinue retention of investment company accounting in reporting its investment in Investment Company B. In addition, Equity Method Investor A should discontinue retention of investment company accounting in reporting its investment in Investment Company C and Investment Company D.

**A-54.** AcSEC considered whether retention of investment company accounting should be discontinued for all equity method investments in investment companies, similar to the provisions for investment company subsidiaries of parent companies, as discussed in paragraph A-52 above. AcSEC concluded that an equity method investor's accounting for investment companies (a) over which it has the ability to exercise significant influence and (b) that are managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment adviser, or functional equivalent should be identical regardless of how many related investment company investees it has, for reasons similar to those applicable to investment company subsidiaries of parent companies, as discussed in paragraph A-52 above. AcSEC concluded that the SOP should include an exception, however, pertaining to investments in investment companies by an equity method investor in circumstances in which the investment companies are not (a) investment companies over which the equity method investor has the ability to exercise significant influence or (b) managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment adviser, or functional equivalent. AcSEC reached this conclusion because circumstances may exist in which the equity method investor uses its influence over an investment company in a manner that leads to

the conclusion that the equity method investor is investing for strategic operating purposes, but that influence may not extend to certain other investment companies, thereby limiting the equity method investor's ability to invest in those other investment companies for strategic operating purposes. AcSEC concluded, however, that if an equity method investor in an investment company is investing for strategic operating purposes, the equity method investor should consider the nature of the activities and relationships with that investment company that lead to the conclusion that the equity method investor is investing for strategic operating purposes in determining whether all or some investments in other investment companies (a) over which the equity method investor uses its influence and (b) that are not managed by the same general partner, investment adviser, or functional equivalent or a related party of that general partner, investment adviser, or functional equivalent are being held for strategic operating purposes and should, therefore, be adjusted (as if the investment company had not applied the Guide).

**A-55.** In certain circumstances, investment companies, parent companies, or equity method investors sometimes obtain tax benefits as a result of their ownership interests. AcSEC believes that tax effects are a component of all investments and any tax benefits resulting from investment ownership should not lead to the conclusion that the parent company or equity method investor has obtained or has the objective of obtaining benefits as a result of the investment through relationships with the investee that are unavailable to noninvestor entities that are not related parties to the investee, unless obtaining the tax benefits was a significant reason for making the investment, in which case the reasons for the investment would be other than for current income, capital appreciation, or both. Accordingly, paragraph .35 of this SOP provides that tax benefits that the parent company or equity method investor may obtain as a result of its ownership interest in the investment company are not inconsistent with the conditions for retaining investment company accounting if persuasive evidence exists that obtaining the tax benefits was not a significant reason for making the investment.

**A-56.** Paragraph .36 of this SOP provides that transfers of investments between a parent company or equity method investor or their related parties and an investment company subsidiary or equity method investee generally provide significant evidence that should lead to the conclusion that investees of the investment company are considered to be held by the parent company or equity method investor (through the investment company) for strategic operating purposes. AcSEC concluded, however, that transfers of investments in the following specific limited circumstances should not, by themselves, lead to a conclusion that such investments are held for strategic operating purposes:

- Transfers in circumstances in which the investments and the effects of holding the investments would be reported the same in the financial statements, regardless of whether they are held by the investment company or a noninvestment company entity. AcSEC believes investment company accounting should be retained in the event of such transfers because they have no effect on financial reporting.
- Transfers that are pro rata distributions to equity method investors of shares of investees in circumstances in which (a) the equity method investor does not have the ability to initiate the distribution and (b) the shares are distributed in a final liquidation of the investment company or can be publicly traded. AcSEC observes that such transfers are not uncommon by investment companies in the liquidation phase. AcSEC believes such transfers should result in not retaining

investment company accounting in circumstances in which they are initiated by an equity method investor that has the ability to initiate the distribution or a parent company. AcSEC believes that such transfers initiated by the investor demonstrate the investor's intent to invest for strategic operating purposes and, therefore, should preclude retaining investment company accounting by the investor.

- In rare situations, transfers between an investment company and a parent company, equity method investor, or their related parties in circumstances in which there have been (a) significant changes in facts and circumstances related to the nature of the parent company's, equity method investor's, or their related parties' business activities unrelated to the investee or its affiliates or (b) significant changes in the investee's or its affiliates' business activities in circumstances in which such change was not initiated or directed by the parent company, equity method investor, or their related parties, such that retaining the investment in the investment company, parent company, equity method investor, or their related parties would result in the conclusion that the investment company would otherwise no longer be within the scope of the Guide. This exception to the limitations on the transfer of investments applies only in circumstances in which significant changes to the parent company's, equity method investor's, or investee's operations exist as described above. This exception is not intended to permit such transfers in circumstances in which the parent company, equity method investor, or investee has not experienced such changes in circumstances. Given the nature of investments held by investment companies, such transfers should be rare. AcSEC believes investment company accounting should be retained in the event of such transfers because to require otherwise could result in unintended consequences and less meaningful financial reporting in certain situations in which facts and circumstances change significantly.
- Transfers that are insignificant and immaterial in all relevant respects, such as in relation to (1) the parent company's or equity method investor's financial statements, (2) the parent company's or equity method investor's interest in the investment company, and (3) the aggregate investment portfolio of investment company subsidiaries and investment company investees reported using the equity method. AcSEC believes investment company accounting should be retained in the event of such transfers because to require otherwise could result in unintended consequences and less meaningful financial reporting.

### ***Affiliates and Related Parties***

**A-57.** The terms *affiliate* and *related party* are used in this SOP as defined in FASB Statement No. 57, *Related Party Disclosures*. FASB Statement No. 57 defines an *affiliate* as "a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise." FASB Statement No. 57 defines *related parties* as follows:

Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one

## Clarification of the Scope for Investments in Investment Companies **21,501**

party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Accordingly, *affiliate* is a more narrow term than is *related party*, because all affiliates are related parties but not all related parties are affiliates. In particular, equity method investors in the investment company are related parties, but are not affiliates of the investment company and investees. AcSEC believes that relationships of affiliates, such as a controlling investor in the entity, should be considered in determining whether the entity is an investment company. Also, AcSEC concluded that relationships between related parties other than affiliates, such as equity method investors in the investment company and investees, should be irrelevant in determining whether the entity is an investment company. AcSEC believes that the entity may be investing for current income, capital appreciation, or both from the perspective of investors other than affiliates, such as equity method investors, regardless of relationships between and among related parties other than affiliates, such as equity method investors, the investment company, or investees. AcSEC believes relationships between and among related parties (including related parties other than affiliates) of a parent company or equity method investor, the investment company, or investees should be relevant, however, in determining whether investment company accounting should be retained in the financial statements of the parent company or equity method investor. Accordingly, activities and relationships in this SOP that result in the entity not qualifying for investment company accounting, or the parent company or the equity method investor not retaining investment company accounting, are framed in the context of relationships with affiliates at the entity level and with related parties at the parent company or equity method investor level.

### **Changes in Status**

**A-58.** AcSEC recognizes that, as a result of changes in circumstances, the provisions of this SOP may result in an entity that previously was:

- a. Considered an investment company under the provisions of the Guide, no longer being considered an investment company under the provisions of the Guide.
- b. Not considered an investment company under the provisions of the Guide, now being considered an investment company under the provisions of the Guide.

In addition, as a result of changes in circumstances, the provisions of this SOP may result in a parent company or equity method investor that previously:

- a. Retained investment company accounting in its financial statements no longer retaining that accounting under the provisions of the Guide.
- b. Did not retain investment company accounting now retaining investment company accounting under the provisions of the Guide.

AcSEC considered how these changes in status should be reported. AcSEC considered whether these changes are *accounting changes* as described in FASB

Statement No. 154, *Accounting Changes and Error Corrections*,<sup>28</sup> and concluded that they are not because these changes are triggered by a change in the entity's activities and relationships rather than changes in the accounting principles applied or the method of applying those principles. AcSEC considered whether these changes are a change in reporting entity because some may view the underlying investees in aggregate as representing different entities depending on whether they were owned by an investment company or an operating company. AcSEC concluded that these changes are not necessarily a change in reporting entity because the provisions of this SOP are such that an entity could have a change in status without effectively becoming a different reporting entity. Also, reporting all changes in status as changes in the reporting entity would have required retrospective application to the financial statements of all prior periods presented under the provisions of paragraph 23 of FASB Statement No. 154 to show financial information for the new reporting entity for all periods, regardless of the direction of the change. AcSEC rejected requiring that all changes be accounted for through retrospective application primarily because the change does not result in financial statements that, in effect, are those of a different reporting entity, as required under paragraph 3f of FASB Statement No. 154, and, to a lesser extent, the difficulty of determining, at the time of change, the fair values of investees in prior periods in circumstances in which an entity that previously was not considered an investment company under the provisions of the Guide may be considered an investment company under the provisions of the Guide.

**A-59.** The exposure draft proposed that if an entity that previously was an investment company under the provisions of the Guide is no longer an investment company under the provisions of the Guide, the entity should reflect the change in status through retrospective application to the financial statements of prior periods as if the Guide had not been applied. In addition, the exposure draft proposed that if an entity that previously was not an investment company under the provisions of the Guide becomes an investment company under the provisions of the Guide, the entity should reflect the change in status by applying the provisions of the Guide as of the date of the change in status, without retrospective application to prior period financial statements. Similar provisions regarding changes in status also would have applied to the financial statements of the entity's parent company or an equity method investor.

**A-60.** Some respondents to the exposure draft commented that restatement of prior periods would be difficult, if not impossible, because the information needed would not be available. Also, some respondents commented that changes in status should be considered a change in accounting principle. AcSEC considered whether entities should report such changes retrospectively, but rejected that conclusion because of practical difficulties in obtaining the necessary information. Rather, AcSEC concluded that entities should report the effect of the change in status for an entity that no longer meets the applicable investment company conditions in paragraphs .05–.29 of this SOP after an initial determination that the entity was an investment company prospectively, by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of the change using fair value in conformity with investment company accounting at the date of the change. For an entity that previously was not an investment company

---

<sup>28</sup> Paragraph 2 of FASB Statement No. 154 defines an *accounting change* as follows: a change in (a) an accounting principle, (b) an accounting estimate, or (c) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

under the applicable provisions of paragraphs .05–.29, but that becomes an investment company under those paragraphs as a result of changes in the entity’s operations and activities, AcSEC concluded that the entity should report the effect of the change in status as of that date in a manner similar to the cumulative effect of a change in accounting principle as an adjustment to retained earnings in the period in which the change occurred. AcSEC reached those conclusions in part, because of practical considerations about choosing another method of reporting changes in status, such as retrospective application. AcSEC considered whether an entity that no longer meets the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the entity was an investment company, should report changes in status in a manner similar to the cumulative effect of a change in accounting principle as an adjustment to retained earnings in the period in which the change occurred. AcSEC rejected that approach, because it would require certain retrospective computations, which rely on information that may be impracticable to obtain. Accordingly, for entities that no longer meet the applicable investment company conditions in paragraphs .05–.29 after an initial determination that the entity was an investment company, AcSEC concluded that the change should be accounted for prospectively.

**A-61.** Some respondents commented that the SOP should provide a window of opportunity to cure any facts and circumstances that result in an entity temporarily not meeting the investment company criteria. Some commented that noncompliance for a period of one year or less should not result in a change in investment company status if the entity otherwise intends to remain an investment company. AcSEC considered whether the SOP should include such exceptions to changes in status. AcSEC concluded that the SOP should not include such exceptions because AcSEC believes that the financial statements should reflect the assets and liabilities for the entity as of the reporting date, as well as the activity of the entity for the reporting period, in conformity with generally accepted accounting principles. AcSEC believes it would be misleading for an entity that is not an investment company under the provisions of this SOP as of the balance sheet date to report using investment company accounting. In addition, AcSEC believes that because of the changes made to the SOP, changes in status will be less frequent than respondents to the exposure draft anticipated.

**A-62.** AcSEC considered what financial statement disclosures, if any, should be required in addition to those required by existing GAAP. AcSEC believes the disclosures required by paragraphs .50–.53 of this SOP, addressing disclosures required in circumstances in which investment company accounting is retained in the consolidated financial statements for investment company subsidiaries or in the financial statements of an equity method investor in an investment company, as well as disclosures required in circumstances in which a change in status exists, provide useful information to financial statement users. Those disclosures are aimed primarily at providing information to financial statement users that would otherwise be unavailable because investment companies carry their investments at fair value, rather than consolidating or applying the equity method of accounting to those investments.

### ***Effective Date***

**A-63.** AcSEC recognizes that entities previously considered investment companies under the Guide may no longer be considered investment companies under the provisions of this SOP and visa versa, but that those entities may be able to modify existing arrangements, policies, and activities to be considered

investment companies under the provisions of this SOP. AcSEC believes that, for practical reasons, these entities should be given the opportunity to modify existing arrangements, policies, and activities prior to the initial application of this SOP to meet or not meet the definition of an *investment company* and continue their current accounting method. In addition, AcSEC believes entities should be given sufficient opportunity to obtain the information necessary to report under the provisions of this SOP. Further, as discussed in footnote 23 of this SOP, in February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115*, which may affect measurement of certain investments by some entities affected by this SOP. (Specifically, for entities other than investment companies, Statement No. 159 permits certain investments currently reported at other than fair value to be reported at fair value.) Entities are permitted to early adopt Statement No. 159. In order to minimize accounting changes and transition issues for entities affected by this SOP, AcSEC believes the effective date of this SOP should be such that entities could apply FASB Statement No. 159 upon adopting this SOP. Accordingly, AcSEC concluded that the provisions of this SOP should be effective for fiscal years beginning on or after December 15, 2007, which would give entities approximately six months after issuance of this SOP to implement its provisions, and avoid requiring entities to adopt this SOP prior to adopting Statement No. 159.

**A-64.** The exposure draft proposed that the provisions of the SOP be effective for fiscal years beginning after December 15, 2003, which was intended to be approximately six months after its expected issuance date. Some respondents commented that more than a six-month window should be provided between the issuance date and the effective date. AcSEC believes that adopting the provisions of this SOP will be less burdensome than adopting the proposed provisions of the exposure draft, in part because of the changes in the transition provisions, as discussed in paragraph A-65 below. AcSEC believes, however, that the effective date should be delayed based on the reasons in paragraph A-63 above.

### **Transition**

**A-65.** AcSEC concluded that entities that previously applied the provisions of the Guide, but that, pursuant to paragraphs .05–.29 of this SOP, do not meet the provisions of this SOP to be an investment company within the scope of the Guide (or that previously retained investment company accounting in the financial statements of a parent company or equity method investor, but do not meet the provisions of paragraphs .30–.45 of this SOP to retain investment company accounting in the financial statements of a parent company or equity method investor), should report the effects of adopting this SOP prospectively by accounting for its investments in conformity with applicable GAAP other than investment company accounting, beginning as of the date of adoption using fair value in conformity with investment company accounting at the date of adoption. In addition, AcSEC concluded that entities that, pursuant to paragraphs .05–.29, are investment companies within the scope of the Guide (or parent companies or equity method investors that meet the provisions of paragraphs .30–.45 to retain investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor), should report the cumulative effect of adopting this SOP as

an adjustment to opening retained earnings as of the beginning of the year that this SOP is adopted. In addition, all entities with changes in accounting as a result of adopting this SOP should disclose the effect of adopting this SOP on the financial statements of the period of adoption, including any changes in accounting for investments as a result of adopting this SOP, the effect of any changes on the reported amounts of investments as of the date of adoption, and any related effects on net income, change in net assets from operations (for investment companies), or change in net assets (for not-for-profit organizations) and related per share amounts.

**A-66.** The exposure draft proposed that entities that previously applied the provisions of the Guide (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that did not meet the investment company conditions in the SOP (or parent companies or equity method investors that do not meet the conditions to retain investment company accounting in the financial statements of the parent company or equity method investor), should be required to apply the provisions of the SOP by retrospective application to the financial statements of prior fiscal years, as if the Guide had not been applied. Also, the exposure draft proposed that entities that met the investment company conditions in the SOP (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor), should be permitted to adopt the provisions of the SOP either as the cumulative effect of an accounting change or by retrospective application to the financial statements for any number of consecutive prior fiscal years. Some respondents commented that the SOP should require that such changes be reported as the cumulative effect of a change in accounting principle or prospectively. Some respondents commented that the information necessary to apply the provisions of the SOP retroactively is either unavailable or, if available, is available only at unjustified costs. Some respondents commented that entities should be permitted, but not required to apply the provisions of the SOP retroactively. In considering the transition guidance in this SOP, AcSEC concluded that, conceptually, retrospective application provides the most meaningful information because it provides the most comparability. AcSEC believes that in certain circumstances, however, retrospective application may be impracticable because the required information may be unavailable. Accordingly, AcSEC concluded that entities that meet the investment company conditions in the SOP (or parent companies or equity method investors that meet the provisions to retain investment company accounting in the financial statements of the parent company or equity method investor), but that previously had not followed the provisions of the Guide (or parent companies or equity method investors that previously did not retain investment company accounting in the financial statements of the parent company or equity method investor) should report the effects of adopting the SOP in a manner similar to the cumulative effect of a change in accounting principle as an adjustment to opening retained earnings as of the beginning of the year that the SOP is adopted. For entities that previously applied the provisions of the Guide (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that do not meet the investment company conditions in the SOP (or parent companies or equity method

investors that do not meet the conditions to retain investment company accounting in the financial statements of the parent company or equity method investor), AcSEC believes it may be impracticable to obtain some of the information necessary to report the cumulative effect of a change in accounting principle, particularly certain retrospective information pertaining to required disclosures. Accordingly, AcSEC concluded that entities that previously applied the provisions of the Guide (or parent companies or equity method investors that previously retained investment company accounting in the financial statements of the parent company or equity method investor), but that do not meet the investment company conditions in the SOP (or parent companies or equity method investors that do not meet the conditions to retain investment company accounting in the financial statements of the parent company or equity method investor) should report such changes prospectively, beginning as of the date of the adoption using fair value in conformity with investment company accounting at the date of adoption.

## Appendix B

### Illustrations

**B-1.** This appendix provides illustrations to help readers understand and apply certain provisions of this Statement of Position (SOP) to specific fact patterns. These illustrations do not address all possible situations or applications of this SOP.

### Separate Financial Statements of an Investment Company

#### *Illustration 1*

**B-2.** Facts: Venture Partners I is formed in XX01 as a limited partnership with a 10-year life. Venture Partners I's offering memorandum provides that its purpose is to "invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners I."

**B-3.** GP I serves as the general partner of Venture Partners I and provides 1 percent of the capital to Venture Partners I. GP I is charged with the responsibility of identifying suitable investments for Venture Partners I.

**B-4.** Approximately 75 limited partners in Venture Partners I provide 99 percent of the capital to Venture Partners I. No limited partner provides 10 percent or more of the total capital of Venture Partners I. The 75 limited partners include entities subject to ERISA regulations (such as pension plans), public employee retirement systems of several states and municipalities, insurance companies, and wealthy individuals. By definition, the limited partners are passive investors in Venture Partners I and have no role in the management of Venture Partners I.

**B-5.** Venture Partners I commences its investment activities in XX01 and acquires equity interests in five entities during its first year of operations. Other than acquiring these equity interests, Venture Partners I conducts no other activities. Such equity interests represent less than a 20 percent ownership interest in each investee. GP I is not on the board of directors of any investee. However, to satisfy certain ERISA regulations, Venture Partners I obtains certain management rights with respect to each investee. These rights include:

- The opportunity to meet annually with the management of the investee to discuss the annual operating plan
- The right to examine the books and records of the investee
- The right to receive copies of all minutes, consents, and other materials provided to the board of directors of the investee (except those items which the investee considers highly confidential proprietary information)
- The right to address the board of directors of the investee regarding significant business issues facing the investee

No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Venture Partners I is investing for strategic operating purposes.

**B-6.** Venture Partners I makes similar investments in each of the next three years. Venture Partners I intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners I. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities, or the acquisition of the investee by a public company.

**B-7. Question:** Is Venture Partners I an investment company within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide)?

**B-8. Conclusion:** Venture Partners I is an investment company within the scope of the Guide.

**B-9. Analysis:** Though Venture Partners I is not an entity regulated by the 1940 Act or similar requirements and therefore is not automatically an investment company within the scope of the Guide pursuant to paragraph .09 of this SOP, Venture Partners I meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Partners I satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

**B-10.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Venture Partners I is an investment company within the scope of the Guide. Specifically, Venture Partners I has pooling of funds from numerous investors with none having a significant interest in Venture Partners I or an ability to influence Venture Partners I's activities; Venture Partners I's level of ownership in its investees provides no evidence that Venture Partners I is investing for strategic operating purposes; Venture Partners I has substantially all passive investors, including employee benefit plans; and neither Venture Partners I nor GP I, the general partner, is involved in the day-to-day management of the investees, provides significant administrative or support services to the investees, or directs the integration of operations of the investees or establishment of business relationships. Though Venture Partners I has obtained certain management rights, those rights impose no obligation on the investees and do not result in Venture Partners participating in the day-to-day management of investees.

## **Illustration 2**

*Illustration 2 builds upon Illustration 1. Information in the fact pattern of Illustration 2 that differs from the facts in Illustration 1 is highlighted by using italics.*

**B-11. Facts:** Venture Partners II is formed in XX01 as a limited partnership with a 10-year life. Venture Partners II's offering memorandum provides that its purpose is to “invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners II.”

**B-12.** GP II serves as the general partner of Venture Partners II and provides 1 percent of the capital to Venture Partners II. GP II is charged with the responsibility of identifying suitable investments for Venture Partners II.

## Clarification of the Scope for Investments in Investment Companies **21,509**

**B-13.** Approximately 75 limited partners in Venture Partners II provide 99 percent of the capital to Venture Partners II. No limited partner provides 10 percent or more of the total capital of Venture Partners II. The 75 limited partners include entities subject to ERISA regulations (such as pension plans), public employee retirement systems of several states and municipalities, insurance companies, and wealthy individuals. By definition, the limited partners are passive investors in Venture Partners II and have no role in the management of Venture Partners II.

**B-14.** Venture Partners II commences its investment activities in XX01. *However, no suitable investments are identified by the end of XX01. In XX02, Venture Partners II acquires an equity interest in one entity, Widget Corporation. Venture Partners II is unable to close another investment transaction until XX03, at which time it acquires equity interests in five additional operating companies. Additionally, in XX03, an employee of GP II, the general partner, assumes a temporary role as chief executive officer (CEO) of Widget Corporation following the unexpected departure of the previous CEO. The GP II employee serves as the CEO for a period of 18 months before a suitable permanent CEO is identified and retained. During substantially all of the period that GP II's employee serves as CEO of Widget Corp, an active search for the replacement CEO is under way.* Further, to satisfy certain ERISA regulations, Venture Partners II obtains certain management rights with respect to each investee. These rights include:

- The opportunity to meet annually with management of the investee to discuss the annual operating plan
- The right to examine the books and records of the investee
- The right to receive copies of all minutes, consents, and other materials provided to the board of directors of the investee (except those items which the investee considers highly confidential proprietary information)
- The right to address the board of directors of the investee regarding significant business issues facing the investee

No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Venture Partners II is investing for strategic operating purposes.

**B-15.** Other than acquiring these equity interests, Venture Partners II conducts no other activities. Such equity interests represent less than a 20 percent ownership interest in each investee.

**B-16.** Venture Partners II intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners II. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities, or the acquisition of the investee by a public company.

**B-17. Question:** During any relevant period from XX01 through XX03, is Venture Partners II an investment company within the scope of the Guide?

**B-18. Conclusion:** Venture Partners II is an investment company within the scope of the Guide during the entire period from XX01 through XX03.

**B-19. Analysis:** Though Venture Partners II is not an entity regulated by the 1940 Act or similar requirements and, therefore, is not automatically an investment company within the scope of the Guide pursuant to paragraph .09

of this SOP, Venture Partners II meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Partners II satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

**B-20.** Though Venture Partners II does not have multiple substantive investments until XX03, during each of XX01, XX02, and XX03, its business purpose is to hold multiple substantive investments and Venture Partners II is actively pursuing investment opportunities during these periods. Paragraph .15 of this SOP provides that the criterion does not require an investment company to have multiple substantive investments at all times throughout its existence, noting in particular periods during which suitable investments have not been identified, provided, however, that the business purpose of the entity includes plans to hold multiple substantive investments. Venture Partners II meets this criterion. Also, its disposition plan satisfies the criterion for an exit within a defined time period.

**B-21.** As noted in paragraph B-19 above, Venture Partners II meets the definition of an *investment company*; consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP, as well as the guidance in paragraphs .05 and .11–.18 of this SOP, in totality, supports the conclusion that Venture Partners II is an investment company within the scope of the Guide. Specifically, Venture Partners II has pooling of funds from numerous investors with none having a significant interest in Venture Partners II or an ability to influence Venture Partners II’s activities; Venture Partners II’s level of ownership in its investees provides no evidence that Venture Partners II is investing for strategic operating purposes; Venture Partners II has substantially all passive investors, including employee benefit plans; and neither Venture Partners II nor GP II, the general partner, is involved in the day-to-day management of the investees, provides significant administrative or support services to the investees, or directs the integration of operations of the investees or establishment of business relationships.

**B-22.** Though the role of an employee of GP II, the general partner, as the CEO, provides evidence that Venture Partners II may be investing for strategic operating purposes, that evidence is not considered significant in this situation because the involvement in management is provided on a temporary basis to address a particular concern pertaining to a particular investee, the investee is actively searching for a permanent CEO, and such involvement has not been provided on a required, continuous, or repeated basis to many investees. Accordingly, that evidence does not outweigh other evidence that Venture Partners II is an investment company within the scope of the Guide.

### **Illustration 3**

*Illustration 3 builds upon Illustration 2. Information in the fact pattern of Illustration 3 that differs from the facts in Illustration 2 is highlighted by using italics.*

**B-23.** *Facts:* Venture Partners III is formed in XX01 as a limited partnership with a 10-year life. Venture Partners III’s offering memorandum provides that its purpose is to “invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners III.”

## Clarification of the Scope for Investments in Investment Companies **21,511**

**B-24.** GP III serves as the general partner of Venture Partners III and provides 1 percent of the capital to Venture Partners III. GP III is charged with the responsibility of identifying suitable investments for Venture Partners III.

**B-25.** *Venture Partners III has four limited partners that provide 99 percent of the capital to Venture Partners III. These limited partners each provide from 10 percent to 50 percent of the total capital of Venture Partners III. The limited partners include one pension plan subject to ERISA regulations, a corporation, and two wealthy individuals.* By definition, the limited partners are passive investors in Venture Partners III and have no role in the management of Venture Partners III.

**B-26.** *Venture Partners III commences its investment activities in XX01 and acquires equity interests in multiple investees during a four-year investment cycle. By XX03, Venture Partners III ultimately invests in 35 companies. The capital structure of the investees typically includes one or two other institutional investors, and Venture Partners III has ownership interests in the investees typically ranging from 15 percent to 35 percent, though Venture Partners III owns 55 percent of one of the investees.* To satisfy certain ERISA regulations, Venture Partners III obtains certain management rights with respect to each investee. These rights include:

- The opportunity to meet annually with management of the investee to discuss the annual operating plan
- The right to examine the books and records of the investee; the right to receive copies of all minutes, consents, and other materials provided to the board of directors of the investee (except those items which the investee considers highly confidential proprietary information)
- The right to address the board of directors of the investee regarding significant business issues facing the investee

*An employee of GP III, the general partner, or an individual designated by Venture Partners III, typically takes a board seat with each investee. Over the four-year investment cycle, GP III serves on the boards of directors of 21 investees and Venture Partners III designates five other individuals, including the employee of one of its limited partner investors, to serve on the boards of directors of five other investees. No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Venture Partners III is investing for strategic operating purposes.*

**B-27.** *In XX02, GP III, the general partner, becomes involved in the management of certain investees on a temporary basis to address particular concerns. Ultimately, from XX02 through XX03, the employees of GP III serve as temporary CEO of one investee for three months; temporary chief operating officer (COO) of another investee for eight months; temporary CEO of a third investee for nine months; and assists five other investees (at the investees' request) in the development of either their marketing plan or project engineering development. During the course of the temporary CEO and COO roles, ongoing efforts exist to retain permanent replacements. Additionally, on two separate occasions, the chief financial officer (CFO) of GP III and Venture Partners III assists two start-up investees in establishing accounting policies and procedures and in developing their initial budgets at the investees' request.*

**B-28.** Other than acquiring these equity interests, Venture Partners III conducts no other activities.

**B-29.** Venture Partners III intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners III. Such dispositions may include the outright sale for cash of the equity interest, the

distribution of marketable equity securities to investors following the successful public offering of the investee's securities, or the acquisition of the investee by a public company.

**B-30. Question:** During any relevant period from XX01 through XX03, is Venture Partners III an investment company within the scope of the Guide?

**B-31. Conclusion:** Venture Partners III is an investment company within the scope of the Guide during the entire period from XX01 through XX03.

**B-32. Analysis:** Though Venture Partners III is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide, Venture Partners III meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Partners III satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

**B-33.** The “Factors to Consider” in paragraphs .19–.29 of this SOP require a more thorough review and consideration because of the existent circumstances, though ultimately, the evidence in totality supports the conclusion that Venture Partners III is an investment company within the scope of the Guide. Extensive pooling of funds does not exist due to the relatively small number of investors (four), some with relatively high investment levels (in particular the 50 percent interest of one investor); Venture Partners III has a significant level of ownership interests in investees (ranging from 15 percent to 35 percent, though Venture Partners III owns 55 percent of one of the investees); and one investor has direct involvement with an investee through the position of the investor's employee as a board member of an investee. Nevertheless, the limited partnership structure, as well as partial ownership by an employee benefit plan, points toward the passive nature of the investors (by definition, limited partners are passive investors and, therefore, have no active role in the management of the entity). The active involvement by employees of GP III, the general partner, in several of the investees (rather than just one), however, provides evidence that Venture Partners III may be investing for strategic operating purposes. In this fact pattern, however, GP III's involvement in each case was for a limited and temporary time period to address a particular concern pertaining to a particular investee and ongoing efforts exist to identify permanent management personnel. Also, Venture Partners III was involved with only three investees (out of 35) in a management role and with seven others at the request of the investees. (As discussed in paragraph .24 of this SOP, participation on the board of directors of investees is not necessarily inconsistent with the definition of an *investment company*.) Accordingly, the evidence pointing toward the conclusion that Venture Partners III is an investment company within the scope of the Guide outweighs the evidence pointing toward the conclusion that Venture Partners III is not an investment company.

#### **Illustration 4**

*Illustration 4 builds upon Illustration 3. Information in the fact pattern of Illustration 4 that differs from the facts in Illustration 3 is highlighted by using italics.*

## Clarification of the Scope for Investments in Investment Companies **21,513**

**B-34.** *Facts:* Venture Partners IV is formed in XX01 as a limited partnership with a 10-year life. Venture Partners IV's offering memorandum provides that its purpose is to "invest in companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Partners IV."

**B-35.** GP IV serves as the general partner of Venture Partners IV and provides 1 percent of the capital to Venture Partners IV. GP IV is charged with the responsibility of identifying suitable investments for Venture Partners IV.

**B-36.** *Venture Partners IV has 11 limited partners that provide 99 percent of the capital to Venture Partners IV. The limited partners include two pension plans subject to ERISA regulations (each with a 45 percent interest) and nine individuals (each with a 1 percent interest). The pension plans are sponsored by XYZ Corporation and the individual investors are board members or members of management of XYZ Corporation. By definition, the limited partners are passive investors in Venture Partners IV and have no role in the management of Venture Partners IV. However, as described below, management and other representatives of XYZ Corporation are involved in the day-to-day management of certain investees. Under the terms of the partnership agreement, the general partner can be replaced by a vote of two-thirds of the limited partnership interests.*

**B-37.** Venture Partners IV commences its investment activities in XX01 and acquires equity interests in multiple investees during a four-year investment cycle. By XX04, Venture Partners IV ultimately invests in 35 companies. The capital structure of the investees typically includes one or two other institutional investors, and Venture Partners IV has ownership interests in the investees typically ranging from 15 percent to 35 percent, *though several of the investments represent greater than 50 percent ownership interests in investees.*

**B-38.** Like many entities with investors subject to ERISA regulations, Venture Partners IV obtains certain management rights with respect to each investee. *Also, Venture Partners IV imposes certain other conditions (referred to as higher conditions) on each investee. Examples of these higher conditions include:*

- *Rather than a more customary right to meet annually with management of the investee to discuss the annual operating plan, Venture Partners IV obtains the right to approve the annual operating plan.*
- *Rather than a right to address the board of directors of the investee regarding significant business issues facing each investee, Venture Partners IV requires the board to consult with the management of XYZ Corporation and to obtain the approval of the management of XYZ Corporation on all important decisions.*
- *Venture Partners IV has blocking rights on all votes of investees regarding mergers, acquisitions, public sales of stock, and all other liquidating events.*

*An employee of GP IV, the general partner, or an individual designated by Venture Partners IV typically takes a board seat with each investee. Over the four-year investment cycle, GP IV serves on the boards of directors of five investees, and Venture Partners IV designates employees of XYZ Corporation to fill board seats on all other investees.*

**B-39.** *XYZ Corporation has a broad diversification of operations and expertise in many industries. As a result, XYZ Corporation has extensive management expertise in many of the industries in which investees of Venture Partners IV*

operate. In XX02, GP IV, the general partner, hires a number of new individuals from XYZ Corporation to provide management assistance to investees. These new employees have expertise in marketing, engineering, and finance. These new employees serve as temporary CEOs, COOs, and CFOs for many of the investees. In addition, other employees of GP IV or XYZ Corporation assist many other investees in the development of either their marketing plans, budgets, or project engineering. During the course of the management involvement and assistance, limited efforts have been made to retain permanent management personnel because plans have been established to sell operations of investees to other companies. As a result of GP IV's and XYZ Corporation's involvement in the management of investees, GP IV directs the integration of operations between certain investees.

**B-40.** Venture Partners IV conducts no other activities.

**B-41.** Venture Partners IV intends to dispose of its interests in each of its investees during the 10-year stated life of Venture Partners IV. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities, *the sale of operations of investees*, or the acquisition of the investee by a public company.

**B-42. Question:** During any relevant period from XX01 through XX04, is Venture Partners IV an investment company within the scope of the Guide?

**B-43. Conclusion:** Venture Partners IV is not an investment company within the scope of the Guide during any relevant period from XX01 through XX04.

**B-44. Analysis:** Venture Partners IV is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. In some respects, Venture Partners IV's activities are consistent with the definition of an *investment company* in paragraph .05 of this SOP. Specifically, Venture Partners IV is a separate legal entity; its stated business purpose is investing for current income, capital appreciation, or both; it has made multiple substantive investments; and it has a defined exit strategy.

**B-45.** However, further consideration of the evidence leads to the conclusion that Venture Partners IV is investing for strategic operating purposes. Though Venture Partners IV is owned by a number of investors, all of the limited partner investors are related to XYZ Corporation. Also, Venture Partners IV has significant ownership interests in certain investees, including some interests over 50 percent. In addition, though limited partners typically are passive investors and the investors are primarily employee benefit plans, representatives of both XYZ Corporation and GP IV are involved in the management of many of Venture Partners IV's investees. Accordingly, evidence exists that Venture Partners IV, XYZ Corporation, and GP IV are exerting significant, continuous, and repeated influence on the day-to-day activities and the strategic direction of Venture Partners IV's investee's. Examples of that evidence include the following:

- XYZ Corporation and GP IV participate on the boards of directors of a significant number of the investees.
- Management of Venture Partners IV, XYZ Corporation, and GP IV have significant involvement in the day-to-day operations of the investees as evidenced by the right to approve the annual operating plan, the requirement to obtain the approval of management of

XYZ Corporation on all important decisions, and blocking rights on all votes of investees regarding mergers, acquisitions, public sales of stock, and all other liquidating effects.

Also, the ability and the practice of Venture Partners IV to compel investees to utilize GP IV and employees of XYZ Corporation as investee board members and management personnel constitutes significant, continuous, and repeated involvement in the day-to-day management of investees. Consequently, significant evidence exists that Venture Partners IV is investing for strategic operating purposes and, based on consideration of the “Factors to Consider,” as discussed in paragraphs .19–.29 of this SOP, little evidence exists to support a conclusion that Venture Partners IV is an investment company within the scope of the Guide. Accordingly, though some evidence exists that Venture Partners IV is an *investment company* within the scope of the Guide, other, more persuasive, evidence exists that Venture Partners IV is investing for strategic operating purposes and, therefore, Venture Partners IV is not an investment company within the scope of the Guide.

### **Illustration 5**

**B-46.** Facts: Technology Investors Corporation is formed in XX01 by Major Retail Corporation, a publicly-traded retail company. Technology Investors Corporation’s articles of incorporation provide that Technology Investors Corporation’s purpose is to “invest in technology companies having rapid growth potential, with the objective of realizing superior capital appreciation.” Technology Investors Corporation is not an entity regulated by the 1940 Act or similar requirements. Employees of Major Retail Corporation direct the investment activities of Technology Investors Corporation.

**B-47.** Technology Investors Corporation commences its investment activities in XX01 with investments in two entities and subsequently makes additional investments in 25 more entities in XX02 through XX06. Major Retail Corporation is not involved in the formation or start-up of the investees. An employee of Major Retail Corporation participates on the boards of directors of some investees. Technology Investors Corporation’s investment in each investee generally is made with other entities (some of whom are investment companies). Technology Investors Corporation typically holds between 5 percent and 25 percent of each investee on a fully diluted basis. Other than its participation on the boards of directors of certain investees, Major Retail Corporation is not involved in the operations of the investees and the operations of investees are unrelated to the operations of Major Retail Corporation. No relationships or activities described in paragraph .18 of this SOP exist that provide evidence that Technology Investors Corporation is investing for strategic operating purposes.

**B-48.** Technology Investors Corporation expects to liquidate its holdings in each investee within six years of its initial investment. The exit strategy is for each investee to either have an initial public offering of equity securities (in which case Technology Investors Corporation will eventually liquidate its holdings through the public markets) or to be acquired for cash or the acquirer’s public stock (in which case Technology Investors Corporation will eventually liquidate its holdings in the acquirer’s public stock through the public markets). As of December 31, XX06, Technology Investors Corporation has liquidated its investments in five of the investees.

**B-49.** *Question:* During any relevant period from XX01 through XX06, is Technology Investors Corporation an investment company within the scope of the Guide?

**B-50. Conclusion:** Technology Investors Corporation is an investment company within the scope of the Guide during the entire period from XX01 through XX06.

**B-51. Analysis:** Though Technology Investors Corporation is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide, Technology Investors Corporation meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Technology Investors Corporation satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

**B-52.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Technology Investors Corporation is an investment company within the scope of the Guide. Though Technology Investors Corporation is wholly owned and, therefore, does not have pooled funds nor is it owned substantially by passive investors, Technology Investors Corporation:

- Has relatively low levels of ownership interests in investees.
- Is not involved in the day-to-day management of investees.
- Does not provide investees with significant administrative or support services.
- Does not direct the integration of operations of investees or the establishment of business relationships between investees or their affiliates.

Though Major Retail Corporation participates on boards of directors of investees, such participation is not necessarily inconsistent with the definition of an *investment company*, as discussed in paragraph .24 of this SOP.

**B-53.** Though Technology Investors Corporation has not exited from all of its investments as of December 31, XX06, no evidence exists that Technology Investors Corporation’s relationships with investees differs from those of the other investors in the investees, and Technology Investors Corporation does have a stated exit strategy. More specifically, no evidence exists to support the conclusion that Technology Investors Corporation is retaining its investment in any investee for strategic operating purposes rather than for current income, capital appreciation, or both.

### **Illustration 6**

**B-54. Facts:** High Technology Fund is formed by six high-technology companies to invest in high-technology start-up companies. Investments generally are expected to represent controlling financial interests in investees. In certain circumstances, investments held by High Technology Fund are expected to be transferred to or acquired by certain investors in High Technology Fund if the technology developed by the investees would benefit the operations of the investors. Though High Technology is managed by an investment adviser that is otherwise not related to the investors, the investors in the High Technology Fund provide significant advice to the investment adviser concerning potential investments. High Technology Fund generally does not participate in the day-to-day management of investees. However, investors in High Technology

Fund sometimes provide strategic direction to investees and participate on the boards of directors of investees. In addition, High Technology Fund intends to direct the integration of certain operations of investees to attempt to maximize the overall value of the portfolio.

**B-55. Question:** Is High Technology Fund an investment company within the scope of the Guide?

**B-56. Conclusion:** High Technology Fund is not an investment company within the scope of the Guide.

**B-57. Analysis:** High Technology Fund is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. As discussed in the description of High Technology Fund's activities and its relationships with its investors, the business purpose of High Technology Fund is for strategic operating purposes, rather than for current income, capital appreciation, or both. High Technology Fund expects to have controlling financial interests in investees and an active role in the management of investees, including providing strategic direction and directing the integration of certain operations of investees. In addition, the exit strategies of High Technology Fund include the potential transfer of operations of investees to investors in High Technology Fund. Those arrangements and circumstances provide evidence that the business purpose of High Technology Fund is investing for strategic operating purposes.

### Parent Companies<sup>29</sup>

#### *Illustration 7*

**B-58. Facts:** Parent Company I owns a 99 percent limited partnership interest in Private Equity Partners I. Private Equity Advisers I GP, a wholly-owned subsidiary of Parent Company I, owns a 1 percent general partnership interest in Private Equity Partners I. Private Equity Partners I's business objective is to invest in private companies that offer the potential for significant capital appreciation. Private Equity Advisers I GP has a staff of investment professionals with expertise in management, restructuring, and financing. Private Equity Partners I's investment strategy is to hold controlling financial interests in investees in distressed situations, work with investee management to restructure and reposition the investee to increase its value, and then sell the investee within three to five years.

**B-59.** As part of the effort to restructure and reposition the investees, Private Equity Advisers I GP, as general partner of Private Equity Partners I, directs the integration of certain investees. Such integration activities include buying and selling divisions or operating units between investees or merging investees. In addition, employees of Private Equity Advisers I GP typically participate in the day-to-day management of investees. Though such participation generally is for limited time periods, those employees generally are active in management activities of most investees.

---

<sup>29</sup> Illustrations 7 to 9 illustrate certain provisions of this SOP pertaining to whether investment company accounting should be retained in the financial statements of a parent company or equity method investor in circumstances in which an entity in which the parent company or equity method investor invests qualifies for investment company accounting under the provisions of this SOP. In order to retain investment company accounting in the financial statements of a parent company or equity method investor, therefore, the entity in which the parent company or equity method investor invests should qualify as an investment company under the provisions of this SOP.

**B-60. Question:** Is Private Equity Partners I an investment company within the scope of the Guide and, if so, should Parent Company I retain investment company accounting in consolidating its interest in Private Equity Partners I?

**B-61. Conclusion:** Private Equity Partners I is not an investment company within the scope of the Guide and, therefore, Parent Company I should not apply investment company accounting in consolidating its interest in Private Equity Partners I.

**B-62. Analysis:** Private Equity Partners I is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. Though Private Equity Partners I has a stated business objective that is consistent with the definition of an *investment company*, the activities related to the implementation of the investment strategy provide evidence that Private Equity Partners I is investing for strategic operating purposes.

**B-63.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Private Equity Partners I is not an investment company within the scope of the Guide. Pooled funds do not exist. Parent Company I owns, directly and indirectly, 100 percent of the ownership interests in Private Equity Partners I and controls the investment decisions through the investment management personnel who are employees of Private Equity Advisers I GP, the general partner and a wholly-owned subsidiary of Parent Company I. The lack of pooled funds provides significant evidence that the entity is investing for strategic operating purposes. Also, Private Equity Partners I typically holds controlling financial interests in investees. Such interests provide significant evidence that Private Equity Partners I is investing for strategic operating purposes. Also, Private Equity Partners I is not substantially owned by passive investors. Rather, Private Equity Partners I is effectively wholly-owned by Parent Company I, which (through its wholly-owned subsidiary, Private Equity Advisers I GP) is involved in management of Private Equity Partners I, determines the strategic direction, and runs the day-to-day operations of Private Equity Partners I. This provides evidence that Private Equity Partners I is investing for strategic operating purposes. Also, Private Equity Partners I is involved in the day-to-day management of investees. Though that involvement generally is intended to be on a temporary basis, Private Equity Partners I’s investment strategy includes plans to participate in day-to-day management to assist distressed investees. That involvement provides evidence that Private Equity Partners I is investing for strategic operating purposes. Also, as part of the effort to restructure and reposition investees, Private Equity Advisers I GP, as general partner of Private Equity Partners I, directs the integration of certain investees. Though Private Equity Partners I has an express business purpose that appears to be consistent with the definition of an *investment company*, the significant evidence described above outweighs any positive evidence that Private Equity Partners I may be an investment company within the scope of the Guide. Accordingly, Private Equity Partners I is not an investment company within the scope of the Guide.

**B-64.** In this example, Private Equity Partners I is not an investment company within the scope of the Guide, in part due to the relationships and activities between Parent Company I (and its subsidiaries) and Private Equity Partners I (and its investees). As discussed in this SOP, relationships and activities of affiliates of an entity, such as a parent company, and its investees

affect the determination of whether the entity is an investment company within the scope of the Guide. Parent Company I and Private Equity Advisers I GP, the general partner, are affiliates of Private Equity Partners I. Because Private Equity Partners I is not an investment company within the scope of the Guide, further analysis of whether investment company accounting should be retained by Parent Company I in consolidation is unnecessary. (The guidance in this SOP pertaining to retaining investment company accounting in consolidated financial statements of a parent company or the financial statements of an equity method investor applies only in situations in which the subsidiary or equity method investee is an investment company within the scope of the Guide. If the subsidiary or equity method investee is not an investment company within the scope of the Guide, investment company accounting should not be applied in the consolidated financial statements of the parent company nor in the financial statements of an equity method investor.) Accordingly, Private Equity Partners I is not treated as an investment company in its separate financial statements nor in the consolidated financial statements of Parent Company I.

### **Illustration 8**

**B-65. Facts:** Parent Company II has business segments in banking, insurance, investment banking, and consumer finance. Parent Company II owns a 99 percent limited partnership interest in Private Equity Partners II. Private Equity Advisers II GP, a wholly-owned subsidiary of Parent Company II, owns a 1 percent general partnership interest in Private Equity Partners II.

**B-66.** The purpose of Private Equity Partners II is to invest in companies having rapid growth potential with the objective of realizing superior capital appreciation. Private Equity Partners II develops exit strategies for each investment at the time of acquisition, generally with the expectation that the investments will be sold within three to five years.

**B-67.** Private Equity Partners II holds a portfolio of over 100 investments in equity securities of investees. Private Equity Partners II has four investments (approximately 8 percent of the value of the portfolio) that represent controlling financial interests in investees (ownership interests range from 60 to 100 percent). Investments in the remaining investees represent ownership interests ranging from 5 to 45 percent. Management of Private Equity Advisers II GP participates on the boards of directors of approximately one-half of investees. In addition, due to the temporary lack of appropriate management expertise at certain investees, Private Equity Advisers II GP has provided limited temporary management assistance to approximately 15 investees over the past several years to address particular concerns to maximize the value of those investments. The period of that assistance generally does not extend beyond several months. However, in one instance, that assistance was necessary for two years due to the extended time required to identify and hire appropriate management at the investee, which was in a highly specialized industry. Other than the temporary involvement in management in certain instances and participation on the boards of directors of many investees, Private Equity Partners II, Private Equity Advisers II GP, and Parent Company II are not otherwise involved in the activities of investees. No relationships or activities described in paragraphs .18 and .35 of this SOP exist that provide evidence that Parent Company II or Private Equity Partners II are investing for strategic operating purposes.

**B-68.** Parent Company II has established policies concerning the types and nature of investments that may be made by Private Equity Partners II. Those

policies provide that Private Equity Partners II may invest in equity securities of private companies in industries specified by an investment committee of Parent Company II (the specified industries currently exclude those in the same line of business as Parent Company II and its subsidiaries); that such investments, unless otherwise approved by the investment committee (including documentation pertaining to the investment committee's consideration of such approval), should not represent controlling financial interests in investees; and that investees should not have any significant business activities with Parent Company II or its related parties. (The controlling financial interests held in certain investees by Private Equity Partners II were approved by the investment committee. Those controlling financial interests were acquired in investees that had financial difficulties subsequent to the initial investments in the companies.) In addition, prior to making investments, Private Equity Partners II is required to make specified inquiries with other business segments of Parent Company II and the treasury group of Parent Company II to identify any potential business activities between Parent Company II or its related parties and potential investees. Any such relationships are referred to the investment committee for evaluation and approval prior to making the investment to ensure that they are not held for strategic operating purposes, and the investment committee documents its consideration of such approval. The intent of these policies is to prohibit Private Equity Partners II from making investments in investees that are involved in the same lines of business as Parent Company II or its related parties or that have significant business activities with Parent Company II or its related parties.

**B-69.** As a result of complying with the consolidated group policies described above, none of Private Equity Partners II's investees has significant business activities with Parent Company II or its related parties and no investments are held in companies that have significant business activities in banking, insurance, investment banking, or consumer finance.

**B-70.** In certain cases following an initial public offering by an investee, Private Equity Partners II transfers marketable equity securities to Parent Company II. In all cases, Parent Company II accounts for those marketable equity securities as trading securities in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Parent Company II has a policy that Private Equity Partners II may not distribute investments to Parent Company II unless such investments are (a) in marketable equity securities that would not represent significant influence or controlling financial interests or (b) otherwise approved by the investment committee.

**B-71. Question:** Is Private Equity Partners II an investment company within the scope of the Guide and, if so, should Parent Company II retain investment company accounting in reporting its interest in Private Equity Partners II?

**B-72. Conclusion:** Private Equity Partners II is an investment company within the scope of the Guide and Parent Company II should retain investment company accounting in its consolidated financial statements.

**B-73. Analysis:** Though Private Equity Partners II is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide, Private Equity Partners II meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Private Equity Partners II satisfies the basic investment company requirements—it is a separate legal entity;

its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

**B-74.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Private Equity Partners II is an investment company within the scope of the Guide. Specifically, Private Equity Partners II generally holds less than controlling financial interests in investees and does not direct the integration of activities of investees or the establishment of business relationships between investees or their affiliates. Evidence that Private Equity Partners II is investing for strategic operating purposes includes the single nonpassive investor in the entity; ownership of controlling financial interests in a limited number of investees; and temporary involvement in the day-to-day management of certain investees. However, due to the few investees in which Private Equity Partners II has controlling financial interests (and the fact that such controlling interests were acquired subsequent to the initial investments due to financial difficulties of the investees) and the limited nature of the involvement in day-to-day management (both in the reasons for such involvement, its duration, and number of investees in which it is involved), evidence that Private Equity Partners II is an investment company within the scope of the Guide outweighs evidence that Private Equity Partners II is not an investment company within the scope of the Guide.

**B-75.** Parent Company II has established policies effectively distinguishing the nature and types of investments to be made by Private Equity Partners II from investments made by Parent Company II and no other relationships exist between Parent Company II or its related parties with investees that provide evidence that investment company accounting should not be retained in consolidation. In addition, any investments transferred to Parent Company II are marketable equity securities that are reported the same regardless of whether they are held by Parent Company II or Private Equity Partners II.

## Equity Method Investors

### *Illustration 9*

**B-76.** *Facts:* Venture Capital Fund I is formed in XX01 as a limited partnership with a 10-year life. Venture Capital Fund I’s offering memorandum states that its purpose is to “invest in technology companies having rapid growth potential, with the objective of realizing superior capital appreciation over the life of Venture Capital Fund I.”

**B-77.** Venture Capital Management Company I GP serves as the general partner of Venture Capital Fund I and provided 1 percent of the capital to Venture Capital Fund I. Venture Capital Management Company I GP is responsible for identifying suitable investments for Venture Capital Fund I. Four limited partners in Venture Capital Fund I exist. Limited partner A has a 9 percent limited partnership interest; limited partner B has a 10 percent limited partnership interest; and limited partners C and D each have a 40 percent limited partnership interest. Other than their investments in Venture Capital Fund I, the limited partners have no relationships with each other or with Venture Capital Management Company I GP. Limited partners A and B do not have the ability to exercise significant influence over Venture Capital Fund I. Representatives of limited partner C and limited partner D participate as advisers to the investment committee of Venture Capital Fund I, which is

composed of representatives of Venture Capital Management Company GP I. Limited partner C is a manufacturing company. Limited partner D is a technology company.

**B-78.** Venture Capital Fund I commences its investment activities in XX01 and acquires equity interests in 35 companies in XX01 through XX03. Venture Capital Fund I typically holds ownership interests in investees ranging from 15 percent to 35 percent. However, Venture Capital Fund I holds two investments that represent greater than 50 percent ownership interests in investees. Approximately 80 percent of the investees of Venture Capital Fund I are in the same line of business as limited partner D. No relationships or activities between Venture Capital Fund I and the investees described in paragraph .18 of this SOP exist that provide evidence that Venture Capital Fund I is investing for strategic operating purposes. In addition, no relationships between limited partners A, B, and C and investees as described in paragraph .35 of this SOP exist that provide evidence that limited partners A, B, and C are investing for strategic operating purposes. Limited partner D, however, has entered into joint venture arrangements with several investees to jointly develop certain technology products. Limited partner D also has acquired certain patents and technology from other investees.

**B-79.** Representatives of Venture Capital Fund I participate as members of the boards of directors for five of the investees. In addition, representatives of limited partner D participate on the board of directors of 10 of the investees. Management of Venture Capital Fund I is not involved in the day-to-day management of investees. However, a number of investees have met separately with representatives of limited partner D to discuss product development and other issues.

**B-80.** Venture Capital Fund I intends to dispose of its interests in each of the investees during the 10-year life of Venture Capital Fund I. Such dispositions may include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors, or other sales of the operations of investees. In addition, limited partner D has expressed interest to Venture Capital Fund I in acquiring operations from certain investees.

**B-81. Question:** Is Venture Capital Fund I an investment company within the scope of the Guide and, if so, should the limited partners retain investment company accounting in applying the equity method to their investments in Venture Capital Fund I?

**B-82. Conclusion:** Venture Capital Fund I is an investment company within the scope of the Guide and limited partners A, B, and C should retain investment company accounting in applying the equity method to their investments in Venture Capital Fund I. Limited partner D, however, does not qualify to retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I.

**B-83. Analysis:** Venture Capital Fund I is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and, therefore, is not automatically an investment company within the scope of the Guide. However, Venture Capital Fund I's business purpose and activities are consistent with the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Venture Capital Fund I satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple

substantive investments from which it intends to exit within a defined time period; and none of its investments is made for strategic operating purposes.

**B-84.** Though Venture Capital Fund I has controlling financial interests in two investees, no other significant evidence exists that Venture Capital Fund I may be investing for strategic operating purposes. Though limited partner D has certain other relationships with investees, those relationships should not be considered in the determination of whether Venture Capital Fund I is an investment company within the scope of the Guide because limited partner D is not an affiliate of Venture Capital Fund I.

**B-85.** Limited partners A and B do not have the ability to exercise significant influence over the operations of Venture Capital Fund I. However, in accordance with SOP 78-9, *Accounting for Investments in Real Estate Ventures* [section 10,240], and Emerging Issues Task Force (EITF) Topic D-46, *Accounting for Limited Partnership Investments*, as described in paragraph .47 of this SOP, those investors are required to apply the equity method to their investments in Venture Capital Fund I. As discussed in footnote 13 and paragraph .47 of this SOP, those investors should retain investment company accounting in applying the equity method to their investments in Venture Capital Fund I.

**B-86.** Limited partner C has the ability to exercise significant influence over Venture Capital Fund I and, therefore, the additional provisions of paragraphs .30-.45 of this SOP should be applied to determine whether limited partner C should retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I. Based on the facts and circumstances, no evidence exists that limited partner C is investing for strategic operating purposes. Therefore, limited partner C should retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I.

**B-87.** Limited partner D also should consider the provisions of paragraphs .30-.45 of this SOP to determine whether investment company accounting should be retained in applying the equity method to its investment in Venture Capital Fund I. In the case of limited partner D, a number of facts and circumstances exist that provide evidence that limited partner D is investing for strategic operating purposes. In particular, the joint venture relationships to jointly develop certain technology products with investees and the acquisition of certain patents and technology from investees provide evidence that limited partner D is investing for strategic operating purposes, as discussed in paragraph .35 of this SOP. In addition, limited partner D's other involvement with investees provides evidence that it is investing for strategic operating purposes, particularly due to the large portion of Venture Capital Fund I's investment portfolio that is in the same line of business as limited partner D. Further, limited partner D has expressed interest in acquiring the operations of certain investees. Accordingly, limited partner D should not retain investment company accounting in applying the equity method to its investment in Venture Capital Fund I. Limited partner D should adjust the financial information of Venture Capital Fund I to account for its investment in Venture Capital Fund I as if Venture Capital Fund I did not apply investment company accounting.

## Real Estate

### *Illustration 10*

**B-88.** *Facts:* Real Estate Company I is formed as a limited partnership with a 10-year life. Its offering memorandum provides that its purpose is to obtain

capital appreciation through investments in high-quality operating office buildings. Real Estate Adviser I GP serves as the general partner and holds a 1 percent interest in Real Estate Company I. (Real Estate Adviser I GP also serves as general partner for five other similar limited partnerships.) Six limited partners hold limited partnership interests, representing 99 percent of the interests in Real Estate Company I. Those limited partners include four pension plans subject to ERISA regulations and two wealthy individuals. One of the pension plan investors owns a 40 percent interest in Real Estate Company I and the remaining investors own varying interests from 10 to 15 percent. The limited partners are not otherwise related to Real Estate Company I or Real Estate Adviser I GP, except that certain limited partners also are limited partners in other partnerships managed by Real Estate Adviser I GP. By definition, the limited partners are passive investors in Real Estate Company I and have no role in the management of Real Estate Company I, selection of investment properties, or management of the investment properties. However, the limited partners have the right to replace the general partner with a vote of a simple majority of the limited partners' interests. As general partner, Real Estate Adviser I GP has the ability to exercise significant influence over Real Estate Company I, but does not control Real Estate Company I because Real Estate Adviser I GP can be removed by a vote of a simple majority of the limited partners' interests. Real Estate Adviser I GP therefore is a related party, but not an affiliate of Real Estate Company I.

**B-89.** In accordance with the terms of the partnership agreement, investment properties are to be disposed of prior to termination of the partnership and proceeds from sales of properties are to be distributed to the partners.

**B-90.** Real Estate Company I holds all of the ownership interests in ten existing office buildings. Real Estate Company I has no employees. Real Estate Adviser I GP, the general partner, hires independent third-party property managers to perform management functions at seven of the properties. A property management affiliate of Real Estate Adviser I GP is hired to perform property management activities at the other three properties. The arrangement with the affiliate is under the same terms as the arrangements with the third-party property managers. Beginning in the seventh year of the partnership, Real Estate Company I begins to dispose of the investment properties. All properties are sold prior to the termination of the partnership and the proceeds of each sale are distributed to the partners.

**B-91.** *Question:* Is Real Estate Company I an investment company within the scope of the Guide?

**B-92.** *Conclusion:* Real Estate Company I is an investment company within the scope of the Guide.

**B-93.** *Analysis:* Though Real Estate Company I is not an entity regulated by the 1940 Act or similar requirements and, therefore, is not automatically an investment company pursuant to paragraph .09 of this SOP, Real Estate Company I meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Real Estate Company I satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it exits within the limited life of the entity; and none of its investments is made for strategic operating purposes.

**B-94.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Real Estate Company

I is an investment company within the scope of the Guide. Specifically, Real Estate Company I has pooled funds; passive investors, including employee benefit plans; management by an unaffiliated investment adviser; and partnership terms requiring proceeds on sales of properties to be distributed to the partners. Evidence that Real Estate Company I is investing for strategic operating purposes includes holding controlling interests in the real estate investment properties and an affiliate of Real Estate Adviser I GP, the general partner, performing the day-to-day management of certain properties.<sup>30</sup> Evidence that Real Estate Company I is an investment company within the scope of the Guide outweighs evidence that Real Estate Company I is not an investment company within the scope of the Guide.

### **Illustration 11**

**B-95. Facts:** Real Estate Partnership I is a limited partnership with a 25-year life. Real Estate Partnership I was formed to own and operate retail properties. The general partner, Retail Property Company I GP, initially has a 20 percent interest in Real Estate Partnership I. The limited partners include ten individuals and five companies. Several of the limited partners are actively involved in other real estate businesses. The limited partners do not have the right to replace or remove the general partner, except in cases of fraud. Retail Property Company I GP has a controlling interest in Real Estate Partnership I and therefore is an affiliate of Real Estate Partnership I.

**B-96.** Real Estate Partnership I acquires land for development through contributions of properties from the general partner, Retail Property Company I GP. Retail Property Company I GP's interest in Real Estate Partnership I is increased based on the value of the contributed properties. The properties are developed into retail centers through development agreements with Retail Property Company I GP. After development, the properties are managed by Retail Property Company I GP. Retail Property Company I GP also develops, owns, and operates other retail properties.

**B-97.** Real Estate Partnership I holds land and develops three retail centers. No specific plans for disposal of the properties exist. Upon termination of Real Estate Partnership I, the properties may be sold to third parties or Retail Property Company I GP, the general partner, may acquire properties from Real Estate Partnership I at values determined by independent appraisals.

**B-98. Question:** Is Real Estate Partnership I an investment company within the scope of the Guide?

**B-99. Conclusion:** Real Estate Partnership I is not an investment company within the scope of the Guide.

**B-100. Analysis:** Real Estate Partnership I is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and therefore is not automatically an investment company within the scope of the Guide. Real Estate Partnership I does not meet the definition of an *investment company* because the business purpose and activities of Real Estate Partnership I are to own, develop, and operate retail properties. Though Real Estate Partnership I has a limited life, the general partner of Real Estate Partnership I (an affiliate) is actively involved in the development and operation

---

<sup>30</sup> As noted in the fact pattern, Real Estate Adviser I GP, the general partner, is a related party, but not an affiliate of Real Estate Company I. Accordingly, the fact that day-to-day management of certain properties is performed by an affiliate of Real Estate Adviser I GP provides less significant evidence than it would if Real Estate Adviser I GP were an affiliate of Real Estate Company I.

of the properties. Also, Retail Property Company I GP may acquire certain properties upon termination of the partnership.

### **Illustration 12**

**B-101. Facts:** Real Estate Partnership II is a limited partnership with a 10-year life. Its offering memorandum provides that its purpose is to obtain capital appreciation through investments in high-quality operating office buildings. Real Estate Adviser II GP serves as the general partner and holds a 1 percent general partner's interest in Real Estate Partnership II. Real Estate Adviser II GP also holds a 10 percent limited partnership interest in Real Estate Partnership II. (Real Estate Adviser II GP also serves as general partner for five other similar limited partnerships, and affiliates of Real Estate Adviser II GP develop, own, and operate numerous real estate properties, including other office buildings.) In addition to Real Estate Adviser II GP, 50 other investors with limited partnership interests in Real Estate Partnership II exist. Those limited partners include pension plans subject to ERISA regulations, endowment funds of colleges and universities, and wealthy individuals. No investor owns more than a 15 percent interest in Real Estate Partnership II. The limited partners are not otherwise related to Real Estate Partnership II or Real Estate Adviser II GP, the general partner, except that certain limited partners also are limited partners in other partnerships managed by Real Estate Adviser II GP. By definition, the limited partners are passive investors in Real Estate Partnership II and have no role in its management, selection of investment properties, or management of the investment properties. However, the limited partners have the right to replace the general partner with a vote of a majority of the limited partners' interests. As general partner, Real Estate Adviser II GP has the ability to exercise significant influence over Real Estate Partnership II, but does not control Real Estate Partnership II because Real Estate Adviser II GP can be removed by a majority vote of the limited partners. Real Estate Adviser II GP, therefore, is a related party but not an affiliate of Real Estate Partnership II.

**B-102.** In accordance with the terms of the partnership agreement, investment properties are to be disposed of prior to termination of the partnership and proceeds from sales of properties are to be distributed to the partners.

**B-103.** Real Estate Partnership II acquires all of the ownership interests in ten existing office buildings. In addition, Real Estate Partnership II acquires three new office building properties that were recently developed by an affiliate of Real Estate Adviser II GP, the general partner.

**B-104.** Real Estate Adviser II GP, the general partner, generally hires independent third-party property managers to perform management functions at the properties. However, Real Estate Adviser II GP's personnel perform certain property management functions at certain properties for limited periods of time though Real Estate Adviser II GP is searching for appropriate full-time property managers. Beginning in the seventh year of the partnership, Real Estate Partnership II begins to dispose of the investment properties. Eleven properties are sold to independent parties prior to the termination of the partnership and proceeds from each sale are distributed to partners. The remaining two properties are sold to an affiliate of Real Estate Adviser II GP for their appraised fair values.

**B-105. Question:** Is Real Estate Partnership II an investment company within the scope of the Guide and, if so, should Real Estate Adviser II GP, the general partner, an equity method investor, retain investment company accounting in reporting its interest in Real Estate Partnership II?

**B-106. Conclusion:** Real Estate Partnership II is an investment company within the scope of the Guide. However, Real Estate Adviser II GP, the general partner, an equity method investor, should not retain investment company accounting in reporting its interest in Real Estate Partnership II.

**B-107. Analysis:** Though Real Estate Partnership II is not an entity regulated by the 1940 Act or similar requirements pursuant to paragraph .09 of this SOP and therefore is not automatically an investment company within the scope of the Guide, Real Estate Partnership II meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, Real Estate Partnership II satisfies the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments with a defined exit strategy; and none of its investments is made for strategic operating purposes.

**B-108.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that Real Estate Partnership II is an investment company within the scope of the Guide. Specifically, Real Estate Partnership II has pooled funds; substantive ownership by passive investors, including employee benefit plans; management of Real Estate Partnership II by an unaffiliated investment adviser; and partnership terms requiring properties to be disposed of prior to termination of the partnership and proceeds thereof to be distributed to the partners. Though Real Estate Partnership II holds controlling interests in the real estate investment properties, the day-to-day management of the properties generally is performed by unaffiliated property managers. Though employees of Real Estate Adviser II GP, the general partner, participate in property management functions at certain properties, those arrangements are intended to be temporary until permanent property management personnel are hired. Evidence that Real Estate Partnership II is an investment company within the scope of the Guide outweighs evidence that Real Estate Partnership II is not an investment company within the scope of the Guide.

**B-109.** However, in assessing whether Real Estate Adviser II GP, the general partner, an equity method investor, should retain investment company accounting in reporting its interest in Real Estate Partnership II, relationships between Real Estate Adviser II GP, the general partner, its related parties, and the underlying properties should be considered. In this situation, Real Estate Adviser II GP’s affiliates develop certain properties that are transferred to Real Estate Partnership II; Real Estate Adviser II GP’s affiliates acquire certain properties from Real Estate Partnership II; affiliates of Real Estate Adviser II GP are in the same line of business as the investments held by Real Estate Partnership II; and significant purchases or sales of the underlying properties between affiliates of Real Estate Adviser II GP and Real Estate Partnership II exist. The evidence therefore leads to the conclusion that Real Estate Adviser II GP, an equity method investor, is investing in Real Estate Partnership II for strategic operating purposes.

## **Collateralized Loan Obligations**

### ***Illustration 13***

**B-110. Facts:** Collateralized Loan Obligation Trust (CLO) was formed in XX03 by Commercial Bank, with Commercial Bank receiving preferred shares of CLO and Commercial Bank transferring loans to CLO in exchange for cash. CLO funds the purchase of the loans by issuing senior notes, preferred shares,

and common shares to independent investors. CLO's business purpose is investing for current income, capital appreciation, or both. Commercial Bank does not provide cash collateral or recourse obligations. Commercial Bank receives fees from CLO as manager of CLO's assets and also retains a subordinate interest in CLO in the form of preferred shares in CLO. Cash collections from the loans, net of related expenses, are distributed to the beneficial interest holders in CLO, namely the holders of the senior notes, preferred shares, and the common shares.

**B-111.** CLO's activities and assets are limited by the terms of its Trust documents (and the related asset management agreement) to investment activities related to the acquired loans. In certain limited circumstances, CLO takes control of collateral on a temporary basis as a result of defaults on loans. CLO does not acquire loans with the intent of taking control of the collateral.

**B-112.** CLO intends to hold the loans to maturity unless Commercial Bank, as asset manager, determines that the loans should be sold prior to maturity.

**B-113.** Commercial Bank consolidates CLO in its consolidated financial statements based on the provisions of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003). Upon formation of CLO, Commercial Bank determines that pursuant to the provisions of this SOP, it should not retain investment company accounting in reporting CLO in its consolidated financial statements.

**B-114. Question:** Is CLO an investment company within the scope of the Guide and, if so, should Commercial Bank retain investment company accounting in consolidating its interest in CLO?

**B-115. Conclusion:** CLO is an investment company within the scope of the Guide. Commercial Bank should not, however, retain investment company accounting in reporting CLO in its consolidated financial statements. (The conclusion that investment company accounting for CLO should not be retained in the consolidated financial statements of Commercial Bank does not affect the analysis or conclusions about whether investment company accounting should be retained by Commercial Bank for other investment company subsidiaries or equity method investees.)

**B-116. Analysis:** Though CLO is not an entity regulated by the 1940 Act or similar requirements and, therefore, is not automatically an investment company within the scope of the Guide pursuant to paragraph .09 of this SOP, CLO meets the definition of an *investment company* in paragraph .05 of this SOP and as further discussed in paragraphs .11–.29 of this SOP. Specifically, CLO meets the basic investment company requirements—it is a separate legal entity; its business purpose and activity is investing for current income, capital appreciation, or both; it makes multiple substantive investments from which it intends to exit within a defined time; and none of its investments is made for strategic operating purposes.

**B-117.** Consideration of the “Factors to Consider” in paragraphs .19–.29 of this SOP provides evidence to support the conclusion that CLO is an investment company within the scope of the Guide. Specifically, CLO has pooled funds from numerous investors with none having a significant interest in CLO or an ability to influence its activities; due to the limitations imposed by the terms of CLO's Trust documents and the related asset management agreement, CLO's investors are in effect passive; and CLO is not involved in the day-to-day management of investees<sup>31</sup> (except in limited circumstances in which CLO takes

---

<sup>31</sup> In this illustration, investments consist of investments in debt instruments. Those investments are referred to herein as *investees*.

control of collateral, such as upon loan defaults, which is permitted as described in paragraph .13 of this SOP).

**B-118.** Though CLO is an investment company within the scope of the Guide, investment company accounting should not be retained in the consolidated financial statements of Commercial Bank. Commercial Bank does not have policies that effectively distinguish loans in CLO from other loans held by Commercial Bank. The investments (loans) of CLO are similar to other investments (loans) held by Commercial Bank that are not reported in the same manner as investment company accounting. That is, in the financial statements of CLO, the loans are reported at fair value whereas Commercial Bank has other loans that are not reported at fair value. Accordingly, in conformity with paragraph .30b of this SOP, Commercial Bank should not retain investment company accounting. In addition, in this situation, the loans were transferred from Commercial Bank to CLO. As discussed in paragraphs .36 and .37 of this SOP, such transfers lead to the conclusion that the investments are held by the parent company for strategic operating purposes.

**B-119.** The determination that investment company accounting for CLO should not be retained in the consolidated financial statements of Commercial Bank was made upon formation of CLO, and it was therefore not previously concluded that investment company accounting should be retained by Commercial Bank in reporting CLO in its consolidated financial statements. Accordingly, the conclusion that Commercial Bank should not retain investment company accounting for CLO does not affect the analysis or conclusions about whether investment company accounting should be retained by Commercial Bank for other investment company subsidiaries or equity method investees.

**B-120.** Commercial Bank should report the loans in its consolidated financial statements using the same accounting principles that apply to other loans held by Commercial Bank.

**B-121.** Paragraph 22 of FASB Interpretation No. 46 provides that “any specialized accounting requirements applicable to the type of business in which the variable interest entity operates shall be applied as they would be applied to a consolidated subsidiary.” The guidance in this SOP to determine whether investment company accounting should be retained in consolidation applies to both entities that are consolidated based on voting interests and variable interest entities that are consolidated based on the provisions of FASB Interpretation No. 46. In this situation, however, investment company accounting does not apply to the consolidated subsidiary for purposes of the consolidated financial statements of Commercial Bank based on the provisions of this SOP.

## Appendix C

### Applying the Provisions of This SOP to Entities That Hold Investments in Real Estate

**C-1.** As discussed in paragraph .03 of this Statement of Position (SOP) and in paragraphs A-25, A-46, and A-47 of the “Basis for Conclusions” of this SOP, certain entities that hold investments in real estate may meet the definition of an *investment company*. Paragraph .05 of this SOP defines an *investment company*, in part, as a “separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies.” This SOP includes no specific conclusions applicable to entities that own direct interests in real estate. Entities with direct interests in real estate should consider whether the entity’s activities pertaining to those investments would result in the entity not meeting the definition of an *investment company*. The Accounting Standards Executive Committee (AcSEC) acknowledges, however, the challenges of applying the guidance in this SOP to investments in real estate. Accordingly, AcSEC has developed this appendix to help readers apply the (a) definition of an *investment company* and (b) additional guidance in paragraphs .11–.29 of this SOP to entities that hold investments that represent direct ownership interests in real estate. The following information therefore should be considered in determining whether the entity is a real estate investment company (an investment company that holds direct ownership of real estate) or an operating company (not an investment company).

#### Express Business Purpose

**C-2.** Real estate investment companies typically are managed by professional investment advisers that establish and express specified investment objectives that are consistent with investing for current income, capital appreciation, or both. As discussed further below, that express business purpose may be supported by defined exit strategies, a limited life of the entity, distribution of proceeds on sales of investment properties, and other factors. Consideration of the express business purpose of an entity that holds direct ownership interests in real estate typically is similar to consideration of the express business purpose of an entity that holds investments other than real estate.

#### Entity’s Activities, Assets, and Liabilities are Limited to Investment Activities, Assets, and Liabilities

**C-3.** Activities of real estate investment companies typically are limited to managing investments in real estate properties. Real estate investment companies typically have few or no employees and the activities of real estate investment companies typically are managed by a professional investment adviser in accordance with an advisory contract. In contrast, real estate operating companies typically have employees that perform the management and other activities of the entity and real estate properties.

#### Multiple Substantive Investments

**C-4.** Though the investment plans of real estate investment companies would include plans to invest in multiple substantive investments, the holding of multiple real estate properties does not necessarily provide evidence to distinguish real estate investment companies from real estate operating companies

because real estate operating companies also sometimes hold multiple properties. Consideration of whether an entity that holds direct ownership interests in real estate invests in multiple substantive investments typically is similar to consideration of whether an entity that holds investments other than real estate invests in multiple substantive investments.

### **Exit Strategies**

**C-5.** Real estate investment companies have defined exit strategies for the investments and those exit strategies sometimes are supported by a limited life of the entity. In addition, real estate investment companies typically are what is commonly referred to as *closed funds*, because new investors are prohibited after the initial capitalization and proceeds from property sales are distributed to the investors rather than reinvested in new properties.

### **Not for Strategic Operating Purposes**

**C-6.** Real estate investment companies are not operated for strategic operating purposes and the operations of each property generally are segregated from the operations of the real estate investment company and other investment properties.

## **Other Factors**

### **Pooling of Funds**

**C-7.** Pooled funds provide significant evidence to support the objective of a real estate investment company as investing for current income, capital appreciation, or both. Due to the potential involvement in the operations of the investment properties as discussed further in the section below, “Involvement in Day-to-Day Management and Administrative and Support Services,” evidence of pooled funds may be necessary to support a conclusion that an entity holding direct ownership interests in real estate meets the definition of an *investment company*. Consideration of whether an entity that holds direct ownership interests in real estate has pooled funds typically is similar to consideration of whether an entity that holds investments other than real estate has pooled funds.

### **Level of Ownership Interests in Investees**

**C-8.** Real estate investment companies may hold partial interests or entire interests in real estate investment properties. Though holding no controlling interests in real estate properties may provide some evidence to support the investment objectives of the entity, ownership of controlling interests in real estate properties does not necessarily preclude the entity from meeting the definition of an *investment company*. Consideration of the level of ownership interests in investees for an entity that holds direct ownership interests in real estate is similar to consideration of the level of ownership interests in investees for an entity that holds investments other than real estate.

### **Nature of Investors**

**C-9.** In addition to pooling of funds, the nature of the investors may provide significant evidence to support the objective of a real estate investment company as investing for current income, capital appreciation, or both. In particular, the existence of passive investors seeking professional investment management expertise may provide evidence to support that objective. In addition, the existence of pension fund investors may also provide evidence to

support the determination that the entity meets the definition of an *investment company*. Consideration of the nature of investors in an entity that holds direct ownership interests in real estate typically is similar to consideration of the nature of investors of an entity that holds investments other than real estate.

### **Involvement in Day-to-Day Management and Administrative or Support Services**

**C-10.** As noted previously, real estate investment companies typically do not have employees. Such real estate investment companies, therefore, typically hire property management companies<sup>32</sup> to perform day-to-day management of the investment properties, which typically require less strategic planning and development than do investments in other than real estate. In contrast, a real estate operating company typically has employees that are involved in the day-to-day property management functions of the real estate properties, as well as employees that are actively involved in directing and performing development activities at the entity's properties. Also, typically, management of properties held by a real estate investment company is dedicated to specific properties and little or no integration of management between properties exists.

### **Integration of Investees**

**C-11.** Operations of investment properties of real estate investment companies typically would not be integrated with other properties. Consideration of integration of investees for an entity that holds direct ownership interests in real estate is similar to consideration of integration of investees for an entity that holds investments other than real estate.

---

<sup>32</sup> Though property management typically is not performed directly by the real estate investment company, in certain circumstances, property management functions may be performed by entities that are affiliated with the real estate investment company. The involvement in property management of a majority-owned real estate investee by a real estate investment company or its affiliates, while a negative factor, is not necessarily inconsistent with the definition of an *investment company*, though it may provide evidence that the entity is investing for strategic operating purposes, depending on the facts and circumstances.

## Appendix D

### Effects on Other Pronouncements

**D-1.** This Appendix discusses amended sections of American Institute of Certified Public Accountants (AICPA) pronouncements (other than the Audit and Accounting Guide *Investment Companies*) by showing changes made by this Statement of Position (SOP).

**D-2.** This SOP reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by AICPA SOP 94–3, *Reporting of Related Entities by Not-for-Profit Organizations* [section 10,610].

The following is added as a footnote to the end of paragraph .05:

AICPA SOP 07-1, *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*, provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation. Not-for-profit organizations with a controlling financial interest in a for-profit entity (through direct or indirect ownership of a majority voting interest in that entity) that applies investment company accounting pursuant to SOP 07-1 should consider whether investment company accounting should be retained in the financial statements of the parent not-for-profit organization pursuant to SOP 07-1.

The following footnote is added to the end of the first sentence of paragraph .06:

As discussed in footnote 6 of this SOP, AICPA SOP 07-1 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the investment company. Not-for-profit organizations with investments in common stock of a for-profit entity that applies investment company accounting pursuant to SOP 07-1, wherein the not-for-profit organization's investment qualifies for the equity method of accounting in conformity with APB Opinion No. 18, should consider whether investment company accounting should be retained in the financial statements of the investor not-for-profit organization pursuant to SOP 07-1.

Paragraph .07 is revised to read as follows:

Chapter 8 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* permits investment portfolios to be reported at fair value in certain circumstances. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*,<sup>33</sup> permits common stock and “in-substance common stock” to be reported at fair value. Not-for-profit organizations are

---

<sup>33</sup> FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurement*. [Footnote added, May 2007, to reflect conforming changes necessary due to the issuance of FASB Statement No. 159.]

permitted to report investment portfolios at fair value in conformity with that Guide or make an election to report investments in common stock or “in-substance common stock” at fair value pursuant to FASB Statement No. 159 instead of applying the equity method of accounting to investments covered by paragraph .06 of this SOP.

**D-3.** This SOP reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guide *Health Care Organizations*.

The following is added as a footnote to the end of the first sentence in paragraph 11.10:

AICPA SOP 07-1, *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*, provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation. Health care organizations with a controlling financial interest in a for-profit entity (through direct or indirect ownership of a majority voting interest in that entity) that applies investment company accounting pursuant to SOP 07-1 should consider whether investment company accounting should be retained in the financial statements of the parent health care organization pursuant to SOP 07-1.

The following footnote is added to the end of the first sentence of paragraph 11.17:

As discussed in footnote X, AICPA SOP 07-1 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under SOP 07-1, the SOP also addresses the retention of that specialized industry accounting by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the investment company. Health care organizations with investments in common stock of a for-profit entity that applies investment company accounting pursuant to SOP 07-1, wherein the health care organization’s investment qualifies for the equity method of accounting in conformity with APB Opinion No. 18, should consider whether investment company accounting should be retained in the financial statements of the investor health care organization pursuant to SOP 07-1.

**D-4.** This SOP includes conditions that should be met for investment company accounting to be retained in the financial statements of the entity’s parent company or an equity method investor. Accordingly, this SOP nullifies the guidance in Emerging Issues Task Force (EITF) Issue No. 85-12, *Retention of Specialized Accounting for Investments in Consolidation*, but only as it applies to investments in investment companies. AcSEC expects that the EITF will revise its literature to be consistent with this SOP.

**D-5.** This SOP provides guidance about which entities are included within the scope of the Audit and Accounting Guide *Investment Companies*. EITF Topic D-74 provides as follows:

Until [AcSEC’s project to develop this SOP] is finalized, an entity should consistently follow its current accounting policies for determining whether the provisions of the current Guide apply to investees of the entity or to subsidiaries

## **Clarification of the Scope for Investments in Investment Companies 21,535**

that are controlled by the entity. AcSEC will provide similar guidance in the scope section of the proposed Guide and in the transmittal letter accompanying it.

AcSEC expects that the EITF will revise its literature to be consistent with this SOP.

## Appendix E

### Schedule of Paragraph Numbers in This SOP and how They Will Be Reflected in the Revised Guide

<b>This SOP</b>	<b>Revised Guide</b>
.01	Not applicable (NA)
.02	NA
.03	1.01
.04	1.02
.05	1.03
.06	1.04
.07	1.05
.08	1.06
.09	1.07
.10	1.08
.11	1.09
.12	1.10
.13	1.11
.14	1.12
.15	1.13
.16	1.14
.17	1.15
.18	1.16
.19	1.17
.20	1.18
.21	1.19
.22	1.20
.23	1.21
.24	1.22
.25	1.23
.26	1.24
.27	1.25
.28	1.26
.29	1.27
.30	9.01

Clarification of the Scope for Investments in Investment Companies **21,537**

<b>This SOP</b>	<b>Revised Guide</b>
.31	9.02
.32	9.03
.33	9.04
.34	9.05
.35	9.06
.36	9.07
.37	9.08
.38	9.09
.39	9.10
.40	9.11
.41	9.12
.42	9.13
.43	9.14
.44	9.15
.45	9.16
.46	9.17
.47	9.18
.48	1.28
.49	9.19
.50	9.20
.51	9.21
.52	7.79
.53	9.22
.54	Glossary
.55	Glossary
.56	Preface
.57	Preface
.58	Preface

## Accounting Standards Executive Committee (2002–2003)

MARK V. SEVER, *Chair*  
MARK M. BIELSTEIN  
VAL R. BITTON  
LAWRENCE N. DODYK  
KARIN A. FRENCH  
JAMES A. KOEPKE  
ROBERT J. LAUX  
FRANCIS T. MCGETTIGAN

ANDREW M. MINTZER  
RICHARD H. MOSELEY  
BENJAMIN S. NEUHAUSEN  
COLEMAN D. ROSS  
ASHWINPAUL C. SONDHI  
MARY S. STONE  
BRENT A. WOODFORD

## Investment Companies Scope Task Force

MARK M. BIELSTEIN, *Chair*  
JOAN LORDI AMBLE  
LAWRENCE N. DODYK  
BRIAN J. GALLAGHER

GEORGE E. KELTS, III  
MATT LUTTINGER  
MICHAEL MAHER

## AICPA Staff

DANIEL J. NOLL  
*Director*  
*Accounting Standards*

JOEL TANENBAUM  
*Technical Manager*  
*Accounting Standards*

---

[The next page is 25,051.]