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Application of FIN 46R to Investment Companies: FASB Agrees to Make Scope Exception Permanent

At its meeting on November 1st, the Financial Accounting Standards Board ("FASB" or the "Board") decided to expose for a 30-day comment period a proposed FASB Staff Position ("FSP") FIN 46R-d, *Application of FASB Interpretation No. 46(R) to Investment Companies* (the "proposed FSP").

The proposed FSP would exclude from the scope of FIN 46R any investments accounted for at fair value in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, *Investment Companies* (the "Audit Guide"), to be amended by the proposed Statement of Position, *Clarification of the Scope of the Audit and Accounting Guide, Investment Companies, and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (the "proposed SOP").

Both the proposed SOP and the proposed FSP are effective for fiscal years beginning after December 15, 2007.

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Background

In FIN 46R, the consolidation framework for so-called variable interest entities, the Board deferred the application of FIN 46R to investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c)(1)¹ but are currently accounting for their investments in accordance with the specialized accounting guidance in the Audit Guide.

The effective date of FIN 46R for those investments was delayed while the AICPA finalized its proposed SOP. The Board indicated that, upon issuance of the final SOP, it would consider modifying paragraph 4(e) of FIN 46R to provide an exception for investment companies that apply the Audit Guide.

The FASB cleared for issuance the proposed SOP at its September 13, 2006 meeting. At the same meeting, the Board discussed making the above deferral permanent through the issuance of a proposed FSP that would clarify the exemption from FIN 46R for unregulated investment companies.

SFG Observation: *At the September 13th meeting, the Board was concerned that the proposed FSP might allow companies not intended to qualify as investment companies to circumvent the consolidation requirements of FIN 46R. The Board's concern was subsequently addressed at its November 1st meeting.*

Proposed FSP

At the meeting on November 1st, the FASB staff recommended that any investments accounted for at fair value in accordance with the specialized accounting guidance in the Audit Guide, as amended by the proposed SOP, not be subject to consolidation pursuant to FIN 46R (View A).

The FASB Staff acknowledged that the View A does not attempt to remedy any of the current ambiguity surrounding the consolidation requirements for an investment company having a controlling interest in another investment company.

Other views presented by the FASB staff were:

- View B - Prescribe consolidation requirements for unregulated investment companies only.

¹ Paragraph 4(e) of FIN 46R provides that "an enterprise subject to SEC Regulation S-X, Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to that same rule." Rule 6-03(c)(1) applies to registered investment companies and business development companies.

- View C - Prescribe consolidation requirements for all investment companies, including regulated investment companies.

The Board agreed with the FASB staff recommendation (View A), and instructed the FASB staff to specify the reporting entity to which the guidance applies.

SFG Observation: *The Board felt that the proposed SOP provided sufficient parameters that an entity must meet to qualify for the specialized accounting accorded in the Audit Guide such that it cannot be used to circumvent the consolidation requirements in FIN 46R. Specifically, the Board cited the restriction in the proposed SOP that a parent company may not apply the specialized accounting in the Audit Guide to certain of its investments held in an investment company subsidiary in instances where the parent company also holds similar investments through a non-investment company subsidiary.*

Although ambiguity remains regarding the consolidation analysis that an investment company (the parent company) must perform relative to its controlling interest in another investment company (the investment company subsidiary), there was no indication at the meeting that the FASB intends to issue any clarifying guidance in this regard.

Next step

The FASB will expose the proposed FSP for a 30-day comment period. It is expected that the final FSP will be issued in late December 2006 or early 2007.

Questions

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