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July 23, 2015

VIA EMAIL TO: director@FASB.org

Technical Director
File Reference No. 2015-280
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Financial Accounting Standards Board (FASB) Proposed Accounting Standards Update, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We are writing to provide comments on the FASB's Proposed Accounting Standards Update, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting* (the "Proposal").

Executive Summary

We commend the FASB for its interest in simplifying accounting standards. We fully support the Board's objective of reducing cost and complexity while maintaining or improving the usefulness of financial statements. However, as explained more fully below, we do not support the Proposal.

We acknowledge that not accounting for the difference between what was paid for an investment in the equity securities of an investee and the investee's book value is simpler than the current accounting model. However, not accounting for deferred taxes, pension and other postretirement liabilities, asset retirement obligations, and leases would also be simpler. That does not mean we should ignore them and thus the underlying economic activity that gives rise to them. To paraphrase a statement often attributed to Albert Einstein, the FASB's goal should be to make financial reporting as simple as possible, but not simpler.

We strongly disagree with the proposal to eliminate the requirement to separately account for the basis difference of equity method investments. We dispute the Board's premise that the current accounting adds cost without improving financial reporting; we object to the Board's conceptual basis for its proposed accounting model; we are very troubled by the results of the proposed accounting model.

We support the elimination of the requirement to retroactively adjust prior financial statements when an investment, previously accounted for on the cost method, qualifies for the use of the equity method. We agree that this reduces cost without significantly reducing the relevance and reliability of financial statements. However, we believe this benefit is dwarfed by the problems created by the Board's proposal to eliminate the requirement to separately account for basis differences of equity method investments.

In summary, we believe the Proposal does not meet the Board's simplification objectives. While "simpler" in some respects, we see the proposed accounting model increasing complexity in other respects. Thus we question whether the proposed approach will reduce either complexity or cost. More importantly, in our view, the Proposal will significantly diminish the usefulness and relevance of financial statements.

The remainder of our letter focuses on our views regarding basis differences in an equity method investment.

Specific Comments

1. *The Board's Premise for Issuing the Proposal*

As we understand it, the Board offers the following arguments to eliminate the accounting for the difference between what the reporting entity paid for its investment in an equity method investee and the underlying book values of the investee (which we will refer to as "the basis difference" for simplicity):

- Accounting for the basis difference adds cost and complexity without improving the usefulness of the information provided to investors. (page 1 of the Proposal)

- Determining the acquisition date fair value of an investee's identifiable assets and liabilities can be costly and, in some cases, the entity may have limited access to the information necessary to perform the assessment. (page 1 of the Proposal)

- The "benefits of accounting for the basis difference for equity method investments are limited at best because the accounting is performed in memo accounts." (paragraph BC6 of the Proposal)

- "In some cases, financial statement users are not aware of the requirements to account for the various components of the basis difference and, therefore, do not factor in the accounting for basis difference in their decisions, which are based on GAAP." (paragraph BC6 of the Proposal)

Usefulness of Information. We are puzzled by the Board's assertion that accounting for the basis difference does not "improve the usefulness" of information presented to investors. Currently, the equity method of accounting approximates a "one-line consolidation" of the investee. Because the investor in an equity method investment accounts for basis differences and "intercompany" transactions similar to consolidated subsidiaries, the reported amount of income or loss from the equity method investee is similar in many cases to the amount that would be reported (after considering noncontrolling interests) from a consolidated subsidiary. As the Board notes in the Proposal, eliminating the requirement to account for basis differences would "move the equity method away from" this result. Yet two years ago, in rethinking the accounting model for equity method investments, the Board said it "continues to believe that the equity method of accounting provides the ***most appropriate representation of the underlying economic activity*** in an investing entity's financial statements"[1] (emphasis added). If the current "one-line consolidation" approach is "the most appropriate representation of the underlying economic activity," how could it not be useful to investors?

The Proposal includes the Board's observation "that the proposed amendments would move the equity method away from what is referred to as 'one-line' consolidation." It continues by saying that "[t]he Board is not troubled by this change because it sees no conceptual basis to account for an investment in an entity in which the investor has the ability to exercise significant influence over an investee in the same manner as an investment in an entity in which the investor has a controlling financial interest; control is different from significant influence."[2] However, we have a different understanding regarding the reason equity method accounting approximates a "one-line consolidation."

In our view, the equity method of accounting does not approximate a "one-line consolidation" of the investee because significant influence is close to control. Rather, the equity method of accounting approximates a "one-line consolidation" of the investee because that accounting represents the accrual method of accounting for the investment in the investee. This concept is explained in Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (Opinion No. 18):

> "Under the equity method, an investor recognizes its share of the earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements rather than in the period in which an investee declares a dividend. An investor adjusts the carrying amount of an investment for its share of the earnings or losses of the investee subsequent to the date of

[1] Paragraph BC26 in Proposed Accounting Standards Update, *Financial Instruments—Overall,* issued February 14, 2013

[2] Paragraph BC 9 of the Proposal

> investment and reports the recognized earnings or losses in income. Dividends received from an investee reduce the carrying amount of the investment. Thus, the equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles in the economic resources underlying the investments. Furthermore, the equity method of accounting more closely meets the objectives of accrual accounting than does the cost method since the investor recognizes its share of the earnings and losses of the investee in the periods in which they are reflected in the accounts of the investee." [3]

Although Opinion No. 18 preceded the issuance of the FASB's Statements of Financial Reporting Concepts, its focus on "recognizing increase or decreases measured by generally accepted accounting principles in the economic resources underlying the investments" echoes the FASB's discussion of accrual accounting in FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6).[4] In our view, applying the equity method of accounting to an investment in an investee is simply the application of accrual accounting. We therefore are puzzled by the view that an accrual method of accounting is not useful.

Cost and Complexity. We certainly acknowledge that determining the acquisition date fair values of the investee's assets and liabilities requires effort and that, by having significant influence but not control, the reporting entity is more limited in its ability to accurately allocate the basis difference. But as the Board has observed in many other areas of financial reporting, expending effort to make estimates based on the best information available is preferable to doing nothing. Given the Board's acknowledgment that "investments accounted for by the equity method generally are strategic and are held for the long term,"[5] it seems difficult to infer, as the Board does, that making these estimates is unduly burdensome and costly. Based on our experiences with clients who make such investments, we doubt that management is making investments sufficient to gain significant influence over a third party's operating and financing activities without having gained a reasonable understanding of the potential investee's major assets, liabilities, opportunities and risks. Finally, we note that under existing GAAP, "if the investor is unable to relate the difference to specific accounts of the investee, the difference shall be recognized as goodwill and not be amortized."[6] We recognize that this "exception" is explicitly written in the context of increases in ownership levels (i.e., from a cost method investment to an equity method investment), but amending the literature to extend it to other fact patterns seems relatively easy, with little in the way of potential unintended consequences.

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[3] Paragraph 10, *Discussion*, in Opinion No. 18. Refer also to the discussion in paragraphs 7-8 and 11-13.

[4] Paragraphs 135-149 of CON 6. In particular, note the statement in paragraph 139 that "[a]ccrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances that have cash consequences for the entity in the periods in which those transactions, events and circumstances occur rather than only in the periods in which cash is received…"

[5] Paragraphs BC29 and 30 in Proposed Accounting Standards Update, *Financial Instruments—Overall*, issued February 14, 2013

[6] Last sentence of paragraph ASC 323-10-35-34

Perhaps more important is the potential for the Board's alternative accounting model to create incremental cost and complexity. Specifically, by not amortizing basis differences, reporting entities will likely report larger equity method investment assets and higher equity method earnings.[7] In turn, those larger balances could lead to (a) more frequent impairment analyses and (b) additional SEC disclosure requirements. The current "other-than-temporary" impairment model for equity method investments is highly judgmental. In our experience, reporting entities expend significant effort to determine whether the cost of the investment exceeds its current fair value and to evaluate whether that difference is "other-than-temporary." In addition, some public companies may trigger additional disclosure requirements under SEC rules such as Rule 3-09 of Regulation S-X (which requires separate audited financial statements of equity method investees that exceed a defined significance threshold) and Rule 4-08(g) of Regulation S-X (which requires footnote disclosure of condensed financial information about equity method investees that meet defined significance tests).[8]

The Board concluded that treating the basis difference as a single amortizable asset "would not reduce complexity" and would not reduce costs as much as treating it as a nonamortizable asset.[9] That focuses only on the cost and complexity of the initial allocation of the basis difference and the subsequent entries to record periodic amortization. We believe it is necessary to also consider the consequences that result from higher reported equity method investment earnings and assets. When addressing goodwill accounting by private companies, the Board observed that goodwill amortization would result in less frequent impairment testing.[10] Ergo, the inverse—turning an amortizable asset into a nonamortizable asset—would logically require *more* frequent impairment testing. And larger amounts of earnings and assets will logically require some entities to provide additional SEC-mandated disclosures.

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[7] For example, assume the reporting entity makes a $300 investment in an equity method investee. Assume the basis difference is $100 (reporting entity paid a 50% premium over the investee's net book value) and relates to an identifiable intangible asset with a useful life of five years. Finally, assume that the reporting entity's pro rata share of the investee's reported income is $20 per year for the next five years. Under existing guidance, the reporting entity will report no equity method earnings ($20 pro rata share of investee income is offset by $20 of amortization) during the five years and the carrying value of the investment will be $300 at the end of year five. Under the Proposal, the reporting entity will report $20 of equity method earnings in each of the next five years and the carrying value of the investment will be $400 at the end of year five.

[8] The significance thresholds are 20% for Rule 3-09 and 10% (individually or in the aggregate) for Rule 4-08(g) and are based on pretax income and total assets.

[9] Paragraph BC6 of the Proposal

[10] Paragraph BC25 of ASU Update No. 2014-2. "Because goodwill will be amortized, the PCC decided that a goodwill impairment test is necessary only when triggers exist, similar to other long-lived assets that are subject to periodic amortization. The PCC concluded that the amortization method … generally should result in testing goodwill for impairment less frequently than once a year, especially in the later years of the useful life of goodwill."

We are not in a position to quantify the costs of current GAAP vs. the costs of the Board's proposed model. However, we can affirm that the volume of questions we receive about "other-than-temporary" impairments of equity method investments and the SEC reporting requirements for those investments far exceeds the volume of questions about allocating basis differences to investee assets and liabilities. We infer from our experience that the impairment analyses and SEC reporting issues are more complex, and thus potentially more costly, than allocating and tracking basis differences.

<u>Benefits of Current GAAP</u>. We also struggle to understand the Board's conclusion that the "benefits of accounting for the basis difference for equity method investments are limited at best because the accounting is performed in memo accounts." Why would the utilization of "memo accounts" affect the usefulness of the resulting information? Supporting worksheets and "memo accounts" are routinely used to develop the information that is reported in the financial statements in numerous areas of accounting. In fact, in our experience, companies that do not push down purchase price allocations to the general ledger of an acquired subsidiary often use "memo accounts" or their equivalent to report and track basis differences. Investors are typically—and justifiably—unaware of the mechanics of preparing consolidated financial statements because the mechanics are irrelevant. What is important to investors is whether the end result is reliable, relevant, useful information. We suggest the Board focus on the relevance, reliability, transparency and neutrality of the information that is presented to users, not the manner in which companies choose to keep their internal records.

<u>User Perspectives</u>. We also find it difficult to accept the Board's assertion that because users are "unaware" of the accounting requirements for equity method investees they "therefore do not factor the accounting for basis differences into their decisions, which are based on GAAP." How does the premise that users are unaware of how basis differences are accounted for lead to the conclusion that users ignore them? We accept that some users may not be aware of the specific requirements of equity method accounting. Users' lack of awareness of specific accounting requirements is most likely not limited to equity method accounting. Indeed, as many users of financial statements are not accountants, it is unrealistic to expect them to be familiar with the specific requirements of the accounting literature. But being "unaware" of how the accounting works does not mean the information presented in the financial statements is not used—or is not useful—in making decisions. To the contrary: given that the amount of the basis difference and the accounting treatment of the difference are disclosed, it would seem more logical to assert that any "failure" on the part of investors to analyze or adjust for those differences means that the accounting model is useful. After all, investors routinely make adjustments to GAAP information in order to improve its usefulness for their purposes. If the Board has no evidence of this happening with equity method accounting, then why would one conclude that the information isn't useful to investors?

Even if the Board's assertion about user ignorance of the accounting for basis differences is correct, why is eliminating the accounting an appropriate solution? The Board is not asserting that accounting for the basis differences is inconsistent with the underlying economics. So why solve users' presumed lack of understanding of basis differences by ignoring the economic substance that created those differences? Would the Board think it appropriate to solve users' lack of understanding of the complexities of accounting for highly structured financial instruments or derivatives by ignoring their inherent volatility?

If anything, we suspect that users would find the Board's proposed accounting model troubling because (a) the absence of amortization for basis differences fails to align the cost of assets with the earnings generated by the use of those assets and (b) the absence of amortization and the higher reported earnings not only increase the risk for delayed recognition of impairments but potentially may catch investors by surprise. We discuss this further below.

Recommendation. Before making such a significant change in a longstanding and widely used accounting principle, we believe it is imperative that the Board first determine whether users agree with the Board's 2013 conclusion that equity method accounting "provides the ***most appropriate*** representation of the underlying economic activity in an investing entity's financial statements" (emphasis added). If they agree, then eliminating the accounting for basis differences would not meet the Board's stated simplification objective.

2. *The Board's Concept for the Alternative Accounting*

As noted above, we object to the Board's conceptual basis for its proposed accounting model.

Current Accounting. Currently, the accounting for an equity interest in another entity falls into one of three broad models: the fair value model (reporting income as the fair value of the investor's interest changes); the cost model (reporting income only as dividends are received or when the interest is sold); the consolidation model (reporting income using generally accepting accounting principles to measure increases and decrease in the economic resources underlying the investment in the subsidiary, i.e. applying accrual accounting). When the reporting entity has significant influence over an investee's operating and financing policies, i.e., when the investment is accounted for under the equity method, the current accounting model represents a variation on the consolidation model. It is often referred to as a "one-line consolidation approach." As noted in paragraph BC8 of the Proposal, there are some differences between this "one-line consolidation approach" and the full consolidation method required when the reporting entity has control. However, those differences apply in two fairly limited situations: (a) an investor discontinues recognizing its proportionate interest in equity method investee losses when the investee's losses reduce the investor's investment to zero and (b) an investor assesses equity method investee impairments at the "investment" level rather than at the underlying asset level.

The fair value and cost methods are largely reserved for situations when the reporting entity has neither control nor significant influence. (We understand that the fair value and cost methods are shortly to be replaced by the fair value method for equity investments with readily determinable fair values and a "cost with one step impairment" method for equity investments without readily determinable fair values but will continue to apply when the reporting entity has neither control nor significant influence.)

Proposed Accounting. The Proposal provides limited insight into the conceptual basis for ignoring the basis difference. As discussed earlier, paragraph BC9 includes the Board's observation "that the proposed amendments would move the equity method away from what is referred to as 'one-line' consolidation, " an outcome that does not trouble the Board because it "sees no conceptual basis to account for an investment in an entity in which the investor has the ability to exercise significant influence over an investee in the same manner as an investment in an entity in which the investor has a controlling financial interest; control is different from significant influence."

If the Board believes that equity method accounting need not be similar to the consolidation model, then what concept governs the accounting? What objective is the equity method trying to achieve? Why not eliminate the equity method entirely? The Board does not address these questions. Nor does the Board discuss why the alternative accounting model ignores basis differences but requires consideration of intra-entity profits and losses. Why is "significant influence" different enough from "control" to ignore the economic consequences of basis differences but similar enough to consider the economic consequences of intra-entity transactions. Why not simplify things by ignoring intra-entity transactions too? Companies most certainly incur costs to identify and track those transactions. If ignoring intra-entity transactions seems "wrong" at some fundamental level, why isn't ignoring the basis difference equally troublesome? Isn't a basis difference (investor's basis in an asset differs from the investee's basis in the same asset) a close cousin to an intra-entity transaction (investor's cost of assets purchased from the investee differs from the investee's cost of those same assets)?[11]

Under the Board's alternative accounting model, the investor's reported amount of income from an equity method investee will not be representative of changes in fair value or the receipt of dividends or the investor's proportionate interest in the investee's income akin to consolidation. Similarly, the investor will report its investment in the investee at an amount that is neither cost nor fair value nor amortized cost nor a "one-line consolidation." We are not sure how to describe this measurement basis other than as the arithmetic product of the investor's acquisition cost plus a percentage of the investee's reported income. In our view, an accounting model that produces assets whose carrying amounts can be explained only as the result of an arithmetic exercise will not stand the test of time.[12]

Even those financial statement users who are unaware of the current accounting for basis differences of equity method investments would likely understand the concept of "one-line consolidation" for investments where the reporting entity has significant influence but not control. They would also likely understand the reason that, lacking control, the investor is required to assess impairment at the investment level and stop recording losses when the investment is reduced to zero. Assuming a financial statement user agrees that significant influence is the appropriate place to shift from cost or fair value to something that approximates consolidation, the current accounting model would seem to "make sense." The "elevator pitch" is that equity method accounting is pretty similar to consolidation,

[11] The Board's model for capitalized interest raises similar questions about the 'internal consistency' of the Proposal. Why require amortization of one type of basis difference - - capitalized interest - - but not others?

[12] Consider, for example, deferred tax charges under Accounting Principles Board Opinion No. 11, *Accounting for Income Taxes*.

except it is presented on one line. It is, for that reason, simple. Simple to explain, simple to understand.

Even if estimating and tracking the fair values of the assets giving rise to the basis difference are unduly costly and complex for some companies, the Board could have proposed a model that would approximate the economics of the basis difference by permitting the election of a simplifying assumption. For example, the Board could have proposed to permit (but not require) an entity to allocate the entire basis difference to the predominant reason for the difference. Or the Board could have proposed to permit (but not require) an entity to assume the basis difference is an amalgamation of finite-lived assets with a weighted average life of, say, no more than 10 years. Alternatively the Board could have shelved this project until it makes a final determination on the accounting for goodwill and certain identifiable intangibles for public companies. For example, if the Board ultimately decides that public companies should be required or permitted to amortize goodwill over a period not to exceed 10 years, then the Board could consider permitting (but not requiring) investors in equity method investees to make a simplifying assumption that the basis difference is goodwill, amortizable over a period not to exceed 10 years.

Instead, the Board chose to develop an accounting model that simply ignores the basis difference until such time as that difference creates an impairment problem.

<u>Recommendation</u>. In our view, the current accounting for basis differences of equity method investments is based on a consolidation-like approach that produces a simple-to-explain, simple-to-understand result that is consistent with the underlying economics. We see no reason to depart from that concept. We especially see no reason to depart from that concept for “some” types of items (basis differences) and not others (intra-entity profits and losses and capitalized interest). And we definitely see no reason to eliminate one accounting concept without identifying its replacement. If the Board decides to finalize the accounting model as proposed, we strongly encourage the Board to articulate its concept so that preparers can explain the results to users of financial statements. Every accounting model, even a simple one, deserves a concept.

3. *The Results of the Proposal*

As noted above, we are very troubled by the results of the Board’s Proposal to ignore the basis difference. Perhaps the simplest way to explain our concern is with two examples.

Investment in a Technology Company

> Investee has developed a new technology that it is ready to commercialize. Because that new technology was internally developed, it is not recorded as an asset on Investee’s books. Investor sees a long-term benefit in buying into this new technology because it is potentially complementary with the Investor’s products and strategic direction. Investor purchases a substantial, but not controlling, equity interest in Investee. Consistent with the market’s view of the value of the new technology, Investor pays well above “book value”

for its equity interest. Under the Proposal, no value is ascribed to this valuable intangible. As the new technology produces income, Investor reports equity earnings without reflecting any amortization of the intangible, effectively pretending as if the intangible was either indefinite lived or not contributing to the earnings generated by the Investee. Investee's high earnings and no cash distributions to investors result in a larger and larger investment balance on Investor's books. The new technology, however, has a relatively short economic life. Within a few years, Investee earnings begin to flatten, then fall as Investee increases R&D spending, trying to develop the "next new thing." However, because Investee remains profitable with reasonably good margins, it takes another year or two before Investor realizes that the fair value of its equity interest may be lower than its carrying value. Because Investee has yet to develop "the next new thing" and the value of the no-longer-new technology has declined dramatically, the market views Investee's value at a small premium over book. Investor records an "other-than-temporary" impairment, surprising both its management and shareholders. A post-mortem analysis by Investor management indicates that, effectively, the amount of the impairment charge approximates the unrecorded amortization of the acquired intangible. Did the reporting of equity earnings that did not adjust for the basis difference potentially mislead financial statements users into viewing the investment as more successful than it was economically? Did the subsequent reporting of an impairment charge misrepresent the nature of the write-down and mislead users by suggesting that the Investee's business was troubled or poorly performing? Did management fail to identify the impairment on a timely basis—in fact, in this fact pattern, with such a large premium paid for essentially a short-lived asset, wasn't impairment nearly inevitable?

Investment in Intellectual Property Venture

Investor/Parent owns 100% of and consolidates Subsidiary. Subsidiary is a business: it owns intellectual property that produces royalty income. The current fair value of the intellectual property is far in excess of its carrying value. Investor/Parent sells 50% of its interest in Subsidiary. Upon losing control, Investor/Parent records a gain on the interest sold and a gain on the interest retained, revaluing its 50% retained interest to current fair value.

Subsidiary (now called JV) does not qualify for pushdown accounting because the new investor did not obtain control. JV sells the intellectual property to an unrelated third party and reports a large gain in its standalone financial statements. Investor (former Parent) now records earnings equal to its 50% interest in JV's reported gain. Does this make sense? Isn't the Investor (former Parent) reporting the same gain twice—once when it revalued its retained interest upon the loss of control and once when it recorded its 50% share of the JV's gain?

Potentially, Investor (former Parent) reports an "other-than-temporary" impairment if JV's sale of its principal asset indicates that the Investor's carrying value (representing fair value at the date control is lost plus the subsequent equity earnings) is in excess of the current fair value of its equity interest. In our simplistic example, the need for an impairment analysis and the likely conclusion that the impairment is "other-than-temporary" are obvious. However, in a more realistic fact pattern, wouldn't both the need for an analysis and the determination of whether the decline in value is "other-than-temporary" be more difficult to determine? If the JV had other intellectual property assets whose value had significantly appreciated since Investor (former Parent) lost control, might the write-down of the Investor's investment be delayed until some later date? Further, how would the financial statements convey the fact that, economically, some or all of the eventual impairment charge was essentially a reversal of previously reported equity earnings that were not "real"? Economically, isn't the case that neither the reported equity earnings nor the impairment charge are "real"?

We believe the Board's Proposal presents the potential for several unwarranted and misleading outcomes:

- Periods of overstated earnings followed by an unexpected impairment.

- Write offs that are mischaracterized as "impairments," thereby misleading both management and financial statements users into viewing the equity method investment as a "loser."

- "Impairments" that are either too little or too late.

- Investors with the same percentage ownership interest reporting the same equity earnings despite having purchased their interest at very different amounts. This type of anomaly existed with poolings of interest vs. purchase accounting for a business combination. With poolings of interest, the accounting model allowed economically identical transactions to produce different financial results. With the Proposal, the accounting model will allow economically different transactions to produce identical financial results.

- Accounting by an investor significantly affected by the voluntary election (or non-election) of pushdown accounting by the investee.

- Investor buying a 51% interest, without obtaining control, reporting significantly different income than if that 51% interest had been accompanied by control. Yes, the balance sheet is different due to non-control vs. control, but should earnings be significantly different when control, in this type of fact pattern, is based on judgment? The Board asserts that it is not troubled by this because it sees no conceptual basis for "significant influence" to be reported similar to "control." But we wonder if that result is consistent with what users would expect or view as appropriate given the significant judgments that may determine whether control exists in nuanced situations.

Recommendation. In our view, there is no need to "simplify" the equity method of accounting by eliminating the accounting for the basis difference. As noted above, based on our experience in helping preparers address complex financial reporting issues, we believe accounting for the basis difference of equity method investees generally is neither particularly complex nor noticeably troublesome (even though it does require additional bookkeeping.) However, if the facts indicate that our experience is not representative and simplification is warranted, we strongly urge the Board to adopt a model that is consistent with the underlying economics when a basis difference is clearly or mostly attributable to finite-lived assets. We suggest that, at a minimum, the Board explicitly permit companies to choose between the current accounting model (so as to preserve the ability to discretely adjust for specific basis differences) and a "pragmatic expedient" to simplify the tracking of specific basis differences while still acknowledging that, economically, the basis difference relates to assets that are being consumed as the investee operates its business.[13]

4. *Other Concerns*

a. It is not often that the FASB chooses to create a void in accounting by eliminating accounting guidance. Basis differences for equity method investments arise frequently in transactions that are common across all sizes and types of entities. And those differences are often significant. When a preparer encounters a significant basis difference, it will be natural to expect the accounting literature to provide guidance, particularly given the variety of accounting models for business combinations, long-lived assets with finite lives, and investments in equity interests where there is no significant influence. Preparers will inevitably consult the Codification. Yet, the Proposal simply eliminates the topic. There will be no discussion: GAAP will be silent. In fact, the Board's proposal doesn't even say that basis differences should *not* be accounted for, as if to suggest that it might be acceptable to analogize to purchase accounting.

[13] We are in the process of developing our comments on the FASB's recently issued proposal to simplify share-based compensation accounting. As we reflected on these two simplification proposals – equity method investments and share-based compensation – we noticed some important distinctions in the FASB's approach to simplification. To simplify share-based compensation, the Board proposes practical expedients for forfeitures and estimates of expected term that approximate a conceptually grounded outcome while continuing to permit the use of a more refined accounting model. The Board's proposed amendment related to excess tax benefits and deficiencies reflects a different concept. And the proposed amendment related to the exception for withholdings for employee taxes maintains the concept that cash-settled awards are liabilities but redefines the bright-line for the exception. In short, the proposed changes for share-based compensation either approximate, maintain or replace the current financial reporting concepts underlying share-based compensation. In this equity method investments simplification project, the Board's proposed model for the basis difference neither approximates nor maintains nor replaces the concept of equity method accounting. The proposal to ignore accounting for the basis difference is not intended to approximate the existing concept. In fact, the Board rejected alternatives that would attempt to approximate an allocation of the basis difference. This proposal also appears to prohibit companies from following a more refined accounting model. It does not maintain the existing concept. And by creating an accounting result that cannot be explained in conceptual terms, it eliminates the existing concept without offering a replacement.

If the Board finalizes the accounting as proposed, the Codification should explicitly address how basis differences should be handled. Are prepares required to ignore them until an impairment arises? Are preparers permitted to analogize to other literature, such as business combinations, as an acceptable (perhaps preferable) alternative accounting policy? Are preparers permitted (or perhaps required) to adjust the basis difference in certain unique circumstances (such as our intellectual property example above)? Whatever the Board believes is appropriate should be explained in the literature so as to eliminate “guess work,” lengthy memos for the files, and diversity in practice. If the objective is simplification, make it simple for accountants to know what to do.

b. We also strongly encourage the Board to address the accounting by the investor when the investee issues new shares to others, thereby decreasing the investor’s ownership percentage (transactions that have historically been referred to as “SAB 51 transactions”). Currently, such transactions are treated as a partial sale of the investor’s interest, with the investor’s basis being used to compute the gain or loss. Does the Board intend for this approach to continue or should the gain or loss be computed based on the investee’s book value?

c. In our view, it would be better to eliminate the equity method of accounting than to issue the Proposal as drafted. If the FASB eliminates accounting for the basis difference, we believe it is inevitable that, within five years’ time, the equity method will need to be revisited because of “unintended consequences” resulting in numerous questions from preparers and auditors, published interpretive guidance from accounting firms, EITF issues, preclearance discussions with the SEC staff and, worst of all, misleading financial reporting. If the Board concludes that the equity method of accounting is too hard and costly for preparers with little relevant information content for investors, then the simplest and most appropriate solution is to eliminate it.

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If you have any questions that you would like to discuss with us further, please feel free to contact either John Stewart at 312-345-9104 or Amy Ripepi at 312-345-9103.

Sincerely,

Financial Reporting Advisors, LLC