

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

31 July 2015

Re: Proposed Accounting Standards Update, Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting (File Reference No. 2015-280)

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting* (the Proposal), from the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective in its simplification initiative to reduce the cost and complexity of financial reporting while improving or maintaining the usefulness of the information provided to financial statement users. We agree that the proposed amendments would simplify the initial recognition and measurement of equity method investments. However, we are concerned that the challenges associated with certain aspects of the Proposal call into question whether this project would be better dealt with as part of a holistic review of the equity method, and whether the Proposal would meet the objective of simplifying US GAAP. In addition, we observe that some constituents have questioned whether the equity method provides information that is meaningful and appropriate.¹ Consequently, we suggest, at a minimum, that the Board perform broader outreach prior to moving forward.

Elimination of 'basis differences' accounting

We agree that eliminating the requirement that an equity method investor identify, account for and make disclosures about the difference between its cost basis of an investment and its proportional interest in the equity of the investee (i.e., the basis difference) would reduce costs and complexities associated with the initial recognition and measurement of an equity method investment for many equity method investors because they would no longer have to determine the fair value of an investee's assets and liabilities and allocate basis differences. However, it will increase complexity by requiring equity method investors to obtain a better understanding of the investee's application of US GAAP with respect to the balances in place as of the investment date. This would be particularly challenging when the investee has not previously applied US GAAP.

¹ See EITF 08-6 issue summary No.1 paper, 27 August 2008, paragraph 3.



The Proposal also would simplify some aspects of the subsequent accounting for equity method investments because equity method investors would not be required to track basis differences and make adjustments to determine equity method earnings. However, we are concerned that the Proposal would introduce challenges when applying the equity method of accounting that may not have been considered. Under the Proposal, we generally would expect higher carrying amounts and earnings (or smaller losses) from equity method investments than under current US GAAP because equity method investors would not adjust their equity method earnings for the depreciation and amortization of basis differences. As described more fully in our response to Question 1, these changes could affect an entity's evaluation of whether an equity method investment is impaired and could trigger additional Securities and Exchange Commission (SEC) reporting requirements, including the possibility of triggering the need for financial statements to be provided under S-X Rule 3-09.

In addition, as described more fully in our response to Question 1, we are concerned that the Proposal may result in entities providing information that is less useful or potentially misleading to users of financial statements, because, for example, the earnings recorded would not be burdened by the equity method investor's cost of acquiring the investment.

In the Basis for Conclusions, the Board said the Proposal would move away from "one-line consolidation." However, under the Proposal, Accounting Standards Codification (ASC) 323 would still include many accounting requirements that are similar to consolidation procedures (e.g., elimination of intra-entity profits and the equity method investor's recognition of its share of the investee's other comprehensive income or OCI in its own OCI). Preparers also often refer to the consolidation guidance when accounting for aspects of equity method investments that are not addressed in ASC 323. As discussed more fully in our response to Question 1, we are concerned that moving away from one-line consolidation in one respect (by eliminating basis differences), but not in others, might create confusion about whether to analogize to the consolidation guidance when there is a lack of directly applicable guidance in the equity method accounting literature and might increase diversity in practice.

Elimination of the retroactive application

We support eliminating the requirement that an equity method investor account for an equity method investment retroactively when the investment initially qualifies for the equity method. The Proposal would reduce costs and complexities because equity method investors would no longer have to retroactively perform a fair value allocation and adjust earnings for the prior periods.

Our responses to the specific questions posed in the Proposal are set out in Appendix A of this letter.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

Appendix A – Responses to questions raised in the Proposed Accounting Standards Update, Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting

Question 1: Should accounting for the basis difference of equity method investments as if the investment were a consolidated subsidiary be eliminated? Why or why not? Would amortization of the entire basis difference through equity method earnings be preferable? If so, what would be the suggested amortization period?

We agree that the Board's Proposal to eliminate the accounting for basis differences of equity method investments as if the investment were a consolidated subsidiary would simplify the initial accounting for equity method investments. Equity method investors no longer would incur costs to determine the acquisition date fair values of the identifiable assets and assumed liabilities for the purpose of allocating the basis difference for an equity method investment. We also agree that the Proposal would simplify certain aspects related to the subsequent measurement of an equity method investment because equity method investors no longer would need to subsequently account for basis differences.

However, as observed by certain members of the Emerging Issues Task Force (EITF) in their deliberations of EITF 08-6, in many cases, after considering the materiality of the investment and the availability of information that was obtained when deciding to make the investment, equity method investors focus on accounting for the most significant basis differences and any insignificant basis differences are subsumed into equity-method goodwill. Therefore, the benefits of the Proposal may not be as significant as anticipated.

In addition, depending on facts and circumstances, the Proposal might increase the cost and effort of other aspects of subsequent measurement of equity method investments as a result of the challenges described below. We also are concerned about consequences of the Proposal that may not have been fully considered by the Board. Therefore, we suggest the Board, at a minimum, perform extended outreach before moving forward.

Challenges

Under the Proposal, we generally would expect higher carrying amounts of and earnings (or smaller losses) from equity method investments than the amounts that would be recorded under current US GAAP because equity method investors would not adjust their equity method earnings for depreciation and amortization of basis differences. Higher equity method investments carrying amounts and earnings could affect financial reporting and auditing in several ways:

- ▶ *Greater possibility of impairment.* An equity method investment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment might not be recoverable (for example, when an investment's fair value is lower than its carrying amount). As a result, there likely will be more instances in which equity method investors will be required to evaluate and record impairments because the carrying amounts of equity method investments likely would be higher under the Proposal than under current US GAAP. It could be more costly and require more effort to obtain a valuation for impairment purposes in subsequent

periods than it would be to obtain the initial valuation at the time of the initial investment (when the equity method investor generally would be performing other due diligence procedures about the financial position and performance of the investee).

- ▶ *SEC reporting.* S-X Rule 3-09, *Separate Financial Statements of Subsidiaries not Consolidated and 50 Percent or Less Owned Persons*, requires that registration statements and annual SEC reporting forms contain separate financial statements and schedules prepared in accordance with Regulation S-X for individually significant equity method investments. Investees are considered individually significant if either the investment test or the income test is met at the 20% level. Under S-X Rule 4-08, *Summarized Financial Information of Subsidiaries not Consolidated and 50 Percent or Less Owned Persons*, if the criteria for a significant subsidiary are met at the 10% level either individually or on an aggregated basis for equity method investments, the equity method investor discloses summarized financial information. Depending on facts and circumstances, higher equity method investment carrying amounts or higher equity method earnings (as compared to the amount that would be recorded under current US GAAP) could result in more investments being deemed to be “significant” for purposes of those two rules, which could result in reporting entities incurring additional costs and effort to obtain investees’ audited financial statements for the investors to furnish to the SEC.
- ▶ *Financial statement audit procedures.* Higher equity method investments and earnings (as compared to the amount that would be recorded under current US GAAP) might change the significance of the investment in financial statements audits and therefore change the nature, timing and extent of substantive audit procedures or tests of internal controls being applied to the equity method investments or to other financial statement line items. In addition, higher equity method investment carrying amounts (as compared to the amount that would be recorded under current US GAAP) may result in the auditor’s needing to refer to the audit of a significant equity method investee performed by another auditor when such a reference is not currently required² as a result of the lesser significance of the equity method investee. This may result in additional costs being incurred and may require additional effort by management and auditors.

Amortization of the entire basis difference through equity method earnings would generally help to mitigate these challenges while still simplifying equity method accounting. The Board could consider aligning the amortization period with the guidance available for private companies under the Private Company Council alternative (as codified in ASC 350-20-35-63) (over 10 years or shorter if the equity method investor could demonstrate that another useful life is more appropriate).

An additional challenge that could arise as a consequence of adopting the Proposal is that an equity method investor would be required to assess the investee’s application of US GAAP as it relates to the historical cost basis of the investee’s financial statements that exists at the date of investment.³ This could be particularly challenging when the investee does not apply US GAAP (e.g., it applies IFRS). Currently, an equity method investor only needs to assess the application of US GAAP as it relates to the fair value of the investee’s assets and liabilities at the investment date.

² As required by SEC S-X Rule 2-05, PCAOB Auditing Standard 508.12-13, or AICPA AU Section 543, as applicable.

³ This also was a challenge when companies previously applied the pooling of interest method.

Meaningfulness of information

We are concerned that the Proposal may result in providing information that is less useful, and potentially misleading, in the following situations:

- ▶ *An investee recognizes a gain on the sale of an asset that had already appreciated at the date of investment.* Under current GAAP, an equity method investor determines the acquisition date fair values of identifiable assets, allocates the basis differences and tracks those basis differences when recording its share of equity method earnings. When the investee sells an asset for a gain, the equity method investor adjusts its equity method earnings so that it only records a gain for the excess of the sales price over the acquisition date fair value (which may be less than its proportion of the gain recorded by the investee). Under the Proposal, the equity method investor would record its share of the investee's gain without any adjustment, regardless of the underlying asset's fair value on the date of the equity method investment. This may provide information that is not meaningful, or potentially misleading, because it would not reflect the economics to the equity method investor because the investor may have paid a higher purchase price for the equity method investment to obtain its portion of the gain.
- ▶ *An equity method investor recognizes impairment prior to the investee's recognizing impairment.* An equity method investor may recognize an other-than-temporary impairment of its investment before the investee recognizes an impairment of an underlying asset in a subsequent period. Under the Proposal, the equity method investor also would recognize its share of the investee's impairment when it recognizes its share of the investee's net income). This information may not be meaningful, or may potentially be misleading, if the factors contributing to the impairment of the equity method investment as a whole primarily were the result of the asset's impairment for which the investee recognized the impairment.
- ▶ *Misleading comparability between equity method investors.* Under current GAAP, the equity method earnings reported by an equity method investor reflect adjustments for the difference between the price paid for the investment and the amount reflected in the investee's financial statements. As a result, two equity method investors that each own 20% of an investee would record different equity method earnings if they paid different amounts. Under the Proposal, the equity method investors would record the same earnings, and the differences in the purchase prices they paid would not be reflected until they recorded gains or losses on the sale of the investments, which we observe may not provide the most meaningful information to users of the financial statements.
- ▶ *Lack of comparability between parent and equity method investors.* We also observe that a parent that owns 50% of an investee and controls and consolidates the investee (as the primary beneficiary of a variable interest entity) would record different earnings than the other 50% equity method investor that only has significant influence over the investee. This is because the parent would apply business combination accounting when it obtained control of the investee, which includes determining the fair values of identifiable assets and liabilities and subsequently reflecting the "step up" in basis when it consolidates the investee. However, an equity method investor would not identify or allocate basis differences with respect to the investee. As a result, the parent and the equity method investor would record different economics from the investee, even though they both own 50%. This is a result that may not provide the most meaningful information to users of the financial statements.

- ▶ *Classification in the statement of cash flows.* If cumulative equity method earnings increase, absent any change in the guidance resulting from the EITF's project on the classification of distributions received from equity method investments, a larger portion of dividends generally would be classified as an operating activity in the statement of cash flows under the "cumulative earnings" approach. This classification may not provide meaningful information to users of the equity method investor's financial statements because it would not reflect the purchase price paid by the equity method investor.

Moving away from one-line consolidation

The Board acknowledged in the Proposal's Basis for Conclusions "that the proposed amendments would move the equity method away from what is referred to as one-line consolidation. The 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." We agree that eliminating the accounting for basis differences would move the equity method away from one-line consolidation and would be consistent with some other requirements in ASC 323 (e.g., impairment of an equity method investment, discontinuing the equity method when the investment and any net advances are reduced to zero). However, the Proposal does not eliminate some other equity method accounting procedures that are akin to consolidation procedures such as:

- ▶ Eliminating intra-entity profits and losses in accordance with ASC 323-10-35-5(a)
- ▶ Making adjustments to reflect the equity method investor's share of changes in the investee's capital in accordance with ASC 323-10-35-5(c)
- ▶ Accumulating the equity method investor's share of investee's OCI in the equity method investor's OCI in accordance with ASC 323-10-35-5(d) and the option to present such amounts together with the equity method investor's OCI components as allowed by ASC 323-10-45-3
- ▶ Accounting for a share issuance by an investee as if the equity method investor had sold a proportionate share of its investment as required by ASC 323-10-40-1
- ▶ Translating foreign currency financial statements of a foreign equity method investee to the reporting currency in the same manner as the financial statements of a consolidated foreign investee under ASC 830-10-15-5, *Foreign Currency Matters – Overall*
- ▶ Applying the earnings-per-share requirements related to subsidiaries to equity method investments as required by ASC 260-10-55-21, *Earnings per Share – Overall* (Under this requirement, diluted EPS might be affected by outstanding options, warrants or convertible securities issued by the investee)

In addition, many equity method investors analogize to the accounting for consolidated subsidiaries when certain events and transactions occur that are not specifically addressed in ASC 323. This analogy is based on the historical view that the equity method is one-line consolidation. It is not clear whether the following analogies and practices, which are common under current GAAP, would still be appropriate if the Proposal is finalized:

- ▶ An equity method investor that is a public business entity conforms any accounting policies used by investees that would be unacceptable in its financial statements (e.g., a PCC alternative) when calculating equity method earnings.
- ▶ When an equity method investor has a direct investment in a subsidiary of the investee, it “looks through” the investee and considers that parent-subsidary relationship to evaluate whether it can exercise significant influence and should apply the equity method to its direct investment in the subsidiary of its equity method investee.
- ▶ Equity method investors generally follow ASC 810-10-45-12, *Consolidation – Overall*, if the equity method investor and investee have different fiscal periods.
- ▶ ASC 323-10-35-6 allows an equity method investor to record its share of the earnings or losses of an investee on a lag. Equity method investors generally apply the same maximum difference allowed in Rule 3A-02(b) of SEC Regulation S-X with respect to consolidated subsidiaries (i.e., a lag of no more than 93 days).
- ▶ Some equity method investors interpret ASC 323-10-35-15 as referring to one-line consolidation and, therefore, record their share of an investee’s capital transaction even if it doesn’t affect the equity method investor’s share of the investee’s net assets (e.g., when investee accounts for share-based payments, it does not affect its net assets), despite the fact that an equity method investee’s capital is not part of the parent’s capital.

In light of the Proposal’s moving away from the one-line consolidation concept in some circumstances while retaining it in others, we encourage the Board to consider the situations described above and address these issues in a final standard. We believe it would be preferable to consider the similarities to and differences from consolidation procedures in a holistic manner, rather than piecemeal, to avoid confusion and diversity in practice.

Question 2: Should the accounting for capitalized interest, which adds to the basis of an entity’s equity method investment and is amortized, also be eliminated for equity method investments? Why or why not?

If the Board decides to finalize the elimination of basis differences, it also should eliminate the capitalization of interest on equity method investees (and the related amortization of such interest) for the following reasons:

- ▶ *Capitalization of interest on an equity method investment creates a basis difference.* Retaining the requirement to capitalize interest on equity method investment would be inconsistent with the Board’s Proposal to eliminate the requirement that equity method investors identify, allocate, account for and disclose basis differences.

- ▶ *The Proposal would move the equity method away from one-line consolidation. ASC 835-20-35-2, Interest – Capitalization of Interest, requires an equity method investor to capitalize interest cost on an equity method investment if the investee's has qualifying assets (and meets certain other criteria). This requirement is based on the premise that the equity method investor looks through the cost of its investment to the investee's underlying assets as if it were a consolidated subsidiary. Retaining the requirement to capitalize interest would be inconsistent with the decision to eliminate one-line consolidation. Retaining the requirement to capitalize interest on equity method investment and eliminate only the subsequent amortization also would add to the operational challenges described in Question 1.*

Question 3: Should an entity be required to apply the proposed amendments related to accounting for the basis difference on a modified prospective basis as of the effective date? Why or why not?

Yes. Applying the proposed guidance to basis differences using a modified prospective approach (i.e., applying the Proposal to all new equity method investments and stopping amortization of all remaining basis differences) would be practical and cost effective. In addition, the proposed requirement for an equity method investor to disclose amortization of basis differences in prior period(s) in the year of adoption would allow for comparison of current and prior periods.

The Board should consider whether to address how an equity method investor should account for a change in its conclusion on its ability to exercise significant influence over an investee's operating and financial policies as a result of the Proposal. In some cases, an equity method investor may have previously concluded pursuant to ASC 323-10-15-10(d) that it was unable to exercise significant influence over the investee's operating and financial policies because it tried and failed to obtain financial information to identify, allocate and account for basis differences. If the Proposal is finalized as currently drafted and an equity method investor concluded that it now is able to apply the equity method, it is not clear whether it also should account for that change prospectively as of the effective date.

Question 4: Should an entity no longer be required to retroactively adopt the equity method of accounting if an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest? Why or why not?

Yes. We agree that the Proposal to eliminate the requirement to retroactively adopt the equity method of accounting when an investment qualifies for the equity method would simplify equity method accounting and reduce costs for the reasons described in the Proposal.

However, if the Board finalizes the Proposal to eliminate the retroactive application of equity method, we encourage it to consider including additional guidance on the accounting for unrealized gains and losses accumulated in OCI when an equity method investor obtains significant influence over an investee that it previously accounted for as an available-for-sale investment and applies the equity method for the first time. The Proposal does not address whether such amounts should remain accumulated within OCI until the equity method investee is sold, should be recycled into earnings or should become part of the cost of the investment.

Question 5: Should the proposed guidance to eliminate the requirement to retroactively adopt the equity method of accounting be applied prospectively? Why or why not?

Yes. Prospective adoption of the Proposal would be the simplest and most cost-effective method of adoption. Retrospective adoption of this Proposal would be burdensome without improving financial reporting.

Question 6: How much time will be necessary to adopt the amendments in this proposed Update? Should early adoption be permitted? Should the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

Given that the Proposal would simplify the equity method of accounting, we generally would not expect the time necessary to adopt the amendments to be significant. However, we acknowledge that some preparers may use systematic processes to track basis differences and adjust their equity method earnings for basis differences amortization. Those preparers would need to modify their systems and processes. Preparers also may need time to explain the effects of adopting the Proposal to the users of their financial statements and to address any consequences (e.g., SEC reporting, debt covenants). In addition, entities may need to put greater focus on improving their processes for identifying other-than-temporary impairments.

Since the objective of the Proposal is to simplify the equity method of accounting, we would support early adoption. In addition, we would not expect that nonpublic entities would need more time than public business entities to adopt the Proposal.