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Heads Up

The Basis for Simplification

FASB Issues Proposed ASU to Amend Equity Method Accounting

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On June 5, 2015, the FASB issued a proposed ASU[1] on equity method accounting as part of its simplification initiative (i.e., the Board's effort to reduce the cost and complexity of current U.S. GAAP while maintaining or enhancing the usefulness of the related financial statement information). The proposal would amend the accounting for equity method investments, eliminating the requirements for an investor to (1) account for basis differences[2] related to its equity method investees and (2) retroactively account for an investment that becomes newly qualified for use of the equity method because of an increased ownership interest as if the equity method had been applied during all previous periods in which the investment was held.

Comments on the proposed ASU are due by August 4, 2015.

Elimination of Basis Differences

Under current U.S. GAAP, a reporting entity is required to analyze the differences between the purchase price of its equity method investee and its share of the underlying net assets of the investee (in a manner similar to the approach required when an investee is consolidated). This basis difference is attributed to the investee's identifiable assets and liabilities whose fair values differ from their book values as of the acquisition date. Any excess cost that is not allocated to the identifiable net assets is considered equity method goodwill. The investor is also required to identify the deferred tax consequences of the equity method basis differences.

Subsequently, the investor must adjust its share of the earnings or losses of the equity method investee to account for the basis differences. For example, the investor would adjust its share of the investee's earnings for additional amortization related to basis differences on identifiable intangible assets. However, the portion of the basis difference that is considered goodwill would not be amortized unless the entity is a private company that has elected the accounting alternative in ASC 350-20[3] to amortize goodwill.

The proposed ASU would eliminate the requirement to separately account for the basis difference of equity method investments. Rather, the entire basis difference would be considered part of the investment basis. The FASB believes that this amendment would reduce complexity because the

[1] FASB Proposed Accounting Standards Update, *Simplifying the Equity Method of Accounting*.

[2] A basis difference can be defined as the amount by which the cost of acquiring an equity method investment exceeds the investor's proportionate interest in the net assets of the investee.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

investor would not be required to determine the acquisition-date fair value of the investee's identifiable assets and liabilities assumed. In addition, no amount of the excess of the cost of the equity method investment over the investor's share of the underlying net assets of the investee would be considered equity method goodwill. Therefore, private companies that have elected to amortize goodwill would no longer amortize the portion of the investment that was previously considered equity method goodwill.

Although the proposed ASU would eliminate the requirement to separately account for the basis differences, it would not affect the requirement to eliminate intra-entity transactions between the investor and investee until the profits and losses are realized.

Example — Equity Method Investment Basis Differences

Investor A purchases 25 percent of Investee B's common stock on January 1, 2015, for $6 million in cash. Investor A has the ability to exercise significant influence over B and accordingly applies the equity method of accounting (income taxes have been ignored).

The carrying value and fair value of B's assets and liabilities on January 1, 2015, are as follows:

	Carrying Value	Fair Value**
Cash	$ 4,000,000	$ 4,000,000
Current assets	8,000,000	8,000,000
Plant and equipment*	9,000,000	13,000,000
Liabilities	(5,000,000)	(5,000,000)
Net assets	$ 16,000,000	$ 20,000,000
Investor A's 25 percent share	$ 4,000,000	$ 5,000,000
Equity method goodwill		1,000,000
Total purchase price		$ 6,000,000

* The remaining useful life of the plant and equipment is 10 years.

** Investee B does not have any other unrecognized identifiable intangible assets.

Under both current U.S. GAAP and the proposed ASU, Investor A would initially recognize its investment in B at $6 million. However, under current U.S. GAAP, A would be required to analyze the difference between the $6 million it paid for its 25 percent interest and its share of the carrying value of B's underlying net assets ($4 million). In this example, A has concluded that $1 million of the basis difference is related to the investee's plant and equipment and $1 million is related to equity method goodwill. Accordingly, A would account for the basis difference related to the plant and equipment by reducing its subsequent share of B's earnings (or losses) by $100,000 each year for the next 10 years. Investor A does not amortize goodwill and therefore would not subsequently separately account for the equity method goodwill.

In accordance with the proposed ASU, A would not be required to analyze the basis differences. Rather, any basis difference would be treated as part of the basis of the investment. Accordingly, A would not adjust its portion of B's earnings or losses for the basis difference when it subsequently applies the equity method of accounting.

Editor's Note: Under current U.S. GAAP, additional basis differences in an equity method investee may exist when an investor acquires its interest in an investee and the investee's assets or liabilities are accounted for at fair value with changes in fair value recorded in accumulated other comprehensive income (e.g., investments in available-for-sale securities or derivative instruments). Under the proposed ASU, these basis differences would not need to be separately identified.

Disclosures

The ASU would eliminate the requirement to disclose the difference, if any, between "the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference." However, equity method investors would be required to disclose in their annual and interim financial statements for the first year after the adoption date the (1) nature and reason for the change in accounting principle and (2) amount of amortization of the basis difference recognized in the comparable prior period.

Transition and Effective Date

The FASB will discuss the proposed ASU's effective date after considering the comment-letter feedback it receives. The Board decided that the transition for existing equity method investments should be on a modified prospective basis. That is, the accounting for basis differences would cease as of the effective date and any remaining basis difference would be treated as part of the basis of the investment (i.e., the investor would no longer be required to prospectively account for the basis differences).

Editor's Note: The proposed ASU could have a significant effect when the basis difference in an equity method investee is predominantly related to a single asset. For example, an investor may acquire an interest in an equity method investee that holds a single real estate property. In this case, the excess of the fair value of the property over its carrying value (as a result of changes in the real estate value after its acquisition) would be included in the purchase price of the investment. If the investee were to subsequently sell the property for an amount greater than its carrying value, a portion of the gain (or potentially all of the gain) the investee realizes would already be reflected in the investor's cost basis of its investment. The proposed ASU would not require the investor to adjust its share of the earnings of the investee when it applies the equity method of accounting for the portion of the gain that was included in its investment as of the acquisition date.

Increase in Level of Ownership or Degree of Influence

Under current U.S. GAAP (ASC 323-10-35-33), if an investor increases its investment in an investee (or otherwise gains significant influence over the investee), the "investment, results of operations (current and prior periods presented), and retained earnings of the investor shall be adjusted retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods in which the investment was held." The proposed ASU would eliminate this requirement. Rather, the cost of acquiring the additional interest in the investee would be added to the carrying value of the investor's previously held interest (which may be at cost or fair value for marketable securities), and the equity method of accounting would be applied subsequently from the date on which the investor obtains the ability to exercise significant influence over the investee.

Example — Increase in Level of Ownership or Degree of Influence

Investor A acquires 10 percent of Investee B's common stock on January 1, 2015, for $400,000. Investor A accounts for this initial investment under the cost method because it does not have the ability to exercise significant influence over B.

On July 1, 2015, A acquires an additional 20 percent of B's common stock for $900,000. Investor A now has a total interest in B of 30 percent and thus has the ability to exercise significant influence over B.

Under current U.S. GAAP, A is required to adjust its financial statements retroactively on a step-by-step basis when it acquires the additional 20 percent interest. Accordingly, A would include 10 percent of B's earnings for the first six months of the year and 30 percent of B's earnings for the last six months of the year in its December 2015 income statement. Under the proposed ASU, A would only be required to include 30 percent of B's earnings for the last six months of the year in its December 2015 income statement.

Transition and Effective Date

The FASB will discuss the proposed ASU's effective date after considering the comment-letter feedback it receives. The Board decided that an investor would apply the amendments in the proposed ASU prospectively to ownership level increases occurring after the effective date of the final ASU.

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