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Contents

FASB Proposes Changes to Equity Method Accounting

The FASB recently issued a proposed Accounting Standards Update (ASU) that would eliminate certain requirements in applying the equity method of accounting to (1) account for the difference between the cost of an investment and the investor's proportionate share of the net assets of an investee (the basis difference), and (2) retroactively apply the equity method when an increase in ownership interest in the investee triggers a change from the cost method to the equity method.[1] The proposed ASU is part of the FASB's simplification initiative. Comments are due by August 4, 2015.

Key Impacts

- Equity method investors no longer would need to identify and value the underlying assets and liabilities of the investee at acquisition.
- Equity method investors would continue to recognize their share of the investee's earnings (or losses), but would not adjust that amount for the periodic effect of any basis difference existing at acquisition. Consequently, the reported equity in earnings under the proposed ASU would differ from current GAAP.
- When the investor paid a premium at acquisition and the investee has earnings, the investor's investment account reported in the statement of financial position would grow more quickly under the proposed ASU because there is no subsequent accounting for the premium paid. This may increase the likelihood of other-than-temporary impairments in subsequent accounting periods.

[1] Proposed Accounting Standards Update, Simplifying the Equity Method of Accounting, available at www.fasb.org.

Basis Differences

Under current GAAP, an equity method investor must determine the acquisition date fair value of the investee's identifiable assets and liabilities as if it was acquiring the investee in a business combination.[2] The investor's proportionate share of the individual differences between the acquisition date fair values of the assets and liabilities and the investee's carrying amounts comprises the *basis difference* in the investment. Investors account for the basis difference like the investee was a consolidated subsidiary.

Under the proposed ASU, investors no longer would need to identify and amortize the components of the basis difference. While the investor would continue to recognize its share of the investee's underlying earnings (or losses), it would not adjust that amount to account for the difference between the amount paid and the investor's share of the carrying amount of the investee's net assets at acquisition.

The proposed ASU also would affect an accounting alternative currently available for private companies.[3] Because the proposed ASU would eliminate the concept of equity method goodwill, private companies no longer would be able to amortize some (or all) of a purchase premium over 10 years.

KPMG's Observations

The Board received stakeholder feedback that accounting for the basis difference, including the retroactive application upon an increase in ownership interest where an investor qualifies for the equity method, can be costly and complex without providing a clear benefit to financial statement users. An investor also may not have access to information necessary to determine the basis difference because it does not control the investee. In addition, the Board believes that some financial statement users are not aware of the requirements to account for the basis difference.

While the proposed ASU appears to simplify the initial and ongoing bookkeeping for an equity method investment, elimination of the accounting for the basis difference may raise other concerns. For example:

- The proposed ASU may result in less comparability of the investors' financial performance depending on how they account for their investments. For example, an investor accounting for an investee under the equity method may, in some situations, report higher earnings from the investee than an investor who controls and consolidates that same investee (see Example).
- Different investors with the same ownership percentage in the investee would recognize the same amount of equity in earnings of the investee under the proposed ASU even if those investors paid drastically different amounts for those investments.

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[2] FASB ASC Topic 805, Business Combinations, available at www.fasb.org.

[3] FASB ASC Topic 350, Intangibles-Goodwill and Other, available at www.fasb.org.

- Eliminating the accounting for the basis difference may result in accelerating or increasing the likelihood of other-than-temporary impairment of equity method investments.
- If an equity method investee also has a change in control that would qualify for the option to apply pushdown accounting, the equity method investor's share of earnings of the investee may differ depending on whether the investee elects to apply pushdown accounting.

The proposed ASU seems to create a hybrid measurement between consolidation and the cost method – an equity method investor would recognize its share of the earnings of its investee based on the investee's recorded amounts but would not reflect any impact on those earnings based on the investor's own costs. It may be appropriate to consider eliminating the equity method of accounting entirely rather than just part of it.

Example: Basis Differences

Assume the following facts.

- Company A acquires a 49% ownership interest in Entity B on 1/1/2015 for $1.47 million.
- Company A accounts for its investment in Entity B under the equity method.
- Entity B is a manufacturing company and its assets are entirely plant and integral equipment with a combined fair value of $3 million and carrying amount of $1 million at 1/1/2015. The plant and integral equipment have a remaining useful life of 20 years.
- Entity B reports net income of $500,000 in its financial statements for the year ended 12/31/2015, comprised of $650,000 of revenue, $100,000 of expenses other than depreciation, and $50,000 of depreciation expense.
- There are no distributions made by Entity B or intercompany transactions during 2015.

Scenario 1 – Under Current GAAP

Company A records its initial investment in Entity B for $1.47 million at 1/1/2015.

Company A records its share of earnings in Entity B for the year ended 12/31/2015 in the amount of $196,000, calculated as follows.

- Share in Entity B's earnings of $245,000 ($500,000 x 49%), and
- Adjustment for the basis difference in the amount of $(49,000) ($2,000,000 x 49% ownership interest / 20 years).

Company A's ending investment balance in Entity B on 12/31/2015 is $1,666,000.

Scenario 2 – Under Proposed ASU

Company A records its initial investment in Entity B for $1.47 million at 1/1/2015.

Company A records its share of earnings in Entity B for the 12-month period ended 12/31/2015 as $245,000.

Company A's ending investment balance in Entity B at 12/31/2015 is $1,715,000.

Under the proposed ASU, Company A's ending investment balance and share of Entity B's earnings would be higher than those reported under Scenario 1.

Scenario 3 – Consolidation versus Equity Method

Assume the same facts as in Scenario 1. In addition to Company A acquiring a 49% ownership interest in Entity B, Company C acquires the remaining 51% equity interest at the same date for $1.53 million. Entity B elects not to apply pushdown accounting.

Because Company C has a controlling financial interest in the investee, it consolidates Entity B. In its consolidated financial statements, Company C:

- Records the plant and equipment for $3 million as of 1/1/2015 and depreciation expense of $150,000 for the year ended 12/31/2015, resulting in an ending plant and equipment balance of $2.85 million at 12/31/2015.
- Records $650,000 of revenue, $100,000 of expenses other than depreciation, and $150,000 of depreciation expense, resulting in net earnings from Entity B of $400,000.
- Company C reports net income attributable to the noncontrolling shareholders of Entity B of $196,000 ($400,000 × 49%) and net income attributable to Company C of $204,000 ($400,000 × 51%).
- Under Scenario 1 (current GAAP), Company A's share of Entity B's earnings of $196,000 is consistent with the amount Company C attributes to it in its consolidated financial statements as the noncontrolling shareholder.
- Under Scenario 2 (proposed ASU), Company A's share of Entity B's earnings of $245,000 is not consistent with the amount Company C attributes to it in its consolidated financial statements as the noncontrolling shareholder ($196,000). Additionally, Company A's reported earnings from Entity B ($245,000) actually *exceeds* the earnings attributable to Company C ($204,000) even though Company C's level of ownership in Entity B (51%) is higher than Company A's (49%).

Retroactive Application of the Equity Method

Currently, when an investor increases its level of ownership interest triggering the use of the equity method, it must adjust the investment, results of operations, and retained earnings retroactively as if the equity method had been applied during all previous periods in which the investment was held. To do so, the investor needs to retroactively perform a fair value allocation as of the initial acquisition date. Under the proposed ASU, that retroactive application would be eliminated. Instead, the investor would add the incremental cost to its existing investment basis and account for the investment under the revised equity method prospectively.

Proposed Transition and Effective Date

Equity method investors would apply the proposed change to account for basis differences on a modified prospective basis by freezing any remaining basis differences at the proposed ASU's effective date. No periodic amortization of the basis difference would be recognized after the effective date. An investor would disclose the nature of, and reason for, the change in accounting principle in the first annual financial statements (and in all the interim period financial statements in that annual period) after the effective date. An investor who stops accounting for the basis difference also would disclose in the first annual period of adoption the amount of amortization recognized in the previous comparable interim or annual period.

The proposed elimination of the retroactive application of equity method accounting would be applied prospectively to ownership level increases occurring after the proposed ASU's effective date. No disclosures would be required at transition.

Both the effective date and considerations for early adoption will be determined after stakeholder feedback is received.

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