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Mr. Lawrence W. Smith
Director, TA&I – FSP
Financial Accounting Standards Board
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Letter of Comment No: 2 File Reference: FSPAPB18A Date Received: 4/25/05

Proposed FASB Staff Position No. APB 18-a, "Accounting by an Investor for its Proportionate Share of Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, upon a Loss of Significant Influence"

Dear Mr. Smith:

Deloitte & Touche LLP is pleased to comment on the proposed FASB Staff Position No. APB 18-a, "Accounting by an Investor for its Proportionate Share of Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, upon a Loss of Significant Influence" ("FSP APB 18-a" or "proposed FSP").

Deloitte & Touche does not support the proposed position of the FASB staff as indicated in FSP APB 18-a. The guidance in the proposed FSP does not appear consistent with current accounting standards and the conceptual framework, or at least it does not provide a basis explaining how it is consistent with such authoritative literature. In addition, an alternative approach exists that appears to be conceptually superior to the proposed guidance. The reasons for this view and the suggested alternative are provided below. Additional editorial suggestions intended to improve the clarity and usefulness of FSP APB 18-a can be found in the appendix to this letter.

#### **Conceptual Principles Underlying the Proposal**

In accounting for an equity method investment under Opinion 18, an investor recognizes its proportionate share of the investee's total comprehensive income, recognizing separately in its net income its proportionate share of the investee's net income and in its other comprehensive income (OCI) its proportionate share of the investee's OCI. When an investor is no longer permitted to account for its investment under the equity method because it loses the ability to exert significant influence over the investee (even if the loss occurs through no action on the part of the investor, such as the loss of board representation or a decline in its ownership percentage of voting stock of the investee due to the investee's issuance of additional voting stock to outside investors), the proposed FSP requires "an investor's proportionate share of an investee's equity adjustments for OCI to be offset against the carrying value of the investment at the time significant influence is lost." If this is an interpretation of Opinion 18, it appears to contradict the general principle in paragraph 19(1); when an investor loses significant influence, the previously recognized share of earnings or losses that relate to the investment should not be reversed but should remain part of the carrying amount of that investment (i.e., the investment's carrying value

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is not adjusted). If the proposed FSP is an amendment to or new provision in Opinion 18, the basis for why proportionate amounts related to the investment recognized within OCI should be treated differently than amounts recognized in net income is unclear as both are components of comprehensive income.

FASB Concepts Statement No. 6, Elements of Financial Statements, defines comprehensive income as "the change in equity [net assets] of a business enterprise during a period from transactions and other events and circumstances from nonowner sources." Because a basis for conclusion was not provided in the proposed FSP, it is unclear why the loss of significant influence is a transaction or event with economic consequences to the equity of the investor such that the investor should immediately recognize a gain or loss in comprehensive income. While the loss of significant influence may be an event that causes a change in the prospective measurement basis of an investment, it is not an event that affects the value of the investment or the equity of the investor. Thus, adjusting the current basis of the investment (potentially further away from fair value and potentially to a negative or credit balance) does not appear appropriate, and recognizing a related gain or loss in OCI will distort comprehensive income.

Also, adjusting the basis of the investment appears at odds with the current accounting framework. In all other situations in U.S. accounting literature involving investments and recognition of related gains or losses in OCI (e.g., FASB Statement Nos. 52, Foreign Currency Translation, and 115, Accounting for Certain Investments in Debt and Equity Securities), when amounts previously recognized in OCI are reversed, at the appropriate time, such amounts are recognized as part of net income, never as a basis adjustment of the investment. In addition, as part of its considerations within FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, the FASB considered an approach for cash flow hedges that would have initially reported the derivative gain or loss in OCI and subsequently reversed such amounts as an adjustment of the basis of the acquired asset (or liability). The Board rejected that approach because it would have distorted periodic comprehensive income (see paragraph 376 of Statement 133). The situation addressed in the proposed FSP seems similar.

### **Suggested Approach**

An investor's accumulated proportionate share of an investee's equity adjustments for OCI should remain as a component of the investor's accumulated OCI until all or a portion of the investment is sold. An investor should recognize its proportionate share of an investee's equity adjustments for OCI as a component of the gain or loss on the sale of the investment in relative proportion to the amount sold. This approach, consistent with View B provided in the January 5, 2005 FASB Board meeting handout, is superior to the approach in the proposed FSP as it is more consistent with the current concepts underlying recognition of comprehensive income and causes of adjustments to carrying amounts of net assets.

Under the equity method, an investor recognizes its proportionate share of the investee's OCI. The investor reclassifies its proportionate amounts from accumulated OCI to net income as the investee realizes and reclassifies such amounts from accumulated OCI to net income. Critics of View B cite the presumption that an investor with significant influence has the ability to influence the timing of realization of gains and losses of the investee. The investor no longer has that ability when significant influence is lost; therefore, previously recorded amounts in OCI should be reversed. In addition, some believe the investor may lose the ability to track the investee's realization of amounts from accumulated OCI to net income when it loses the ability to exert significant influence over the investee. Deloitte & Touche does not share these concerns and

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does not believe that they validate adjusting the basis of a recorded asset and recognizing comprehensive income for an event that does not affect the value of the investment. Because the amounts the investor has previously recognized in its OCI under the equity method are associated with its investment, when the investor is no longer able to apply the equity method to this investment, the associated amounts accumulated from OCI should be recognized in net income when the investment is derecognized and affects net income.

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Deloitte & Touche appreciates the opportunity to comment on the proposed FSP. If you have any questions concerning these comments, please contact Robert Uhl at (203) 761-3705.

Yours truly,

Deloitte & Touche LLP

# APPENDIX DELOITTE & TOUCHE LLP COMMENTS Proposed FASB Staff Position APB 18-a Other Suggestions

Transition – Some investors, upon losing the ability to exert significant influence, may have previously reclassified amounts from accumulated OCI to net income. The proposed FSP should provide transition guidance for these investors.

### Editorial suggestions

- In the title of the proposed FSP and throughout the document, reference is made to the investor's proportionate share of an investee's equity adjustments for OCI. The language should be clarified to indicate that the issue is dealing with the investor's accumulated other comprehensive income. For example, the title would be revised as follows: "Accounting by an Investor for its Accumulated Proportionate Share of Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, upon a Loss of Significant Influence."
- Paragraph 1 should clarify that the guidance in this proposed FSP relates to the portion of
  the investment that continues to be owned by the investor after loss of significant
  influence. For example, an investor owns 25 percent of an investee and subsequently
  sells a portion of its investment, reducing its ownership percentage to 15 percent. The
  proposed FSP addresses the accounting for the remaining 15 percent, not the incremental
  change in ownership (i.e., the 10 percent sold).
- Footnote 1 should be clarified as follows: "In this FSP, *investee* refers to an <u>issuer of an equity instrument underlying an investment that is accounted for under the equity method by an investor in accordance with Opinion 18."</u>
- Footnote 3 should be more explicit in its reference to APB Opinion No. 20, Accounting
   Changes. That is, instead of providing a vague reference to the entire Opinion, the FASB
   staff should specifically reference the section or paragraphs in the Opinion that the staff
   believes would be applicable.
- If the staff proceeds with the view expressed in the proposed FSP, in the last sentence of
  the proposed FSP (Effective Date and Transition), the word "reclassified" should be
  replaced with "retrospectively adjusted" or with similar terminology. Recognition of
  comprehensive income and adjusting the basis of the investment is not a reclassification.