FASB Emerging Issues Task Force

Issue No. 06-9

Title: Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Subsidiary or an Equity Method Investee

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Previously distributed EITF materials: None

References:

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51)

Accounting Principles Board Opinions No. 18, *The Equity Method of Accounting For Investments in Common Stocks* (APB 18)

Accounting Principles Board Opinion No. 20, *Accounting Changes* (APB 20)

Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies* (APB 22)

International Accounting Standard 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8)

International Accounting Standard 27, *Consolidated and Separate Financial Statements* (IAS 27)

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

International Accounting Standard 28, *Investments in Associates* (IAS 28)

AICPA Auditing Section No. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU 332)

AICPA Auditing Section No. 508, *Reports on Audited Financial Statements* (AU 508)

Background

1. Paragraph 4 of ARB 51 provides guidance for when a consolidated subsidiary has a different reporting year-end than its parent company (parent), and states:

> A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

2. In relation to an investment recognized under the equity method of accounting, paragraph 19(g) of APB 18 also states:

> If financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily should record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting should be consistent from period to period.

3. ARB 51 and APB 18 allow for the utilization of a lag period to consolidate the results of a subsidiary's operations (or recognize the change in an equity method investment) as a convenience procedure to allow for more timely preparation of consolidated financial statements. While ARB 51 and APB 18 are consistent in providing accounting recognition when a difference exists between the reporting year-end of a parent and a consolidated subsidiary or an equity method investee, questions have arisen on a parent's accounting recognition when there has been a change to the reporting year-end of either a consolidated subsidiary or an equity method investee. This change may include a change in or an elimination of the previously existing difference (lag period) due to the parent's ability to obtain financial results for a reporting period that is more consistent with, or the same as that of the parent. Historically, companies have utilized several methods to report the elimination of an existing difference between a parent's fiscal year-end and the fiscal year-end of a consolidated subsidiary or an equity method investee. Some have recognized this change as a direct adjustment to retained earnings while others have

considered it to be a change in accounting principle and, pursuant to APB 20, have recognized the change through a cumulative effect adjustment to retained earnings at the beginning of the period in which the change was made. However, the adoption of FAS 154 (which replaced APB 20) changed the methodology for recognizing an accounting change from that of APB 20. That is, FAS 154 requires a change in accounting principle to be recognized through retrospective application unless it is impracticable to do so.

4. For purposes of illustrating the individual views of this Issue Summary, assume a company with a December 31 year-end consolidates a subsidiary including the results based on the subsidiary's fiscal year-end (which is November 30). Further assume that in 2006, the parent makes a decision to conform the year-end of its subsidiary to December 31.

Scope

5. The scope of this issue applies to all entities that change (or eliminate) a previously existing difference in a reporting period between a parent and a consolidated subsidiary or a parent and an equity method investee.

Accounting Issue and Alternatives

How a parent should recognize the effect of a change to (or the elimination of) an existing difference between the parent's reporting period and the reporting period of a consolidated subsidiary or an equity method investee.

View A: The parent should report the subsidiaries' financial results (or change in an equity method investment) in the parent's consolidated financial statements as a change in accounting principle through retrospective application pursuant to the provisions of FAS 154.

6. Proponents of View A reference the term *change in accounting principle*, as defined in paragraph 2(c) of FAS 154, which states

> A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle

> formerly used is no longer generally accepted. A change in the *method* of applying an accounting principle also is considered a change in accounting principle. [Emphasis added.]

In this instance, the change (reporting the results on a 1 month lag versus reporting the results for a 12 month period consistent with that of the parent) represents a different *method* (both of which are acceptable) of applying the same accounting principle. The principle is defined by ARB 51 (or APB 18) as reporting 12 months of results of the subsidiary (or change in an equity method investment) in the parent's consolidated financial statements. Paragraph 6 of APB 22 provides guidance related to the disclosure of accounting policies. APB 22 describes an accounting policy as the accounting principles and the *methods* of applying those accounting principles in paragraph 14 and indicates that the requirements of FAS 154 should be applied when there is a change in an accounting policy. This definition and the related cross reference to FAS 154 further support the view that the change or elimination of a previously existing difference between a parent and the parent's subsidiary (or an equity investee) is a change in accounting principle because the method of applying that principle has changed.

7. AU 332, paragraph .32, states:

> There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph should be added to the auditor's report because of the change in reporting period.[fn 15] [Emphasis added.]

8. Paragraph .32 of AU 332 references (in footnote 15) AU 508, .16–.18. AU 508 discusses the implications of a lack of consistency and comparability in the financial statements on an auditor's report, especially as it relates to a change in accounting principle (or method). Proponents of View A believe that the express linkage between these two sections appears to support the view that a change in or elimination of a lag in reporting is a change in accounting

principle (or method). Although AU 332 does not specifically address accounting for consolidated subsidiaries, proponents of this method believe that the reporting for the elimination of previously existing differences between the fiscal year-end of a parent and those of a consolidated subsidiary should be no different than for the elimination of a difference between the fiscal year-end of a parent and an equity investee of the parent.

9. Opponents to View A believe that requiring entities to consider the change to be a change in accounting principle pursuant to FAS 154 may be onerous as a result of the financial statement restatement (and related audit requirements), particularly for equity method investees that the investor does not control. This view might dissuade entities that would otherwise reduce an existing lag in reporting since the cost may outweigh the benefit that would be derived. In addition, this view also requires that an entity justify the use of the alternative method on the basis that it is preferable. In response, proponents of View A have indicated that preferability should not be difficult to obtain and will help ensure that future changes to an entity's method of consolidation are not made frivolously.

10. In applying this view to the example in paragraph 4, the parent would include the financial results of its consolidated subsidiary for the 12 months ended December 31, 2006, in its financial statements for the year ending December 31, 2006, and the subsidiary's results for the 1 month ended December 2005 would be included as a part of the 12 months of retrospectively restated results for the year ended December 2005. Retrospective application would apply to all periods that are presented.

View B: The parent should report the subsidiary's (or the equity method investee's) results of operations as a direct adjustment to retained earnings as of the beginning of the parent's fiscal year.

11. Proponents of View B believe that a change in, or the elimination of a lag period, is not a change in accounting principle since it is not a change in the way that the results of operations or financial position of the consolidated entity are measured. Proponents of View B believe that a change in accounting principle must include a change in the principles or practices (or in the

methodology of applying those principles) that changes the way the results of operations, financial position, or cash flows are measured.

12. Reporting the elimination of or change in the "lag" as an adjustment to retained earnings is consistent with the approach contemplated by Regulation S-X Rule 3A-02(b)(2) in combinations of entities under common control (and, previously, for a business combination accounted for as a pooling of interests) where the combining companies' fiscal years do not end within 93 days of each other, and the financial statements for the latest year need to be recast to dates that do not differ by more than 93 days. In those situations, the net income or loss of any interim periods excluded from or included more than once in the results of operations as a result of such recasting, is recorded directly to retained earnings.

13. Other proponents of View B believe that an elimination of or a change in the lag period is a change in accounting principle for the reasons described above, but nevertheless believe that a direct charge or credit to retained earnings is an acceptable convention for reporting the cumulative effect of eliminating the lag, based on long-standing practice without the need for a preferability letter. Opponents to this view counter that the requirement to obtain a preferability letter from an entity's independent auditors does not reduce the fact that the change in or elimination of a previously existing difference is a change in accounting principle. In addition, opponents believe that this point provides little or no support on whether a nonpublic entity would consider this to be a change since the requirement for a preferability letter does not extend to them.

14. In applying this view to the example in paragraph 4, the parent company would include the financial results of its consolidated subsidiary for the 12 months ended December 31, 2006, in its 2006 financial statements and the subsidiary's results for the 1 month ended December 2005 would be recorded directly to retained earnings as of the beginning of the parent's 2006 fiscal year.

International Convergence

15. IAS 27 paragraphs 25-26 provide guidance on the reporting period of a consolidation subsidiary and state:

> The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same reporting date. When the reporting dates of the parent and a subsidiary are different, the subsidiary prepares, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so.
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> When, in accordance with paragraph 26, the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a reporting date different from that of the parent, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the parents financial statements. In any case, the difference between the reporting date of the subsidiary and that of the parent shall be no more than three months. The length of the reporting periods and any difference in the reporting dates shall be the same from period to period.

Therefore, while the concept in a lag period is similar between IAS and U.S. GAAP, no guidance is provided on the recognition requirements when there is a change or elimination of the lag period.

Disclosure

16. The FASB staff recommends that if the Task Force reaches a consensus on View A, an entity should make the disclosures required pursuant to FAS 154. However, if the Task Force reaches a consensus on View B, then the FASB staff recommends that an entity disclose:

a. The change in the fiscal period that is being consolidated

b. The net effect of the adjustment made to retained earnings for the period excluded from the reported results of operations

c. The detail of the adjustment made to retained earnings including revenue, expenses, extraordinary items, net income, and other changes to shareholders equity for the period excluded from the reported results of operations.

Effective Date and Transition

17. The FASB staff believes that if the Task Force reaches a consensus on View A, the application of the consensus on this Issue may result in a significant change for certain entities that have not accounted for the change in or elimination of a lag reporting period in a manner that is consistent with the consensus reached on this Issue. Therefore the FASB staff recommends that the consensus on this Issue be effective for future changes to, or the elimination of a previously existing difference between the reporting period of a parent and a consolidated subsidiary (or equity investee) beginning in the first interim or annual period following Board ratification. Earlier application of this guidance is permitted in periods for which financial statements have not yet been issued.