FASB Emerging Issues Task Force

Issue No. 08-6

Title: Equity Method Investment Accounting Considerations

Document: Issue Summary No. 1*

Date prepared: August 27, 2008

FASB Staff: Bonn (ext. 226)/Moritz (ext. 330)

EITF Liaison: Jim Campbell

Date previously discussed: None

Previously distributed EITF materials: None

References:

FASB Statement No. 5, *Accounting for Contingencies* (FAS 5)

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115)

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 141, *Business Combinations* (FAS 141)

FASB Statement No. 141(R), *Business Combinations* (FAS 141(R))

FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142)

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144)

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

FASB Statement No. 157, *Fair Value Measurements* (FAS 157)

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Liabilities* (FAS 159)

FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (FAS 160)

---

* **The alternative views presented in this Issue Summary 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.**

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

AICPA Issues Paper, "Accounting in Consolidation for Issuances of a Subsidiary's Stock" (Subsidiary's Stock Issues Paper)

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB 18)

SEC Staff Accounting Bulletin No. 51, *Miscellaneous Accounting*, Topic 5H, "Accounting for Sales of Stock by a Subsidiary" (SAB Topic 5-H)

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

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

IFRS Standard 3, *Business Combinations* (IFRS 3)

Background

1. Some of the accounting for equity method investments described in APB 18 requires an investor to account for the investment as if the investee were a consolidated subsidiary. Application of the equity method is also impacted by business combinations principles, including certain of the principles of ARB 51 and FAS 141. Recently, FAS 141(R) and FAS 160 were issued, which concluded a joint effort by the IASB and the FASB to converge the accounting for business combinations as well as the accounting and reporting of noncontrolling interests in consolidated financial statements. The objective of the FASB's business combinations project was to improve and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements. The goal of these projects was not a reconsideration the equity method of accounting, however, certain provisions of FAS 141(R) and FAS 160 as well as certain amendments to APB 18 made by these standards have raised questions as to how the equity method should be applied after the effective date of those statements.

2. The rationale for the accounting principles included in both FAS 141(R) and FAS 160 is based on the premise that the parent obtains/retains control of the subsidiary. FAS 141(R) is applicable to transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree). By definition, purchases and sales of ownership interests in equity method investments would not meet the definition of a business combination because control would not be obtained. Hence, some constituents have questioned whether all of the provisions of FAS 141(R) and FAS 160 should be applied to transactions involving non-controlling interests.

3. The issuance of FAS 141(R) and FAS 160 has highlighted the complexity associated with applying the equity method of accounting. Furthermore, confusion surrounding the composition of the reported results under the equity method has prompted some constituents to question the meaningfulness and appropriateness of this accounting method for such transactions. Some believe that using fair value to account for investments currently accounted for under the equity method would be an improvement in financial reporting. They also contend that a fair value

measurement could reduce the complexity in financial reporting introduced by the equity method.

4. As described in paragraph A3 of FAS 159, the Board continues to believe that fair value is the most relevant measurement attribute for financial instruments. However, the Board concluded that more work needs to be done before it would be appropriate to require the use of fair value to account for all financial instruments. The FASB has a research project underway relating to reducing complexity in the reporting of all financial instruments that if added to the Board's agenda would likely include the reconsideration of the accounting for equity method investments as well as cost method investments. Consideration of whether to require a fair value model for equity method investments would likely negatively impact another objective of this Issue which is to reduce or eliminate the period of time over which inconsistent treatment may be applied to equity method investments subsequent to the adoption of FAS 141(R) and FAS 160 in periods beginning on or after December 15, 2008. The staff also notes that constituents are currently allowed to apply the fair value option to equity method investments under FAS 159.

5. Given the factors discussed above, the staff determined that the scope of this Issue should not include consideration of eliminating the equity method of accounting prescribed by APB 18 in favor of a fair value model but, rather, should focus on the questions arising from the issuance of FAS 141(R) and FAS 160, and on the resultant potential inconsistencies within existing GAAP. Further background is provided on each of these questions within the applicable issues sections below.

Scope

6. This Issue applies to all investments accounted for under the equity method.

Accounting Issues and Alternatives

7. To facilitate the Task Force's consideration of the various issues associated with the equity method of accounting, the issues have been organized under two categories, initial recognition/measurement and subsequent measurement.

Initial Recognition/Measurement Issues

Issue 1: How the initial carrying value of an equity method investment should be determined.

8. The accounting under the equity method is based on a cost accumulation model whereby an investor initially records an investment in the stock of an investee at cost, and then adjusts the carrying amount of the investment to recognize the investor's share of the earnings or losses of the investee after the date of acquisition. Further, an equity method investment is presented as an asset on one line on the balance sheet of an investor. Some constituents have questioned whether certain provisions of FAS 141(R) and FAS 160 should be applicable to equity method investments as there would be inconsistencies between some of the principles introduced by those Statements and the cost accumulation model.

9. Prior to the issuance of FAS 141(R) and FAS 160, acquisitions of additional ownership interests in investments accounted for under the equity method followed the same accounting principles of a consolidated subsidiary, as indicated in APB 18. FAS 141(R) and FAS 160 made certain amendments to APB 18; specifically, paragraphs 19(e) and 19(m),[1] to eliminate the reference "to account for the investee as if the investee were a consolidated subsidiary." However, paragraphs 6(b), 19(b), and 19(n), were not amended and specifically state that the accounting principles should be followed as if the investee were a consolidated subsidiary. Paragraph 19(b) of APB 18 highlights the apparent contradiction:

> ...a difference between the cost of an investment and the amount of the underlying equity in net assets of an investee should be accounted for **as if the investee were a consolidated subsidiary.** [Emphasis added and footnote reference omitted.]

10. The staff is aware of recent inquiries from constituents about whether the purchase price allocation for an equity method investment should be performed using the cost of the investment, as stated in paragraph 6(b) of APB 18, or the consideration transferred, as determined by the

[1] A difference exists in the amendments to paragraph 19(m), included in Appendix E of FAS 141(R) and Appendix C of FAS 160; such a difference will be revised in a separate Omnibus FSP addressing all necessary technical corrections in the near future.

acquisition method of FAS 141(R), consistent with the treatment it would receive if it was a consolidated subsidiary. That distinction will impact whether transaction costs and contingent consideration should be included in the carrying value of the equity method investment. Under the cost accumulation model, transaction costs are capitalized and contingent consideration is only recognized if it is required to be recognized by other standards. FAS 141(R) requires transaction costs to be expensed and contingent consideration to be recognized on the transaction date at its fair value.

View A: The initial carrying value should be determined by applying the cost accumulation model described in Appendix D to FAS 141(R).

11. Proponents of View A believe that an equity method investment is an asset, not a business combination, and should be accounted for accordingly using a cost accumulation model upon acquisition. They believe that this is supported by paragraph 6(b) of APB 18, which requires that the equity method investor record an investment in stock of an investee at cost. As such, View A proponents would include transaction costs in the initial carrying amount of the equity method investment. They believe that this accounting is supported by paragraph D4 of FAS 141(R), which states that:

> Assets are recognized based on their *cost* to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the fair value of noncash assets given as consideration differs from the assets' carrying amounts on the acquiring entity's books.

12. View A proponents also note that the capitalization of transaction costs in the carrying value of an asset is required by various other standards involving asset acquisitions.[2] They stress that the overriding concept is that an asset acquisition is subject to a cost accumulation model and that the concept of accounting for an equity method investment as if it was a consolidated subsidiary should only be applied where explicitly required by APB 18. Proponents of View A note that there are several situations in which equity method accounting differs from that of a

[2] The following standards require the capitalization of transaction costs in the carrying value of an asset (list is not exhaustive): FAS 91, TB 90-1, FAS 67, , and SOP 04-2, FAS 19, , Issue 04-02, and FAS 60.

consolidated subsidiary, which further supports the view that consolidation accounting is not always applied to equity method investments.[3]

13. Given that View A proponents believe that a cost accumulation model should be used, contingent consideration should not be included in the initial cost of the equity investment unless it is required to be recognized in accordance with applicable accounting standards such as FAS 133 or FAS 5. They believe that this treatment is consistent with the cost accumulation model and that the fair value treatment prescribed by paragraph 41 of FAS 141(R) is only to be applied in a business combination. View A proponents note that what is relevant in a cost accumulation model is the fair value of the consideration given *once the contingency is resolved*, not its fair value at the acquisition date. The acquisition date fair value is affected by the probability that the contingency will be resolved and is therefore always different from the consideration that is ultimately conveyed.

14. Paragraph 46 of FAS 141 prescribes that when a contingent consideration arrangement exists that might result in an additional element of cost of the acquired entity when the contingency is resolved, an amount equal to the lesser of the maximum amount of contingent consideration or the excess of the amounts assigned to the assets acquired and liabilities assumed over the cost of the acquired entity prior to the pro rata allocation required by paragraph 44 of FAS 141, shall be recognized as if it was a liability. View A proponents acknowledge that FAS 141 was previously analogized to in asset acquisitions in which the sum of the amounts assigned to assets acquired and liabilities assumed exceeds the cost of the acquired entity. Once FAS 141(R) becomes effective, this guidance will no longer exist within GAAP. View A proponents would therefore propose to retain this guidance for accounting for contingent consideration related to acquisitions of interests in equity method investees to avoid situations in which transactions are structured to avoid or delay expense recognition related to an equity method investment. For example, a contingent consideration arrangement could be structured to avoid

[3] For example, an equity investor's share of an investee's losses are not recognized once the carrying value of the investment reaches zero unless an investor has guaranteed obligations or is otherwise committed to provide further financial support to the investee (paragraph 19(i) of APB 18. There is no such limitation in consolidation accounting under FAS 160.

recognizing the amortization expense which would have been recorded on an asset if the additional cost had been recognized and allocated to that asset at the acquisition date.

View B: The initial carrying value should equal the fair value of the net assets acquired as determined under FAS 141(R) and FAS 157.

15. Proponents of View B believe that there should be no difference between the amount that is allocated to the underlying assets and liabilities of an equity method investment or an acquired business accounted for as a consolidated subsidiary. They note that the accounting treatment for an equity method investment is meant to be similar to a one-line consolidation with reported results that are generally the same as if it was a consolidated subsidiary. As such, they believe that the principles within FAS 141(R) and FAS 157 should be applied. They note that in applying the "acquisition method" under FAS 141(R), a business combination is recognized at fair value in accordance with FAS 157. As indicated in paragraph 9 of FAS 157,

> The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. [Footnote references omitted.]

16. In paragraph B366 of FAS 141(R), the Board noted that acquisition-related costs are not part of the fair value exchange between the buyer and seller of a business, rather, they are separate transactions in which the buyer pays for the fair value of services received. Additionally, the Board noted that those costs generally do not represent assets of the acquirer at the acquisition date because the benefits obtained are consumed as the services are received. Therefore, the Board concluded that acquisition-related costs associated with a business combination should generally be expensed as incurred.

17. View B proponents believe that acquisition-related costs for acquisitions of equity method investments should be expensed for the same reasons the Board cited in the paragraph B366 of

FAS 141(R). These proponents also note that if an entity executes a step acquisition that results in gaining control of an investee that was previously accounted for under the equity method, application of paragraph 48 of FAS 141(R) would effectively result in capitalized transaction costs being written off at the acquisition date as an adjustment to the gain or loss on the pre-existing interest in the entity.

18. View B proponents also believe that contingent consideration should be recognized at fair value when an equity method investment is acquired, consistent with its measurement under FAS 141(R). They note that the accounting treatment for an equity method investment is meant to be similar to a one-line consolidation with reported results that are generally the same as if it was a consolidated subsidiary. To measure contingent consideration at other than fair value would be inconsistent with this concept. They also note that recognizing contingent consideration at fair value would also resolve the concern raised by View A proponents with respect to excess cost situations involving contingent consideration arrangements.

Issue 2: How the difference between the investor's carrying value, as determined in Issue 1, and the underlying equity of the investee should be allocated to the underlying assets and liabilities of the investee.

19. Paragraph 6(b) of APB 18 states that the equity method requires that an equity method investor adjust the carrying amount of its investment to amortize any difference between investor cost and underlying equity in net assets of the investee at the date of the investment. This requires the equity method investor to complete a purchase price allocation as discussed in paragraph B169 of FAS 142 with any excess of the investment cost over the investor's underlying equity in the investee assigned to assets and liabilities in the same manner that the purchase price is allocated in a business combination under FAS 141.

20. FAS 141(R) requires the allocation of the purchase price to additional assets and liabilities that previously may not have been recognized under FAS 141; specifically, contingent assets and liabilities. FAS 141(R) requires assets acquired and liabilities assumed for contractual contingencies to be recognized at their acquisition date fair value. Assets acquired and liabilities

assumed for non-contractual contingencies are required to be recognized at their acquisition date fair value if it is more likely than not that the contingency will give rise to an asset or a liability. Under FAS 141, contingent assets and liabilities are currently recognized at their fair value only if the fair value can be determined during the allocation period; otherwise, the contingency is recognized if it is probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination **and** the amount of the asset or liability can be reasonably estimated.

21. Questions have arisen about whether recognition of these contingent assets or liabilities at fair value is appropriate when the investor holds a non-controlling interest given that FAS 141(R) was written from a controlling interest perspective. In addition, some constituents have expressed concern that an investor may not have the ability to obtain the information necessary to initially and subsequently evaluate these assets and liabilities each reporting period, despite the fact that the investor has the ability to exercise significant influence over the operating and financial policies of an investee.

22. Another allocation question that has been raised involves the accounting for bargain purchase situations. Paragraph 36 of FAS 141(R) defines a bargain purchase as a business combination in which the net acquisition-date amounts of the identifiable assets acquired and liabilities assumed exceeds the sum of the consideration transferred (generally measured at fair value), plus the fair value of the noncontrolling interest in the acquiree, plus the fair value of the acquirer's previously held equity interest in the acquiree. Under FAS 141(R), an acquirer recognizes a gain in earnings for such excess after reassessing the values ascribed in its purchase price allocation. This treatment differs from FAS 141 whereby any such excess is first allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets (with certain limitations). If any excess remains after reducing to zero the amounts that otherwise would have been assigned to those assets, the remaining excess is recognized as an extraordinary gain.

23. Some constituents have raised concerns that the 141(R) model could lead to an unusual scenario when applied to bargain purchase situations involving equity method investments. On

the acquisition date, a gain would be recognized with an offsetting increase to the investment account. This could lead to a situation in which the carrying value of the investment exceeds its fair value creating an immediate impairment concern.

View A: The allocation should be consistent with the acquisition method guidance in FAS 141(R).

24. Proponents of View A note that paragraph 19(b) of APB 18 was not amended by FAS 141(R) or FAS 160. Paragraph 19(b) states that the "difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary"(footnote reference omitted). View A proponents believe that FAS 141(R) will be the only authoritative standard to provide a basis for performing an acquisition allocation. The provisions of FAS 141 were previously used to perform such allocation so they believe that the application of FAS 141(R) would naturally follow once effective. Proponents of View A believe that the appropriate allocation should be based on the fair value of the assets and liabilities of the investee, whether or not they have been recorded by the investee.

25. By definition, an equity method investor has the ability to exercise significant influence over the operating and financial policies of an investee. View A proponents believe that the ability to exercise significant influence over the investee should allow an equity method investor to access the requisite information necessary to value all assets and liabilities of an investee and subsequently monitor those assets and liabilities consistent with the requirements of FAS 141(R).

26. View A proponents also question the conceptual basis on which application of only certain of the FAS 141(R) provisions is appropriate (that is, where the line should be drawn). They are also concerned that establishing a higher threshold for recognizing liabilities could increase the likelihood of a deemed bargain purchase situation. That is because non-recognition of contingent liabilities may cause the acquired net assets of the investee to exceed the transaction consideration.

27. View A proponents believe that no exception should be made in applying the bargain purchase provisions of FAS 141(R). They believe that if the fair value of the investment acquired exceeds its cost to the acquiring entity, it has realized an economic benefit that should be reflected in earnings. While these proponents acknowledge the heightened potential for an impairment situation shortly after acquiring the investment, they note that this increased impairment risk was considered in the basis for conclusions section of FAS 141(R) (paragraph B378). The Board nonetheless decided to require gain recognition in such situations as they concluded that the incentive to overstate assets was limited for this very reason as well as for the reason that users of financial statements often discount one-time gains.

View B: The allocation should be consistent with the guidance in FAS 141(R) with certain modifications.

28. FAS 141(R) requires most acquired assets and liabilities to be recognized at their acquisition date fair value. View B proponents believe that FAS 141(R), after its effective date, is the appropriate framework for allocating the difference between the investor's carrying value of the investment and the underlying equity of the investee, with certain exceptions. View B proponents believe that the allocation to contingent assets and liabilities should be consistent with FAS 5 and other applicable U.S. GAAP literature, not based on acquisition date fair values (unless other standards require fair value measurement, such as FAS 133). View B proponents note that the basis for conclusions for FAS 141(R) states that most of the objections to a fair value measurement basis for contingent assets and liabilities were the result of element uncertainty or the difficulty in determining whether a contingency met the definition of a liability or asset at the acquisition date. As a result, the Board added a threshold for recognizing a non-contractual contingent asset based on whether it is more likely than not that the acquirer has gained *control* of a future economic benefit as a result of a past transaction or other event. For a non-contractual contingent liability, the threshold is whether it is more likely than not that the *acquirer* has a present obligation to sacrifice future economic benefits as a result of a past transaction or other event. View B proponents note that the conclusions reached in FAS 141(R) and FAS 160 are from the perspective of a controlling owner. While an equity method investor presumably has the ability to exercise significant influence over the operating and financial

policies of an investee, that ability does not rise to the level of control. Therefore, View B proponents believe that the equity method investor does not meet the criterion for recognition of contingent assets or liabilities under FAS 141(R). Additionally, information that may be available to a controlling owner may not be as easily obtained by an equity method investor, which increases the element uncertainty when compared with an acquirer. For example, an equity method investor may not have access to the controlling owner's assessment of litigation and potential outcomes and may not have the ability to determine the acquisition date fair values of contingencies. After acquisition, it may be equally or more difficult for an investor to obtain information related to changes in a contingent asset or liability that do not result in the investee recording the contingency. The investee may not gather the information required on its own behalf, making it more difficult for the investor to obtain it.

29. View B proponents would also depart from the bargain purchase provisions of FAS 141(R) when accounting for an equity method investment. View B proponents note that by requiring a higher threshold for recognition of contingent assets and liabilities in accordance with FAS 5, it is more likely that there may be unrecorded liabilities that nevertheless affected the acquisition price of the equity method investment. Therefore, it would be inconsistent with both the economics of the transaction and the cost accumulation model to record the difference as a gain in earnings. Accordingly, View B proponents would retain the current practice prescribed by FAS 141 for acquisitions of equity method investments by requiring a pro rata reduction of the amounts allocated to the underlying assets of the investee.

Subsequent measurement issues

Issue 3: How an impairment assessment of an underlying indefinite-lived intangible asset of an equity method investment should be performed.

30. The staff understands that diversity exists in practice in the evaluation of impairments for indefinite-lived intangible assets underlying an equity method investment. Some constituents perform impairment assessments of these assets in accordance with FAS 142 in addition to evaluating the entire investment for impairment in accordance with APB 18. Others, however, are only performing an APB 18 impairment assessment of the investment as a whole and not for

the underlying assets. FAS 142 requires that an impairment assessment be performed annually for both indefinite-lived intangible assets and goodwill, or more frequently in certain situations. FAS 142 explicitly states that its impairment provisions do not apply to goodwill underlying an equity method investment; however, it does not specifically address impairment assessments of indefinite-lived intangible assets underlying an equity method investment. While this issue is not necessarily new, it may become a more prevalent practice issue after the effective date of FAS 141(R) as that standard requires that in-process research and development be capitalized as an indefinite-lived intangible asset and constituents have requested clarification on how to perform these impairment assessments.

View A: An indefinite-lived intangible asset should be tested for impairment annually in accordance with FAS 142 in addition to the other-than-temporary impairment evaluation performed on the entire equity method investment in accordance with APB 18.

31. Proponents of View A believe that it is supported by paragraph 19(b) of APB 18, which requires an investor to account for the excess cost, which is the difference in the investor's cost and the underlying net assets of the equity investee, as if the investee were a consolidated subsidiary. They believe that the investor is required to account for the excess cost in its determination of income or loss attributable to the equity method investment each period. Ordinarily, this is achieved through the amortization of the excess cost as an adjustment to its share of the equity investee's income or loss each period, as appropriate.

32. View A proponents argue that since indefinite-lived intangible assets are not amortized pursuant to FAS 142, the excess cost assigned to such assets might never reverse or may be significantly delayed even if a substantial decline in the asset's value occurs. That situation is made even more prominent in a case in which the indefinite-lived intangible asset has little or no book value at the investee level. The investee would therefore not recognize an impairment loss for such an asset, which might otherwise alert the equity method investor that an adjustment was necessary for the equity method investor's excess cost allocated to such assets. That situation could become even more common after the effective date of FAS 141(R) as in-process research and development will be recognized as an indefinite-lived intangible asset.

33. These proponents acknowledge that paragraph B170 of FAS 142 states that "equity method investments are reviewed for impairment in accordance with Opinion 18, and it is the equity investment as a whole that is reviewed for impairment, not the underlying net assets." However, they also point out that this statement is made in the context of assessing whether goodwill of an equity method investee should be tested for impairment and that paragraph B170 also states that equity goodwill is not separable from the related investment. Accordingly, they believe that the inseparability of the goodwill from the investment is the driving factor in the conclusion not to test goodwill for impairment. Therefore, they believe that this conclusion does not apply to an indefinite-lived intangible asset since it is separable.

View B: The indefinite-lived intangible asset should not be separately tested for impairment and the entire equity method investment should be subject to the other-than-temporary impairment model of APB 18.

34. View B is consistent with the decision reached in FAS 142 that goodwill of an equity method investee is not tested for impairment separately from the related investment. Proponents of View B note that paragraph B170 of FAS 142 states that "equity method investments are reviewed for impairment in accordance with Opinion 18, and it is the equity investment as a whole that is reviewed for impairment, not the underlying net assets." Proponents of this view also point out that FAS 144 does not include in its scope investments accounted for under the equity method. They believe that this scope exception is consistent with the premise that an equity method investment is tested at the investment level as a whole under the "other than temporary" impairment model described in paragraph 19(h) of APB 18.

35. View B proponents believe that the accounting would be simplified if it required an impairment evaluation at the investment level only for goodwill and indefinite-lived intangible assets without resulting in poorer information for users. Indefinite-lived intangible assets would be separated from goodwill as an indicator of impairment of such assets may suggest that the investment as a whole has suffered an other-than-temporary decline in value, however, the investor would not have to test the indefinite-lived intangible assets annually for impairment.

Additionally, View B proponents note that under FAS 141(R), in-process R&D becomes a finite-lived intangible asset when the related research is completed or would be written off if it ceases to be an ongoing project.

Issue 4: How an equity method investee's issuance of shares should be accounted for.

36. Minimal guidance exists with respect to investor accounting for equity transactions by an equity method investee. Common transactions include the repurchase or issuance of shares by the investee. In practice, an equity method investor accounts for the investee's repurchase of shares as if it had acquired an additional ownership interest in the investee. In cases in which the investee repurchases shares in excess of their book value, the result is that the investor increases its basis in the underlying assets on a step-by-step basis by allocating the cost of each incremental purchase to the underlying assets and liabilities of the investee proportionally based on its incremental ownership interest. In cases in which the investee repurchases shares below their book value, the result is that the investor decreases its basis in the underlying net assets through a pro-rata reduction of the assets.[4]

37. Constituents have generally looked to the Subsidiary's Stock Issues Paper or SAB Topic 5-H when accounting for the issuances of shares by an equity method investee, both of which have been impacted by the issuance of FAS 160. FAS 160 determined that subsidiary share transactions should be accounted for in equity unless control is lost. The Subsidiary's Stock Issues Paper concluded that any change in interest gain or loss from a subsidiary share issuance should be recognized in earnings, while SAB Topic 5-H allowed the parent to select an accounting policy to recognize the resulting gain or loss either in earnings or in equity. While SAB Topic 5-H does not explicitly relate to equity method investments, it has been analogized to in practice when accounting for similar transactions involving the issuance of shares by an equity method investee. The staff understands that the SEC intends to rescind SAB Topic 5-H as a result of the issuance of FAS 160. Constituents have therefore requested that the Task Force consider whether specific guidance is needed to address such situations for equity method investors.

[4] This pro-rata reduction is performed in accordance with paragraphs 44-46 of FAS 141.

View A: Share issuances should be recognized as equity transactions.

38. View A proponents believe that the premise of APB 18 is to account for an equity method investee as if it were a consolidated subsidiary via a one-line consolidation. Therefore, the accounting treatment by the investor should be consistent with that described in FAS 160. Paragraph 32 of FAS 160 requires that changes in a parent's ownership interests in a subsidiary be recognized as an equity transaction unless a change of control occurs. View A proponents believe that investee share issuances are viewed as giving rise to additional capital paid in to the consolidated or affiliate group by outside parties on behalf of the investor. View A proponents do not believe that the equity method investor has necessarily realized a gain or loss as a result of the subsidiary share issuance and believe that to recognize the transaction in earnings would be inappropriate.

View B: Share issuances should be accounted for as if the equity method investor had sold a proportionate share of its investment.

39. View B proponents would account for the issuance of shares by the investee as if the investor had directly sold shares itself with any resultant gain or loss recognized in earnings. View B proponents believe that the resulting dilution in the investment should be reflected similarly whether the investor sold shares it held in the investee or the investee sold shares. View B proponents point out that an equity method investor generally recognizes its share of the changes of the investee's net equity in income. As the investee sells its assets, the equity method investor picks up its share of the income as effectively realized. View B proponents believe that a share transaction by an equity method investee is no different from any other transaction impacting the investee's net assets, in that an economic event has occurred that should result in the realization of a gain or loss. Proponents of this view believe that to not recognize this transaction in earnings would disregard the economic substance of the transaction. View B proponents also question the conceptual basis for recognizing an equity method investee's capital transactions in the parent company's capital accounts since the equity method investment is not part of the parent's capital.

40. View B proponents would retain the existing exceptions within SAB Topic 5-H, which prohibit gain recognition in certain circumstances.[5] Retaining those exceptions addresses concerns raised by situations in which realization of the gain is uncertain.

View C: The equity method investor can make a policy election to apply either View A or View B, consistent with the existing guidance in SAB Topic 5-H.

41. Consistent with proponents of View B, View C proponents note that the conclusions reached in FAS 160 were from the perspective of a controlling shareholder. Accordingly, they do not believe that a change in the existing practice that resulted from an analogy to SAB Topic 5-H, is warranted. They believe that conceptual views could be stated to support either accounting method and that either method could be used if applied on a consistent basis.

42. Opponents of View C believe that optionality contributes to the avoidable complexity in accounting and increases the lack of comparability amongst constituents. For these reasons, financial statement users generally do not favor optionality in accounting standards. Opponents of this view do not believe that a sufficient basis exists to support optionality when accounting for gains or losses resulting from subsidiary share transactions.

Issue 5: How to account for a change in an investment from the equity method to the cost method.

43. As previously noted, the objective of the joint projects on business combinations and non-controlling interests was not a reconsideration of the equity method of accounting. The IASB, however, did amend IAS 28 to require that a retained interest be remeasured at fair value when a change from the equity method to the cost method occurs. That was deemed to be a significant economic event similar to that of a loss of control of a subsidiary, which should result in full remeasurement of the retained interest. The FASB did not amend APB 18 to address those

[5] These include transactions that are part of a broader corporate reorganization or where the investee/subsidiary is a newly-formed, non-operating entity; a research and development, start-up or development-stage company; an entity whose ability to continue in existence is in question; or other similar circumstances.

situations. Some constituents have requested a reconsideration of this accounting for U.S. GAAP purposes.

View A: The entire investment should be remeasured at fair value and a gain or loss on the retained interest should be recognized. After the remeasurement, the provisions of FAS 115 or APB 18 should be applied.

44. View A proponents believe that a change in interest from the equity method to the cost method is a significant economic event that changes the nature of the investment. Accordingly, remeasurement of the retained interest at fair value provides the most relevant information about the value of the retained interest. View A proponents believe that when an investor loses significant influence, the retained interest should be remeasured at fair value and any difference between the carrying amount of the investment at the date significant influence is lost, the disposal proceeds (if any), and the fair value of any retained interest should be recognized in profit or loss.

45. View A proponents believe that this accounting treatment is consistent with the view reached in FAS 141(R) and FAS 160 to remeasure the pre-existing or retained interest at fair value after a controlling interest is gained or lost. View A proponents believe that applying this treatment to changes of significant influence situations is a logical extension of the concept of accounting for an investment at fair value when a significant economic event occurs. They also point out that revising this accounting would further IFRS convergence efforts as it is consistent with IAS 28, which was amended by the IASB upon the conclusion of the joint project on noncontrolling interests.

View B: Cease equity method accounting and apply the provisions of FAS 115 or APB 18 for cost method investments, as appropriate.

46. View B proponents believe that there is no confusion in practice as to how to account for a change from an equity method investment to a cost-basis method investment. They observe that the existing guidance in paragraph 19(l) of APB 18 explicitly addresses the accounting for such

situations. They note that the Board decided not to address the accounting for equity method investments in the FAS 160 scope; accordingly, to extend the remeasurement concept to a change in significant influence event would not be appropriate as there is a considerable difference between losing significant influence and losing control. While they acknowledge that it would eliminate a difference between U.S. GAAP and IFRS, they point out that convergence would still not be fully achieved because other differences would still exist between IFRS and U.S. GAAP in the accounting for equity method investments and noncontrolling interests in consolidated financial statements.[6] They also note that a pre-existing interest is not remeasured at fair value under either U.S. GAAP or IFRS when an investment moves from the cost method to the equity method but, rather, is accounted for as a step acquisition (with retroactive application of the equity method). These proponents note that if a change to significant influence is considered a significant economic event, the accounting should be consistent whether significant influence is gained or lost.

International Convergence

47. There is no detailed guidance within IFRS for Issues 1-4. Adopting View A on Issue 5 would converge U.S. GAAP with IFRS.

Interaction with Other Board Agenda Projects

48. There is no project on the Board's agenda to address equity method investments; however, a Research Project is underway relating to reducing complexity in the reporting of financial instruments, which, if added to the Board's agenda, could include investments accounted for under the equity method. The IASB is concurrently performing a parallel project on this topic.

Transition and Effective Date

49. The Task Force is being asked to consider whether the consensus reached in this Issue be effective for transactions occurring in fiscal years, and interim periods within those fiscal years,

[6] For example, IFRS permits proportional consolidation for joint ventures whereas U.S. GAAP requires the equity method with limited exceptions. When a change from the cost method to the equity method occurs, prior periods are adjusted to reflect those periods under the equity method under U.S. GAAP but are not adjusted under IFRS. In a change of control acquisition situation, U.S. GAAP requires the minority interest to be measured at fair value, while IFRS allows the option to account for the minority interest at fair value or at its proportionate share of the acquiree’s identifiable net assets .

beginning on or after December 15, 2008, consistent with the effective dates of FAS 141(R) and FAS 160. Early adoption would be prohibited consistent with FAS 141(R) and FAS160.

50. The Task Force is being asked to consider whether the consensus reached on Issues 1, 2, 4, and 5 should be applied prospectively, consistent with the decisions reached in FAS 141(R) and FAS 160. Given the connection and similarity of these issues with FAS 141(R) and FAS 160, it does not seem reasonable to apply a different transition provision.

51. If a consensus is reached on Issue 3 for View A that results in a change in accounting policy, the Task Force is being asked to consider whether an impairment assessment should be performed as of the beginning of the year of adoption. Any resultant impairment charge would then be recorded under one of the following alternatives. Note that retrospective application was also considered, however, it would likely be difficult to objectively perform an impairment assessment for all prior periods. Additionally, retrospective application may not be cost effective based on the additional data that may be required to recreate the information needed to retrospectively apply a consensus to prior periods.

Alternative A – Cumulative-Effect Adjustment to Beginning Retained Earnings

Any impairment adjustment should be recognized as a cumulative effect adjustment to beginning retained earnings. Thereafter, impairment assessments would continue to be performed in accordance with FAS 142 or APB 18, as applicable. This transition provision allows for an early recognition of any impairment triggered by the consensus. Recording the adjustment through retained earnings rather than current earnings acknowledges that the impairment may have been recognized in prior periods had the consensus been applied and does not distort current period earnings. An adjustment through retained earnings would, however, create inconsistency in financial reporting since some constituents may have recognized related impairment charges through earnings in prior periods. No adjustment would be made to the financial statements to reverse previously recorded impairments.

Alternative B – Adjustment to Earnings in the Period of Adoption

Any impairment adjustment should be recognized in earnings in the period of adoption. Thereafter, impairment assessments would continue to be performed in accordance with FAS 142 or APB 18, as applicable. This transition provision removes the inconsistency that would exist between constituents who had previously recognized impairment charges in earnings noted in Alternative A.

Disclosures

52. If adoption of any of these issues results in a change in accounting principle, the Task Force is being asked to consider whether the disclosures required by paragraphs 17 and 18 of FAS 154 should be provided. If a consensus is reached for View A in Issue 5, the Task Force is also being asked to consider whether the investor should disclose the following in periods in which there is a change in an investor's proportional ownership of an investee resulting in the loss of significant influence:

a. The gain or loss resulting from the change as well as the portion of the gain or loss attributable to remeasuring the retained interest in the investee at its fair value;
b. The valuation method used to determine the fair value of the retained interest.