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September 4, 2015

Mr. Russell Golden
Chair
Financial Accounting Standards Board
401 Merritt 7
P.O Box 5116
Norwalk, CT 06856-5116

Re: Comment Letter on *Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting*

Dear Mr. Golden,

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Proposed Accounting Standards Update ("Proposed Update"), *Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting*.

CFA Institute is comprised of more than 130,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

[1] With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 133,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 151 countries, of whom more than 125,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 145 member societies in 70 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

Proposed Update

Current guidance requires an investor with significant influence in an investee to account for a basis difference upon acquisition as if the investee were a consolidated subsidiary. The Proposed Update would provide relief to the investor both at acquisition and in subsequent periods from making such adjustments in basis. Under the proposed guidance, an investor would record an investment in an investee in which it has significant influence at cost – consistent with current guidance – but would not identify or allocate basis differences. As a result, the investor entity would no longer need to obtain or estimate the acquisition date fair value of an investee's identifiable assets and liabilities to allocate the basis difference. Subsequently, 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 (i.e. amortization or recognition) of any basis differences existing at acquisition. Essentially, recording the acquisition price on the new basis and reporting the earnings pick-up on the old basis of accounting to produce a value which is not reconcilable to underlying records of the old or new basis of the entity.

Additionally, the Proposed Update would eliminate the requirement for an investor to disclose any difference between the amount at which an investment is carried and the amount of underlying equity in net assets.

Further, the proposal would no longer require investors to retrospectively apply the equity method in all periods in which it held the investment if it subsequently obtains significant influence.[3]

Simplification or Better Information for Investors?

The FASB developed the proposal as part of its "simplification" initiative to reduce the cost and complexity of financial reporting while improving or maintaining the usefulness of information reported to financial statement users. Simplification, however, is judgmental based upon the perspective and experience of the individual making the assessment.

Equity method investors (also the preparers in this scenario) would no longer need to identify and value the underlying assets and liabilities of the investee at acquisition. The reasoning provided in the Proposed Update is that an investor (preparer of financial statements) may not have access to information necessary to determine the basis difference because it does not control the investee. This conclusion seems inconsistent with how investors would have made a decision to invest and how they would determine their purchase price. When making an acquisition – particularly where there is significant influence – investors generally perform due diligence and in doing so review the financial records of the company. Accordingly, the investor is likely to have access, or can negotiate access, to information to perform the necessary accounting. When the investor makes the investment, and likely has the most information regarding the investee, it seems inconsistent for the Board to conclude they don't have access to the information to prepare the financial statements. Further, equity method investors have significant influence over the operating and financial policies of affiliates. This implies that equity method investors have access to the information necessary to affect operating and financial decisions of affiliates and likely to continue to have sufficient access to determine and

[3] This part of the proposal would converge with IFRS.

maintain basis differences. Accordingly, it seems like this is more simplification for the preparer who must maintain these records than the financial statement user of these accounts.

Further, compounding the impression that this simplification initiative is based upon simplification for the preparer – rather than simplification or improvement in information for financial statement users and external owners of the firm – are these paragraphs in the basis for conclusions:

> ***Paragraph BC 6:*** *The Board concluded that the benefits of accounting for the basis difference for equity method investments are limited at best because the accounting is performed in memo accounts. In some cases, financial statement users are not aware of the requirements to account for the various components of the basis difference and, therefore, do not factor in the accounting for basis difference in their decisions, which are based on GAAP.*
>
> ***Paragraph BC 23:*** *The Board does not anticipate that the proposed amendments would reduce the availability of relevant information because users generally are not aware of the accounting for the basis difference or the retroactive application of the equity method when an investment becomes eligible for the equity method.*

Whether basis differences are recorded in general ledger accounts, memo accounts or excel spreadsheets, investors care about the usefulness of the information. The benefits of the basis differences should not be judged by where they are recorded but by the informational value they provide to users of financial statements. References such of these connote a concern with simplification for preparers rather than usefulness for financial statement users.

Further, the second sentence in Paragraph BC 6 and the entirety of Paragraph BC 23 suggest that because users aren't (or, are presumed not to be) aware of the underlying basis differences – and their impact on the equity in earnings of subsidiary – that they are not interested in the analytical impact of a change in such information based upon the recognition of fair value basis differences at acquisition and there effects in subsequent accounting periods. We do not believe this lack of transparency to investors is a relevant basis making a conclusion that they should be eliminated. Simply because investors are unaware of the specific requirements or adjustments being made does not mean that the resulting information does not more fairly represent the results of the entity than what is being proposed by the Board. We address this more fully in the following section on analytical implications for financial statement users.

Overall, the proposal appears to reduce the cost of reporting. It does not, however, demonstrate that it maintains or improves the usefulness of information reported to users. The focus of financial reporting is to provide decision-useful information to investors. Accordingly, how these benefits outweigh the costs and how the standard meets the criteria of being an improvement in financial reporting – a necessary element of issuing a standard – is unclear. The proposal is based on a measure of costs (borne by investors) and it does not demonstrate a comprehensive analysis of its benefits. This is an overarching concern for investors on the FASB's simplification initiatives.

Analytical Considerations for Financial Statement Users
As noted above, the Proposed Update does not consider the loss of analytical information for users. When an investor makes an investment in an investee the investor is paying fair value which includes the fair value of the underlying assets (i.e. including identifiable intangibles assets) and liabilities and any resulting goodwill. Subsequent earnings should reflect the performance of that investment. Under the proposal, the earnings reflected in the financial statements will reflect the performance of the original investee's basis not the current investee's basis. Unfortunately, even the existing accounting does not reflect the most relevant basis for the investee to measure performance which is fair value.

Impact on Earnings of Failure to Adjust for Subsequent Accounting: While we don't see the current accounting as providing the most useful information – because it is not fair value with changes in fair value recognized in income to reflect the total return on the investment – it at least provides earnings on a basis consistent with other historical financial statements to which users are accustomed. The discussion above in Paragraph BC 6 suggests that investors can't use the basis differences because they don't know about them – with the implication that because they don't know about them being that removing them is not detrimental to the information content provided by the earnings based upon a method similar to that used in consolidated financial statements. At least they are currently prepared using a stepped up basis reflecting the premium, and related implication on future earnings of the amortization of the premium likely paid at acquisition for profitable business. Under the revised proposal, earnings will not reflect the impact of the subsequent accounting (i.e. amortization or recognition) for the premium associated with the purchased price allocated to the fair value of assets and liabilities.

Further, under this proposal different investors with the same ownership percentage in the investee would recognize the same amount of equity in earnings of the investee even if those investors paid drastically different prices for those investments.

Greater Risk of Impairment: Still further, since the carrying amounts of equity method investments would generally be larger under the proposal than under current US GAAP (generally accepted accounting principles) – because of the lack of subsequent accounting for any premium paid – there may be a greater risk that an equity method investment could have and impairment. We illustrate this below.

Illustration: We considered a very simple example (See table below) to illustrate the issue to ourselves and those we discussed the issue with.

Company A has only one asset, a 10% coupon bond which it just purchased at $400 with a five year maturity and a par value of $500 resulting in income of $70 ($50 coupon plus $20 discount amortization) per year for the next five years. It holds the bond to maturity (i.e. at amortized cost).

Two years later an investor, Company B, takes a 20% interest in the company – interest rates have dropped substantially. Company A's historical financial statements now reflect the bond at amortized cost of $440. The market value of the bond is now $560. Company A now also has cash of $100 and retained earnings of $140 for a total asset and equity balance in the company of $540. The fair value of Company A is now $660 ($560 bond plus $100 cash). Company B, the investor, pays $132 for its 20% interest in Company A.

Under existing equity method accounting the investee, Company B, would recognize the initial investment of $108 plus $24 of fair value basis adjustments to arrive at the purchase price of $132. The historical financials of the underlying company will continue to recognize income of $70. If the entire financial statements in Company A had been fair valued, the resulting income would have been $30 ($50 coupon plus $20 of original discount amortization less of $40 premium amortization on the fair value basis difference). In the following three years, under the existing accounting the investor, Company B, would recognize earnings of $6 (20% of $20).

Under the proposed accounting, Company B will recognize $14 (20% of $70) of income for each of the next three years. Users of the financial statements of Company B would see the investment in Company A grow from $132 to $174 over the next three years while the underlying financial statements in Company A reflect cash of $750 ($500 for bond and $250 for five coupons of $50) of which they own $150. At that time, the investment would be impaired by $24 ($174 of $150).

Without careful monitoring of the underlying investment in Company A – and the value of the underlying bond investment it holds – the equity method investment can quickly become impaired. In this example, it is relatively easy to see the question regarding impairment begins to occur in Year 2 and it must be concluded at the maturity of the bond in Year 5 that there is an impairment in Company B's investment in Company A as it holds the investment at $174 when Company A holds cash of $750 of which Company B holds at 20% interest of $150. With more complicated examples – with entities holding many assets and liabilities with longer lives and less obvious ongoing fair value – it is even more likely the investment may become impaired and recognized much later as ascertaining the fair value of the investee is more challenging.

COMPANY A: HISTORIC BALANCE SHEET

	T=0	T=1	T=2	T=3	T=4	T=5
Balance Sheet						
Assets						
Cash	-	50	100	150	200	750
Bond	400	420	440	460	480	-
Total Assets	400	470	540	610	680	750
Liabilities	-	-	-	-	-	-
Equity	400	470	540	610	480	750
Total Liabilities & Equity	400	470	540	610	480	750
Income Statement						
Income						
Cash Interest Income		50	50	50	50	50
Amortization		20	20	20	20	20
Total Income		70	70	70	70	70
Expense		-	-	-	-	-
Net Income*		70	70	70	70	70

* - Made the simplifying assumption that there is no income tax.
Does not change the point of the illustration.

COMPANY A: ADJUSTED BALANCE SHEET

	T=0	T=1	T=2	T=3	T=4	T=5
Balance Sheet						
Assets						
Cash	-	50	100	150	200	750
Bond	400	420	440	460	480	-
Basis Adjustment			120	80	40	-
Total Assets	400	470	660	690	720	750
Liabilities	-	-	-	-	-	-
Equity	400	470	660	690	720	750
Total Liabilities & Equity	400	470	660	690	720	750
Income Statement						
Income						
Cash Interest Income		50	50	50	50	50
Amortization		20	20	20	20	20
Basis Adjustment Amortization		-	-	(40)	(40)	(40)
Total Income		70	70	30	30	30
Expense		-	-	-	-	-
Net Income*		70	70	30	30	30

* - Made the simplifying assumption that there is no income tax.
Does not change the point of the illustration.

**COMPANY B: 20% of EQUITY METHOD INVESTMENT IN COMPANY A
CARRYING VALUE & EARNINGS**

	T=0	T=1	T=2	T=3	T=4	T=5
Current Practice						
Carrying Value			132	138	144	150
Equity in Earnings of Investee				6	6	6
Proposed Practice						
Carrying Value			132	146	160	174
Equity in Earnings of Investee				14	14	14
Impairment			-	(8)	(16)	(24)

Potential Impairment in T=3 and T=4 - would depend on fair value of bond.
Actual Impairment in T=5 as bond has matured.

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Impressions of the Proposal: As we have socialized this issue, it has become apparent that those financial statement users which we discussed the issue with were not aware of these basis differences but they concurred with our views that the Board's proposal was likely to overstate earnings and result in impairments later down the road as discussed and illustrated above.

What we heard as we socialized the proposal is that financial statement users want more information on the investee company as their job is to assess the value of, and return on, that investment each period. There was support for retaining the existing accounting or making further improvements as described below. There was little support for the proposal. One investor surveyed stated it best:

> *You would be moving from fair value at acquisition with related earnings which becomes quickly outdated to cost with unrelated equity pickup… that's moving from less useful to useless information….analysts are required to make their assessment of the value (i.e. fair value) of the equity investment each period. I need more information on the investee not less. Just because I didn't know what they were doing doesn't mean I want them to make it worse.*

Other Comparability Considerations:

The Proposed Update may result in less comparability of the investors' financial performance depending on how investors 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 – when they simultaneously make an acquisition of slightly different ownership percentages (e.g. 49% vs. 51%) but with different control conclusions.[4]

We also note the proposal would create a difference between US GAAP and International Financial Reporting Standards (IFRS). Comparability is an essential ingredient of financial analysis. Investors would not be supportive of creating a difference between US GAAP and IFRS.

[4] See Scenario 3 of Example in [KPMG Defining Issues 15-24, FASB Proposes Changes to Equity Method Accounting, June 2015](#).

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The Most Useful Analytical Construct: As noted above, financial statement users want more information on the investee company as their job is to assess the value of, and return on, that investment each period. While many expressed skepticism that management would provide an appropriate fair value they expressed that fair value information would be more useful to them – as well as underlying financial information of the investee company – than the current accounting and certainly the proposed accounting.

We believe that the purpose of this initiative should be to provide more useful information for users rather than just reduce reporting costs. An improvement over the equity method would be to move to fair value measures. As we noted in our 2010 comment letter to the FASB on its proposal, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*[5], we support the provision of fair value of equity methods for the most decision –useful information for investors.

> *We fully support the proposed guidance to account for equity method investments at fair value unless the investee can be demonstrated to be related to the entity's consolidated business.*

Indeed Accounting Principles Board (APB) Opinion 18 states:

> *Reporting of investments in common stock at market value (or at approximate fair value if market value is not available) is considered to meet most closely the objective of reporting the economic consequences of holding the investment. However, the market value method is now used only in special circumstances. While the Board [APB] believes the market value method provides the best presentation of investments in some situations, it concludes that further study is necessary before the market value method is extended beyond current practice.* [6]

That was in 1971.

Those who continue to oppose such a change even today contend that market-value measures lack reliability. But the real question is whether some measure of market value more reliably describes the current cash-flow potential of the investment than the equity-method book value, which is book value based on original cost plus a fraction of the investee's adjusted earnings less dividends. We believe that change in current market value is the most useful measure of investment performance in general, whether or not that change is realized.[7]

Increase in the Level of Ownership Interest
The proposed amendments related to applying the equity method retroactively when an investment becomes eligible for the equity method require the equity method to apply prospectively to ownership level increases. We generally support retrospective adjustment, but in this case, the usefulness of the information several years later seems limited so we would not oppose this change.

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5 Comment letter on the Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

6 APB 18, Paragraph 9.

7 Accounting Today, *It's Time to Throw the Equity Method Overboard*, 6 August, 2007.

Need to Acknowledge Anti Abuse Nature of Standard

APB Opinion 18 issued in 1971 adopted the equity method because it was considered an improvement over the cost method. The cost method signals investing successes and losses by reporting income from dividends and disposal gains or losses. The lags between the investee's earnings and its dividends or sale of the investor make these signals untimely and ineffective. That is to say the cost method may not reflect substantial changes in the affairs of an investee. APB 18 indicates that the equity method provides useful information to investors, stating:

> *Thus, the equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles in the economic resources underlying the investments.* [8]

One of the primary reasons equity method accounting was introduced was to eliminate structuring transactions to avoid consolidation and abuse from the use of accounting for an investment that marginally failed consolidation requirements. It was abuses related to the structuring of subsidiaries to fail the consolidation requirements (i.e. they would then be accounted for at cost with the ability to time the recognition of earnings through the timing of dividends) during the 1960s that resulted in the implementation of the equity method. We are concerned that the Proposed Update does not acknowledge the history and anti-abuse nature of the equity method. Without such acknowledgment, we are concerned that some will, on the basis of "simplification", push to eliminate the equity method all together – especially given the lack of decision-useful information provided which will be provided by the equity in earnings of subsidiary being recognized under the proposed standard.

The Board needs to acknowledge that sometimes accounting standards must be adopted to thwart abuse. This is particularly true under US GAAP where the cliff nature of the requirement to consolidate already encourages structuring. It is less so, but none the less true, under IFRS where the equity method is used for most investments in joint arrangements where clearly each investor has a say in what the entity does or does not do.

Our Recommendation: Do Not Proceed with Proposal

The focus of financial reporting is to provide decision-useful information to investors. In the absence of moving to fair value, we urge the Board to retain the equity method as opposed to regress to the current proposal, which will result in the loss of analytical information. That said, we think further study of what investors find most useful is necessary. Our outreach suggests additional information, depending on the significance some suggest full financial statements, on the equity method investee or fair value are preferable alternatives for investors. Some even believe proportionate consolidation would be an improvement. We worry that movement away from the equity method without such research and investor outreach will result in less useful information to investors and ultimately some movement back to the cost method.

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[8] APB 18, Paragraph 10.

Specific Comments on Language of Proposed Update

323-10-35-7

It is unclear why the FASB is proposing to delete the words "as if the investee were consolidated" in a paragraph on elimination of intercompany profit. Note that paragraph 323-10-35-5 says that the investor "shall reflect adjustments similar to those made in preparing consolidated financial stalemates when applying the equity method." If the intercompany profit is not eliminated as if the investee were consolidated, how is it to be eliminated? These words add helpful guidance to preparers.

323-10-35-8

We are concerned by unintended consequences of elimination of all linkage between equity method procedures and consolidation procedures. Firstly, it significantly reduces what little guidance exists for applying the equity method. Secondly, it raises the age old debate about whether the equity method is intended to be a valuation method, or simply a recognition and measurement technique.

323-10-35-32A

It is unclear why this guidance is being eliminated. We assume that the FASB must still intend that an equity method investment be tested for impairment. However, as now drafted, there is no guidance on how or when an entity should test its equity method investment for impairment – when the example of the proposal's implementation discussed above would suggest it may become even more important.

323-10-35-34

We have reservations about the elimination of the linkage between an investors share in the reported net assets of an investee and the investor's carrying amount of the investment under the equity method.

We believe that any such changes ought to be, in all instances, accompanied by an extensive outreach process to investors – outlining the nature and pervasiveness of facts and circumstances that necessitate the proposed changes and articulating the implications of such changes. Unfortunately, the proposed amendments appear not to have been subject to a broad-based investor outreach. Additionally, the changes don't appear to have been framed in a manner that makes the case for the amendments backed up by investors' understanding of the implications and their agreement that the anticipated reporting outcomes would be a more faithful representation of the underlying economics. As addressed above, the focus of the changes seems to be largely on addressing preparer concerns.

Investors need to see examples of what effect eliminating the current guidance may have on the determination of the amount of the investor's share of earnings or losses of the investee. Without such information it is impossible to tell whether this improves or even maintains the current quality of financial reporting or whether it will result in recognition of earnings of an investee by an investor that is not representative of the economics.

350-20-35-59
We assume that the elimination of this guidance does not mean that an entity may amortize equity method goodwill. We do note that with this elimination there appears to be no guidance on how an investor evaluates an equity method investment for impairment.

835-20-35-2
This elimination combined with the elimination of guidance on impairment testing for an equity method investment could result in capitalized interest remaining on the balance sheet of the investor indefinitely. That would not provide investors with the best information particularly for joint ventures or other entities that are close to the consolidation thresh hold. Rather than simply eliminate the requirement for amortization, it would be better if the FASB eliminated the requirement to capitalize interest cost on an investment accounted for by the equity method completely.

We would also observe that this amendment is not related to the acquisition of the equity method investee and is a separate simplification initiative not prominently articulated as such.

BC7
BC7 states "The Board also considered attributing the entire basis difference to equity method goodwill. The Board ultimately rejected that alternative because assigning the entire basis difference to goodwill would be seen as arbitrary if an entity is aware that the basis difference is due to other factors."

We believe this would be a better option than the Board's current proposal because it will attribute some element of the premium likely paid to the earnings of the entity's operations over time and reduce the likelihood of delay or unrecognized impairments.

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Thank you again for the opportunity to comment on the FASB Proposed Update. If you or your staff have questions or seek further elaboration of our views, please contact either Mohini Singh, ACA, by phone at +1.434.951.4882, or by e-mail at mohini.singh@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

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