

FINANCIAL ACCOUNTING SERIES



No. 2016-07
March 2016

Investments—Equity Method and Joint Ventures (Topic 323)

Simplifying the Transition to the
Equity Method of Accounting

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

The Board is issuing this Update as part of its Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

Stakeholders told the Board that the requirement to retroactively adopt the equity method of accounting is costly and time consuming when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence. Stakeholders noted that this requirement does not provide a clear benefit to users of financial statements.

The amendments in this Update eliminate the requirement to retroactively adopt the equity method of accounting.

Who Is Affected by the Amendments in This Update?

The amendments in this Update affect all entities that have an investment that becomes qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence.

What Are the Main Provisions?

The amendments in this Update eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required.

The amendments in this Update require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated

other comprehensive income at the date the investment becomes qualified for use of the equity method.

When Will the Amendments Be Effective?

The amendments in this Update are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted.

No additional disclosures are required at transition.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–5. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 323-10

2. Amend paragraph 323-10-35-33, with a link to transition paragraph 323-10-65-2, as follows:

Investments—Equity Method and Joint Ventures—Overall

Subsequent Measurement

> Change in Level of Ownership or Degree of Influence

> > Increase in Level of Ownership or Degree of Influence

323-10-35-33 Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. If the investment was previously accounted for as an available-for-sale security, an entity shall recognize in earnings the unrealized holding gain or loss from accumulated other comprehensive income at the date the investment becomes qualified for the equity method. ~~The investment, results of operations (current and prior periods presented), and retained earnings of the investor shall be adjusted retroactively on a step-by-step basis as if the equity method had been in effect~~

~~during all previous periods in which the investment was held. The amount of interest cost capitalized through application of Subtopic 835-20 shall not be changed if restating financial statements of prior periods.~~

3. Amend paragraph 323-10-35-33, with a link to transition paragraph 825-10-65-2, as follows:

[Note: Upon the effective date of the amendments in Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, paragraph 323-10-35-33 should be amended as follows.]

323-10-35-33 Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. ~~If the investment was previously accounted for as an available for sale security, an entity shall recognize in earnings the unrealized holding gain or loss from accumulated other comprehensive income at the date the investment becomes qualified for the equity method.~~

4. Add paragraph 323-10-65-2 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2016-07, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*

323-10-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2016-07, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*:

- a. The pending content that links to this paragraph shall be effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Earlier application is permitted.
- b. An entity shall apply the pending content that links to this paragraph prospectively to increases in the level of ownership interest or degree of

influence that result in the adoption of the equity method after the effective date of the pending content that links to this paragraph.

5. Amend paragraph 323-10-00-1, by adding the following items to the table, as follows:

323-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
323-10-35-33	Amended	2016-07	3/15/2016
323-10-65-2	Added	2016-07	3/15/2016

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The Board is issuing this Update as part of its Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

Background Information

BC3. Stakeholders told the Board that the requirement to retroactively adopt the equity method of accounting is costly and time consuming when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence. Stakeholders noted that this requirement does not provide a clear benefit to users of financial statements.

BC4. Stakeholders also stated that the accounting for the difference between the cost of an investment and the investor's proportionate share of the net assets of the investee—the basis difference of equity method investments—adds cost and complexity to financial statement reporting without improving the usefulness of the information provided to investors.

BC5. At its March 18, 2015 meeting, in response to stakeholder requests, the Board added to its agenda a project with the objective of simplifying the equity method of accounting. At that meeting, the Board tentatively decided to eliminate:

- a. The requirement to account for the difference between the cost of an investment and the investor's proportionate share of the net assets of an investee (the basis difference)
- b. The requirement to retroactively apply the equity method of accounting to an investment that qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence.

BC6. On June 5, 2015, the Board issued proposed Accounting Standards Update, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting*, for public comment. The amendments in the

proposed Update reflected the decisions made at the March 18, 2015 Board meeting. The Board received 42 comment letters in response to the questions in the proposed Update.

BC7. Feedback on eliminating the accounting for the basis difference varied. A number of respondents raised concerns that preparers may incur additional costs in financial reporting because for certain entities the proposed amendments may lead to an increase in the frequency of impairments. Other respondents expressed concern about moving away from their view of the conceptual basis of the equity method of accounting. While acknowledging those concerns, certain Board members continued to support moving forward with a more immediate project to reduce the current unnecessary cost and complexity embedded in the requirements to identify the so-called basis difference in individual assets and liabilities of the investee. They believe that this could be achieved by moving forward to either finalize the proposal or allow such treatment as a policy election. However, as a result of the respondents' concerns, the Board determined that additional research should be performed to consider potential improvements to the equity method of accounting, including the accounting for the basis difference.

BC8. Overall, respondents supported eliminating the requirement to retroactively adopt the equity method when an increase in ownership interest or degree of influence occurs. The amendments in this Update address the elimination of that requirement.

Increase in the Level of Ownership Interest or Degree of Influence

BC9. The amendments in this Update eliminate the requirement that an entity retroactively adopt the equity method of accounting if an investment qualifies for use of the equity method as a result of an increase in ownership interest or degree of influence. In accordance with the amendments, an equity method investor will begin to apply the equity method when the investor obtains significant influence without having to retroactively adjust the investment and record a cumulative catch up for the years when the investment did not qualify for the equity method of accounting. The amendments improve consistency with International Financial Reporting Standards (IFRS), which do not require retroactive adjustment when an investment becomes qualified for the equity method.

BC10. The Board supports eliminating the requirement to retroactively apply the equity method because the requirement is costly and time consuming, with minimal benefits to users. An entity often will not have the necessary financial information readily available to retroactively apply the equity method, which creates challenges and results in inaccuracies. Although an entity with significant influence might have access to the appropriate information, the Board concluded that it is not cost

beneficial and is potentially misleading to retroactively apply the equity method to periods before the investment qualifies for use of the equity method. The Board also noted that retroactive application is inconsistent with how business combination accounting is applied.

BC11. Auditors stated that they, along with preparers, spend a considerable amount of time debating the benefits of retroactive application (for example, debating whether the requirement to apply retroactive treatment can be considered immaterial) because users do not receive decision-useful information from the restatement and they often are not aware that it occurred.

BC12. The Board considered adding a disclosure of the amount of earnings for all periods presented that would have been recorded if the investment had been accounted for under the equity method in lieu of retroactive application. However, the Board rejected this alternative because:

- a. It would require an entity to perform a similar, costly process to that of retroactive application of the equity method without a clear benefit to users.
- b. It is misleading, since the entity did not qualify for the equity method in those prior periods.

Available-for-Sale Equity Securities

BC13. Some respondents requested that the Board clarify how to account for the balance in accumulated other comprehensive income when an available-for-sale equity security becomes qualified for the equity method.

BC14. The amendments in Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, eliminate equity securities that qualify for available-for-sale classification. Therefore, the Board acknowledges that the issue of how to account for unrealized gains and losses in accumulated other comprehensive income for an available-for-sale investment that becomes eligible for the equity method will only exist until an entity adopts the amendments in Update 2016-01. To reduce the already limited potential for diversity in practice until those amendments are adopted, the Board decided to require that an entity, under this circumstance, recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment qualifies for use of the equity method.

BC15. The Board considered retaining the unrealized holding gains or losses in accumulated other comprehensive income until the equity method investment is sold. The Board rejected this alternative because it could produce unusual results that would be confusing and irrelevant to users. Examples of those results are:

- a. Instances in which a gain is held up in accumulated other comprehensive income and an impairment of the equity method investment subsequently occurs
- b. Instances in which a loss is held up in accumulated other comprehensive income and the equity method investment is sold at a gain.

BC16. The Board also considered recognizing a cumulative-effect adjustment to the statement of financial position as of the date the investment qualifies for use of the equity method. The Board rejected this alternative because although it is consistent with the transition guidance on the elimination of available-for-sale equity securities in Update 2016-01, transactions recognized through retained earnings generally are limited to dividends and the effects of transition upon adoption of new accounting standards; therefore, it would be unusual for such an event—the transition from an available-for-sale investment to an equity method investment—to affect retained earnings.

BC17. Finally, the Board considered reclassifying the accumulated unrealized holding gain or loss to the basis of the investment at the date that the investment qualifies for use of the equity method. The Board rejected this alternative because:

- a. It would not provide a relevant beginning carrying amount of the equity method investment to users.
- b. The beginning carrying amount of the investments would be inconsistent with the beginning carrying amount of available-for-sale securities upon the effective date of the amendments in Update 2016-01.

Effective Date and Transition

BC18. The amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The Board decided that the amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted.

BC19. The Board concluded that the benefits of requiring retrospective application do not justify the costs. The amendments simplify the transition to the equity method for all entities that have an investment that becomes qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. Because these amendments are not costly to implement, the Board decided that it is not necessary to delay the effective date for entities that are not public business entities.

BC20. The Board decided not to require additional disclosures in the period of adoption.

Benefits and Costs

BC21. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC22. The Board does not anticipate that significant costs will be incurred by an entity as a result of the amendments in this Update. The Board expects that the amendments will eliminate costs related to retroactively performing a fair value allocation of the basis difference as of the original purchase date of the investment and adjusting prior earnings to reflect equity method earnings, which include consideration of intercompany profits and losses, amortization of the basis difference, and impairment testing. The amendments will not reduce the availability of relevant information provided to users, because there was no clear benefit to users from the application of the previous retroactive requirement.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*[®] in this Accounting Standards Update require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Those changes, which will be incorporated into the proposed 2017 Taxonomy, are available for public comment through [ASU Taxonomy Changes](#) provided at www.fasb.org, and finalized as part of the annual release process.