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Equity method investments and joint ventures

Partially updated September 2023

About the Equity method investments and joint ventures guide

PwC is pleased to offer our updated *Equity method investments and joint ventures* guide. This guide discusses the identification of investments that are subject to the equity method of accounting guidance, and the initial and subsequent accounting for those investments. It also includes discussion of the accounting upon formation of a joint venture.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Consolidation (CG)*
- *Derivatives and hedging (DH)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Foreign currency (FX)*
- *Income taxes (TX)*
- *Loans and investments (LI)*
- *Property, plant, equipment and other assets (PPE)*
- *Stock-based compensation (SC)*

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in March 2024

Chapter 2: *Ability to exercise significant influence*

- **EM 2.2** was updated to enhance the examples on assessing the ability to exercise significant influence when an investor's investment is less than 20%.

Revisions made in September 2023

Chapter 6: *Joint ventures*

- **EM 6.4.1** was updated to reflect accounting by the joint venture entity for contributions received at formation, after adoption of ASU 2023-05, *Business Combinations—Joint Venture Formations*. The content previously in **EM 6.4.1** on current accounting for contributions received at formation (before ASU 2023-05) was moved to **EM 6.4.1A**.

Revisions made in June 2023

Chapter 1: *Scope*

- **EM 1.3.6** was updated to reflect the accounting for investments in tax credit entities after adoption of ASU 2023-02, including the broader application of the proportional amortization method. The content previously in **EM 1.3.6**, on current accounting for investments in tax credit entities, was moved to **EM 1.3.6A**.

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Chapter 1:
Scope—updated June 2023

1.1 Overview of equity method investments

Equity investments represent an ownership interest (for example, common, preferred, or other capital stock) in an entity, and may be made in a variety of legal entities, such as corporations, limited liability partnerships, or limited liability corporations.

The accounting for an equity investment depends on the degree to which the investor can influence the investee. An investor that directly or indirectly holds a controlling financial interest in another entity is required to consolidate that entity pursuant to either the variable interest entity (VIE) or voting interest entity (VOE) consolidation model, as prescribed by ASC 810, *Consolidation*. This determination may require extensive analysis depending on the terms and nature of the investment. See CG 1.3 for further information regarding the application of the VIE and VOE consolidation models.

Once an investor has determined that it does not have a controlling financial interest, it should determine if the equity method of accounting applies, as prescribed by ASC 323, *Investments – Equity Method and Joint Ventures*. The equity method is used to account for investments in common stock or other eligible investments by recognizing the investor’s share of the economic resources underlying those investments. Investments within the scope of the equity method include investments in either common stock and/or in-substance common stock of corporate entities, as well as investments in entities such as partnerships, unincorporated joint ventures, and limited liability companies. The equity method is applied if these investments provide the investor with the ability to exercise significant influence over the investee. Additionally, the equity method must be applied to a limited partner’s interest unless the interest is so minor that the limited partner has virtually no influence over partnership’s operating and financial policies. See EM 1.2 and EM 1.3 for further discussion of these investments and EM 2 for further discussion of the concept of significant influence.

There are certain exclusions to applying the equity method of accounting, such as when an investor has elected to measure an investment at fair value or is applying the proportionate consolidation method allowed in limited circumstances. See EM 1.4 for further information regarding these exclusions.

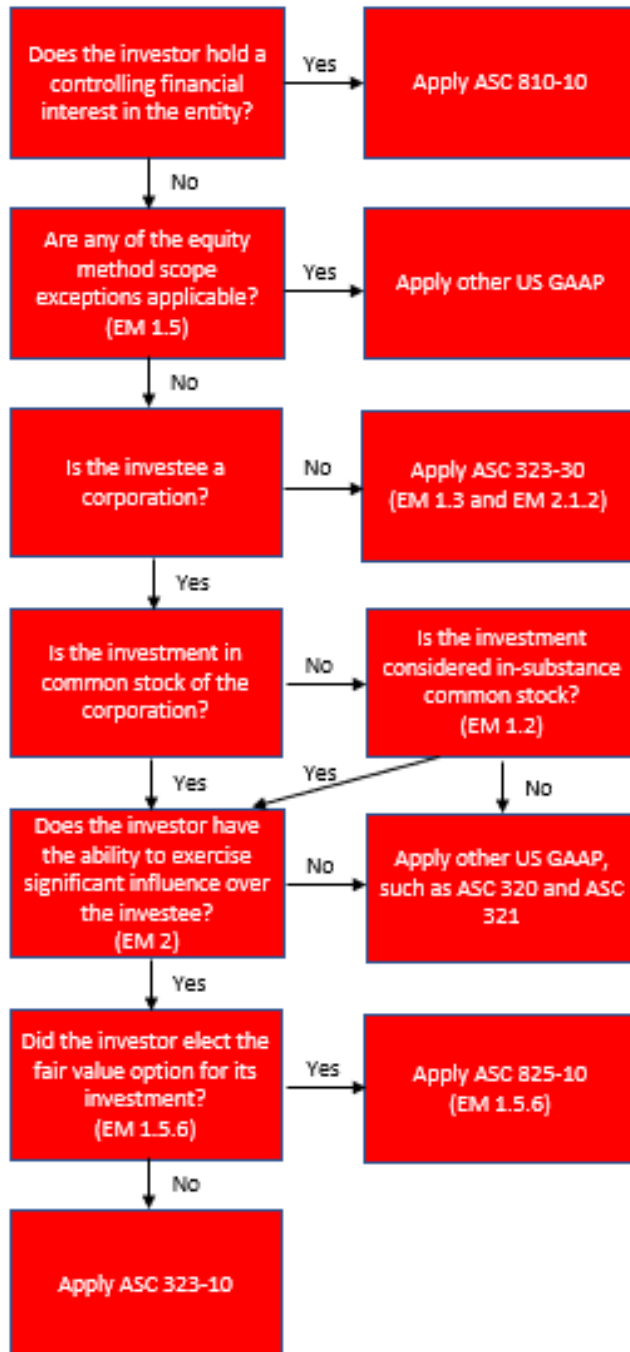
An investment that, individually or in combination with other financial and nonfinancial interests, does not provide the investor with the ability to exercise significant influence should be accounted for under other accounting guidance (e.g., ASC 320, *Investments – Debt Securities* or ASC 321, *Investments – Equity Securities*).

1.1.1 Framework to determine if the equity method applies

The following framework illustrates the accounting for equity investments and should be read in conjunction with the referenced sections.

Figure EM 1-1

Framework to determine those investments that should be accounted for under the equity method of accounting



1.2 Investments in common stock

Common stock is subordinate to all other equity of the issuer and is often referred to as residual equity. A share of common stock usually provides its holder with voting rights, which enables it to influence the operating and financial policies of an investee. Common stock represents the residual value of an entity after all senior interests (e.g., liabilities, senior classes of equity) have been considered.

1.2.1 In-substance common stock investments

An investor may hold stock or other instruments that have risk and reward characteristics that are substantially similar to common stock. These instruments are commonly referred to as in-substance common stock investments.

To determine whether an investment is “substantially similar” to common stock, an investor should consider the following characteristics outlined in ASC 323-10-15-13:

- Subordination (see EM 1.2.1.1)
- Risks and rewards of ownership (see EM 1.2.1.2)
- Obligation to transfer value (see EM 1.2.1.3)

If any of these characteristics of the investment are not substantially similar to common stock, the investment is not in-substance common stock and would not be within the scope of ASC 323. In that case, the investor should not apply the equity method of accounting, even if the investor has significant influence.

If an investor cannot make a determination based on a qualitative assessment of these characteristics, the investor should perform a quantitative assessment by analyzing whether the future changes in the fair value of the investment are expected to vary directly with the changes in the fair value of the investee’s common stock. If not, the investment is not considered in-substance common stock.

The guidance for considering whether an instrument is in-substance common stock applies only to investments in corporations or limited liability companies that do not maintain specific ownership accounts. Refer to ASC 323-10-15-4 and ASC 323-10-15-5. Partnerships or limited liability companies with specific ownership accounts are not subject to the in-substance common stock guidance and should be accounted for under ASC 323-30-15-2. See EM 1.3 for further information.

1.2.1.1 Subordination criterion – in-substance common stock

An investment without a stated liquidation preference, or with a nonsubstantive liquidation preference, over the investee’s common stock, may be substantially similar to common stock and further analysis of the other criteria will be needed. In contrast, an investment with a substantive liquidation preference over common stock is not substantially similar to that entity’s common stock. An investor should consider the following when assessing if a stated liquidation preference is substantive:

- The liquidation preference may be substantive if it is significant in relation to the purchase price of the investment.

- A liquidation preference in an investment is more likely to be substantive when the fair value of subordinated equity (i.e., the investee's common stock) is significant. If there is little or no fair value associated with the investee's common stock, the investment would participate in substantially all of the investee's losses in the event of liquidation, and the liquidation preference would not be considered substantive.

Example EM 1-1, Example EM 1-2, and Example EM 1-3 illustrate the evaluation of whether an investment has substantially similar subordination as common stock.

EXAMPLE EM 1-1

Investee's common stock has little fair value

On January 1, 20X1, Investor purchased 200,000 shares of preferred stock of Investee in exchange for \$20,000,000 (\$100 par value, liquidation preference of \$100 per share). On January 1, 20X1, the fair value of Investee's outstanding common stock was \$300,000.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Are the subordination characteristics of Investor's investment in the preferred stock of Investee substantially similar to the subordination characteristics of Investee's common stock?

Analysis

The liquidation preference stated in the preferred stock of Investee is equal to the purchase price (and fair value) of the preferred stock on the date of purchase. Therefore, the stated liquidation preference is significant in relation to the purchase price of the investment. However, the fair value of Investee's common stock (\$300,000), compared to the fair value of Investee's preferred stock (\$20,000,000), indicates that Investee's common stock has little fair value compared to the investment.

In the event of liquidation, Investor's investment, while preferred stock, would likely participate in substantially all of Investee's losses. As a result, it's likely that the liquidation preference in its investment in the preferred stock of Investee is not substantive and that the subordination characteristic of its investment in the preferred stock of Investee are substantially similar to that of the Investee's common stock.

Investor should also evaluate the risks and rewards of ownership (see EM 1.2.1.2) and obligation to transfer value (see EM 1.2.1.3) to determine whether its investment in the preferred stock of Investee is in-substance common stock.

EXAMPLE EM 1-2

Liquidation preference is insignificant in relation to the purchase price of the investment

On January 1, 20X1, Investor purchased 200,000 shares of preferred stock of Investee in exchange for \$20,000,000 (\$100 par value, liquidation preference of \$1 per share). On January 1, 20X1, the fair value of Investee's outstanding common stock was \$100,000,000.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Are the subordination characteristics of Investor's investment in the preferred stock of Investee substantially similar to the subordination characteristics of Investee's common stock?

Analysis

The liquidation preference stated in the preferred stock of Investee is equal to 1% (\$1 per share divided by \$100 per share) of the purchase price (and fair value) of the preferred stock on the date of purchase.

The fair value of Investee's common stock (\$100,000,000), as compared to the fair value of Investee's preferred stock (\$20,000,000), indicates that Investee has significant value associated with its common stock from a fair value perspective.

Given that the liquidation preference is only 1% of the purchase price, Investor is likely to conclude that the liquidation preference of its investment is not substantive and that the subordination characteristic is substantially similar to the subordination characteristics of Investee's common stock.

Investor should also evaluate the risks and rewards of ownership (see EM 1.2.1.2) and obligation to transfer value (see EM 1.2.1.3) criteria in its determination of whether its investment in the preferred stock of Investee is in-substance common stock.

EXAMPLE EM 1-3

Subordination is not substantially similar to common stock

On January 1, 20X1, Investor purchased 200,000 shares of preferred stock of Investee in exchange for \$20,000,000 (\$100 par value, liquidation preference of \$100 per share). On January 1, 20X1, the fair value of Investee's outstanding common stock was \$100,000,000.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Are the subordination characteristics of Investor's investment in the preferred stock of Investee substantially similar to the subordination characteristics of Investee's common stock?

Analysis

The liquidation preference stated in the preferred stock of Investee is equal to the purchase price (and fair value) of the preferred stock on the date of purchase and, consequently, the stated liquidation preference is significant in relation to the purchase price of the investment. Further, the fair value of Investee's common stock (\$100,000,000), as compared to the fair value of Investee's preferred stock (\$20,000,000), indicates that the Investee common stock has significant fair value.

Therefore, in the event of liquidation, Investor's investment in the preferred stock of Investee would likely be protected through the existence of Investee's common stock, which would most likely absorb a substantial portion of the losses of Investee. As a result, Investor might conclude that the liquidation preference in its investment in the preferred stock of Investee is substantive and that the subordination characteristics of its investment in the preferred stock of Investee are not substantially similar to the subordination characteristics of Investee's common stock. If so, the preferred stock would not be considered in-substance common stock.

Investor would not be required to evaluate the risks and rewards of ownership and obligation to transfer value criteria once the subordination criterion is not met.

1.2.1.2 Risks and rewards of ownership — in-substance common stock

An investment is not substantially similar to common stock if it is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock.

In contrast, if an investee pays dividends on common stock and the investment participates in a substantially similar manner, it indicates that the investment is substantially similar to common stock. Investors should consider whether the investee is expected to pay dividends when determining if participation in dividends is relevant to assessing risks and rewards of ownership.

The ability to convert an investment into that investee's common stock without any significant restrictions or contingencies may indicate that the investor may participate in capital appreciation of the investee in a manner that is substantially similar to common stock. The right to convert an instrument to common stock (such as the exercise of a deep-in-the-money warrant) enables the interest to participate in the investee's earnings (and losses) and capital appreciation (and depreciation) on a substantially similar basis to common stock.

In making a determination, an investor should consider not only the benefits but also the risks inherent in the investment.

Example EM 1-4 and Example EM 1-5 illustrate the evaluation of whether an investment is expected to participate in the risks and rewards of ownership of common stock.

EXAMPLE EM 1-4

Investment expected to participate in risks and rewards of ownership

On January 1, 20X1, Investor purchased a warrant for \$1,000,000. The warrant enables Investor to acquire 50,000 shares of Investee's common stock at an exercise price of \$1.50 per share (total exercise price of \$75,000). The warrant is exercisable at any time on or before December 31, 20X1. There are no significant restrictions or contingencies associated with Investor's ability to exercise the warrant. The warrant does not participate in dividends paid to the common shareholders of Investee. However, Investor does not expect Investee to pay dividends to its common shareholders during the exercise period (January 1, 20X1 – December 31, 20X1). On January 1, 20X1, the fair value of Investee's common stock is approximately \$21.00.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Is Investor's investment expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to Investee's common stock?

Analysis

Investor can exercise the warrant and convert its investment to common stock at any time during the exercise period, without any significant restrictions or contingencies; therefore, Investor's investment enables it to participate equally with the common shareholders in increases in Investee's fair value.

Investor also does not expect Investee to pay dividends to its common shareholders during the exercise period; therefore, dividends that could become payable to common shareholders are not expected to result in a difference in the earnings and losses available to the (a) Investor's investment (warrant) and (b) Investee's common shares.

Investor should also evaluate whether it will participate in the investee's capital depreciation in a manner similar to the common shareholders and has alternatives in making this assessment. In this case, the current fair value of Investee's common stock (\$21.00) is substantially similar to the current fair value of a warrant to purchase one share of common stock (\$20.00, or \$1,000,000/50,000). Therefore, the warrant's expected participation in Investee's capital depreciation is substantially similar to the common shareholders' participation.

As a result, Investor is likely to conclude that, before exercise, the warrant is expected to have risks and rewards of ownership substantially similar to common stock, i.e., the warrant participates in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock.

Investor should also evaluate the subordination (see EM 1.2.1.1) and obligation to transfer value (see EM 1.2.1.3) criteria in its determination of whether its warrant is in-substance common stock.

EXAMPLE EM 1-5

Investment not expected to participate in risks and rewards of ownership

On January 1, 20X1, Investor purchased a warrant for \$150,000. The warrant enables Investor to acquire 50,000 shares of Investee's common stock at an exercise price of \$19.00 per share (total exercise price of \$950,000). The warrant is exercisable at any time on or before December 31, 20X1. There are no significant restrictions or contingencies associated with Investor's ability to exercise the warrant. The warrant does not participate in dividends paid to the common shareholders of Investee. However, Investor does not expect Investee to pay dividends to its common shareholders during the exercise period (January 1, 20X1 – December 31, 20X1). On January 1, 20X1, the fair value of Investee's common stock is \$21.00.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Is Investor's investment expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to Investee's common stock?

Analysis

Investor can exercise the warrant and convert its investment to common stock at any time during the exercise period, without any significant restrictions or contingencies; therefore, Investor's investment enables it to participate equally with the common shareholders in increases in Investee's fair value. Investor also does not expect Investee to pay dividends to its common shareholders during the exercise period; therefore, dividends that could become payable to common shareholders are not expected to result in a difference in the earnings (and losses) available to the (a) Investor's investment (warrant) and (b) Investee's common shares.

Investor should also evaluate whether the warrant would participate in Investee's capital depreciation in a manner substantially similar to common stock. The current fair value of Investee's common stock

(\$21.00) is substantially different from the current fair value of a warrant to purchase one share of common stock (\$3.00, calculated as \$150,000/50,000 shares). Therefore, the warrant's expected participation in Investee's capital depreciation is substantially different from the common shareholders' participation. Specifically, Investor's investment in the warrant has substantially less at risk in the event of capital depreciation than Investee's common shares.

As a result, Investor is likely to conclude that, before exercise, the warrant is not in-substance common stock.

Investor would not be required to evaluate the subordination and obligation to transfer value criteria once the risks and rewards of ownership criterion is not met.

1.2.1.3 Obligation to transfer value – in-substance common stock

An investment is not substantially similar to common stock if the investee is expected to transfer substantive value to the investor that is not also available to common shareholders. An example of this may be an investment that includes a fixed price mandatory redemption provision or a non-fair value put option that is not available to common shareholders.

An investor should evaluate whether provisions to transfer value are substantive obligations. For example, preferred stock with a mandatory redemption in 100 years is not considered a substantive obligation to transfer value through the redemption feature, given the extreme long-dated nature of the specified future date. Additionally, if an investee does not have the ability to pay the related redemption price that the investor is or would be entitled to at the time of investment, the redemption provision would also not be considered a substantive obligation to transfer value.

Example EM 1-6 and Example EM 1-7 illustrate the assessment if an Investee is obligated to transfer substantive value.

EXAMPLE EM 1-6

Investee not obligated to transfer substantive value

On January 1, 20X1, Investor purchased 1,000,000 shares of redeemable convertible preferred stock in Investee for \$5,000,000. At the date of the investment, 100% of Investee's common stock was valued at \$400,000. The preferred shares can be converted into common shares on a one-for-one basis, or redeemed for \$5,000,000. The common shareholders of Investee do not have a redemption feature.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Does the redemption feature obligate Investee to transfer substantive value to Investor that is not also available to common shareholders?

Analysis

The \$5,000,000 redemption feature is substantive as compared to the fair value of the investment (\$5,000,000) on the investment date. However, given that the fair value of the Investee's common stock was \$400,000, Investor is likely to conclude that Investee would not have the ability to pay the redemption amount if exercised. If Investee's operating results deteriorated, the common shareholders

would not be able to absorb significant losses and it would be unlikely that Investee would have the ability to redeem Investor's preferred stock at the \$5,000,000 redemption amount. Therefore, Investor's redemption feature is not considered substantive as Investee is not expected to transfer substantive value to the Investor.

Investor should also evaluate the subordination (see EM 1.2.1.1) and risks and rewards of ownership (see EM 1.2.1.2) criteria in its determination of whether its investment is in-substance common stock.

EXAMPLE EM 1-7

Investee obligated to transfer substantive value

On January 1, 20X1, Investor purchased 1,000,000 shares of redeemable convertible preferred stock in Investee for \$5,000,000. At the date of the investment, 100% of Investee's common stock was valued at \$10,000,000. The preferred shares can be converted into common shares on a one-for-one basis, or redeemed for \$5,000,000. The common shareholders of Investee do not have a redemption feature.

Investor has the ability to exercise significant influence over Investee's operating and financial policies through its investment in Investee.

Does the redemption feature obligate Investee to transfer substantive value to Investor that is not also available to common shareholders?

Analysis

The redemption feature is substantive. The fair value of Investee's common stock was \$10,000,000 and Investor concluded when it made the investment that Investee had the ability to pay the redemption amount if exercised. Therefore, the investment in the redeemable convertible preferred stock obligates Investee to transfer substantive value to Investor that is not available to Investee's common shareholders. As such, the redeemable convertible preferred stock is not in-substance common stock.

Investor would not be required to evaluate the subordination and risk and rewards of ownership criteria once the obligation to transfer value criterion was not met.

1.2.1.4 Initial determination and reconsideration events

Investors should determine whether an investment is substantially similar to common stock based on information that exists on the date the investor determines that it has the ability to exercise significant influence. This date may be subsequent to the date that the investment was originally acquired. For example, subsequent to an initial investment, an investor may obtain representation on the board of directors that gives it the ability to exercise significant influence over the investee's operating and financial policies. At this point, the investor would perform the initial assessment as to whether its investment is considered in-substance common stock.

As noted in ASC 323-10-15-16, an investor should reconsider its initial determination if any of the following occur:

- The contractual terms of the investment are amended, resulting in a change in one or all of the characteristics described in EM 1.2.1. For example, a change in the form of the investment, such as

an exchange of preferred stock for another series of stock, is generally considered a reconsideration event. An expected change provided for in the original terms of the contractual agreement would generally not be considered a reconsideration event.

- There is a significant change in the investee's capital structure, including the investee's receipt of additional subordinated financing. For example, an increase in both the number of shares and value of outstanding common stock could affect whether the subordination characteristics of an investment are substantially different from that of common stock.
- The investor obtains an additional interest in the investment. When reconsidering the characteristics of the investment, an investor should consider its cumulative position in the investment (including both new and existing interests) and the facts and circumstances that existed at the time the additional interest was acquired.

The determination of whether an investment is similar to common stock should not be reconsidered solely due to losses of the investee, even if those losses change the investee's capital structure. Rather, an investor should only reconsider whether its investment is substantially similar to common stock when one of the identified reconsideration events or conditions occurs.

1.2.1.5 Put or call option representing in-substance common stock

An investor may obtain an instrument, such as a call option that provides it with the right to purchase the voting common stock of an investee at a future point in time. Alternatively, investor may write a put option, obligating it to purchase the voting common stock of an investee at a future point in time. The investor with significant influence over the investee must determine whether these instruments represent in-substance common stock. In performing this evaluation, an investor should first determine whether the instrument is a freestanding instrument or an embedded feature within a host agreement that might require bifurcation and separate accounting.

If the instrument is freestanding, the investor should determine whether it should be accounted for pursuant to ASC 815, *Derivatives and Hedging*. If the instrument is an embedded feature within a host agreement, the investor should evaluate whether the instrument should be bifurcated and accounted for separately from the host agreement pursuant to ASC 815. See DH 3 for more information.

The equity method of accounting does not apply to investments accounted for in accordance with ASC 815. Therefore, the investor should only evaluate those instruments that are not within the scope of ASC 815 to determine whether they represent in-substance common stock of the investee. Put options, call options, and other instruments that are not accounted for pursuant to ASC 815 may meet the characteristics of in-substance common stock.

1.3 Investments in partnerships, joint ventures, and LLCs

In accordance with ASC 323-30-25-1, investors in partnerships, unincorporated joint ventures, and limited liability companies (LLCs) should generally account for their investment using the equity method of accounting by analogy if the investor has the ability to exercise significant influence over the investee. However, there may be situations when significant influence does not exist but the equity method of accounting applies.

1.3.1 *Investments in general partnerships*

A general partnership interest in assets, liabilities, earnings, and losses accrues directly to the individual partners. No “corporate veil” exists between the partners and the related investment. General partners in a general partnership usually have the inherent right, absent agreements in partnership articles to the contrary, to influence the operating and financial policies of a partnership.

An interest in a general partnership usually provides an investor with the ability to exercise significant influence over the operating and financial policies of the investee. As such, assuming an investor does not hold a controlling financial interest, a general partnership interest is generally accounted for under the equity method of accounting.

1.3.2 *Limited partnerships and unincorporated joint ventures*

Generally, interests in a limited partnership or unincorporated joint venture when the investor does not have a controlling financial interest would be accounted for under the equity method of accounting by analogy. ASC 323-30-S99-1 describes the SEC staff’s view on the application of the equity method to investments in limited partnerships.

This guidance requires a limited partner to apply the equity method of accounting to its investment unless the limited partner’s interest is so minor that the limited partner has virtually no influence over the operating and financial policies of the partnership.

An ownership interest greater than 3-5% in limited partnerships is presumed to provide an investor with the ability to influence the operating and financial policies of the investee. This differs from the threshold of 20% of outstanding voting securities presumed to create influence for an investment in common stock or in-substance common stock of a corporation. See EM 2.1 for further discussion.

See EM 1.3.3 for guidance on whether a limited liability company should be viewed as a limited partnership or a corporation for purposes of determining whether the equity method of accounting is appropriate.

1.3.3 *Investments in limited liability companies*

Limited liability companies frequently have characteristics of both corporations and partnerships. Investors must determine whether a limited liability company should be viewed as similar to a corporation or a partnership for purposes of determining whether its investment should be accounted for under the equity method of accounting.

Per ASC 323-30-35-3, a noncontrolling investment in a limited liability company that maintains a specific ownership account (similar to a partnership capital account structure) for each investor should be viewed similarly to an investment in a limited partnership when determining whether the investment provides the investor with the ability to influence the operating and financial policies of the investee.

An investment in a limited liability company that does not maintain specific ownership accounts for each investor should be viewed similar to an investment in a corporation when determining whether to apply the equity method of accounting.

1.3.4 *Investments in joint ventures*

ASC Master Glossary

Joint venture: An entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.

Joint ventures are often used to create alliances to enter new markets or expand business operations while sharing risks and expertise with other investors. Joint ventures are not limited by the type or legal form of the entity and can be formed as corporations, partnerships, and limited liability companies. The most distinctive characteristic of a joint venture is the concept of joint control. Refer to EM 6 for discussion around identifying and accounting for a joint venture.

1.3.5 *Trusts that maintain specific ownership accounts*

Other entities, such as trusts, can take a variety of forms, and may maintain specific ownership accounts. When evaluating investments in these entities, it is often appropriate to analogize to the guidance for limited liability companies (EM 1.3.3) to determine what level of ownership requires the use of the equity method of accounting. Investors should consider all relevant facts and circumstances.

1.3.6 *Investments in tax credit entities (after adoption of ASU 2023-02)*

New guidance

In March 2023, the FASB issued ASU 2023-02, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for investments in tax credit structures using the proportional amortization method*. The new guidance expands the use of the proportional amortization method of accounting (PAM) for investments in tax credit vehicles, which historically was only allowed for qualifying investments in affordable housing tax credit structures.

ASU 2023-02 is effective for public entities for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2024. Early adoption is permitted.

Companies, particularly financial institutions, may invest in limited partnerships or limited liability companies that generate various tax credits, such as those for qualified affordable housing projects, new markets, or renewable energy such as solar or wind. These investors earn federal tax credits as the principal return for providing capital to facilitate the development, construction, and/or rehabilitation of qualified projects.

Under ASC 323-740, investors in these entities may be eligible, subject to meeting a number of criteria, to elect to apply the proportional amortization method rather than the equity method of accounting. Under the proportional amortization method, investors amortize the cost of their investment as a component of income taxes in the income statement. See TX 3.3.6 for further information on these criteria and the application of the proportional amortization method.

To be eligible for the election, one of the criteria is that the investor cannot have the ability to exercise significant influence over the operating and financial policies of the underlying project. This is evaluated using the indicators of significant influence for determining eligibility for the equity method of accounting (see EM 2.2). The guidance in EM 2.1 includes certain ownership levels at which it is presumed that the equity method should be applied to limited partnerships and similar entities. That guidance should not be considered when determining if significant influence exists for the purpose of this analysis. Companies should evaluate the existence of significant influence for these entities, as the organizational and operating documents for the entities may provide investors with various rights.

Investors that do not qualify for PAM (or do not elect to apply it for a particular type of tax credit program) would account for their equity investments in these entities under either ASC 323 or ASC 321 depending on the facts and circumstances (see EM 1.3.2 on limited partnerships and EM 1.3.3 on LLCs), or under ASC 310 if the investment represents a loan. When accounting for investments in tax credit entities under the equity method, the hypothetical liquidation at book value method would typically be used. See EM 4.1.4.

1.3.6A *Investments in low-income housing tax credit partnerships (before adoption of ASU 2023-02)*

Companies, particularly financial institutions, may invest in limited partnerships or limited liability companies that operate qualified affordable housing projects or invest in entities that operate qualified affordable housing projects. These investors earn federal tax credits as the principal return for providing capital to facilitate the development, construction, and rehabilitation of low-income rental property. Per ASC 323-740, investors in these entities may be eligible, subject to meeting a number of criteria, to elect to apply the proportional amortization method rather than the equity method of accounting. Under the proportional amortization method, investors amortize the cost of their investment as a component of income taxes in the income statement. See TX 3.3.6 for additional information.

To be eligible for the election, one of the criteria is that the investor cannot have the ability to exercise significant influence over the operating and financial policies of the entity. This is evaluated using the indicators of significant influence for determining eligibility for the equity method of accounting (see EM 2.2). The guidance in EM 2.1 includes certain ownership levels at which it is presumed that the equity method should be applied to limited partnerships and similar entities. That guidance should not be considered when determining if significant influence exists for the purpose of this analysis. Therefore, care should be taken when evaluating the existence of significant influence for these entities.

Investors that do not qualify for the proportional amortization method (or do not elect to apply it) would account for their investments in these partnerships under the equity method if the investor has a more than minor interest in the investee. When accounting for investments in low-income housing tax credit partnerships under the equity method, the hypothetical liquidation at book value model would typically be used. See EM 4.1.4.

For guidance related to accounting for investments in tax credit entities after adoption of ASU 2023-02, refer to EM 1.3.6.

1.4 Investments for which the equity method is not applicable

The equity method of accounting does not apply for certain investments as detailed in ASC 323.

ASC 323-10-15-4

The guidance in this Topic does not apply to any of the following:

- a. An investment accounted for in accordance with Subtopic 815-10
- b. An investment in common stock held by a nonbusiness entity, such as an estate, trust, or individual
- c. An investment in common stock within the scope of Topic 810
- d. Except as discussed in paragraph 946-323-45-2, an investment held by an investment company within the scope of Topic 946.

ASC 323-30-15-4

This Subtopic does not provide guidance for investments in limited liability companies that are required to be accounted for as debt securities pursuant to paragraph 860-20-35-2.

Certain investments scoped out of the equity method guidance are discussed in the following sections. Additionally, equity method is not applied when the fair value option is elected or when the proportionate consolidation method is used.

1.4.1 Investments in common stock held by a nonbusiness entity

Nonbusiness entities, such as an estate, trust, or an individual, are not required to account for their investments in common stock under the equity method of accounting even if they are able to exercise significant influence over the financial and operating policies of the investee. A nonbusiness entity is not precluded from the use of the equity method if it has significant influence. Rather, this exemption recognizes the diverse nature of nonbusiness entities and that the use of fair value or the measurement alternative to recognize these investments may better present the financial position and changes in financial position of such entities. Nonbusiness entities should consider applying the equity method of accounting to investments held for long-term operating purposes. However, nonbusiness entities generally would not use the equity method of accounting to account for portfolio investments.

Real estate investment trusts (REITs) are considered to have business activities, typically by earning income through real estate loans and investments, and therefore do not qualify for the nonbusiness entity exception. As a result, investments held by REITs should be analyzed to determine if the equity method of accounting should be applied.

1.4.2 Investments in common stock within the scope of ASC 810

An investment in common stock that represents a controlling financial interest should be consolidated pursuant to ASC 810, *Consolidation*. It would not be appropriate for a reporting entity preparing consolidated financial statements to account for an investment in common stock that represents a controlling financial interest under the equity method of accounting. See CG 1.3 for an overview of the accounting for investments that represent a controlling financial interest under the VIE and VOE consolidation models.

1.4.3 Investment in common stock held by an investment company

An investment held by an investment company, as defined in ASC 946, is required to be accounted for at fair value, except as described below. Therefore, use of the equity method of accounting by an investment company is not appropriate, regardless of whether or not the investment company has the ability to exercise significant influence over the investee.

The one exception to this general principle is when an investment company has an investment in an operating entity that provides services to the investment company, such as investment advisory or transfer agent services. The purpose of this type of investment is to provide services to the investment company and not to realize a gain on the sale of the investment. These types of investments should be accounted for under the equity method of accounting (not at fair value), provided that the investment otherwise qualifies for use of the equity method.

1.4.4 Investments in LLCs accounted for as debt securities

An investor may have significant influence over the operating and financial policies of an investee, but if the investment does not qualify as common stock or in-substance common stock, the application of the equity method would not be appropriate. Per ASC 860-20, investments in limited liability companies that can be contractually prepaid or settled in a way that the investor would not recover substantially all of its recorded investment are accounted for as debt securities under ASC 320. These types of securities are outside the scope of the equity method.

1.4.5 Equity investments for which the fair value option is elected

ASC 825 permits reporting entities to choose to elect the fair value option at specified election dates and measure eligible items at fair value.

Excerpt from ASC 825-10-15-4

All entities may elect the fair value option for any of the following eligible items:

- a. A recognized financial asset and financial liability...

Equity method investments are financial assets and are generally eligible for the fair value option under ASC 825-10. However, if the investor's interest includes a significant compensatory element (e.g., a performance incentive interest embedded as part of a general partner's equity interest) and no bifurcation of the compensatory element is required, the investor is precluded from electing the fair value option for its equity investment. For example, if an equity investment included a substantive obligation for the investor to provide services to the investee, the election of the fair value option

would not be appropriate as it could result in the acceleration of revenue that should be earned when future services are provided to the investee.

An investor electing to adopt the fair value option for any of its equity method investments is required to present those equity method investments at fair value at each reporting period, with changes in fair value reported in the income statement. In addition, certain disclosures are required in the investor's financial statements when it has elected the fair value option for an investment that otherwise would be accounted for under the equity method of accounting. See FSP 20.6.3.2 for these disclosure requirements.

An investor can generally elect the fair value option for a single eligible investment without needing to elect the fair value option for identical types of investments in other entities. That is, an instrument-by-instrument election is permitted. However, when an investor elects the fair value option for a specific investment, it must apply the fair value option to all of its eligible interests in the same entity (e.g., all tranches of equity, debt investments, guarantees).

The fair value option can be elected when an investment becomes subject to the equity method of accounting for the first time. For example, an investment may become subject to the equity method of accounting for the first time when an investor obtains significant influence by acquiring an additional investment in an investee or when an investor loses control of an investee, but retains an interest that provides it with the ability to exercise significant influence.

The election of the fair value option is irrevocable, unless an event creating a new election date occurs. Therefore, absent a qualifying event, a reporting entity that elects to adopt the fair value option to account for an equity method investment is precluded from subsequently applying the equity method of accounting to that investment. An investor that elects the fair value option and subsequently loses the ability to exercise significant influence would be required to continue to account for its retained interest on a fair value basis (i.e., the retained investment would not be eligible to be accounted for pursuant to other GAAP, such as the measurement alternative under ASC 321). See FV 5.4.2 for further information on qualifying election dates.

1.4.6 *The proportionate consolidation method*

Proportionate consolidation is appropriate only in limited circumstances. There is a longstanding practice in the construction and extractive industries of investors displaying investments in separate unincorporated legal entities (versus an investment in an incorporated entity or an undivided interest in the separate assets and liabilities) accounted for using the equity method of accounting on a proportionate gross basis, such that the investor's financial statements reflect the investor's pro rata share of each of the venture's assets, liabilities, revenues, and expenses (rather than the one-line treatment) consistent with the guidance in ASC 810-10-45-14. See CG 8.4 for further details.

Chapter 2:
***Ability to exercise significant
influence—updated March
2024***

2.1 Significant influence presumption

An investor should generally apply the equity method of accounting for investments in common stock or in-substance common stock of corporations when the investor does not control but has the ability to exercise significant influence over the operating and financial policies of the investee.

The significant influence determination requires evaluation of the related facts and circumstances for each investment and should be assessed on an ongoing basis. Therefore, an investor's initial conclusion regarding significant influence may change. For example, an investee that files for bankruptcy or becomes subject to significant exchange restrictions or other government controls may cast doubt on an investor's ability to exercise significant influence. This could result in a change in the investor's conclusion regarding its ability to exercise significant influence.

In addition, the ability to exercise significant influence over an investee is different from the ability to control an investee. Multiple investors may have the ability to exercise significant influence over the operating and financial policies of an investee, even in instances when there is one investor with a controlling financial interest that consolidates the investee.

The voting percentage that is presumed to provide an investor with the required level of influence necessary to apply the equity method of accounting varies depending on the nature of the investee (e.g., corporation, partnership). Figure EM 2-1 summarizes voting percentages by type of investee. These are general guidelines and not bright lines (for example, the difference between a 20% voting interest in common stock and a 19.9% voting interest would not be considered substantive).

Figure EM 2-1

Voting percentages generally presumed to demonstrate significant influence

Investment in:	Investor does not own a controlling financial interest, but owns:	Discussed in:
Common stock	20% or more of the outstanding voting securities	EM 1.2, EM 2.1.1
In-substance common stock	20% or more of the outstanding voting securities	EM 1.2.1, EM 2.1.1
General partnership interest in a partnership	Any noncontrolling financial interest	EM 1.3.1, EM 2.1.2
Limited partnership or unincorporated joint venture	3-5% or more of a limited partnership or other interest ¹	EM 1.3.2, EM 2.1.2
Limited liability company or partnership that does not maintain specific ownership accounts for each investor (similar to a corporation)	20% or more of the outstanding voting securities	EM 1.3.3, EM 2.1.1

Investment in:	Investor does not own a controlling financial interest, but owns:	Discussed in:
Limited liability company or partnership that maintains a specific ownership account for each investor (similar to a limited partnership)	3-5% or more of the outstanding voting securities ¹	EM 1.3.3, EM 2.1.2

¹Equity method accounting for interests in limited partnerships is generally appropriate unless the interest is so minor that the investor has virtually no influence (less than 3%). See EM 2.1.2.

2.1.1 *Investments in voting common stock or in-substance common stock*

The presumption of significant influence is based on ownership of outstanding securities whose holders have current, not potential, voting privileges. An investor would generally disregard potential voting privileges that may become available in the future (e.g., call options or convertible instruments). Also, an investor must consider voting privileges attached to all classes of common stock, preferred stock, and debentures of the investee. For example, some convertible investments may allow investors to vote on an as-converted basis. Others may not permit exercise of voting rights until conversion to common stock. In the second example, those voting rights would not be considered in assessing the presumption of significant influence as they are not currently exercisable. See CG 7.2.3 for further information regarding consideration of potential voting privileges.

While significant influence is presumed to exist for investments of 20% or more of the investee's outstanding voting common stock, this can be overcome if there is predominant contrary evidence. These factors are discussed in EM 2.3. Additionally, an investment of less than 20% of the voting common stock of an investee, in combination with other indicators (e.g., board representation), could also provide the investor with the ability to exercise significant influence. See EM 2.2 for further information.

An investor might be relatively passive and still have the ability to exercise significant influence over an investee's operating and financial policies. That is, an investor does not need to actively exercise and demonstrate such ability. Therefore, it is not appropriate for an investor with an ownership interest of greater than 20% of the outstanding voting securities of an investee to overcome the significant influence presumption solely on the basis that it (1) has not historically exercised influence, and (2) does not intend to influence the investee in the future.

2.1.2 *Considerations for limited partnerships and similar entities*

Investments in limited partnerships and similar entities (e.g., a limited liability company that maintains a specific ownership account for each investor) should generally be accounted for under the equity method of accounting unless the investment is so minor that the limited partner has virtually no influence over the partnership's operating and financial policies. In practice, investments exceeding 3 to 5% are viewed as more than minor. This threshold is different than the level applied for an investment in a corporation (see EM 2.1.1).

Excerpt from ASC 323-30-S99-1

The SEC staff's position on the application of the equity method to investments in limited partnerships is that investments in all limited partnerships should be accounted for pursuant to paragraph 970-323-25-6. That guidance requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor.

The use of the equity method may be applied in situations when an investor has a less than 3% investment in an entity that maintains separate ownership accounts for each investor based on facts and circumstances.

Investments in a limited liability company that does not maintain specific ownership accounts for each investor (see EM 1.3.3) should be assessed under the guidance discussed in EM 2.1.1 for common stock and in-substance common stock.

A general partnership interest should be accounted for under the equity method of accounting unless the investor has a controlling financial interest and is required to consolidate.

2.1.3 Direct and indirect investments

When determining significant influence, investors must consider both direct and indirect investments (i.e., those that may be held by its other investees) in an investee.

Example EM 2-1, Example EM 2-2, Example EM 2-3, Example EM 2-4, Example EM 2-5, and Example EM 2-6 illustrate the consideration of direct and indirect investments held by an investor.

EXAMPLE EM 2-1**Investment in each tier qualifies for equity method accounting**

Company A owns a 20% voting common stock interest in Company B. Company B owns a 20% voting common stock interest in Company C. Therefore, Company A indirectly owns 4% of Company C. No contrary evidence exists to overcome the presumption that Company A has significant influence over Company B and that Company B has significant influence over Company C. All investors and investees are corporate entities.



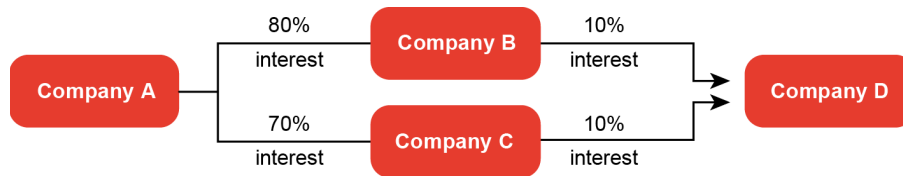
How should Company A and Company B account for their investments?

Analysis

Company B should account for its investment in Company C pursuant to the equity method of accounting. Company A should account for its investment in Company B pursuant to the equity method of accounting. Company B would record its proportionate share of the earnings or losses of Company C in its financial statements before Company A records its proportionate share of the earnings or losses of Company B in its financial statements.

EXAMPLE EM 2-2**Investment qualifies for equity method accounting through ownership by commonly controlled investors**

Company A owns an 80% voting common stock interest in Company B and a 70% voting common stock interest in Company C. Company B and Company C each own a 10% voting interest in Company D. Company A's investments in Company B and Company C represent controlling financial interests. Therefore, Company A consolidates Company B and Company C. All investors and investees are corporate entities.



How should Company A account for its interest in Company D?

Analysis

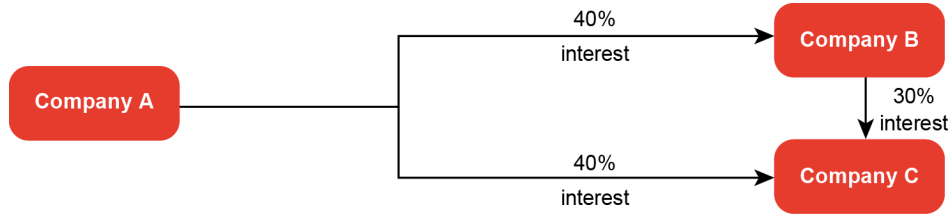
Company A's economic interest in Company D is 15%: an 8% interest through its controlling financial interest in Company B ($80\% \times 10\%$) and a 7% interest through its controlling financial interest in Company C ($70\% \times 10\%$). However, because Company A controls both Company B and Company C, Company A would not limit its indirect investment in Company D due to the partial ownership. Instead, it would be considered to have a 20% voting interest in Company D (10% through its control of Company B and 10% through its control of Company C).

Therefore, Company A's indirect ownership interest in Company D, absent evidence to the contrary, is presumed to provide it with the ability to exercise significant influence over Company D. Therefore, if the presumption is not overcome, Company A should account for its investment in Company D under the equity method of accounting.

In their standalone financial statements, Company B and Company C would separately evaluate whether they have the ability to exercise significant influence over Company D. Given their parent (Company A) controls 20% of Company D's voting stock, Company B and C would generally conclude in their separate financial statements that they have significant influence over Company D.

EXAMPLE EM 2-3**Equity method accounting despite majority interest through direct and indirect interests**

Company A owns a 40% voting common stock interest in each of Company B and Company C. Company B also owns a 30% voting common stock interest in Company C. The remaining interests in Company B and Company C are widely held by other investors and there are no other agreements that affect the voting or management structures of Company B and Company C. All investors and investees are corporate entities. Company C is not a VIE.



How should Company A account for its direct and indirect interests in Company C?

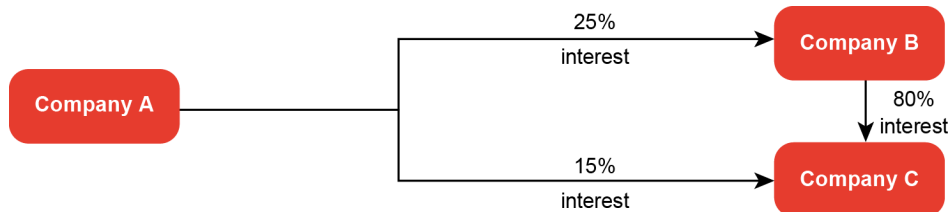
Analysis

As there are no other agreements that affect the voting or management structures of Company B and Company C, Company A's interest in Company B is not sufficient to direct the actions of Company B's management. This includes how Company B should vote its 30% interest in Company C. Therefore, despite its 52% economic interest in Company C (40% direct interest, plus its 12% indirect interest through Company B (40% * 30%)), Company A would not consolidate Company C in its financial statements. Instead, Company A would account for its investment in Company C under the equity method of accounting.

EXAMPLE EM 2-4

Investment in investee and direct investment in investee's consolidated subsidiary

Company A owns a 25% voting common stock interest in Company B, which is accounted for under the equity method of accounting. Company A also owns a 15% voting common stock interest in Company C. Company B owns an 80% voting common stock interest in Company C, which provides Company B with a controlling financial interest; therefore, Company B consolidates Company C. All investors and investees are corporate entities.



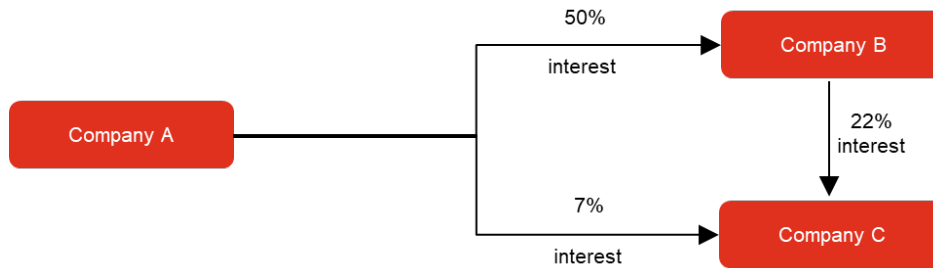
How should Company A account for its direct interest in Company C?

Analysis

Company A has the ability to exercise significant influence over Company B. Company B has control over Company C; therefore, through its ability to exercise significant influence over Company B, Company A also has the ability to exercise significant influence over Company C, despite only having a 15% direct interest. As such, Company A should account for its direct investment in Company C under the equity method of accounting.

EXAMPLE EM 2-5**Equity method accounting through direct and indirect interests**

Company A owns 50% of the voting common stock of Company B and applies the equity method of accounting since it has significant influence over Company B. Company B owns 22% of the voting common stock of Company C and applies the equity method of accounting since it has significant influence over Company C. Company A owns (directly) 7% of the voting common stock of Company C. All investors and investees are corporate entities.



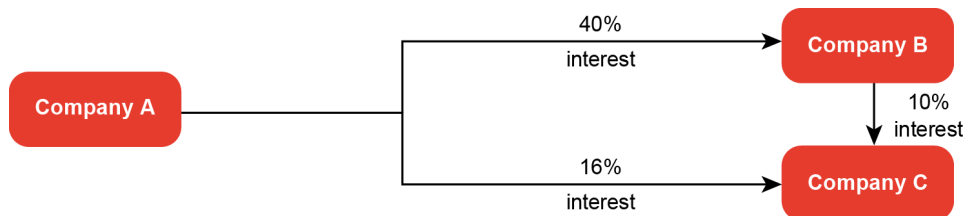
How should Company A account for its direct investment in Company C?

Analysis

Company A's economic interest in Company C is 18% (7% direct interest plus its 11% indirect interest (50% * 22%)). Given that Company A has the ability to exercise significant influence over the operating and financial policies of Company B (including Company B's investment in Company C), Company A would apply the equity method of accounting to its 7% direct investment in Company C.

EXAMPLE EM 2-6**Investment may not qualify for equity method of accounting despite an economic interest of 20%**

Company A owns a 40% voting common stock interest in Company B, which is accounted for under the equity method of accounting. Company A also owns a 16% voting common stock interest in Company C. Company B owns a 10% voting common stock interest in Company C. Individually, Company A and Company B are not able to exercise significant influence over the operating and financial policies of Company C. All investors and investees are corporate entities.



How should Company A account for its direct and indirect interests in Company C?

Analysis

Company A's economic interest in Company C is 20% (16% direct interest, plus its 4% indirect interest (40% * 10%)). As neither Company A nor Company B have the ability to exercise significant influence over the operating and financial policies of Company C individually, Company A's 20% economic interest in Company C is not, in and of itself, sufficient to indicate that it has the ability to exercise significant influence over Company C. Absent other factors that indicate that Company A has the ability to exercise significant influence over Company C (e.g., Company A having representation on Company C's board), the equity method of accounting would not be appropriate for Company A's investment in Company C.

2.2 Other indicators of significant influence

The determination of significant influence is not limited to the evaluation of voting interests and the level of ownership interest an investor holds. An investor must consider all relationships and interests (voting and nonvoting) in an investee, including any means through which the investor might influence the operating and financial policies of an investee. Examples include board representation, veto rights, or participating rights conveyed by a security other than voting common stock. An investor should also consider the capitalization structure of the investee, how significant its investment is to the investee's capitalization, and the rights and preferences of other investors.

ASC 323-10-15-6 provides a list of indicators that investors should consider when evaluating whether or not it has the ability to exercise significant influence over the operating and financial policies of an investee.

ASC 323-10-15-6

Ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

- a. Representation on the board of directors
- b. Participation in policy-making processes
- c. Material intra-entity transactions
- d. Interchange of managerial personnel
- e. Technological dependency
- f. Extent of ownership by an investor in relation to the concentration of other shareholdings (but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor).

The list of factors in ASC 323-10-15-6 is not all-inclusive, and the determination of whether other factors provide an investor with the ability to exercise significant influence over the financial and operating policies of an investee requires significant judgment and consideration of all relevant facts and circumstances.

2.2.1 Representation on the board of directors

An investor that has representation on the board of directors can influence the operating and financial policies of an investee through its presence and participation at the board of directors meetings. An investor may conclude that the combination of board representation, with a less than 20% investment in the voting common stock of an investee, may result in significant influence. Specific consideration should be given to board representation that is disproportionate to an investor's ownership interest in the voting securities of the investee. Additionally, consideration should be given to the number of board seats relative to the total size of the board (e.g., holding one seat on a smaller board of five may be more indicative of significant influence than holding one seat on a larger board of 20) as well as the circumstances under which the board seats are obtained (e.g., a guaranteed seat specified through a contractual agreement may be more representative of significant influence than a seat voted by general shareholder election). Example EM 2-7 illustrates how significant influence may be demonstrated through representation on the board of directors.

EXAMPLE EM 2-7

Representation on the board of directors

Investor has a 19.5% ownership interest in the voting common stock of Investee. Investor also holds one of five seats on Investee's board of directors. There are no other indicators that Investor has the ability to exercise significant influence over the operating and financial policies of Investee.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

Investor is likely to conclude that the combination of its voting common stock ownership interest and its representation on the board of directors provides it with the ability to exercise significant influence over the operating and financial policies of Investee. Careful consideration should be given whenever an investor has an ownership interest of less than 20% and investee board representation. The number of representatives and the size of the board are important considerations when determining whether the equity method of accounting is appropriate.

2.2.2 Participation in policy-making processes

An investor should evaluate its ability to participate in the operating and financial decision making of the investee through voting rights, veto rights, or other participating rights or arrangements. For example, in some cases, investors attend board of directors meetings in an "observer" capacity. While observers usually do not vote with the board, attendance alone may provide the investor with the ability to exercise influence as the investor is able to obtain confidential materials and participate in discussions at the board meetings. Therefore, investors should evaluate whether an observer seat at board of directors meetings provide it with the ability to exercise significant influence. Example EM 2-8 illustrates how participation in policy-making processes should be considered in assessing significant influence.

EXAMPLE EM 2-8

Significant influence consideration of observer seat on the board of directors

Investor owns a less than 20% ownership interest in the voting common stock of Investee. Investor also has an observer seat on the board of directors. There are no other indicators that Investor has the ability to exercise significant influence over the operating and financial policies of Investee.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

Investor's observer seat on the board of directors usually provides an investor with the ability to exercise some level of influence over policy making. As such, Investor should consider whether the combination of its voting common stock ownership interest and its observer seat on the board of directors provide it with the ability to exercise significant influence.

2.2.3 *Material intra-entity transactions*

An investor may enter into material transactions with an investee that may provide the investor with the ability to exercise significant influence. The related facts and circumstances should be evaluated. For example, routine intra-entity transactions, such as purchases and sales of non-specialized inventory (e.g., commodity inventories), may not provide an investor with the ability to exercise significant influence, even if those transactions are material. However, the sale or purchase of highly specialized goods or services may provide the investor with significant influence. Consideration should be given to the investee's ability to source goods or services from alternative providers, considering any significant cost barriers associated with such alternatives. Additionally, when evaluating transactions involving sales from the investee to the investor, consider both the volume of sales as well as the concentration of customers when determining whether the transaction provides the investor with significant influence.

2.2.4 *Interchange of managerial personnel*

Key members of management at an investor may serve in significant management roles (e.g., CEO, CFO) at the investee level. Investor employees serving in such roles at the investee level may provide an investor with the ability to exercise significant influence over the operating and financial policies of the investee. However, consideration should be given to the level of responsibilities of the employees as well as potential oversight and control by the investee board of directors (while considering any common directors with the investor board of directors).

2.2.5 *Technological dependency*

An investee may be technologically dependent upon an investor in the operation of its business. This technological dependence may provide the investor with the ability to exercise significant influence, even if the investor's ownership interest in the voting common stock of investee is less than 20%. Additionally, the nature of the technology should be considered. For instance, a time-limited license rather than a perpetual one gives the investor the discretion to choose not to renew the license and may serve as an indication that the investor has significant influence compared to a scenario in which

the investee holds a perpetual license for the same technology. Example EM 2-9 illustrates how significant influence may be demonstrated through technological dependency.

EXAMPLE EM 2-9

Significant influence consideration of technological dependency

Investor owns a less than 20% voting interest in Investee. Investee's operations are dependent upon a type of technology that is licensed to it by Investor for a 5-year term. Investee could license similar technology from a small number of other companies. However, Investee would incur significant termination fees, higher licensing fees, and significant effort to incorporate the alternative technology into its operations.

Does Investor have the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

Investor should consider whether the combination of its voting interest and its licensing agreement provides it with the ability to exercise significant influence over the operating and financial policies of Investee. Investee is dependent upon Investor's technology and would have to incur significant costs and effort to choose an alternative technology supplier. Additionally, in this particular case, the license is not perpetual; it has a duration of 5 years, affording Investor the option to decline renewal. Therefore, Investor may have significant influence over Investee through a combination of its equity interest and licensing agreement.

2.2.6 Ownership in relation to the concentration of other shareholdings

An investor should consider the extent of its ownership interest in an investee in relation to the ownership interests held by other investors. There may be a few investors, each with significant voting interests in an investee or interests in an investee may be more widely held, with no single investor holding a significant voting interest.

An investor that holds a substantial or majority ownership interest in the voting stock of an investee does not preclude another investor from having the ability to exercise significant influence. For example, absent predominant evidence to the contrary (see EM 2.3), an investor that owns a 25% voting interest in an investee is presumed to have the ability to exercise significant influence, even if a single investor owns the remaining 75% voting interest in the investee.

An investor that holds a less than 20% voting interest may be able to demonstrate significant influence in a widely-held investee when all other investors, individually, have substantially smaller ownership interests. Judgment will need to be applied.

2.3 Predominant evidence to the contrary

As discussed in EM 2.1, there's a presumption that an investor has the ability to exercise significant influence when it owns (directly or indirectly) 20% or more of the outstanding voting common stock or in-substance common stock of an investee. However, ASC 323-10-15-10 provides a list of indicators

(not all-inclusive) that an investor may be unable to exercise significant influence, despite an ownership interest of greater than 20% of the outstanding voting common stock.

ASC 323-10-15-10

Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary. Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

- a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.
- b. The investor and investee sign an agreement (such as a standstill agreement) under which the investor surrenders significant rights as a shareholder. (Under a standstill agreement, the investor usually agrees not to increase its current holdings. Those agreements are commonly used to compromise disputes if an investee is fighting against a takeover attempt or an increase in an investor's percentage ownership. Depending on their provisions, the agreements may modify an investor's rights or may increase certain rights and restrict others compared with the situation of an investor without such an agreement.)
- c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.
- d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
- e. The investor tries and fails to obtain representation on the investee's board of directors.

ASC 323-10-15-11

The list in the preceding paragraph is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies.

However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

There are other indicators that may provide predominant evidence to overcome the presumption of significant influence. For example, if an investor owns a 20% interest in a foreign investee that operates in a country that has imposed exchange restrictions or in a market that creates other significant uncertainties, the investor may not be able to exercise significant influence.

Additionally, no individual circumstance is necessarily conclusive that an investor is unable to exercise significant influence over an investee's operating and financial policies. As stated in ASC 323-10-15, predominant evidence is necessary to overcome the presumption of significant influence. An evaluation of all related facts and circumstances is required.

Example EM 2-10 and Example EM 2-11 illustrate the evaluation of whether contrary evidence exists to overcome the presumption of an investor's ability to exercise significant influence over the operating and financial policies of an investee.

EXAMPLE EM 2-10

Contrary evidence not sufficient to overcome presumption

Investor owns a 25% voting interest in Investee. Investor is a passive investor and has not exercised its ability to influence the operating and financial policies of Investee in the past. Further, Investor does not intend to influence the operating and financial policies of Investee in the future. No other contrary evidence exists to overcome the presumption of significant influence.

Is there predominant evidence to the contrary to overcome the presumption that Investor has the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

The fact that Investor (1) has not exercised its ability to influence Investee in the past and (2) does not intend to influence Investee in the future is not considered contrary evidence to overcome the presumption that Investor has the ability to exercise significant influence.

EXAMPLE EM 2-11

Contrary evidence exists to overcome presumption

Investor owns a 20% voting interest in Investee. The majority ownership of Investee is concentrated among a small group of shareholders who operate Investee without regard to the views of Investor. Investor has tried unsuccessfully to obtain representation on Investee's board of directors. Investee has actively and publicly resisted the exercise of influence by Investor.

Is there sufficient evidence to the contrary to overcome the presumption that Investor has the ability to exercise significant influence over the operating and financial policies of Investee?

Analysis

Investor may be able to conclude that there is predominant evidence to overcome the presumption that it has the ability to exercise significant influence as a result of (1) the small group of shareholders that own a majority ownership interest in Investee and operate Investee without regard to the views of Investor, (2) Investor's failed attempts to obtain representation on Investee's board of directors, and (3) Investee's active and public resistance to the exercise of influence by Investor. Investor should evaluate all other facts and circumstances relating to the investment.

***Chapter 3:
Initial measurement of equity
method investments—updated
February 2023***

3.1 Overview of the initial measurement of equity method investments

A reporting entity will initially measure and recognize its equity method investment using a cost accumulation model, following the asset acquisition guidance in ASC 805-50-30. The investment should be presented on the investor's balance sheet as a single amount, as described in FSP 10.3.

The investor's cost of the investment will generally differ from the investor's proportionate share of the net assets of the investee. More specifically, the investor's initial carrying amount will reflect its cost to acquire the investment, while the investee continues to carry the underlying assets and liabilities based on its historical application of GAAP. Therefore, to properly account for its investment, an investor will need to determine and track the difference between its own carrying amount in the underlying assets and liabilities, and those of the investee, commonly referred to as basis differences.

An investor's previously held ownership percentage in an investee may change. Alternatively, an investor may be required to apply the equity method to a previously owned investment even when its percentage ownership interest does not change, such as when it gains significant influence. See EM 5 for a discussion of how to apply the equity method when an investor had a prior interest in the investee.

3.2 Initial measurement of equity method investment

When an investor acquires an equity method investment for a fixed amount of cash, the cost of the investment is straightforward and reflects the cash transferred to the seller in return for the equity method investment, as described in ASC 323-10-30-2. Often, however, a transaction includes transaction costs, contingent consideration, or other items that warrant further consideration to determine the cost of the investment, as described in the following subsections.

When cash is used to acquire an equity method investment, the investor should recognize the equity method investment at the point at which it acquires both (1) the common stock (or in-substance common stock), as discussed in EM 1.2 and (2) the ability to exercise significant influence, as discussed in EM 2.

When noncash consideration is used to acquire an equity method investment, the investor should evaluate what it transferred to the seller, or contributed to the investee, in return for its interest in order to determine the point at which the equity method investment should be recognized, as further described in EM 3.2.4.

3.2.1 Transaction costs to obtain an equity method investment

The initial measurement of an equity method investment should include the cost of the investment itself and all direct transaction costs incurred by the investor in order to acquire the investment.

Direct transaction costs are generally out-of-pocket costs directly associated with the acquisition of an investment and paid to third parties. Examples of direct transaction costs include appraisal fees (e.g., fees paid to third party valuation specialist to assist management in determining whether to invest in an investee and to determine its fair value), legal and consulting fees (e.g., fees paid to external legal counsel to draft and review investment agreements in order to consummate the transaction), and finder's fees (e.g., fees paid to a broker to identify and facilitate the acquisition of an interest in the

investee). All costs that are not directly associated with the acquisition of an investment, including all internal costs, should be expensed as incurred. Costs associated with financing the acquisition, such as debt or equity issuance costs, would not be considered direct costs and would be accounted for in accordance with other applicable guidance. See FG 1.2.2 and FG 7.4.2.

Costs incurred by the investor on behalf of the investee may not be part of the cost of the investment. See EM 4.3.7 for a discussion of stock compensation costs that should be viewed as those of the investee.

The treatment of transaction costs incurred in connection with the acquisition of an equity method investment is different than the treatment of such costs incurred in connection with the acquisition of a business, which are required to be expensed as incurred pursuant to ASC 805. See BCG 2 for further information regarding business combinations.

3.2.2 Contingent consideration

In some situations, an investor and the seller of an equity interest may be unable to agree on the value of the investee, and therefore tie a portion of the consideration to future events or conditions. Contingent consideration represents an obligation of the investor to transfer additional cash, noncash assets, or equity interests to the selling shareholders if future events occur or conditions are met.

If contingent consideration is recognized by the investor, it will increase the carrying amount of the equity method investment, and result in the recognition of an obligation.

Contingent consideration should only be recognized when:

- a) recognition is required by specific authoritative guidance other than ASC 805, or
- b) the fair value of the investor's share of the investee's net assets exceeds the investor's initial cost.

The contingent consideration guidance for an equity method investment is described in ASC 323 and the following subsections, and is different from the contingent consideration guidance for business combinations (see BCG 2).

ASC 323-10-25-2A

If an equity method investment agreement involves a contingent consideration arrangement in which the fair value of the investor's share of the investee's net assets exceeds the investor's initial cost, a liability shall be recognized.

ASC 323-10-30-2A

Contingent consideration shall only be included in the initial measurement of an equity method investment if it is required to be recognized by specific authoritative guidance other than Topic 805.

ASC 323-10-30-2B

A liability recognized under paragraph 323-10-25-2A shall be measured initially at an amount equal to the lesser of the following:

- (a) The maximum amount of contingent consideration not otherwise recognized

- (b) The excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

3.2.2.1 **Contingent consideration recognized under other guidance**

If contingent consideration is required to be recognized by specific authoritative guidance other than ASC 805 (e.g., ASC 480, *Distinguishing Liabilities from Equity*, ASC 450, *Contingencies*, ASC 610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*, or ASC 815, *Derivatives and hedging*), it should be recognized in accordance with that guidance and recorded as part of the cost of the equity method investment.

If the contingent consideration is a derivative within the scope of ASC 815, it would be initially recorded at fair value, which would be included in the carrying amount of the equity method investment. The derivative would, however, represent a separate unit of account from the equity method investment. Accordingly, subsequent changes in the fair value of the derivative should be recorded in the income statement and not as an increase or decrease to the carrying amount of the equity method investment. See DH 2 for the characteristics of a derivative instrument.

Example EM 3-1 illustrates the accounting for contingent consideration that meets the definition of a derivative.

EXAMPLE EM 3-1

Contingent consideration recognized pursuant to ASC 815

Investor acquired a 20% interest in the voting common stock of Investee for cash consideration of \$100 and a contingent consideration arrangement meeting the definition of a derivative with a fair value of \$10. Investor's interest in Investee provides it with the ability to exercise significant influence over the operating and financial policies of Investee. Therefore, Investor accounts for its investment in Investee pursuant to the equity method of accounting.

At what amount should Investor's investment in the common stock of Investee be measured on the date of acquisition?

Analysis

The contingent consideration arrangement is required to be recognized pursuant to ASC 815. Therefore, the initial cost of Investor's investment should be measured at \$110 (\$100 (cash consideration) plus \$10 (fair value of derivative)). Subsequent changes in the fair value of the contingent consideration would be accounted for pursuant to ASC 815 and would not affect the carrying value of the equity method investment.

3.2.2.2 **Contingent consideration recognized based on fair value**

In some situations, the fair value of the investor's share of the investee's net assets is greater than its initial cost, which would include the consideration initially transferred and any contingent consideration recognized under other guidance. In these cases, ASC 323-10-30-2B requires that the investor recognize a liability equal to the lesser of the following:

- The maximum amount of contingent consideration not otherwise recognized, and
- The excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

While not explicit in the guidance, we believe that "excess of the investor's share of the investee's net assets" should be understood as the excess of the investor's share in the fair value of the investee's net assets. In determining the fair value of the investee's net assets, the investor should include only the identifiable net assets and should not consider the fair value of the overall investment, which might include implied goodwill.

If contingent consideration is recognized based on this guidance, upon resolution of the contingency, the carrying amount of the investment should be adjusted to reflect the ultimate settlement amount. Accordingly, if the consideration paid exceeds the liability initially recorded, that amount should be recognized as an additional cost of the investment. Alternatively, if the consideration paid is less than the liability initially recorded, the difference should reduce the cost of the investment.

ASC 323-10-35-14A

If a contingency is resolved relating to a liability recognized in accordance with the guidance in paragraph 323-10-25-2A and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the investment. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess shall reduce the cost of the investment.

Example EM 3-2 illustrates the recognition of contingent consideration when the fair value of the investor's share of the investee's net assets exceeds the investor's initial cost.

EXAMPLE EM 3-2

Contingent consideration when the fair value of the Investor's share of the Investee's net assets exceeds the investor's initial cost

On January 1, 20X0, Investor acquired a 20% interest in the voting common stock of Investee for cash consideration of \$100. On the date of acquisition, the fair value of Investor's share of the Investee's net assets was \$120. Investor is required to pay additional consideration of \$25 to Investee if certain performance targets are met. Contingent consideration was not required to be recorded upon acquisition pursuant to other specific authoritative guidance (e.g., ASC 450).

At what amount should Investor's investment in the common stock of Investee be measured on the date of acquisition?

Analysis

The investor should record a liability for the contingent consideration equal to the lesser of (1) the maximum amount of contingent consideration not otherwise recognized, which is \$25 and (2) the excess of the fair value of Investor's share of the Investee's net assets over the cost of Investor's investment of \$20 (\$120 – \$100).

As such, Investor should initially record its investment in the common stock of Investee at \$120 and would recognize a liability of \$20. When the contingency is resolved, the difference between the contingent consideration liability recorded at the acquisition date (i.e., \$20) and the consideration paid should be recorded as an increase or decrease to the carrying amount of the equity method investment.

3.2.3 *Guarantee issued by investor on behalf of equity method investee*

An investor may issue a guarantee to a third party on behalf of an equity method investee. In such situations, the investor should consider the guidance in ASC 460, *Guarantees*, and if applicable record a liability to reflect its obligation.

Although a parent's guarantee of its subsidiary's debt is not subject to ASC 460, as noted in ASC 460-10-25-1(g), an investor's guarantee of the debt of an equity method investee is subject to that guidance as the equity method investee is not a subsidiary.

ASC 460-10-25-4

At the inception of a guarantee, a guarantor shall recognize in its statement of financial position a liability for that guarantee. This Subsection does not prescribe a specific account for the guarantor's offsetting entry when it recognizes a liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. See paragraph 460-10-55-23 for implementation guidance.

Excerpt from ASC 460-10-55-23

Although paragraph 460-10-25-4 does not prescribe a specific account, the following illustrate a guarantor's offsetting entries when it recognizes the liability at the inception of the guarantee:

...

- a. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.

If an investor issued a guarantee in connection with the formation of the equity method investment, or provided the guarantee as part of consideration transferred to the investee in return for the shares, the guarantee should be viewed as part of the total consideration provided in return for the investment. Accordingly, the recognized guarantee would be reflected as an increase to the carrying value of the investment.

After the initial recognition of the guarantee, all subsequent accounting for the guarantee would be in accordance with ASC 460, and therefore would not impact the carrying amount of the equity method investment.

If a guarantee is issued by the investor after the formation of the equity method investment, see EM 4.5.

3.2.4 *Noncash assets used to acquire an equity method investment*

Investors may transfer noncash assets in exchange for an equity interest in an investee. The counterparty may be another investor that is selling its interest in the investee, or may be the investee itself issuing interests to the investor. For situations in which an investor had a prior interest in the investee, see EM 5.

When noncash assets are used to acquire an equity method investment, the equity method investment is recognized when the noncash assets are derecognized, which is generally once control has been transferred. Noncash assets can be either financial assets or nonfinancial assets and the determination of when control has transferred depends on the type of noncash assets transferred. When nonfinancial assets are transferred, the guidance discussed in PPE 6.2 and illustrated in Figure PPE 6-1 should be followed. When financial assets are transferred, the guidance in ASC 860 (discussed in TS 3) should be followed. If those financial assets are equity method investments, see EM 3.2.4.1.

3.2.4.1 *Exchange of an equity method investments*

ASC 860 establishes accounting and reporting standards for transfers and servicing of financial assets. Equity method investments are financial assets; therefore, transfers of equity method investments are within the scope of ASC 860 provided they meet the definition of a transfer, as defined in ASC 860.

Definition from ASC 860-10-20

Transfer: The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.

The implementation guidance in ASC 845-10-55-2 (related to nonmonetary transactions) also confirms that the exchange of one equity method investment for another equity method investment must be accounted for pursuant to the guidance in ASC 860.

Accordingly, the sale of investee shares accounted for under the equity method of accounting must meet all of the criteria in ASC 860-10-40-5 in order to qualify for derecognition and to recognize the associated gain or loss. This guidance is further explained in TS 3.

Provided the criteria are met, the full gain or loss would be recognized for the difference between the carrying amount of the equity method investment that is surrendered and the consideration received (i.e., the fair value of the equity method investment that is obtained) as described in the equity method guidance in ASC 323-10-35-35 and the transfers guidance referenced in TS 4.2.

Example EM 3-3 illustrates the accounting for an exchange of equity method investments under ASC 860.

EXAMPLE EM 3-3

Exchange of one equity method investment for another equity method investment accounted for as a sale pursuant to ASC 860

Investor A has a 20% investment in Investee, an operating company that manufactures and sells airplanes. The carrying value of Investor's A interest is \$400. Investor accounts for its investment in

Investee using the equity method. Assume no basis difference exists between Investor A's investment balance and its underlying interest in the net assets of Investee (i.e., both are \$400).

Acquiror LP, which manufactures and sells speed boats and off-road vehicles, acquires the 20% interest held by Investor A by providing Investor A with a 4% equity interest in Acquiror LP. The fair value of the 4% interest in Acquiror LP is \$2,000.

How should Investor A account for its exchange of a 20% interest in Investee for a 4% interest in Acquiror LP?

Analysis

Investor A should account for this exchange under ASC 860, and recognize a gain on the sale of its equity interest in Investee once it meets the criteria for derecognition. The gain will be \$1,600 (the difference between the \$2,000 selling price and the \$400 carrying value of the interest sold at the time of sale). Investor A's cost basis in its investment in Acquiror LP would be \$2,000. Prospectively, Investor A would account for its 4% interest in Acquiror LP under the equity method of accounting (see EM 2.1.2).

In certain circumstances, the exchange of one equity method investment for another equity method investment may in substance be a change in interest transaction (i.e., a change in the percentage ownership of one investment), and not the exchange of one investment for another. This is illustrated in Example EM 3-4, where the exchange of interests is in substance a dilution event. In such situations, the issuer (investee) is deemed to have effectively issued additional shares to other investors and the change in interest guidance discussed in EM 5.4.2.2 would be applied.

In practice, judgment must be applied in determining whether an exchange of equity method investments should be accounted for as a sale as illustrated in Example EM 3-3, or a change in interest transaction, as illustrated in Example EM 3-4.

EXAMPLE EM 3-4

Exchange of one equity method investment for another equity method investment accounted for as a change in interest transaction

Investors A, B, and C own the following interests in Investee, an operating company that manufactures and sells goods:

Shareholder	Shares	Percent ownership	Carrying value of underlying net assets
Investor A	40	40%	\$400
Investor B	30	30%	300
Investor C	30	30%	300
Total	100	100%	\$1,000

Assume no basis difference exists between Investor A's investment balance and its underlying interest in the net assets of Investee (i.e., both are \$400). Investors A, B, and C created a new company ("Newco"), which had no assets, liabilities, or operations immediately subsequent to formation. Newco issued 15 shares (15% interest) to each of Investors D and E in exchange for \$1,500. The proceeds will be used to fund Newco's operations. At the same time, Investors A, B, and C exchange their equity interests in Investee for equity interests in Newco. Investors A, B, and C receive 28, 21, and 21 shares in Newco, respectively. Immediately after these transactions, the shareholdings of Newco are as follows.

Shareholder	Shares	Percent ownership	Carrying value of underlying net assets, prior to change in interest computation	Fair value
Investor A	28	28%	\$400	\$2,800
Investor B	21	21%	300	2,100
Investor C	21	21%	300	2,100
Investor D	15	15%	1,500	1,500
Investor E	15	15%	1,500	1,500
Total	100	100%	\$4,000	\$10,000

How should Investor A account for its exchange of a 40% interest in Investee for a 28% interest in Newco?

Analysis

Newco is effectively the same business as that of Investee because Newco has no additional assets, liabilities, or operations, except for the cash paid by Investors D and E to obtain 15% ownership interests in Newco. Therefore, Investor A has an investment in the same underlying business both before and after the transaction; however, its ownership interest has been diluted by virtue of Newco's issuance of shares to Investors D and E for cash. As such, Investor A should account for this exchange as a change in interest transaction. As further explained in EM 5.4.2.2, Investor A should recognize a change in interest gain of \$720, calculated as the difference between (a) Investor A's proportionate share of Newco's new carrying value ($28\% \times \$4,000 = \$1,120$) and (2) the carrying value of Investor A's ownership interest in the Investee prior to the transaction (\$400). This would result in a gain of \$720 ($\$1,120 - \400).

Investor A's change in interest gain can also be calculated as follows:

Fair value per share	\$100.00	a
Investor A's carrying value per share	14.29	b
Excess paid over carrying value per share	85.71	
Shares issued to Investors D and E by Newco	<u>x 30</u>	
Total excess paid over carrying value	2,571	
Investor A's % ownership in Newco	<u>x 28%</u>	
Investor A's change in interest gain	\$720	

a – Investors D and E each paid \$1,500 in exchange for 15 shares, or \$100 per share.

b – Prior to Newco's issuance of shares to Investors D and E, Investor A held 28 shares of Newco with a carrying value of \$400, or \$14.29 per share.

Investor A's cost basis in its continuing investment in Newco is \$1,120 (28% of \$4,000).

3.2.5 *Purchase agreements for equity method investments*

An investor may enter into a purchase agreement to acquire an investment that will be accounted for using the equity method when the transaction closes. These arrangements are effectively forward or option contracts and are subject to ASC 321 if they do not meet the definition of a derivative under ASC 815.

When a purchase agreement is in the scope of ASC 321, an investor should account for changes in its fair value prior to closing through earnings, unless the contract qualifies for the measurement alternative and it is elected. If the measurement alternative is elected, the change in the fair value of the contract would be reflected in earnings upon closing. In addition, remeasurement of the contract to fair value if the entity observes transactions in the underlying shares or they are impaired.

When the equity method investment is acquired, any amount associated with the purchase agreement that was recognized on the balance sheet in accordance with ASC 321 should be considered part of the cost of the equity method investment and included in its carrying amount.

3.3 *Allocating the cost basis to assets and liabilities*

Although an equity method investment is presented on the balance sheet of the investor as a single amount, the underlying accounting for the investment is similar to how an entity would account for a consolidated subsidiary. That is, an investor must allocate the initial cost of its equity method investment to its proportionate share of the individual assets and liabilities of the investee.

ASC 323-10-35-13

A difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary...

ASC 323-10-35-34

The carrying amount of an investment in common stock of an investee that qualifies for the equity method of accounting as described in paragraph 323-10-15-12 may differ from the underlying equity in net assets of the investee. The difference shall affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary. However, if the investor is unable to relate the difference to specific accounts of the investee, the difference shall be recognized as goodwill and not be amortized in accordance with Topic 350.

3.3.1 Determination of basis differences

While the investor's initial carrying amount of an equity method investment will reflect its cost of the investment, the investee carries the underlying assets and liabilities utilizing its own historical cost basis. Therefore, a difference will usually exist between (a) the carrying value of the investment and (b) the investor's proportionate share of the carrying amount of the investee's net assets.

The investor should use its own cost basis in the investee, rather than the investee's basis in its own assets and liabilities to record the equity method investment.

Application of the guidance in ASC 323-10-35-13 requires that the investor account for the basis adjustments as if the subsidiary was a consolidated subsidiary in memo accounts. Accordingly, the investor must determine its cost basis in the individual assets and liabilities of the investee, including those assets and liabilities not recorded in the investee's general ledger (e.g., unrecognized intangible assets), similar to how the acquisition method is applied in a business combination. The difference between the cost of an investment and the investor's share of the net assets as recognized by the investee is generally attributable to multiple assets and liabilities of the investee.

While assets that have appreciated will have a positive basis difference (i.e., the investor's basis will be greater than that of the investee), basis differences can be either positive or negative.

As illustrated in Example EM 3-3 and Example EM 3-4, subsequent to acquisition, basis differences assigned to identified assets and liabilities will often impact earnings, with a corresponding increase or decrease to the equity investment balance.

See BCG 2 for general information on the application of the acquisition method. See EM 3.3.4 for a discussion of the deferred tax implications of these basis differences. See EM 4.3.1 for further information on the subsequent accounting for the basis differences identified.

An investor, through its ability to exercise significant influence over the investee, will generally be able to obtain sufficient financial data to determine the primary assets and liabilities giving rise to a basis difference. In the unusual circumstance when an investor is unable to do so, the inability to obtain such information from the investee must be reconciled with the conclusion that the investor has the ability to exercise significant influence over the operating and financial policies of the investee.

New guidance

In October 2021, the FASB issued ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*. The guidance requires all contract assets and contract liabilities from contracts with customers acquired in a business combination to be recognized and measured by the acquirer on the acquisition date in accordance with ASC 606, *Revenue from Contracts with Customers*. ASU 2021-08 is effective for public business entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Equity method investments are not directly within the scope of the new guidance. However, as described in ASC 323-10-35-13, when an entity acquires an equity method investment, any difference between the investor's cost basis and its share of the investee's net assets should be accounted for as if the investee were a consolidated subsidiary. In practice, that means that the investor performs an acquisition accounting-like allocation to determine its share of the underlying net assets of the investee in order to calculate its "basis differences" for subsequent recognition. We believe an investor would apply the new guidance in ASU 2021-08 when performing such calculations.

Example EM 3-5 illustrates the assignment of a positive basis difference on the date of acquisition when the positive basis difference is attributable to one asset. Example EM 3-6 illustrates the assignment of a negative basis difference on the date of acquisition when the negative basis difference is attributable to one asset. For purposes of each example, transaction costs and tax implications are ignored.

EXAMPLE EM 3-5

Accounting for a positive basis difference on the date of acquisition

Investor purchased a 40% interest in the voting common stock of Investee for \$56 million. Investor determined that it has the ability to exercise significant influence over the operating and financial policies of Investee. Therefore, Investor accounts for its interest in Investee under the equity method.

Investor engaged a third-party valuation firm to perform a fair value assessment of Investee's fixed assets and determined that the fair value was \$90 million. Investor also concluded that Investee's carrying value of its current assets was representative of fair value.

At the date of acquisition, Investee's assets and liabilities are as follows (in millions):

Line item	Carrying value (CV) of Investee	Fair value (FV) of Investee	Investor share of Investee CV	Investor share of Investee FV
Current assets	\$50	\$50	\$20	\$20
Fixed assets	50	90	20	36
Net assets	\$100	\$140	\$40	\$56

How should Investor record its investment in Investee on the acquisition date?

Analysis

Investor should record its investment in Investee at its cost of \$56 million. The difference between the Investor's share of the net assets measured at (1) fair value (i.e., its outside basis) and the (2) investors share of the investee's carrying value (i.e., the inside basis) is \$16 million (\$56 – \$40) and is entirely attributable to the fixed assets. The positive basis difference would be recorded as fixed assets in the investor's memo accounts and would be depreciated over the useful life of the fixed assets. The depreciation would be recorded by the Investor as a reduction of the Investor's share of the Investee's earnings and would reduce the Investor's equity method investment balance.

EXAMPLE EM 3-6**Accounting for a negative basis difference on the date of acquisition**

Investor purchased a 40% interest in the voting common stock of Investee for \$32 million. Investor determined that it has the ability to exercise significant influence over the operating and financial policies of Investee. Therefore, Investor accounts for its interest in Investee under the equity method.

Investor performed extensive due diligence of Investee. During that process, Investor noted that Investee had recently performed a long-lived asset impairment test for its fixed assets and determined that the carrying value of its fixed assets were recoverable under a held and used model. Therefore, no impairment charge was recorded by Investee (even though there had likely been a decline in the fair value of the fixed assets to below carrying value). As a result, the cost of the investment was less than the Investor's proportionate share in the amount at which the Investee carries the underlying net assets.

At the date of acquisition, Investee's assets and liabilities are as follows (in millions):

Line item	Carrying value (CV) of Investee	Fair value (FV) of Investee	Investor share of Investee CV	Investor share of Investee FV
Current assets	\$50	\$50	\$20	\$20
Fixed assets	50	30	20	12
Net assets	\$100	\$80	\$40	\$32

How should Investor record its investment in Investee on the acquisition date?

Analysis

Investor should record its investment in Investee at its cost of \$32 million. The difference between the Investor's share of the net assets measured at (1) fair value (i.e., its outside basis) and (2) the investors share of the investee's carrying value (i.e., the inside basis) is negative \$8 million (\$32- \$40) and is entirely attributable to the fixed assets. This negative basis difference would be accreted in the investor's equity method memo accounts reducing depreciation expense over the life of the fixed

assets. This accretion would be recorded by the Investor as an increase in Investor's share of the Investee's earnings and would also increase the Investor's equity method investment balance.

3.3.2 Basis differences when investee has a noncontrolling interest

An investee may consolidate a non wholly-owned subsidiary, and therefore present a noncontrolling interest on its balance sheet. In such cases, the investor should be mindful of the value held by the noncontrolling interest when determining the fair value of the assets and liabilities underlying its investment, as illustrated in Example EM 3-7.

EXAMPLE EM 3-7

Accounting for the investor's interest in the net assets of an investee's non wholly-owned subsidiary

Investor purchased a 40% interest in the voting common stock of Investee and determined that it should account for its interest under the equity method.

Investee holds an 80% interest in Subco and consolidates Subco in its financial statements. Investee presents the 20% interest in Subco held by other investors as a noncontrolling interest.

Subco has fixed assets which Investee includes in its consolidated financial statements. The carrying amount of the fixed assets for Investee is \$100, and it is determined that the fair value of the fixed assets is also \$100.

When determining its proportionate share in the assets and liabilities of Investee, what would be the Investor's interest in the fixed assets of Subco?

Analysis

Investee is required to consolidate 100% of the net assets of Subco and present separately the 20% noncontrolling interest, as described in FSP 2.5. Investor, however, should only recognize its proportionate share of the investee's interest in those net assets. The Investor's interest in the fixed assets of Subco would be \$32 (Fair value of the fixed assets [\$100] x percentage owned by Investee [80%] x Investor's ownership percentage [40%]). Accordingly, Investor should allocate \$32 to the fixed assets of Subco in its memo accounts.

3.3.3 Equity investment acquired as part of a business combination

A reporting entity may acquire a business that has an equity method investment. As part of its purchase price allocation, the reporting entity should determine the fair value of the equity method investment, as described in BCG 2.5. The reporting entity should also determine any basis differences, following the guidance described in EM 3.3.1.

3.3.4 Deferred taxes in investor's equity method memo accounts

While an investee's financial statements will already reflect deferred tax assets and liabilities for temporary differences between the carrying values of the investee's assets and liabilities and their associated tax bases, incremental temporary differences may be created when the investor allocates its investment cost to individual assets and liabilities in memo accounts, as described in EM 3.3.1.

Accordingly, an investor must track the deferred tax consequences associated with these incremental basis differences and reflect those tax consequences in its equity method memo accounts. This is accomplished by tax affecting basis differences using the investee's tax rate and including any resulting deferred tax asset or liability in the memo accounts.

As the investor amortizes its excess basis in the memo accounts, it would unwind the corresponding deferred tax liability, and recognize the associated impact of the tax effected amortization in its calculated share of the investee's earnings.

At acquisition, an investor may also need to consider how its equity method accounting interplays with any previously established valuation allowances of the investee. See EM 3.3.4.1 for further discussion.

Subsequent to the acquisition, an investor may recognize income for book purposes but not receive distributions of those earnings. This will create a difference between the carrying amount of the equity method investment and its tax basis (i.e., outside basis difference), which is discussed in TX 11.6.

Example EM 3-8 illustrates the establishment of a deferred tax liability related to basis differences.

EXAMPLE EM 3-8

Establishing a deferred tax liability related to basis differences

Investor obtains a 40% interest in Investee. Investee's carrying amount of its fixed assets is \$50, whereas the fair value is \$90. Accordingly, a difference exists between Investor's proportionate share of the fair value of Investee-owned property, plant, and equipment, which is \$36 ($\$90 \times 40\%$), and the Investee's carrying amount in those same assets, which is \$20 ($\$50 \times 40\%$). This basis difference of \$16 ($\$36 - \20) would be reflected in the Investor's memo account.

Investee's tax rate is 25%.

Should Investor recognize a deferred tax liability in connection with allocating its cost basis to the acquired assets and liabilities?

Analysis

Yes. In the equity method memo accounts, a deferred tax liability should be recognized. That deferred tax liability reflects the taxable temporary difference created in the memo account of the Investor (i.e., the amount by which the investor's carrying amount exceeds its proportionate interest in the investee's carrying value of those assets). Accordingly, a deferred tax liability of \$4 would be established, calculated as the \$16 basis difference multiplied by the Investee's 25% tax rate.

3.3.4.1 Considerations related to investee's valuation allowance

An investee may have deferred tax assets for which a partial or full valuation allowance has been recorded. This would occur when the investee has concluded that the deferred tax assets are not "more-likely-than-not" to be realized.

When an investor records its proportionate interest of the investee, the investor must consider whether there is any new information resulting from its acquisition of the investee which results in an impact on investee's valuation allowance. ASC 740 provides four sources of future taxable income to

consider when assessing the need for a valuation allowance (see TX 5.3). One of the sources is future taxable amounts resulting from the reversal of taxable temporary differences. When an investor recognizes a deferred tax liability in its memo accounts (as explained in EM 3.3.4), the investor should consider whether that deferred tax liability can serve as a source of future taxable income to support realization of the investor's proportionate share of deferred tax assets acquired.

Example EM 3-9 illustrates a scenario where a deferred tax liability recognized in the investor's memo account serves as a source of realization for a deferred tax asset of an investee. This source of realization relates to the investor's memo accounts and investor's share of the earnings of investee.

EXAMPLE EM 3-9

Determining whether a deferred tax liability recognized in a memo account serves as a source of realization for a deferred tax asset of an equity method investee

Investee has a deferred tax asset of \$400 associated with net operating losses. Investee recognized a valuation allowance of \$400 against the deferred tax asset as it believes that it is "more-likely-than-not" that the benefit associated with the deferred tax asset will not be realized. Investee's balance sheet shows net assets of \$750. Investee has a tax rate of 25%.

Investor acquires a 40% equity interest in Investee for \$800, and accounts for its investment using the equity method of accounting. Investor's proportionate share in the investee's book basis is \$300 ($\$750 \times 40\%$), resulting in a basis difference of \$500 ($\$800 - \300). Investor determined that the basis difference is entirely associated with intellectual property which will be amortized for book purposes over 10 years. Investor's acquisition of Investee's equity interest did not generate any tax basis in the intellectual property. Accordingly, Investor should record a deferred tax liability of \$125 ($\$500 \times 25\%$) related to the basis difference in its equity method memo accounts.

Investor determined that its proportionate share of Investee's deferred tax asset is \$160 ($\$400 \times 40\%$).

Should Investor recognize any portion of the underlying deferred tax asset of Investee?

Analysis

Yes. The deferred tax liability recorded by Investor within the equity method memo accounts should be considered a potential source of taxable income to support realization of its proportionate share of Investee's deferred tax assets, regardless of the assessment concluded and recorded by Investee. Therefore, Investor would recognize \$125 of the deferred tax asset (i.e., no valuation allowance is needed for that portion) in its equity method memo accounts upon acquisition of Investee. This reflects the portion of the deferred tax asset for which Investor has a source of taxable income to support realization of its portion of Investee's deferred tax assets (through future reversal of the deferred tax liability recognized in its equity method memo account).

In some cases, an investor may be willing to pay a premium to obtain an interest in such an investee if the investor believes that the associated deferred tax assets have value in excess of the amount recorded (net of the valuation allowance) in the investee's financial statements. Simply paying a premium does not in and of itself provide evidence of future taxable income under ASC 740. In such cases, no portion of the premium would be allocated to the investee's deferred tax assets.

Example EM3-10 illustrates an investor's accounting for the excess of the cost of the investor's share of investee net assets when a premium is attributable to tax benefits of the investee that carry a valuation allowance.

EXAMPLE EM 3-10

Accounting for the excess of cost over the investor's share of investee net assets when a premium is attributable to tax benefits of the investee that carry a valuation allowance

Investee is a public company that has a substantial deferred tax asset related to net operating loss (NOL) carryforwards. Investee has a full valuation allowance recorded against the deferred tax asset because of losses in recent years. Investee is currently traded at a premium compared to its net assets, which has been attributed to a belief by investors that Investee will eventually be able to employ a strategy to utilize its NOL carryforwards.

Investor acquired a 20% ownership interest in the voting common stock of Investee and determined that it should account for the investment under the equity method of accounting. At the date on which Investor acquires its 20% interest in Investee at market price, its cost exceeds its proportionate share of the carrying amount of the net assets of Investee by \$500. For simplicity, assume there are no unrecognized intangible assets or liabilities and no other recognized assets or liabilities of Investee to which the premium paid by Investor should be attributed.

Should any portion of the \$500 premium paid by Investor be assigned to the deferred taxes related to NOL carryforwards, or is the entire premium allocated to goodwill?

Analysis

The premium should be allocated to goodwill. There are no new sources of taxable income as a result of the initial equity method accounting that could provide for realization of Investee's deferred tax assets. Additionally, since there has been no change in control, the Investor's investment does not provide the Investee with any new ability to recover the deferred tax asset. Accordingly, Investor would not assign any carrying value to the deferred tax asset when assigning the premium paid to acquire the investment. Instead, the \$500 premium of cost over fair value should be considered goodwill in Investor's equity method memo accounts.

Prospectively, Investor will need to analyze its investment for impairment in accordance with the provisions of ASC 323-10-35-32. See EM 4.8 for further information.

3.3.5 Accounting for excess assigned to purchased IPR&D (equity method)

A portion of the value paid by an investor to acquire an equity interest in an investee may be due to the value of in-process research and development (IPR&D) of the investee. An investor should measure the underlying IPR&D at fair value at the acquisition date in its memo accounts.

If the investee is not a business (i.e., an asset acquisition), as defined in ASC 805, the investor should immediately recognize a charge to expense for acquired IPR&D if the IPR&D does not have an alternative future use (see ASC 805-50-35-1).

If the investee qualifies as a business, the investor should record an intangible asset to capitalize the IPR&D in its equity method memo accounts, regardless of whether it has an alternative future use, as if the investee were a consolidated subsidiary pursuant to the guidance in ASC 323-10-35-13.

See the guidance described in BCG 1.2 to determine if an acquisition meets the definition of a business. See BCG 4.3.4.1 for further information on the accounting for purchased IPR&D.

3.3.6 Equity method goodwill

The investor's cost of an equity method investment may exceed its proportionate share of the fair value of the investee's underlying assets and liabilities identified. This excess consideration paid over the investor's share of the investee's net assets, should be assigned by the investor to "equity method goodwill," if the investee meets the definition of a business as described in BCG 1.2. If the investee does not meet the definition of a business, equity method goodwill should not be recognized. Rather, the excess, if any, should be allocated to the assets acquired, based on their relative fair values, in a manner similar to the acquisition of assets described in ASC 805-50-30-3.

An investor should make all reasonable efforts to attribute the cost of the investment to identifiable assets and liabilities of the investee before determining that the excess paid reflects goodwill. This includes considering not only the fair value of assets and liabilities already recognized by the investee, but also assets and liabilities that may not have been previously recognized by the investee, such as intangibles. If the cost of the investment is incorrectly attributed to goodwill, ongoing earnings may be misstated as goodwill is generally not amortized.

The carrying amount of an equity method investment reflects the accumulated cost of the investment and includes items such as transaction costs (see EM 3.2.1), and subsequent changes in the value of contingent consideration (see EM 3.2.2), which would not be included in the carrying amount of business combination accounted for in accordance with ASC 805. Accordingly, goodwill for an equity method investment, which is calculated as the residual of the cost paid over the assets and liabilities identified, may be different than if the investment was a business combination accounted for under ASC 805.

This subsequent accounting for goodwill, including the private company goodwill accounting alternative, is discussed in EM 4.3.1.

Example EM 3-11 illustrates the process for allocating the cost of an investment to the underlying net assets, deferred taxes, and equity method goodwill.

EXAMPLE EM 3-11

Assignment of basis differences with residual excess assigned to equity method goodwill

Investor purchased a 25% interest in the voting common stock of Investee for cash consideration of \$1,000. On the acquisition date, the net assets of Investee, as reflected in its general ledger and determined in accordance with GAAP, were as follows:

Line Item	Balance
Cash	\$175
Other net current assets	125
Fixed assets	1,200
Net assets	\$1,500
Investor's 25% share	\$375

Investor determined the following:

- Investee's property and plants are modern with current technologies and have a fair value of \$2,400.
- Investee holds valuable patents on its technical processes that have a fair value of \$400. Costs associated with developing the processes were fully expensed by Investee.
- Investee has a strong earnings growth record, a relevant consideration for income tax accounting purposes (e.g., realizability of deferred tax assets). Investee's applicable tax rate is 25%.
- Other net current assets represent raw materials, receivables, and payables. The carrying values of these items approximate their fair value.

How should Investor account for the basis difference between the cost of its investment and its share of the net assets of the Investee?

Analysis

The following table illustrates how Investor would assign the \$625 basis difference that reflects the difference between its proportionate interest in (a) the carrying value of the investee's assets and liabilities and (b) the fair value of those assets and liabilities.

Line item	Carrying value (CV)	Fair value (FV)	Excess of FV over CV	Investor's interest in CV	Investor's basis difference
Cash	\$175	\$175	\$0	\$44	\$0
Other net current assets	125	125	0	31	0
Fixed assets	1,200	2,400	1,200	300	300
Patents	0	400	400	0	100
Deferred tax liability	0	(400) A	(400)	0	(100)
Goodwill	0	1,300	1,300	0	325 C
Total	1,500	4,000 B	2,500	375	625

A – The deferred tax liabilities relate to the difference between the underlying fair values and the carrying values of the investee’s assets and liabilities. The deferred tax liability of \$400 is calculated as the product of total taxable temporary differences, excluding goodwill (\$1,200 basis difference of fixed assets + \$400 basis difference of patents), and the Investee’s applicable tax rate (25%). It is assumed for simplicity that at the date of investment there is no difference between the investor’s book and tax bases in the investment. If there were such a difference, the deferred tax effects might have to be considered in allocating the investor’s excess cost of its investment. See TX 11 for further information.

B – Investor purchased a 25% interest in the voting common stock for \$1,000. Therefore, for illustrative purposes, the fair value of 100% of the Investee is assumed to be \$4,000.

C – Equity method goodwill is calculated as the excess of Investor’s purchase price paid to acquire the investment over the fair value amounts assigned to the identified tangible and intangible assets and liabilities (fair value of Investor’s share of Investee’s net assets).

Investor would record its 25% interest in the voting common stock of Investee based on the \$1,000 cost of its investment. The underlying acquired assets include the investors proportionate interest in: (1) the net assets of the investee based on the investee’s carrying amount ($\$1,500 \times 25\% = 375$), (2) the net excess of fair value over the investee’s carrying value of the identified tangible and intangible assets and liabilities as well as goodwill (\$625).

3.3.7 *Bargain purchase*

In limited cases it is possible that the fair value of the investment acquired (i.e., the fair value of the investor’s share of the investee’s net assets) exceeds the cost of the investment. In such situations, the investor should not recognize a bargain purchase gain, even though such gains would be recognized in the context of a business combination in accordance with ASC 805.

A bargain purchase gain should not be recognized when an investor acquires an equity method investment because, unlike in a business combination, an investor in an equity method investment does not control the underlying assets of the investee. Therefore, the investor would not be able to realize the gain by selling the underlying assets of the investee. Additionally, the carrying amount of an equity method investment is based on the accumulated cost of acquiring the investment, not on a fair value basis.

Therefore, if the fair value of the investment acquired exceeds the cost of the investment, the investor should allocate the difference as a pro-rata reduction (on a fair value basis) to the amounts that would otherwise have been assigned to the acquired noncurrent assets. This treatment of the residual excess is consistent with the asset acquisition guidance in ASC 805-50.

Example EM 3-12 illustrates the allocation of a bargain purchase as a pro rata reduction to the acquired noncurrent assets.

EXAMPLE EM 3-12

Assignment of a bargain purchase to reduce acquired noncurrent assets

Investor purchased a 25% interest in the voting common stock of Investee for cash consideration of \$1,000. Investee’s tax rate is 25%. On the acquisition date, Investor’s share of the net assets of Investee on a book and fair value basis are as follows:

Line item	Carrying value	Fair value	Investor's share of carrying value	Investor's share of preliminary fair value	
Cash	\$800	\$800	\$200	\$200	A
Accounts receivable	1,000	1,000	\$250	\$250	A
Fixed assets	2,000	3,700	\$500	925	B
Patent (noncurrent)	0	220	0	55	C
Deferred tax liability	0	(480)	0	(120)	D
Accounts payable	(800)	(800)	(200)	(200)	A
Total	\$3,000	\$4,440	\$750	\$1,110	E

A – Investor concluded that Investee's carrying value was representative of fair value.

B – Investor determined that its share of the fair value of Investee's fixed assets was \$925.

C – Investor determined that its share of the fair value of Investee's patent was \$55.

D – The preliminary deferred tax liability (\$120) is calculated as the product of total taxable temporary differences, excluding goodwill. That includes the sum of the basis difference for fixed assets (\$925-\$500 = \$425) and the basis difference of the patent (\$55) multiplied by the Investee's applicable tax rate (25%). It is assumed for simplicity that there is not any difference at the date of investment between the investor's book and tax bases in the investment. If there were such a difference, the deferred tax effects might have to be considered in allocating the investor's excess cost of its investment. See TX 11 for further information.

E – Investor's proportionate share of the fair value of Investee's net assets of \$1,110 exceeds the cost of its investment of \$1,000, resulting in residual excess of \$110.

How should Investor account for the basis difference between the cost of the investment (\$1,000) and its share of the Investee's net assets (\$1,110)?

Analysis

Investor should not recognize a bargain purchase gain of \$110 for the amount by which the fair value of its investment exceeds its cost. Rather, Investor should allocate the excess \$110 as a pro-rata reduction of the preliminary fair value amounts assigned to the fixed assets and patent and related deferred tax effects utilizing an iterative calculation as illustrated below.

Step 1: For those assets with basis differences (i.e., the acquired fixed assets and patent), it is necessary to first determine what percentage of the preliminary fair value each makes up:

	Preliminary fair value	% of total
Fixed assets	\$925	94.4%
Patent (noncurrent)	55	5.6%
Total	\$980	

Step 2: Calculate the tax rate to apply to the excess amount using the iterative calculation illustrated in paragraphs ASC 805-740-55-9 through ASC 805-740-55-13, which takes the applicable tax rate/ (1-applicable tax rate).

$$25\% / (1 - 25\%) = 33.3\%$$

Step 3: Determine the impact on the deferred tax liability by applying the tax rate determined in step 2 to the excess amount.

$$33.3\% * \$110 = \$37 \text{ (rounded)}$$

The preliminary fair value of the deferred tax liability of (\$120) is reduced by \$37 for a final fair value of (\$83).

Step 4: Determine what portion of the excess amount and related tax impact should be allocated to the fixed assets using the percentages established in step 1.

$$(\$110 * 94.4\%) + (\$37 * 94.4\%) = \$139 \text{ (rounded)}$$

The preliminary fair value of \$925 is reduced by \$139 for a final fair value of \$786.

Step 5: Determine what portion of the excess amount and related tax impact should be allocated to the patent using the percentages established in step 1.

$$(\$110 * 5.6\%) + (\$37 * 5.6\%) = \$8 \text{ (rounded)}$$

The preliminary fair value of \$55 is reduced by \$8 for a final fair value of \$47.

The following table summarizes the results of the above calculations:

Line item	Carrying value	Preliminary fair value	Final fair value	Basis difference (Final fair value less Carrying value)
Cash	\$200	\$200	\$200	\$0
Accounts receivable	250	250	250	0
Fixed assets	500	925	786	286
Patent (noncurrent)	0	55	47	47
Deferred tax liability	0	(120)	(83)	(83)
Accounts payable	(200)	(200)	(200)	0
Share of net assets	\$750	\$1,110	\$1,000	\$250

After performing such an iterative calculation, the final fair value of Investor's proportionate share of the Investee's net assets, including the deferred tax liability, should be equal to Investor's cost of the investment (\$1,000). Investor should assign the adjusted basis differences of \$286, \$47, and (\$83) to the acquired fixed assets, patent, and deferred tax liability, respectively, within the equity method memo accounts.

3.3.8 Accumulated other comprehensive income – basis differences

An investee may hold assets or liabilities whose changes in value are reported in accumulated other comprehensive income (AOCI) pursuant to other GAAP. For example, an investee may have investments in available-for-sale securities accounted for pursuant to ASC 320, *Investments—Debt and Equity Securities*, derivative financial instruments accounted for pursuant to ASC 815, *Derivatives and Hedging* (e.g., derivative financial instrument designated as a cash flow hedge), and/or pension or post-employment benefits accounted for pursuant to ASC 715, *Compensation—Retirement Benefits*.

At the date on which it obtains an investment that is to be accounted for under the equity method of accounting, an investor must identify and measure all of the investee's identifiable assets and liabilities at their acquisition date fair values. For those assets and liabilities whose changes in value are reported in AOCI, the investor will not recognize its proportionate share of the amounts previously reported in the investee's AOCI balance. This is because the investor would record the associated assets and liabilities at fair value and, therefore, there are no unrealized amounts to report in AOCI from the investor's perspective.

Accordingly, the amounts reported in the investee's AOCI balance create additional basis differences that must be tracked by the investor within the equity method memo accounts in order to ensure that the investor does not recognize such amounts when they are reclassified to earnings in the investee's financial statements.

Example EM 3-13 illustrates an investor's accounting for the investee's AOCI at date of acquisition and upon sale.

EXAMPLE EM 3-13

Investor's accounting for investee's AOCI at date of acquisition and upon sale

Investor acquired a 20% interest in the voting common stock of Investee that will be accounted for under the equity method of accounting. Investee holds an available-for-sale debt security that it purchased for \$100. The fair value of the available-for-sale debt security at the investment date is \$150; therefore, investee reports \$50 in unrealized gains in AOCI. One year later, Investee sells the available-for-sale security for \$150.

How should Investor account for its proportionate share of Investee's available-for-sale debt security at the investment date and upon Investee's sale of the available-for-sale security?

Analysis

At the acquisition date, Investor would recognize in its memo accounts its proportionate share of the fair value of the available-for-sale debt security of \$30 ($\$150 \times 20\%$) and AOCI of \$0, creating a basis difference of \$10 in the investor's AOCI memo accounts.

Upon sale for \$150, Investee would recognize a realized gain of \$50; however, Investor would not record its proportionate share of Investee's realized gain because its basis in the Investee's available-for-sale debt security would already reflect the security's appreciation. Therefore, Investor would reduce its equity in earnings of Investee by \$10 ($\$50 \times 20\%$), reflecting the reversal of the AOCI basis difference.

3.3.9 Investee financial statements are not US GAAP

When an investee's financial statements are prepared on a basis other than US GAAP, an investor that follows US GAAP should convert the investee's financial statements to US GAAP to eliminate variances, prior to determining the difference between the cost of its investment and its share of the underlying equity in the investee's net assets. Variances from US GAAP must be accounted for on a continuing basis, similar to the required accounting for basis differences discussed in EM 3.3.1. See EM 4.3.4 for further discussion of adjustments for the application of different accounting principles by the investee.

3.3.10 Investee reporting on a lag

If an investor determines that the financial statements of an investee will not be ready at the time the investor files its financial statements, the investor can elect to adopt an accounting policy to use financial statements of the investee as of an earlier reporting period. A lag in reporting should be consistent from period to period as noted in ASC 323-10-35-6.

While ASC 323 does not specifically state the maximum permissible lag for equity method investees, ASC 810-10-45-12, which addresses consolidated subsidiaries, states it should not be more than "about three months." We believe the same guidance can be applied by analogy to equity method investees.

When lag reporting will be applied, the investor should determine the equity method basis differences

***Chapter 4:
Subsequent accounting for
equity method investments
—updated December 2022***

4.1 *Subsequent accounting for equity method investments*

The subsequent accounting for an equity method investment generally follows the consolidation model. An investor increases the carrying amount of the investment to reflect its contributions and its share of the investee's earnings, and reduces it to reflect its share of investee's losses, investee distributions, and other-than-temporary impairments.

4.1.1 *Share of earnings of the investee*

When the initial equity method investment is recorded at cost, the investor recognizes its proportionate share of the reported earnings or losses of the investee through net income and as an adjustment to the investment balance. This proportionate share is subject to adjustments, such as for the elimination of intra-entity (intercompany) gains or losses or amortization of basis differences.

The investor's share of investee earnings or losses is generally based on shares of common stock or in-substance common stock held by the investor. However, there may also be other investments that participate in earnings. For example, an investor may need to record earnings on an investment in investee's preferred stock. Refer to EM 4.5.2 for further discussion.

Determining the investor's share of the earnings or losses of the investee may be straightforward when all income and distributions (including distributions in liquidation) are determined based on interests held or a fixed percentage allocated to each equity holder. The allocation becomes more complex when the investee has multiple classes of equity outstanding or the allocation of earnings or cash distributions to investors is not commensurate with ownership interests.

If an investee has multiple classes of common stock outstanding, analysis is required to determine if a single class is subordinate or if all classes possess substantially identical subordination characteristics when determining the investor's share of the investee's earnings or losses.

4.1.2 *Preferred stock impact on share of earnings of the investee*

An investor would not adjust its share of the investee's earnings or losses for any non-cumulative preferred dividends unless those dividends were declared, but would adjust to deduct the investee's cumulative preferred dividends, regardless of whether those dividends have been declared. However, some preferred dividends are only cumulative when earned, so preferred shareholders would not have a future claim for dividends if sufficient income has not been generated. In that case, the investee income (loss) is only adjusted to the extent preferred dividends are earned.

Accretion of redeemable preferred stock classified in temporary equity is required when the stock is redeemable at a fixed or determinable date, or at any time at the holder's option. The equity method investor should adjust its share of earnings (or losses) of the investee for this accretion.

4.1.3 *Non-pro rata profit allocations*

Investment agreements may include allocations among investors for the investee's earnings, taxable profit and loss, distributions of cash from operations, and/or distributions of cash proceeds on liquidation that differ from the investor's ownership interest. These agreements can impact the investor's recognition of its share of the investee earnings for accounting purposes. All relevant

agreements among the investors should be evaluated to determine the rights of each investor. To be considered substantive, the profit allocation should be consistent over time (i.e., not able to be unwound based on subsequent events).

ASC 970, *Real Estate*, contains guidance on the allocation of investee earnings for investments in real estate ventures. In practice, this guidance is also considered when determining an investor's share of an investee's earnings for investments in non-real estate ventures.

Excerpt from ASC 970-323-35-17

Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph 970-323-35-10. To determine the investor's share of venture net income or loss, such agreements or arrangements shall be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with GAAP) will affect cash payments to the investor over the life of the venture and on its liquidation. Specified profit and loss allocation ratios shall not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis.

ASC 970-323-35-17 concludes that the contractual non-pro rata profit allocation should be followed for accounting purposes only when the allocation of cash distributions over the life of the investee and upon its liquidation are determined on the same basis.

One example of a specified profit allocation is when one investor that may be able to monetize tax benefits generated by the investee entity is allocated all tax credit benefits, while the other investors receive all other operating income and losses. Alternatively, an investor may have preference over other investors for the first set amount of income earned by the investee entity, after which there is a pro-rata allocation among all investors.

One way to apply the equity method in these circumstances is referred to as the hypothetical liquidation at book value method, which is discussed in ASC 323-10-35-27 to ASC 323-10-35-28 and ASC 323-10-55-48 to ASC 323-10-55-57 and the following section.

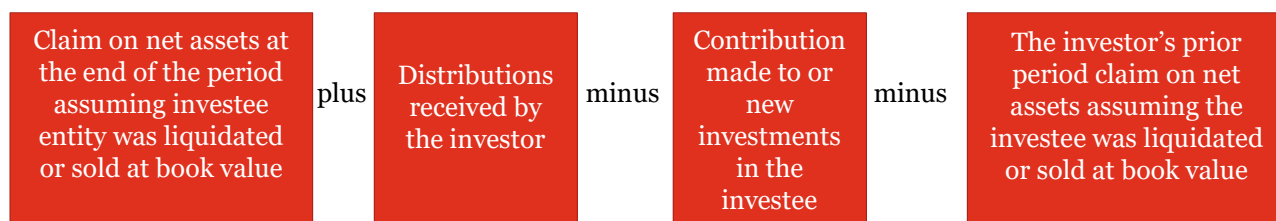
4.1.4 Hypothetical liquidation at book value method

There is no prescriptive guidance for determining an investor's share of investee earnings for investments in complex structures. The hypothetical liquidation at book value (HLBV) method, referred to as a balance sheet approach, calculates the share of investee earnings or losses based on the change in the investor's claim on the net assets of the investee (i.e., how an entity would allocate and distribute its cash if it were liquidated as of the balance sheet date based on its articles of incorporation, bylaws, or other governing documents).

Under the HLBV method, an investor would calculate its share of current period investee earnings as illustrated in Figure EM 4-1.

Figure EM 4-1

HLBV method to determine current period investee earnings



The AICPA detailed the HLBV method in a proposed Statement of Position, *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*. While it was never finalized, the proposed guidance is used by investors to determine equity method earnings when a non-pro rata profit allocation is in place. However, investors should assess if the use of the HLBV method is appropriate and consistent with the economic substance of the profit allocation. In practice, contractual distribution of cash upon liquidation (i.e., liquidation waterfalls) are often complex and reporting entities should carefully evaluate all relevant agreements.

ASC 323-10-55-49 begins an example that illustrates the approach to determining the amount of equity method earnings based on the change in the investor's claim on the investee's book value. While not specifically referred to as HLBV, the example illustrates similar concepts.

Excerpt from ASC 323-10-55-49

- a. Investee was formed on January 1, 20X0.
- b. Five investors each made investments in and loans to Investee on that date and there have not been any changes in those investment levels (that is, no new money, reacquisition of interests by Investee, principal payments by Investee, or dividends) during the period from January 1, 20X0 through December 31, 20X3.
- c. Investor A owns 40 percent of the outstanding common stock of Investee; the common stock investment has been reduced to zero at the beginning of 20X1 because of previous losses.
- d. Investor A also has invested \$100 in preferred stock of Investee (50 percent of the outstanding preferred stock of Investee) and has extended \$100 in loans to Investee (which represents 60 percent of all loans extended to Investee).
- e. Investor A is not obligated to provide any additional funding to Investee. As of the beginning of 20X1, the adjusted basis of Investor's total combined investment in Investee is \$200, as follows:

Common stock	\$—
Preferred stock	\$100
Loan	\$100

- f. Investee operating income (loss) from 20X1 through 20X3 is as follows:

20X1	(\$160)
20X2	(\$200)

20X3

\$500

g. Investee's balance sheet is as follows:

	1/1/X1	12/31/X1	12/31/X2	12/31/X3
Assets	\$ 367	\$ 207	\$ 7	\$ 507
Loan	167	167	167	167
Preferred stock	200	200	200	200
Common stock	300	300	300	300
Accumulated deficit	(300)	(460)	(660)	(160)
	\$ 367	\$ 207	\$ 7	\$ 507

ASC 323-10-55-54

Under this approach, Investor A would recognize equity method losses based on the change in the investor's claim on the investee's book value.

ASC 323-10-55-55

With respect to 20X1, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X1, it would have \$207 available to distribute. Investor A would receive \$120 (Investor A's 60% share of a priority claim from the loan [\$100] and a priority distribution of its preferred stock investment of \$20 [which is 50% of the \$40 remaining to distribute after the creditors are paid]). Investor A's claim on Investee's book value at January 1, 20X1, was \$200 (60% × \$167 = \$100 and 50% × \$200 = \$100). Therefore, during 20X1, Investor A's claim on Investee's book value decreased by \$80 and that is the amount Investor A would recognize in 20X1 as its share of Investee's losses. Investor A would record the following journal entry.

Equity method loss	\$80	
Preferred stock investment		\$80

ASC 323-10-55-56

With respect to 20X2, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X2, it would have \$7 available to distribute. Investor A would receive \$4 (Investor A's 60% share of a priority claim from the loan). Investor A's claim on Investee's book value at December 31, 20X1, was \$120 (see the preceding paragraph). Therefore, during 20X2, Investor A's claim on Investee's book value decreased by \$116 and that is the amount Investor A would recognize in 20X2 as its share of Investee's losses. Investor A would record the following journal entry.

Equity method loss	\$116	
Preferred stock investment		\$20
Loan		\$96

ASC 323-10-55-57

With respect to 20X3, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X3, it would have \$507 available to distribute. Investor A would receive \$256 (Investor A's 60% share of a priority claim from the loan [\$100], Investor A's 50% share of a priority distribution from its preferred stock investment [\$100], and 40% of the remaining cash available to distribute [\$140 × 40% = \$56]). Investor A's claim on Investee's book value at December 31, 20X2, was \$4 (see above). Therefore, during 20X3, Investor A's claim on Investee's book value increased by

\$252 and that is the amount Investor A would recognize in 20X3 as its share of Investee's earnings. Investor A would record the following journal entry.

Loan	\$ 96	
Preferred stock	100	
Investment in investee	56	
Equity method income		\$252

4.2 Elimination of intercompany transactions

An investor applying the equity method may need to make adjustments to eliminate the effects of certain intercompany transactions. While ASC 323 refers to the consolidation guidance under ASC 810 for guidance on eliminations, the extent of the eliminations under the equity method are more limited than those required when consolidating a subsidiary.

4.2.1 Intercompany profits and losses—updated January 2022

An investor should eliminate its intercompany profits or losses related to transactions with an investee until profits or losses are realized through transactions with third parties. For example, assume an investor holds a 25% interest in an investee entity and sells inventory at arm's length to that investee. If the inventory remains on the books of the investee at the reporting date, then the investor would generally eliminate 25% of the intercompany profit. Once the inventory is sold by the investee to a third party, any previously eliminated intercompany profit is recognized. However, intercompany profits or losses should not be eliminated for arm's-length transactions that do not result in an asset that remains on the books of either party. For example, an investee may provide outsourcing services to the investor for a fee. Intercompany profits or losses for this transaction would not be eliminated.

As discussed in ASC 323-10-35-8, there is a difference in intercompany elimination principles for equity method investments compared to consolidation. One example is when an investor leases an item to an investee under an operating lease arrangement. The investor would normally earn rental income while the investee recognizes rental expense in the same period. No intercompany elimination would be needed on the basis that the earnings process is complete (i.e., no asset such as inventory remains on the books of the investor/investee). In contrast, if the investor consolidated the investee, all rental income earned by the investor and all rental expense incurred by the investee would be eliminated in the consolidated financial statements.

ASC 323-10-35-7

Intra-entity profits and losses shall be eliminated until realized by the investor or investee as if the investee were consolidated. Specifically, intra-entity profits or losses on assets still remaining with an investor or investee shall be eliminated, giving effect to any income taxes on the intra-entity transactions, except for any of the following:

- a. A transaction with an investee (including a joint venture investee) that is accounted for as a deconsolidation of a subsidiary or a derecognition of a group of assets in accordance with paragraphs 810-10-40-3A through 40-5.
- b. A transaction with an investee (including a joint venture investee) that is accounted for as a change in ownership transaction in accordance with paragraphs 810-10-45-21A through 45-24

- c. A transaction with an investee (including a joint venture investee) that is accounted for as the derecognition of an asset in accordance with Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

ASC 323-10-35-8

Because the equity method is a one-line consolidation, the details reported in the investor's financial statements under the equity method will not be the same as would be reported in consolidated financial statements under Subtopic 810-10. All intra-entity transactions are eliminated in consolidation under that Subtopic, but under the equity method, intra-entity profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.

ASC 323-10-35-9

Paragraph 810-10-45-18 provides for complete elimination of intra-entity income or losses in consolidation and states that the elimination of intra-entity income or loss may be allocated between the parent and the noncontrolling interests. Whether all or a proportionate part of the intra-entity income or loss shall be eliminated under the equity method depends largely on the relationship between the investor and investee.

ASC 323-10-35-10

If an investor controls an investee through majority voting interest and enters into a transaction with an investee that is not at arm's length, none of the intra-entity profit or loss from the transaction shall be recognized in income by the investor until it has been realized through transactions with third parties. The same treatment applies also for an investee established with the cooperation of an investor (including an investee established for the financing and operation or leasing of property sold to the investee by the investor) if control is exercised through guarantees of indebtedness, extension of credit and other special arrangements by the investor for the benefit of the investee, or because of ownership by the investor of warrants, convertible securities, and so forth issued by the investee.

ASC 323-10-35-11

In other circumstances, it would be appropriate for the investor to eliminate intra-entity profit in relation to the investor's common stock interest in the investee. In these circumstances, the percentage of intra-entity profit to be eliminated would be the same regardless of whether the transaction is downstream (that is, a sale by the investor to the investee) or upstream (that is, a sale by the investee to the investor).

If an intercompany transaction is not considered to be at arm's length, all (as opposed to a portion) of the intercompany profit or loss is eliminated until it has been realized through sale to third parties. Investors should consider all facts and circumstances to determine if the transaction is at arm's length, including the transaction's economic substance, whether the sales price is collectible, whether the sales price represents fair value, and if the terms of the transaction are similar to those in third-party transactions.

After consideration of the nature of the transaction and the relationship between the investor and investee, the appropriate portion (all or some) of intercompany profits or losses should be eliminated, even if the investor's share of the unrealized profit to be eliminated exceeds the carrying amount of the equity method investment and would reduce the investor's equity method investment balance below zero. Profits that were recognized before the investor acquired its interest in the investee, such as when

inventories or other assets were sold by one company to another prior to the equity method investment, should generally not be eliminated.

The examples in ASC 323-10-55-27 through ASC 323-10-55-29 illustrate the elimination of intercompany profit in both upstream (investee sells inventory to investor) and downstream (investor sells inventory to investee) transactions within the scope of ASC 606.

The general approach to eliminate intercompany profits by debiting equity method earnings and crediting the equity method investment is an acceptable presentation method for both sales by an investor to an investee and sales by an investee to an investor. A net-of-tax basis of elimination is also considered acceptable because the presentation of equity in income of the investee under the equity method is normally on a single line, net-of-tax basis in the income statement of the investor.

Example EM 4-1 and Example EM 4-2 illustrate the general presentation approach and several alternatives for income statement and balance sheet presentations in the context of a sale of inventory within the scope of ASC 606, at arm's length between an investor and investee. Example EM 4-3 and EM 4-4 illustrate the general presentation approach when the sale of an asset is within the scope of ASC 610-20, at arm's length between an investor and investee.

EXAMPLE EM 4-1

Sale of inventory within the scope of ASC 606—downstream

Investor has a 30% interest in Investee, and accounts for its investment under the equity method of accounting. Investor sells five units of inventory to Investee for \$100 each for total intercompany sales of \$500. As the Investor's related cost for this inventory is \$50 per unit (\$250 in total), the intercompany profit related to this transaction is \$250. As of the end of the Investee's reporting period, two units remain in inventory. This results in an elimination of \$30 intercompany profit before taking into consideration any tax effects (\$50 profit per unit remaining in inventory \times Investor's 30% ownership interest in Investee). Investor and Investee are both subject to a 20% income tax rate. The sale of inventory by Investor to Investee is an arms-length transaction.

What are the ways in which the elimination entries can be determined?

Analysis

General approach: Debit equity method earnings and credit investment account on a net-of-tax basis to eliminate the profit for the two units left in inventory.

Dr. Equity method earnings	\$24 ¹	
Cr. Equity method investment		\$24 ¹

Alternative 1: Debit cost of sales and credit the investment account for the pre-tax amount of the intercompany income elimination. Credit a deferred income tax provision in the income statement and debit a deferred income tax asset on the balance sheet.

Dr. Cost of sales	\$30 ²	
Dr. Deferred income tax benefit	\$6 ³	
Cr. Equity method investment		\$30 ²
Cr. Deferred income tax provision		\$6 ³

Alternative 2: Debit cost of sales and credit deferred income for the pre-tax amount. Credit a deferred income tax provision in the income statement and debit a deferred income tax asset on the balance sheet.

Dr. Cost of sales	\$30 ²	
Dr. Deferred income tax benefit	\$6 ³	
Cr. Deferred income		\$30 ²
Cr. Deferred income tax provision		\$6 ³

Alternative 3: Debit equity method earnings for the net-of-tax amount and a deferred income tax benefit for the amount of the tax benefit. Credit a deferred income account on the balance sheet.

Dr. Equity method earnings	\$24 ¹	
Dr. Deferred income tax benefit	\$6 ³	
Cr. Deferred income		\$30 ²

¹ \$50 profit × 2 units on hand × Investors 30% ownership interest in Investee less 20% income tax

² \$50 profit × 2 units on hand × Investors 30% ownership interest in Investee

³ \$50 profit × 2 units on hand × Investors 30% ownership interest in Investee × 20% income tax rate

EXAMPLE EM 4-2

Sale of inventory within the scope of ASC 606—upstream

Investor has a 30% interest in Investee, and accounts for its investment under the equity method of accounting. Investee sells five units of inventory to Investor for \$100 each for total intercompany sales of \$500. As the Investee's related cost for this inventory is \$50 per unit (\$250 in total), the intercompany profit related to this transaction is \$250. As of the end of the Investor's reporting period, two units remain in inventory. This results in an elimination of \$30 intercompany profit before taking into consideration any tax effects (\$50 profit per unit remaining in inventory × Investor's 30% ownership interest in Investee). Investor and Investee are both subject to a 20% income tax rate. The sale of inventory by Investee to Investor is an arms-length transaction.

What are the ways in which the elimination entries can be determined?

Analysis

General approach: Debit equity method earnings and credit investment account on a net-of-tax basis to eliminate the profit for the two units left in inventory.

Dr. Equity method earnings	\$24 ¹	
Cr. Equity method investment		\$24 ¹

Alternative 1: Debit equity method earnings for the net-of-tax amount, credit inventory for the gross amount of the elimination, and debit the investment account for the amount of the tax benefit.

Dr. Equity method earnings	\$24 ¹	
Dr. Equity method investment	\$6 ²	
Cr. Inventory		\$30 ³

When inventory has been acquired from a "cost company" (a joint venture formed to serve as a source of supply in which the venturers agree to take production of the investee proportionate to their

respective interests; this is substantially a cost-sharing arrangement), the purpose of the intercompany income elimination is to reduce the investor's inventory cost to the investee's cost. In the "cost company" situation, Alternative 1 is an acceptable method to record the intercompany profit elimination.

Alternative 2: Debit equity method earnings and credit inventory for the net-of-tax amount

Dr. Equity method earnings	\$24 ¹	
Cr. Inventory		\$24 ¹

¹ \$50 profit × 2 units on hand × Investors 30% ownership interest in Investee less 20% income tax

² \$50 profit × 2 units on hand × Investors 30% ownership interest in Investee × 20% income tax rate

³ \$50 profit × 2 units on hand × Investors 30% ownership interest in Investee

EXAMPLE EM 4-3

Sale of equipment within the scope of ASC 610-20—downstream

Investor has a 30% interest in Investee, and accounts for its investment under the equity method of accounting. Investor sells equipment that is not a business and is not an output of its ordinary activities to Investee for \$500. The sale of equipment to Investee is an arm's length transaction. As the Investor's related cost for this equipment is \$200, the intra-entity profit related to this transaction is \$300. This example does not include the effect of income taxes.

On the transaction closing date, Investor concludes the transaction is the sale of a nonfinancial asset within the scope of ASC 610-20 and that control of the equipment has transferred to Investee pursuant to the control criteria in ASC 606 and ASC 810. Investee does not intend to sell the equipment, which has a useful life of 10 years.

Analysis

Given control of the equipment has successfully transferred to Investee, Investor concludes that the equipment should be derecognized under the guidance in ASC 610-20. The gain of \$300 is recognized immediately (i.e., no portion of profit or loss is eliminated) based on the guidance in ASC 323-10-35-7(c). Investor records the following journal entry to reflect the transaction.

Dr. Cash	\$500	
Cr. Equipment		\$200
Cr. Gain on sale		\$300

Investor would not defer any profit or adjust its equity method earnings related to this intra-entity sale in subsequent periods.

EXAMPLE EM 4-4

Sale of equipment within the scope of ASC 610-20—upstream

Investor has a 30% interest in Investee, and accounts for its investment under the equity method of accounting. Investee sells equipment that is not a business and is not an output of its ordinary activities for \$500 to Investor. The sale of equipment to Investor is an arm's length transaction. As the Investee's related cost for this equipment is \$200, the intra-entity profit related to this transaction is

\$300. Prior to the sale, it is assumed there are no basis differences associated with the equity method investment. This example does not include the effect of income taxes.

On the transaction closing date, Investee concludes the transaction is the sale of a nonfinancial asset within the scope of ASC 610-20 and that control of the equipment has transferred to Investor pursuant to the control criteria in ASC 606 and ASC 810. Investor does not intend to sell the equipment, which has a useful life of 10 years.

Analysis

Given that the transaction is upstream, and the equipment remains on Investor's books, Investor must eliminate its share of Investee's intra-entity profit. Specifically, ASC 323-10-35-7(c) does not apply to upstream transactions. There are multiple ways in which the Investor can account for this transaction with the Investee.

Alternative 1 - Recognize the intra-entity profit elimination against the equipment

Investor first records its share of Investee income in the following entry.

Dr. Equity method investment	\$90 ¹	
Cr. Equity method earnings		\$90

Investor then records the purchase of the equipment and eliminates the intra-entity profit against the equipment acquired.

Dr. Equipment	\$410 ²	
Dr. Equity method earnings	\$90	
Cr. Cash		\$500

Annually, Investor recognizes depreciation expense of the equipment over the 10-year useful life of the asset.

Dr. Depreciation expense	\$41 ³	
Cr. Accumulated depreciation		\$41

¹ \$300 Investee profit on sale * 30% ownership interest in investee

² \$500 purchase price less \$90 intra-entity profit

³ \$410 carrying value / 10-year useful life

Alternative 2 - Recognize the intra-entity profit elimination against the equity method investment¹

Investor records the purchase of equipment at the purchase price of \$500.

Dr. Equipment	\$500	
Cr. Cash		\$500

Investor records its share of Investee income similar to alternative 1 above.

¹ For transactions involving the purchase of real estate refer to ASC 970-323-30-7.

Dr. Equity method investment	\$90 ⁴	
Cr. Equity method earnings		\$90

Rather than eliminating the profit against the equipment as shown in alternative 1, the intra-entity profit is eliminated against the equity method investment as follows:

Dr. Equity method earnings	\$90	
Cr. Equity method investment		\$90

This eliminating entry results in a basis difference between the Investor's share of the net assets of the Investee and the Investor's carrying value of the equity method investment. This basis difference is entirely attributed to the equipment and should be amortized over the remaining useful life of the equipment.

Annually, Investor recognizes depreciation expense of the equipment over the 10-year useful life of the asset.

Dr. Depreciation expense	\$50 ⁵	
Cr. Accumulated depreciation		\$50

Annually, Investor amortizes the basis difference attributable to the equipment over the 10-year useful life of the asset.

Dr. Equity method investment	\$9 ⁶	
Cr. Equity method earnings		\$9

It should be noted that the net effect on the income statement is the same under both of the above alternatives.

⁴ \$300 Investee profit on sale * 30% ownership interest in investee

⁵ \$500 carrying value / 10-year useful life

⁶ \$90 basis difference / 10-year useful life

4.3 *Other adjustments to investor's share of investee earnings*

In addition to adjusting for intercompany profits or losses, an investor may need to make other adjustments to its share of earnings or losses of the investee, including for:

- subsequent accounting for basis differences (see EM 4.3.1),
- changes in the investee capital accounts, specifically other comprehensive income (see EM 4.3.2),
- investee prior period adjustments (see EM 4.3.3),
- differences in accounting principles (see EM 4.3.4),
- investor shares held by investee (see EM 4.3.5),

- the receipt of dividends, which are applied as a reduction of the carrying amount of the investment, and
- stock compensation considerations (see EM 4.3.6 and EM 4.3.7).

As highlighted in ASC 323-10-45-1, an investor's share of earnings or losses from its investment is shown as a single amount within the investor's income statement, including the impact of any basis differences or other adjustments. Included in these adjustments, an investor would report its share of the investee's discontinued operations as part of the single amount in the income statement representing the investor's share of the investee's earnings or losses (see EM 4.3.3 for further discussion).

4.3.1 Subsequent accounting for basis differences

As discussed in EM 3.3, the purchase price paid by an investor for an ownership interest in the voting common stock of an investee is presumed to reflect fair value (i.e., the price that would be received to sell an asset in an orderly transaction between market participants). The underlying assets and liabilities of the investee are recorded at historical cost; therefore, there is usually a basis difference between the cost of an investment and the investor's share of the net assets of the investee as reflected by the investee (historical carrying value).

The basis differences attributed to tangible and separately identifiable intangible assets should be amortized or depreciated as an adjustment to the investor's share of earnings or losses of the investee.

Excess cost of the equity method investment over the proportional fair value of the assets acquired and liabilities assumed of the investee is recognized as equity method goodwill. Differences that are attributed to equity method goodwill generally would not be amortized. However, a company that adopts the private company goodwill accounting alternative ("goodwill alternative") approved by the Private Company Council and endorsed by the FASB should account for equity method goodwill in the same manner in which it accounts for goodwill recognized in connection with a business combination. A private company that recognizes equity method goodwill in connection with an equity method investment in an investee and adopts the goodwill alternative should amortize such goodwill on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate, in accordance with ASC 323-10-35-13. See BCG 9.11 for further information regarding the goodwill alternative.

For situations when the investee entity is private and has adopted the goodwill alternative, a public company investor must eliminate the related effects when calculating its proportionate share of the equity in earnings of the investee, as the goodwill alternative is not available to public companies. See further discussion at EM 4.3.4.

If an investee disposes of an asset in which the investor has a related basis difference, the investor should write off the basis difference and adjust the equity in earnings to correctly reflect the investor's proportionate share of the investee's reported gain or loss.

If an investee records an impairment charge on its long-lived assets under ASC 360, the investor should review its outside basis in such assets to determine whether any adjustments to its proportionate share of the investee's recorded impairment loss are necessary. For example, assume an investee recognizes a \$100 impairment charge on its long-lived assets under ASC 360. If an investor owns a 40% interest in the voting common stock of the investee and has a \$20 basis difference

attributed to the long-lived assets at the impairment date (i.e., the investor's carrying value in the investee's long-lived assets is higher than the investee's carrying value), a \$60 impairment charge would be included in the investor's equity in earnings (i.e., its proportionate share of the investee's reported impairment charge of \$40, adjusted to reflect the write-off of the investor's \$20 basis difference attributed to the long-lived assets). See EM 4.8.4 for further information on the impact of impairments recognized by the investee on the investor's financial statements.

4.3.2 Investee other comprehensive income considerations

If an investee records an increase or decrease in OCI, the investor should record a corresponding proportionate increase or decrease in its equity method investment, along with an adjustment to its OCI account, as described in ASC 323-10-35-18. For example, if the investee records an increase in the fair value of its available-for-sale debt securities within OCI, the investor would record a proportionate increase in its own OCI balance with an offsetting entry to its equity method investment balance. While an investor is able to present OCI from equity method investees with its own OCI, it is also permitted to present components of OCI attributed to an equity method investee separately.

ASC 323-10-35-18

An investor shall record its proportionate share of the investee's equity adjustments for other comprehensive income (unrealized gains and losses on available-for-sale securities; foreign currency items; and gains and losses, prior service costs or credits, and transition assets or obligations associated with pension and other postretirement benefits to the extent not yet recognized as components of net periodic benefit cost) as increases or decreases to the investment account with corresponding adjustments in equity. See paragraph 323-10-35-37 for related guidance to be applied upon discontinuation of the equity method.

An investor should generally not record investee losses in excess of its investment and any additional advances whether through net income or OCI, unless the investor has guaranteed the investee's obligations or has committed to provide further financial support to the investee. See EM 4.5.

Accounting for cumulative OCI upon the sale of an interest in investee

An investor that sells a portion of its interest in the investee may recognize a gain or loss on the sale of those shares. In determining this gain or loss, the basis of the investment would include the investor's cumulative OCI relating to the portion of the investment to be sold. The investor would record a corresponding reclassification adjustment for the credit or debit balance in OCI (i.e., the investor would reclassify the amounts in OCI to earnings under ASC 220, *Comprehensive Income*). See EM 5 for further information on sales of investee shares.

Accounting for cumulative translation adjustment relating to an equity method investment

An equity method investment in a foreign operation may be a standalone foreign entity or it may be part of a larger foreign entity. If the investor sells its entire ownership interest in an equity method investment that is part of a larger foreign entity (i.e., the disposition of the equity method investment did not involve the entire foreign entity), it should not recognize the cumulative translation adjustment account balance in net income unless the sale is a substantially complete liquidation of that foreign entity. A partial sale of an equity method investment that is a standalone foreign entity for

which the retained interest will also be accounted for using the equity method requires a pro rata portion of the cumulative translation adjustment to be recognized in measuring the gain or loss on sale as prescribed by ASC 830-30-40-2. See FX 8 for more information.

4.3.3 *Investee prior period adjustments*

Issues can arise when an error or other adjustment reported by the investee relates to a period prior to when the investor made its investment. The portion of the investor's share of the investee prior period adjustment that pre-dates the investment would be treated as an adjustment to the investor's basis difference, which would need to be assigned based on the investee's revised balance sheet amounts as of the investment date. Depending upon the underlying reasons for the adjustment to the investee's financial statements, the investor may need to consider whether its investment is impaired.

If the investee reports a discontinued operation, the investor should consider whether this represents a strategic shift that has (or will have) a major effect on its own operations and financial results and, therefore, also requires discontinued operation presentation by the investor. It is rare that the criteria for discontinued operations would be met at the investor level and therefore an investor would generally not report discontinued operations in its income statement for its share of the discontinued operations of an equity method investee. See FSP 27 for further information on the presentation of discontinued operations. If the investor does not report discontinued operations, it would report its share of the investee's discontinued operations as part of the single amount in the income statement representing the investor's share of the investee's earnings or losses.

4.3.4 *Differences in accounting principles*

An investor and investee may apply different accounting principles in the preparation of their financial statements.

Investee applies US GAAP

ASC 323-10-20 defines earnings or losses of an investee as income or loss determined in accordance with US GAAP. The investee is ultimately responsible for the selection of its accounting policies. The investee may apply different accounting policies than the investor provided they are acceptable alternatives under US GAAP. For example, an investee could apply the FIFO method of inventory costing while the investor applies the LIFO method. As the investee's method is permissible under US GAAP, the investor does not need to adjust the investee's financial statements before recording its proportionate share of the investee's earnings.

However, care must be taken in the elimination of intra-entity profits and losses to avoid the recognition of profit or loss that results solely from differences in accounting policies. For example, an investor and investee may be counterparties in a long-term natural gas supply contract in which the investor accounts for the contract as a derivative instrument pursuant to ASC 815, *Derivatives and Hedging* (i.e., on a mark-to-market basis, with changes in fair value being reported in earnings) and the investee elects the normal-purchase, normal-sale scope exception, which results in the investee accounting for the contract on an accrual basis. The investor may have to eliminate unrealized intra-entity profits and losses recognized on such a contract. See EM 4.2 for discussion on the elimination of intercompany profits on transactions between an investor and an investee.

Investee does not apply US GAAP

An investor reporting under US GAAP is required to record its share of earnings or losses and other changes in net assets of the investee using investee financial statements that are prepared under US GAAP. The investor should arrange for the investee to prepare financial statements in accordance with US GAAP or obtain the information necessary to adjust the investee's financial statements to a US GAAP basis when the investee's financial statements have been prepared in accordance with other acceptable alternatives (e.g., IFRS, other GAAP, or accounting principles prescribed by a regulatory agency). In cases when an investee's policies under other GAAP (e.g., IFRS) are not acceptable alternatives under US GAAP, the investor should conform the investee's financial information using policies consistent with its own policies.

Investee applies industry-specific accounting principles

If an investee uses industry-specific accounting principles when preparing its own financial statements, the investor is required to retain the industry-specific accounting principles in its application of the equity method as described in ASC 323-10-25-7.

ASC 323-10-25-7

For the purposes of applying the equity method of accounting to an investee subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that investee.

This requirement is consistent with the consolidation guidance that similarly requires industry-specific accounting applied by a subsidiary be retained in its parent's financial statements.

Investee applies private company accounting alternatives

A public company investor may have an equity method investment in a private company investee that has elected an accounting alternative ("PCC alternative") approved by the PCC and endorsed by the FASB, such as the goodwill accounting alternative discussed in EM 4.3.1. A public company investor should eliminate the effects of its private company investee's application of such PCC alternatives as PCC alternatives are not available to public companies.

Accounting standards separately adopted by investee

It is common for new accounting standards to allow either early adoption or a delayed mandatory adoption date for private companies. If the investee adopts an accounting standard before the investor, the investor is not required to eliminate the effects of the adoption by the investee in its (the investor's) financial statements. Similarly, if an investor adopts a new accounting standard before the investee entity, the investee is not required to also adopt the new accounting standard solely for purposes of the investor's equity method accounting. However, care must be taken in the elimination of intercompany transactions to avoid the recognition of profit or loss that results from a difference in the investor or investee adopting a new accounting standard before the other entity.

4.3.5 **Reciprocal interests**

A reciprocal relationship exists when the investor and investee each hold an equity method investment through interests in the other's stock. Two methods are commonly applied in practice for an investor to account for shares held by the investee (the reciprocal shareholding):

- The treasury stock method
- The simultaneous equation method

While the treasury stock method is more common in practice, the simultaneous equation method is also an acceptable alternative, though significantly more complex in application. The investor should apply its selected method consistently for all reciprocal interests.

Treasury stock method

The treasury stock method considers the investor's stock held by the investee to be investor treasury stock. Accordingly, the investor's share of the investee's net income is recorded excluding the investee's equity method earnings from the investee's investment in the investor. The investor should not include shares held by the investee as treasury stock on the investor's balance sheet.

Simultaneous equation method

The simultaneous equation method is based on a concept for reciprocal interests between a parent entity and its consolidated subsidiary that are viewed as a single economic unit. The combined earnings of the equity method investor "parent" and the equity method investee "subsidiary" needs to reflect the amount that accrues to the "noncontrolling" interests in the equity method investee (i.e., the other investors in the investee entity), given those investors indirectly own a portion of the investor's equity. That is, the amount that accrues to the investee's other investors (other than the equity method investor) in the combined economic unit is comprised of the following amounts:

- The other investors' interest in the equity method investee's earnings from its own separate operations. This excludes any earnings the investee has from its investment in the equity method investor
- The other investors' interest in:
 - the investor's earnings from its separate operations, and
 - the investor's share of the equity investee's earnings from the equity investee's separate operations (excluding earnings the investee may have from its investment in the investor entity).

4.3.6 **Stock compensation awarded by investee to its employees**

Stock-based compensation awarded by an investee to its own employees results in recognition of compensation cost in net income in the investee's financial statements over the related vesting period. The investor would therefore recognize its proportionate share of the compensation expense as part of its equity method earnings.

When the stock-based compensation is equity classified, the investee records expense with an offsetting entry to additional paid-in-capital, the net effect of which does not change the investee's reported equity. The investor would record its proportionate share of the investee's stock-based compensation expense, but there's a question as to how the investor should account for its share of the investee's "credit" entry to additional paid-in-capital.

Generally, an investor accounts for change in interest transactions only when common shares have been issued by the investee. Therefore, during the vesting period, the investor would generally track its share of the investee's credit to additional paid-in-capital in its equity method memo accounts as a reconciling item. Alternatively, the investor could record the adjustment in its own equity with a corresponding increase in the investment account similar to how an investee's changes in OCI are treated by an investor (see EM 4.3.2 for further information).

However, we do not believe the investor should record its share of the investee's increase in additional paid-in-capital as part of its share of earnings of the investee as it would effectively result in the investor not recording its share of the investee's compensation expense.

The exercise of an option or vesting of restricted shares decreases the investor's percentage ownership in the investee. Therefore, the investor should account for a change in interest as an indirect sale of a portion of its interest in the investee. Regardless of how the investor accounts for the investee's increase in additional paid-in-capital, the investor should adjust its investment for a change in its share of the investee's net assets upon exercise of the option or for the vesting of restricted shares. See EM 5 for further information on accounting for change in interest transactions.

4.3.7 *Stock compensation awarded by investor to investee employees*

Stock-based compensation that is awarded by an investor to employees of its equity method investee can have an impact on both the reported investment and the investor's share of the earnings or loss of the equity method investment.

An investor may sponsor a stock-based compensation plan for its investee's employees. If the other investors do not provide proportionate funding or the investor does not receive any consideration, such as an increase in its relative ownership percentage of the investee for the awards, the investor should expense the entire cost associated with the award when the investee recognizes the related expense in its books, not just its proportionate share based on ownership interest in the investee. This assumes that the awards were not agreed to and accounted for as part of the investor's acquisition of an interest in the investee.

The investee will recognize the costs of the stock-based compensation incurred by the investor on its behalf with a related capital contribution.

Investors that do not participate in sponsoring the stock-based compensation plan for investee employees are also impacted. Such investors would recognize their respective share of the expense recorded by the investee as part of the share of earnings or losses of the investee. In addition, as the investee would have recorded an increase in its capital, the other non-contributing investors would also record their share of the investee's increase in net assets as part of their share of earnings or losses, with a corresponding increase in their equity method investment. The accounting is described in ASC 323-10-25-3 through ASC 323-10-25-5. See SC 7.1.8 for further information.

ASC 323-10-25-3

Paragraphs 323-10-25-4 through 25-6 provide guidance on accounting for share-based payment awards granted by an investor to employees or nonemployees of an equity method investee that provide goods or services to the investee that are used or consumed in the investee's operations when no proportionate funding by the other investors occurs and the investor does not receive any increase in the investor's relative ownership percentage of the investee. That guidance assumes that the investor's grant of share-based payment awards to employees or nonemployees of the equity method investee was not agreed to in connection with the investor's acquisition of an interest in the investee. That guidance applies to share-based payment awards granted to employees or nonemployees of an investee by an investor based on that investor's stock (that is, stock of the investor or other equity instruments indexed to, and potentially settled in, stock of the investor).

ASC 323-10-25-4

In the circumstances described in paragraph 323-10-25-3, a contributing investor shall expense the cost of share-based compensation granted to employees and nonemployees of an equity method investee as incurred (that is, in the same period the costs are recognized by the investee) to the extent that the investor's claim on the investee's book value has not been increased.

ASC 323-10-25-5

In the circumstances described in paragraph 323-10-25-3, other equity method investors in an investee (that is, noncontributing investors) shall recognize income equal to the amount that their interest in the investee's net book value has increased (that is, their percentage share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the compensation costs. Further, those other equity method investors shall recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf).

ASC 323-10-55-19 through ASC 323-10-55-26 includes a comprehensive example that demonstrates an investor's accounting for stock-based compensation awarded to employees of an equity method investee by the investor.

ASC 323-10-55-19

This Example illustrates the guidance in paragraphs 323-10-25-3 and 323-10-30-3 for share-based compensation by an investor granted to employees of an equity method investee. This Example is equally applicable to share-based awards granted by an investor to nonemployees that provide goods or services to an equity method investee that are used or consumed in the investee's operations.

ASC 323-10-55-20

Entity A owns a 40 percent interest in Entity B and accounts for its investment under the equity method. On January 1, 20X1, Entity A grants 10,000 stock options (in the stock of Entity A) to employees of Entity B. The stock options cliff-vest in three years. If an employee of Entity B fails to vest in a stock option, the option is returned to Entity A (that is, Entity B does not retain the underlying stock). The owners of the remaining 60 percent interest in Entity B have not shared in the funding of the stock options granted to employees of Entity B on any basis and Entity A was not

obligated to grant the stock options under any preexisting agreement with Entity B or the other investors. Entity B will capitalize the stock-based compensation costs recognized over the first year of the three-year vesting period as part of the cost of an internally constructed fixed asset (the internally constructed fixed asset will be completed on December 31, 20X1).

ASC 323-10-55-21

Before granting the stock options, Entity A's investment balance is \$800,000, and the book value of Entity B's net assets equals \$2,000,000. Entity B will not begin depreciating the internally constructed fixed asset until it is complete and ready for its intended use and, therefore, no related depreciation expense (or compensation expense relating to the stock options) will be recognized between January 1, 20X1, and December 31, 20X1. For the years ending December 31, 20X2, and December 31, 20X3, Entity B will recognize depreciation expense (on the internally constructed fixed asset) and compensation expense (for the cost of the stock options relating to Years 2 and 3 of the vesting period). After recognizing those expenses, Entity B has net income of \$200,000 for the fiscal years ending December 31, 20X1, December 31, 20X2, and December 31, 20X3.

ASC 323-10-55-22

Entity C also owns a 40 percent interest in Entity B. On January 1, 20X1, before granting the stock options, Entity C's investment balance is \$800,000.

ASC 323-10-55-23

Assume that the fair value of the stock options granted by Entity A to employees of Entity B is \$120,000 on January 1, 20X1. Under Topic 718, the fair value of share-based compensation should be measured at the grant date. This Example assumes that the stock options issued are classified as equity and ignores the effect of forfeitures.

ASC 323-10-55-24

Entity A would make the following journal entries.

	12/31/20X1	12/31/20X2	12/31/20X3
To record cost of stock compensation and Entity C's additional Investment for costs incurred by Entity A on behalf of investee			
Entity A (Contributing Investor)			
Investment in Entity B ^(a)	\$ 16,000	\$ 16,000	\$ 16,000
Expenses ^(b)	24,000	24,000	24,000
Additional paid-in capital	\$40,000	\$40,000	\$40,000
Entity B (investee)			
Fixed asset	\$ 40,000	—	—
Expenses	—	\$ 40,000	\$ 40,000
Additional paid-in capital	\$ 40,000	\$ 40,000	\$ 40,000
Entity C (noncontributing Investor)			
Investment in Entity B	\$ 16,000	\$ 16,000	\$ 16,000
Contribution income ^(c)	\$ 16,000	\$ 16,000	\$ 16,000
To record Entity A's and Entity C's share of the earnings of investee (same entry for both Entity A and Entity C)			
Entity A and Entity C			
Investment in Entity B	\$ 80,000	\$ 80,000	\$ 80,000
Equity in earnings of Entity B	\$ 80,000	\$ 80,000	\$ 80,000
Consolidated impact of all the entries made by Entity A and Entity C			
Entity A			
Investment in Entity B	\$ 96,000	\$ 96,000	\$ 96,000
Expenses	24,000	24,000	24,000
Additional paid-in capital	\$ 40,000	\$ 40,000	\$ 40,000
Equity in earnings of Entity B	80,000	80,000	80,000
Entity C			
Investment in Entity B	\$ 96,000	\$ 96,000	\$ 96,000
Contribution income	\$16,000	\$16,000	\$16,000
Equity in earnings of Entity B	80,000	80,000	80,000

^(a) Entity A recognizes as an expense the portion of the costs incurred that benefits the other investors (in this Example, 60 percent of the cost or \$24,000 in 20X1, 20X2, and 20X3) and recognizes the remaining cost (40 percent) as an increase to the investment in Entity B. As Entity B has recognized the cost associated with the stock-based compensation incurred on its behalf, the portion of the cost recognized by Entity A as an increase to its investment in Entity B (40 percent) is expensed in the appropriate period when Entity A recognizes its share of the earnings of Entity B.

^(b) It may be appropriate to classify the debit (expense) within the same income statement caption as equity in earnings of Entity B.

^(c) This amount represents Entity C's 40 percent interest in the additional paid-in capital recognized by Entity B related to the cost incurred by the third party investor. It may be appropriate to classify the credit (income) within the same income statement caption as equity in earnings of Entity B.

4.4 Lag in investee reporting

The financial statements of an investee may not be available for the investor to apply the equity method as of the current reporting date. For example, the investor and investee may both have a reporting period ending on March 31, but the investor might not receive the investee's financial statements for several months. The investor can make an accounting policy election to record its share of the earnings or losses of the investee using a lag period of one to three months. The lag should be applied consistently from period to period.

The decision to record an investee's results on a lag can be made on an investment-by-investment basis. Therefore, each investment should be assessed separately to determine if a lag in investee reporting is necessary.

While ASC 323 does not specify a limit on the extent of the lag period, the provisions relating to consolidation of subsidiaries with different fiscal year ends than its parent entities offer a reasonable guideline (i.e., three months).

ASC 810-10-45-12

It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, financial statements for a period that corresponds with or closely approaches the fiscal period of the parent. However, if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.

When results of the investee are reported on a lag, the investee results should be for the same length of time as what is included in the investor's financial statements. For example, for an investor's annual financial statements, the investee's results for 12 months should be included, although the results are for a different 12 months than those of the investor's standalone results. Including the investee's results for a period greater or less than 12 months in the investor's annual financial statements is generally not appropriate. See EM 4.4.1 for information regarding the investor's accounting for a new investment that is reported on a lag.

The investor should consider the effect of any known events occurring during the lag period that materially affect the financial position or results of operations of the investee if those events are also material to the financial position or results of operations of the investor.

An investor may elect to either (1) disclose or (2) disclose and record adjustments for material events occurring during the intervening period. This policy should be applied on a consistent basis from one period to the next. Often reporting entities choose disclosure only for material intervening events as it may be challenging to determine a threshold for when to adjust for intervening events. The investor would also need to track adjustments to ensure it does not record its share of intervening events in subsequent periods.

4.4.1 Initial lag period

An investor may elect to include the investee's results on a lag for an investment in an investee for which it will apply the equity method for the first time. The investor would include its share of the

investee earnings from the date of acquisition through the end of the date selected for lag reporting in the investor's first reporting period. Example EM 4-5 illustrates an investor's accounting for the acquisition of an equity method investment that is reported with a lag period.

EXAMPLE EM 4-5

Acquisition of equity method investment reported with a lag

Investor, a public company with a calendar year end, acquires an equity method investment in Investee on December 1, 20X1, which will be accounted for on a two-month lag.

How should Investor record its share of Investee's earnings for 20X1 and 20X2?

Analysis

In its annual 20X1 financial statements, Investor would record the acquisition of its interest in Investee at cost. However, Investor would not record any share of Investee earnings despite having owned the investment for the month of December.

In its first quarter 20X2 financial statements, Investor would include its share of Investee earnings for December 20X1 and January 20X2. Investor's share of Investee earnings for the year ended 20X2 would include 11 months (December 1, 20X1 to October 31, 20X2).

4.4.2 Sale of interest when reporting on a lag

When an investor disposes of all or a portion of its investment in an investee that it reported on a lag, it should generally reflect its share of the investee earnings in net income only up to the end of the date selected for lag reporting. An investor would usually record its gain or loss on sale of the investment when it is sold and would not record the disposal on a lag.

There is no authoritative guidance on an investor's accounting for the sale of its investment when reporting on a lag. We believe one acceptable method would be for the investor to continue to record earnings on a lag. For example, assume that a calendar year end investor sells its equity method investment, which it is reporting for on a three-month lag, on September 30, 20X2. Under this method, the investee results for the three months ended June 30, 20X2 would be reflected in the investor's quarter ended September 30, 20X2. The investor would then recognize a gain or loss on disposal when the investment is sold as the difference between the carrying amount of the investment on September 30, 20X2 and the proceeds received. The investor would not recognize any equity method earnings for the investment in the quarter ended December 31, 20X2 (related to September 30, 20X2 earnings) as investee earnings for that quarter would already be reflected in the selling price of the investment and the recorded gain or loss on disposal.

4.4.3 Change to lag in investee reporting

The change or elimination of a lag between investor and investee reporting periods is considered a change in accounting principle. The investor is required to demonstrate preferability before making the change. In addition, public companies are required to obtain a preferability letter from the investor's independent auditor when the change is material. See FSP 30.4 for a discussion of changes in accounting principles.

ASC 810-10-45-13

A parent or an investor should report a change to (or the elimination of) a previously existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee in the parent's or investor's consolidated financial statements as a change in accounting principle in accordance with the provisions of Topic 250. While that Topic generally requires voluntary changes in accounting principles to be reported retrospectively, retrospective application is not required if it is impracticable to apply the effects of the change pursuant to paragraphs 250-10-45-9 through 45-10. The change or elimination of a lag period represents a change in accounting principle as defined in Topic 250. The scope of this paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. That change may include a change in or the elimination of the previously existing difference (lag period) due to the parent's or investor's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the parent or investor. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

Generally, retrospective application is required under ASC 250 unless impracticable to apply the effects of the change. Therefore, for the elimination of a lag period, an investor should adjust its financial statements for all periods presented as if the reporting lag never existed. For example, assume Investor, a calendar year end public company, eliminated the existing three-month reporting lag in the fourth quarter 20X1. Investor would adjust its 20X1 financial statements to reflect its share of investee's earnings for the twelve months ended December 31, 20X1. Investor would reverse its share of Investee's earnings for the three months ended December 31, 20X0, which, absent the elimination of the lag, would have been recognized in its 20X1 financial statements. Such amounts would be recorded as a direct adjustment to the current period opening retained earnings balance as if recognized in the prior period.

In practice, it is difficult to justify the preferability of a change that creates (or lengthens) a lag period. The inability to obtain timely information when historically able to do so is unusual, and is generally not on its own a sufficient reason for introducing a lag in reporting. Further, the inability to obtain timely financial information may indicate that the investor does not have the ability to exert significant influence over an investee and the applicability of the equity method of accounting should be reevaluated (see EM 2 for a further discussion).

4.4.4 Availability of public information

If an investee is a public entity, certain laws may preclude an investor from disclosing information about a public investee that is not already publicly available. This can occur when the investee's financial statements are not due to be filed until after the investor's financial statements. As a result, the investor may elect to report its investment in the investee on a lag, provided such lag does not exceed three months.

Similarly, even when an investor elects the fair value option for an investment in a public company that would otherwise qualify for the equity method, it may be difficult to provide the required equity method disclosures for that investee. Even though fair value is determined at the end of the current reporting period, it may be appropriate to provide the disclosures based on the most recent publicly available financial statements, as long as the lag does not exceed three months.

4.5 *Losses in excess of investment carrying amount*

An investor's share of losses of an investee (including any impairments of its investment as discussed in EM 4.8) may exceed the carrying amount of its investment (including unsecured or subordinated intercompany advances made by the investor other than accounts receivable in the ordinary course of business). It is appropriate to consider deferred intercompany profits (as discussed in EM 4.2) as a reduction in the carrying amount of the investment. The investor should also consider any other comprehensive income (OCI) amounts recorded by the investor that relate to its equity method investment. We believe that the equity method investment carrying amount should include the effects of any OCI amounts, except for OCI related to foreign currency translation adjustments.

There is a general presumption that equity method should be suspended and losses should not be recognized in excess of the total investment (including any additional advances). It is important that investors continue to track unrecognized equity method losses to determine when to record subsequent period equity method earnings. See EM 4.5.3 for further discussion.

An investor may record losses in excess of the carrying amount of the investment if the investor has guaranteed the investee's obligations or has committed to provide further financial support to the investee, as described in ASC 323-10-35-20.

ASC 323-10-35-20

The investor ordinarily shall discontinue applying the equity method if the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.

Judgment should be exercised when assessing if the investor is committed to provide further financial support for the investee and should be based on an analysis of the related facts and circumstances. The following are factors that should be considered in making this assessment:

□ *Legal and quasi-legal obligations*

When the investor is legally obligated to assume, underwrite, or guarantee investee obligations, an investor would recognize losses in excess of its investment.

When an investor has guaranteed investee obligations, it may need to record losses allocable to the other investors instead of only its proportionate share of the investee's losses. If the investor is legally obligated to fund more than its portion of the investee losses (i.e., other investors are not obligated to fund losses), the investor will generally be required to record investee losses otherwise allocable to other investors, since it is likely that such other investors will not bear their share.

When the other investors are obligated to fund a proportionate share, the investor should assess the ability of the other investors to fund if necessary, not the probability that the investee will require funding. If it is probable that the other investors will not fund their portion of the investee losses, the investor is required to record the entire loss of the investee up to its legal obligation (i.e., beyond its proportionate share). This could occur when the other investors, while legally obligated to provide support, choose not to or lack the financial capability to fund.

Investors should also consider joint and several liability arrangements under which the lender can demand payment of the total amount from any one of the obligors (investors) or combination of obligors. While the investor may be able to pursue payment from the other investors, it again would need to consider the likelihood that the other investors would be able to fund their respective obligations. The accounting for joint and several liability arrangements is contained in ASC 405-40. See FG 2 for further information on the accounting for joint and several liability arrangements.

Losses in excess of the investment should ordinarily be recognized when the investor has a “quasi-legal” obligation to underwrite investee losses. A quasi-legal obligation is based on factors other than a strict obligation, such as the business relationship and credit standing of the other investors. When the investor has followed the practice of underwriting investee losses through advances, or there is a strong presumption that the investor would “make good” the obligations of an investee in order to preserve its credit rating, business reputation, or other important relationships, recognition of losses may be required even without a legally binding obligation. This determination requires judgment and may be based predominantly on the intent of the investor. When the investor has previously acted upon that intent by funding the investee, it would be difficult to support a change in intent not to fund the investee, absent the occurrence of a change in business strategy.

The investor must consider whether the other investors also have a quasi-legal obligation and will bear their share of the losses. This is necessary to determine whether the investor should record losses otherwise allocable to other investors, in addition to its allocated losses. The requirements of ASC 460 should be considered as they relate to such guarantees.

To the extent an investor is funding the losses of an investee, the investor should consider the provisions of the variable interest entity model to determine whether the investee may be a VIE and require consolidation by the investor. The funding of losses may also require reconsideration of previous consolidation conclusions under ASC 810-10.

□ *Publicly stated investor intentions*

Public statements by the investor of its intention to abandon, or to continue to provide support to, an investee should be considered.

□ *Operating considerations*

Operating matters should be considered to the extent practicable. The following circumstances may indicate the investor is unlikely to abandon the investee and, therefore, full recognition of losses in excess of the investor’s investment is appropriate:

- Investee losses are attributable to start-up costs, or similar circumstances that are considered temporary or nonrecurring, and a turnaround to profitable operations is expected.
- The investee may be in an industry in which accounting losses can be sustained more or less indefinitely without impairing the going concern assumption (e.g., real estate development companies).
- The operation experiencing losses may integrate favorably with other consolidated operations.
- The investor is a major supplier to or major purchaser from the investee.

- The investor is dependent on the investee for strategic development processes (for example, research and development or new technologies).
- Any other factors indicating that the investor has an incentive to protect and support the investee.

The key consideration from an operating perspective is whether the investor would abandon the investee. This assessment is based on the investor's relationship with the investee and the other investors and should consider all relevant facts and circumstances.

Losses are also required to be recognized by an investor in excess of its investment when the imminent return to profitability by the investee is assured. This determination requires the exercise of judgment. This differs from consolidation guidance in ASC 810-10, which requires losses to continue to be attributed to the noncontrolling interest even if that results in a debit balance.

ASC 323-10-35-21

An investor shall, however, provide for additional losses if the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired.

4.5.1 *Change of interest after suspension of equity method losses*

An investor should consider whether a subsequent investment in an investee after the investor has suspended recognizing equity method losses provides the investor with a controlling financial interest in the investee. If the investor gains a controlling financial interest in the investee, the investor would follow the acquisition guidance in ASC 805. See EM 5 for further discussion on the accounting for changes in interest.

When an additional investment does not provide an investor with a controlling financial interest, the investor should consider whether the additional investments, in substance, represent the funding of prior losses versus an additional investment. The investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses. The investor should also consider whether it has otherwise become committed to provide financial support to the investee when making an additional investment.

Whether an investment represents the funding of prior losses depends on the facts and circumstances. Judgment is required to determine whether prior losses are being funded. All available information should be considered in performing the related analysis. ASC 323 provides additional factors for consideration.

ASC 323-10-35-29

If a subsequent investment in an investee does not result in the ownership interest increasing from one of significant influence to one of control and, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (see (b)). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances. Judgment is required in determining whether prior losses are being funded and all

available information should be considered in performing the related analysis. All of the following factors shall be considered; however, no one factor shall be considered presumptive or determinative:

- a. Whether the additional investment is acquired from a third party or directly from the investee. If the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.
- b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.
- c. Whether the additional investment results in an increase in ownership percentage of the investee. If the investment is made directly with the investee, the investor shall consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.
- d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

4.5.2 *Investor holds other investments in the investee*

When an investor has investments outside its equity method investment, such as preferred stock and loans, the investor would continue to recognize investee losses up to the investor's aggregate carrying value in those other investments. The recognition of losses would include any additional financial support made or committed to by the investor. An investment considered to be in-substance common stock may generally be grouped with, and considered, common stock for the purposes of performing the investee loss allocations required.

ASC 323-10-35-25

The cost basis of the other investments is the original cost of those investments adjusted for the effects of write-downs, unrealized holding gains and losses on debt securities classified as trading in accordance with Subtopic 320-10 or equity securities accounted for in accordance with Subtopic 321-10 and amortization of any discount or premium on debt securities or financing receivables. The adjusted basis is the cost basis adjusted for the allowance for credit losses account recorded in accordance with Topic 326 on measurement of credit losses for an investee financing receivable and debt security and the cumulative equity method losses applied to the other investments. Equity method income subsequently recorded shall be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (that is, equity method income is applied to the more senior investments first).

Equity method losses should be applied to other investments based on seniority, beginning with the most subordinated investments. For each period, the basis of the other investments should first be

adjusted for equity method losses and may need to be further adjusted after applying the relevant impairment guidance for those investments. For example, assume an investor invests in both common stock and preferred stock of an investee and made advances to the investee in the form of debt. Subsequently, if the investor's share of equity method losses reduces the basis of its common stock investment to zero, the investor should continue to recognize equity method losses to the extent of, and as an adjustment to, the basis of the preferred stock (the next most senior security). The advance to the investee in the form of debt would continue to be accounted for in accordance with the provisions of an impairment of a loan by a creditor. However, once the cost basis of the investment in the preferred stock also reaches zero, investee losses would be recognized to the extent that the net carrying amount of the debt (net of any valuation account or amortization) exceeded zero. At all times, the preferred stock would require a write-up (or write-down) to fair value through income if it is an equity security as defined in ASC 321 (absent applying the measurement alternative) or through OCI if it is a debt security as defined in ASC 320 (and reported as available for sale).

Excerpt from ASC 323-10-35-24

[T]he investor shall continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments shall follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments shall be adjusted for the equity method losses, then the investor shall apply Subtopic 310-10, 320-10, 321-10, 326-20, or 326-30 to the other investments, as applicable.

When an investor's investment in common stock has been reduced to zero and it has other investments in the investee, the investor generally should not recognize incremental equity method losses against its other investments based only on percentage of investee common stock held in accordance with ASC 323-10-35-28. There are two acceptable methods that could be applied. An investor would either recognize investee losses based on (1) the ownership level of the particular investee security or loan/advance held by the investor to which the equity method losses are being applied, or (2) the change in the investor's claim on the investee book value (hypothetical liquidation book value as described in EM 4.1.4). Once elected, one method should be applied consistently for all equity method investments.

Example EM 4-6 illustrates the approach to attribute investee losses based on ownership level of the particular investee security or loan/advance held by the investor. EM 4.1.3 includes an example of a change in the investor's claim on the investee book value from ASC 323-10-55-49.

EXAMPLE EM 4-6

Attribution of investee losses when investor has other investment

On January 1, 20X1, Company XYZ began its operations with three investors, Company A, Company B, and Company C.

- Company A acquired 1,000,000 shares of Company XYZ's common stock for \$1 per share and loaned Company XYZ \$1,000,000 in cash.
- Company B acquired 750,000 shares of Company XYZ's common stock for \$1 per share and 1,000,000 shares of Series A voting preferred stock in Company XYZ for \$2 per share. The preferred stock is not considered in-substance common stock.

- Company C acquired 750,000 shares of Company XYZ's common stock for \$1 per share.

Company A, Company B, and Company C account for their respective investments in common stock under the equity method of accounting.

For simplicity, this example assumes the preferred stock is measured using the measurement alternative with no observable changes in fair value or impairment under ASC 321, *Investments – Equity Securities*, and the loan was not impaired under ASC 310, *Receivables*.

	Company A	Company B	Company C	Total
Common stock (shares)	1,000,000	750,000	750,000	2,500,000
Percent of common stock ownership	40%	30%	30%	100%
Preferred stock (shares)	—	1,000,000	—	1,000,000
Total shares	1,000,000	1,750,000	750,000	3,500,000
Percent of total voting shares outstanding	28.6%	50.0%	21.4%	100%
Total value of shares outstanding	\$1,000,000	\$2,750,000	\$750,000	\$4,500,000
Loan	1,000,000	—	—	1,000,000
Total investment in company XYZ	\$2,000,000	\$2,750,000	\$750,000	\$5,500,000

Company XYZ incurred losses of \$2,500,000 and \$2,750,000 in 20X1 and 20X2, respectively. None of Company XYZ's investors is required to provide additional financial support. Assume that Company XYZ is not a VIE.

What are Company A, Company B, and Company C's respective shares of Company XYZ's losses for 20X1 and 20X2?

Analysis

The following table illustrates how Company A, B, and C should account for the losses in Company XYZ for 20X1 and 20X2, given their investments in Company XYZ.

Company A		
	Common stock	Loan
Equity investment in Company XYZ - 1/1/20X1	\$1,000,000	\$1,000,000
Company A's share of 20X1 net losses $(\$2,500,000) \times 40\%$	(1,000,000)	—

Equity investment in Company XYZ - 12/31/20X1 (a)	—	1,000,000
Company A's share of 20X2 net losses (\$750,000) [that is, \$2,750,000 less \$2,000,000 that is first applied to preferred stock]	—	(750,000)
Equity investment in Company XYZ - 12/31/20X2 (b)	—	250,000
Company B		
	Common stock	Preferred stock
Equity investment in Company XYZ - 1/1/20X1	\$750,000	\$2,000,000
Company B's share of 20X1 net losses (((\$2,500,000) × 30%)	(750,000)	—
Equity investment in Company XYZ - 12/31/20X1 (a)	—	2,000,000
Company B's share of 20X2 net losses [that is, \$2,750,000, of which \$2,000,000 is first applied to preferred stock]	—	(2,000,000)
Equity investment in Company XYZ - 12/31/20X2 (b)	—	—
Company C		
	Common stock	
Equity investment in Company XYZ - 1/1/20X1	\$750,000	
Company C's share of 20X1 of net losses (((\$2,500,000) × 30%)	(750,000)	
Equity investment in Company XYZ - 12/31/20X1 (a)	—	
Company C's share of 20X2 net losses	—	
Equity investment in Company XYZ - 12/31/20X2 (b)	—	

a – In 20X1, Company XYZ's losses (\$2,500,000) should be allocated proportionately to the common stock held by Companies A, B, and C. As a result, at December 31, 20X1, the investment balance of Companies A, B, and C in the common stock of Company XYZ have all been reduced to zero due to the allocation of their proportionate share of Company XYZ's net loss. This allocation was based on the percentage of common stock owned by each investor, not on the percentage ownership of total voting stock. As noted above, the preferred stock is not in-substance common stock for purposes of this example.

b – Because each company’s equity investment in Company XYZ is zero, in 20X2, the \$2,750,000 net loss must be allocated to the next most senior level of capital (the \$2,000,000 of preferred stock held by Company B), and then the remaining amount (\$750,000) is allocated to Company A’s loan. Accordingly, at December 31, 20X2, Company B’s preferred stock investment in Company XYZ has been reduced to zero since the \$2,750,000 net loss is first applied against the preferred stock investment, as it is the next most senior investment. Similarly, at December 31, 20X2, Company A’s loan investment in Company XYZ has been reduced to \$250,000 since the remaining portion of Company XYZ’s net loss (\$750,000) is applied against the loan investment balance.

4.5.3 *Investee return to profitability*

When the investor does not recognize investee losses in excess of its investment and the investee returns to profitability and subsequently reports net income or OCI, the investor generally should resume applying the equity method, absent any investee capital transactions, only after the investee’s shareholders’ deficit is eliminated (i.e., once the investor has equity in the net assets of the investee). This requires the investor to separately track its unrecorded share of investee losses and other comprehensive losses in its equity method memo accounts during the period the equity method has been suspended.

The “share of net losses not recognized” should be the aggregate of the investor’s share of investee losses and any adjustments related to subsequent accounting for basis differences (see EM 4.3.1) that would have been charged to income during the period when losses were not recognized. When the investee recognizes net income or OCI, it is applied to those memo accounts. Once the cumulative losses in the memo accounts have been reduced to zero, the investor would resume applying the equity method. When the investor resumes applying the equity method, the recognized earnings and OCI would be the same as if the investor has never suspended applying the equity method.

Excerpt from ASC 323-10-35-26(b)(2)

If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported.

When an investee returns to profitability, an investor generally restores its investment balance only to the extent of the investor’s equity in net assets of the investee. Therefore, an investor would generally not restore the remaining balance of any unamortized basis differences that were not recognized after losses reduced the investor’s investment balance to zero.

Example EM 4-7 illustrates the methodology that is generally employed when an investor restores its investment balance after (1) an investor does not recognize investee losses in excess of its investment balance and (2) an investee returns to profitability.

EXAMPLE EM 4-7**Prior losses in excess of investment not recognized**

Investor pays \$100 for a 20% common stock investment in Investee on 1/1/20X1 and determines that it is able to exercise significant influence over Investee. At the date of acquisition, Investor's 20% share of Investee's net assets is \$70. Investor determines that the \$30 excess cost over the net assets of Investee (initial basis difference) relates entirely to a manufacturing plant. The basis difference assigned to the plant is being depreciated on a straight-line basis over 10 years (\$3 per year).

Investee has incurred losses for the first three years. Investor's share of those losses amounted to \$40 per year. Investee is profitable in year four and five and Investor's share is \$70 in each of those years.

Date	Investor share of Investee income (loss)	Depreciation of basis difference	Equity income (loss) reported by Investor	Investor investment balance (A)	Investor portion of Investee's equity (B)	Memo Account (C) = A-B
1/1/20X1	\$ -	\$ -	\$ -	\$100	\$70	\$30
12/31/20X1	(40)	(3)	(43)	57	30	27
12/31/20X2	(40)	(3)	(43)	14	(10)	24
12/31/20X3	(40)	(3)	(14) ¹	—	(50)	50
12/31/20X4	70		20 ²	20	20	0
12/31/20X5	70		70	90	90	0

- For the year ended 12/31/20X3, Investor's share of Investee's losses of \$40 plus the \$3 depreciation of initial basis differences would result in additional loss of \$43 reported by Investor. However, Investor only records a loss of \$14 which reduces Investor's investment balance in column A to zero. Investor does not record a loss in excess of its \$14 investment because Investor has not guaranteed Investee's obligations or committed to provide further financial support to Investee. The incremental unrecognized loss must be tracked on Investor's books in columns B and C as once the cumulative losses in the memo accounts have been reduced to zero, Investor would resume applying the equity method.
- In 20X4, Investee returns to profitability. Investor's share of Investee's income of \$70 is first applied to the \$50 of unrecognized losses tracked by Investor in 12/31/20X3. The remaining \$20 is recorded as Investor's proportionate share of Investee's net income ($\$20 = (\$50) + 70$). At this point Investor's investment balance equals Investor's portion of Investee's equity, and the memo account is zero (i.e., all previously tracked unrecognized losses have been recognized and no basis differences remain).

If an investor had other investments (e.g., preferred stock) in the investee entity when equity method losses had also been recorded as an adjustment to these investments, the investor's share of investee's

earnings in a subsequent return to profitability should first be applied to those other investments in reverse order (i.e., starting with the most senior investment).

4.6 *Interest costs related to equity method investment*

An investor should consider interest costs related to equity method investments. ASC 835-20 requires an investor to capitalize interest costs while the investee has activities in progress to begin planned principal operations and the investee is using funds to acquire assets for its operations. Interest cannot be capitalized after the planned principal operations have commenced, for example, when an investee has several factories under construction but one begins operations.

Excerpt from ASC 835-20-15-5

Interest shall be capitalized for the following types of assets (qualifying assets)...

c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization.

Excerpt from ASC 835-20-15-6

Interest shall not be capitalized for the following types of assets...

d. Investments accounted for by the equity method after the planned principal operations of the investee begin (see paragraph 835-20-55-2 for clarification of the phrase after planned principal operations begin)

Separately, an investee may qualify to capitalize interest on allowable projects in its own financial statements, even if the investor is not permitted to capitalize the interest it incurs. The investor would recognize interest capitalized by the investee through its equity method earnings (i.e., its proportionate share of the depreciation expense related to the investee's capitalized interest). However, if the investee's capitalized interest is related to a loan from the investor, the investor should adjust equity method earnings for its proportionate share of capitalized interest from its equity method investment with a related deduction from its equity method investment. Example EM 4-8 illustrates this concept.

EXAMPLE EM 4-8

Investee capitalizes interest costs for loan from investor

Investor has a 25% investment in Investee common stock that is accounted for under the equity method of accounting. On 1/1/20X1, Investor loans \$1 million with a 6% annual interest rate to Investee to build a factory. Investee does not have any other loans outstanding. Investee's planned principal operations have not yet commenced, and so the related interest qualifies for capitalization per ASC 835-20. Investee has net income for the year ending 12/31/20X1 of \$300,000.

How should Investor record its share of Investee's earnings?

Analysis

Investor would record its 25% share of Investee's earnings for the year ending 12/31/20X1 as follows.

Dr. Equity method investment	\$75,000	
Cr. Equity method earnings		\$75,000

Investor would also record \$60,000 of interest income for the year ending 12/31/20X1 (\$1,000,000 loan balance multiplied by 6% annual interest rate).

Dr. Cash	\$60,000	
Cr. Interest income		\$60,000

Investee has capitalized the interest associated with the loan provided by Investor. Therefore, Investor needs to adjust equity method earnings to deduct Investor's proportionate share of the interest capitalized by Investee (25% of \$60,000 total Investee interest).

Dr. Equity method earnings	\$15,000	
Cr. Equity method investment		\$15,000

This example does not consider the effect of any basis differences on the factory resulting from Investee being able to capitalize interest that is not capitalizable by Investor. The investor should consider the effects of basis differences that arise from capitalized interest on loans from the investor and should adjust equity method earnings over the same period of the associated underlying assets of the investee (e.g., depreciation of the related PP&E).

Investors should evaluate if loans to the investee are considered in-substance capital contributions, such as a scenario when all investors are required to make loans or advances in proportion to their equity interests. If an in-substance capital contribution, interest received by the investor would be accounted for as a distribution from the investee, with a reduction to the investor's equity method investment instead of interest income.

ASC 835-20-30-6 limits the total interest cost to be capitalized by a consolidated group to the interest incurred by the parent and its consolidated subsidiaries. An equity method investee is not a part of the investor's (parent's) consolidated group. Therefore, interest incurred by the investee is not eligible for capitalization by the investor. Similarly, interest incurred by the investor is not capitalizable by the investee.

4.7 Distributions in excess of carrying amount of investment

An investor may receive cash distributions in excess of the carrying amount of its investment. We believe that an investor should account for cash distributions received in excess of its investment in an investee as a gain when (a) the distributions are not refundable by agreement or by law and (b) the investor is not liable for investee obligations and is not committed or expected to provide financial support. Otherwise, the investor should account for the excess distribution as a liability. Whether an investor has a non-legal commitment to provide financial support to an investee depends on the facts and circumstances surrounding an investor's relationship with the investee and other investors. The

considerations in assessing whether a non-legal obligation exists are similar to those set forth in EM 4.5.

If a general partner has an equity method investment in a limited partnership and receives cash distributions in excess of its investment balance, the excess distributions are recorded as a reduction of its partnership interest, even if it results in a negative net investment (liability). This treatment, consistent with ASC 970-323, is due to the general partner's ongoing obligation to support the partnership. Alternatively, for a limited partner investor, gain recognition may be appropriate if it does not have an obligation (by agreement or law) or intent to fund future cash flow requirements of the partnership.

If an investor records an excess distribution from an equity method investee as income, the investor should generally not record its share of any subsequent investee income until it equals the gain recorded. This approach is similar to the method applied for the recovery of unrecorded excess losses by the investor in ASC 323-10-35-22. If an investor records an excess distribution from an equity method investee as a liability (negative investment), the investor should record its portion of any subsequent investee income as equity method income.

4.8 Impairment of an equity method investment

An investor is required to assess its equity method investment for impairment when events or circumstances suggest that the carrying amount of the investment may be impaired.

4.8.1 Loss in investment value that is other than temporary

An investor records an impairment charge in earnings when the decline in value below the carrying amount of its equity method investment is determined to be other than temporary. "Other than temporary" does not mean that the decline is of a permanent nature. The unit of account for assessing whether there is an other-than-temporary impairment (OTTI) is the carrying value of the equity method investment as a whole.

ASC 323-10-35-32

A loss in value of an investment that is other than a temporary decline shall be recognized. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity that would justify the carrying amount of the investment. A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors that shall be evaluated.

Continued operating losses at the investee may suggest that the investor would not recover all or a portion of the carrying value of its investment, and therefore that the decline in value is other than temporary.

ASC 323-10-35-31

A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that shall be recognized even though the

decrease in value is in excess of what would otherwise be recognized by application of the equity method.

All available evidence should be considered in assessing whether a decline in value is other than temporary. The relative weight placed on individual factors may vary depending on the situation.

Factors to consider in assessing whether a decline in value is other than temporary include:

- The length of time (duration) and the extent (severity) to which the market value has been less than cost.
- The financial condition and near-term prospects of the investee, including any specific events which may influence the operations of the investee, such as changes in technology that impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential.
- The intent and ability of the investor to retain its investment in the investee for a period of time sufficient to allow for any anticipated recovery in market value.

Investors should also consider the reasons for the impairment and the period over which the investment is expected to recover. The longer the expected period of recovery, the stronger and more objective the positive evidence needs to be in order to overcome the presumption that the impairment is other than temporary. As the level of negative evidence grows, more positive evidence is needed to overcome the need for an impairment charge. The positive evidence should be verifiable and objective.

Figure EM 4-2 contain examples of negative evidence that may suggest that a decline in value is other than temporary. Figure EM 4-3 contains examples of positive evidence that may suggest a decline in value is not other than temporary. These examples are not all-inclusive, and investors should assess all relevant facts and circumstances.

Figure EM 4-2

Negative evidence that indicates decline is other than temporary

- A prolonged period during which the fair value of the security remains at a level below the investor's cost
- The investee's deteriorating financial condition and a decrease in the quality of the investee's asset, without positive near-term prospects for recovery. For example, adverse changes in key ratios and/or factors, such as the current ratio, quick ratio, debt to equity ratio, the ratio of stockholders' equity to assets, return on sales, and return on assets. With respect to financial institutions, examples of adverse changes are large increases in nonperforming loans, repossessed property, and loan charge-offs
- The investee's level of earnings or the quality of its assets is below that of the investee's peers
- Severe losses sustained by the investee in the current year or in both current and prior years
- A reduction or cessation in the investee's dividend payments

- A change in the economic or technological environment in which the investee operates that is expected to adversely affect the investee's ability to achieve profitability in its operations
- Suspension of trading in the security
- A qualification in the accountant's report on the investee because of the investee's liquidity or due to problems that jeopardize the investee's ability to continue as a going concern
- The investee's announcement of adverse changes or events, such as changes in senior management, salary reductions and/or freezes, elimination of positions, sale of assets, or problems with equity investments
- A downgrading of the investee's debt rating
- A weakening of the general market condition of either the geographic area or industry in which the investee operates, with no immediate prospect of recovery
- Factors, such as an order or action by a regulator, that (1) require an investee to (a) reduce or scale back operations or, (b) dispose of significant assets, or (2) impair the investee's ability to recover the carrying amount of assets
- Unusual changes in reserves (such as loan losses, product liability, or litigation reserves), or inventory write-downs due to changes in market conditions for products
- The investee loses a principal customer or supplier
- Other factors that raise doubt about the investee's ability to continue as a going concern, such as negative cash flows from operations, working-capital deficiencies, or noncompliance with statutory capital requirements
- The investee records goodwill, intangible or long-lived asset impairment charges

Figure EM 4-3

Positive evidence indicating decline is not other than temporary

- Recoveries in fair value subsequent to the balance sheet date
- The investee's financial performance and near-term prospects (as indicated by factors such as earnings trends, dividend payments, analyst reports, asset quality, and specific events)
- The financial condition and prospects for the investee's geographic region and industry

In situations where the fair value is known, such as in the case of an investment with a quoted price or when an investee stock transaction occurs, and that fair value is below the investor's carrying amount, the investor would need to assess whether that impairment is other than temporary. The fact that the fair value is below the carrying amount does not automatically require an impairment charge to be recognized. All facts and circumstances would need to be considered.

Excerpt from ASC 323-10-35-32

A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors that shall be evaluated.

For investments in private companies, information that would usually be considered includes:

- The price per share of the most recent round of equity investments
- The expected timing of the next round of financing
- The history of operating losses and negative cash flow
- Earnings and cash flow outlook and expected cash burn rate
- Technological feasibility of the company's products

Once a determination is made that an OTTI exists, the investment should be written down to its fair value in accordance with ASC 820 at the reporting date, which establishes a new cost basis. Any bifurcation of declines in value between “temporary” and “other than temporary” is not allowed. Subsequent declines or recoveries after the reporting date are not considered in the impairment recognized. A previously recognized OTTI also cannot subsequently be reversed when fair value is in excess of the carrying amount.

When an investor records an OTTI charge, the investor is required to attribute the impairment charge to the underlying equity method memo accounts of its investment. The attribution may create new basis differences or impact existing basis differences. ASC 323 does not provide guidance on attributing the amount of an OTTI charge to the investor's equity method memo accounts. We believe there are several acceptable methods to attribute the charge; however, the method applied should be reasonable given the nature of the OTTI charge. Two acceptable methods include the specific identification method and the fair value method. Under the specific identification method, the investor would create a new basis difference or adjust an existing one for the specific items (e.g., litigation) that resulted in the OTTI charge and eliminate related AOCI balances, if any. Under the fair value method, the investor would reset all its basis difference, including those related to AOCI balances, as if the investor had acquired the investment on the date of recording the OTTI charge. See Example EM 3-13 for more discussion of allocating the cost basis to assets, liabilities, and AOCI.

Example EM 4-9 illustrates the adjustment of an existing basis difference under the specific identification method.

EXAMPLE EM 4-9**Subsequent accounting for negative basis differences created by an impairment charge**

In 20X1, Investor acquired a 40% investment in Investee (a public company) for \$25 million. At the date of the acquisition, the book value of the net assets of Investee totaled \$50 million and the fair value of the net assets totaled \$62.5 million. The assets held by Investee consisted primarily of net

current assets with a carrying value and fair value of \$30 million and long-lived assets with remaining useful lives of 10 years, a carrying value of \$20 million, and a fair value of \$32.5 million. As a result, the carrying value of Investor's proportionate interest in the net assets of Investee was \$20 million. The \$5 million basis difference was attributed entirely to fixed assets.

Five years later (i.e., in year 20X6), Investee lost the contract of a significant customer and experienced some production issues. No impairment charge was recorded within Investee's financial statements (impairment was tested under the long-lived asset impairment model using the undiscounted future cash flows, which were in excess of the book value of the assets). However, the market price per share of Investee declined below Investor's investment balance per share, representing a potential impairment of \$5 million. Based on all available information, Investor concluded that the decline in value of Investee's market price per share was other than temporary. For simplicity, all tax implications are ignored.

How should Investor subsequently account for negative basis differences created by an impairment charge?

Analysis

Assuming Investor determines that the decline in value of \$5 million is other than temporary, Investor would record an impairment charge of \$5 million against the investment in Investee.

Given the nature of Investee's operations and asset base (principally working capital and fixed assets), this loss could be considered attributable to Investee's fixed assets. As a result, the impairment charge would eliminate the remaining fixed asset basis difference of \$2.5 million ($\$5.0 \text{ million} \times 5/10 \text{ years}$ amortized), and create an additional \$2.5 million negative basis difference.

The negative basis difference would be amortized over the remaining asset lives. Investor would need to determine the appropriate amortization period. While there are 5 years remaining of the original 10-year useful life determined at the date of the initial investment, the estimated remaining lives of Investee's fixed assets at the date of impairment should be considered in determining the appropriate amortization period. For this example, we have assumed 5 years.

Investee's net income would include \$2,000,000 of depreciation expense ($\$20,000,000$ [investee's carrying value of its fixed assets]/10 years [estimated useful life]), which reflects the carrying value of the fixed assets as reported in Investee's financial statements. Investor would recognize its proportionate share of Investee's net income; however, Investor should also amortize \$500,000 ($\$2.5 \text{ million}/5 \text{ years}$) of the negative basis difference as an increase (credit) to equity method earnings in order to reflect Investor's lower cost basis in Investee's fixed assets, which results in lower annual depreciation expense.

4.8.2 Cumulative translation adjustment balance in impairment

An investor may have an equity method investment in, or within, a foreign entity and a related cumulative translation adjustment balance. Unless an entity has committed to a plan that would cause reclassification of some amount of CTA into earnings upon sale (i.e., the equity method investment is a part of disposal group classified as held for sale), any effects from foreign currency translation adjustments should be excluded from the carrying value of an equity method investment when assessing it for impairment. See PPE 5.3.3.4 and FX 8.4.

4.8.3 *Impairment considerations when reporting on a lag*

Fair value is determined at the reporting date for the purposes of an impairment, regardless of whether the investor accounts for the investment on a lag.

4.8.4 *Impairments recorded at the investee level*

An investor applying the equity method does not need to separately test the investee's underlying assets for impairment (or the value it has recorded in its equity method memo accounts related to those assets). Equity method goodwill is also not required to be separately assessed for impairment. ASC 350 indicates that the impairment guidance is not applicable to an investor applying the equity method on the basis that the investor does not control the business or underlying assets that give rise to the goodwill.

If the investee recognizes an impairment charge, including for goodwill, then the investor would generally need to record at least its share of that impairment charge. An impairment charge at the investee may also impact the investor's basis differences in those impaired assets.

The investor and investee often apply different impairment models and at a different unit of account – impairment is tested at the investment level under the equity method of accounting compared to individual asset groups by the investee. Therefore, an impairment charge may need to be recorded at the investor level where no impairment exists at the investee level. This could eliminate or create a new basis difference.

Chapter 5:
Accounting for changes
in interest or influence—
updated June 2023

5.1 Overview of changes in interest

An investor with an existing interest in an investee may acquire an additional interest, or dispose of part of its interest, resulting in a change to its ownership interest. A change in ownership interest may cause an investment:

- not previously accounted for under the equity method to qualify for the equity method for the first time,
- accounted for using the equity method, to be adjusted to reflect a gain or loss in interest, while continuing to be accounted for under the equity method, or
- to cease qualifying for the equity method of accounting and become subject to other accounting guidance.

When an investee undertakes a capital transaction, such as when issuing or purchasing its shares, the investor's ownership interest may change, even though the investor did not directly acquire or sell an additional interest in the investee. Like investor transactions, investee transactions can have an accounting impact for the investor.

Finally, even when there is no change in the investor's ownership interest, amendments to governing documents or other terms of the arrangement may impact the level of influence or control that an investor has, which can also impact the investor's accounting for its investment.

The reassessment of whether an investor has significant influence or control over the investee is an ongoing evaluation. EM 2 addresses whether an investor has significant influence and CG 1 addresses whether an investor has control.

See FSP 10.4.3 for information on the presentation of an investment that qualifies for the equity method of accounting.

5.2 Determining applicable change in interest guidance

A change in the investor's ownership interest can arise from transactions entered into by the investor, the investee, or some combination thereof. Additionally, even where the investor does not obtain or dispose of an interest in the investee, a change in the level of influence or control can cause an investor to revisit how it accounts for its investment.

How an investor should account for a change in an ownership interest is dependent upon how the investment was accounted for prior to the change in interest, and what the appropriate accounting will be after the change.

5.2.1 Increase in ownership or influence in an investee

The ownership interest of an investor may increase when it purchases additional shares from a third party, or as a result of capital transactions undertaken by an investee. Additionally, an investor may gain significant influence or control of an investee, such as when there is an amendment to the agreements governing the arrangement. Figure EM 5-1 outlines the possible scenarios that can occur

when the proportional ownership interest of an investor increases, or the investor gains significant influence or control.

Figure EM 5-1

Accounting for an increase in ownership or influence in an investee

Change in interest	Impact to investor	Discussed in
<p>Prior accounting: Fair value or measurement alternative (ASC 321)</p> <p>New accounting: Equity method (ASC 323)</p>	<p>Assuming fair value option not elected:</p> <ul style="list-style-type: none"> Recognize investment at investor's current basis of previously held interests plus cost of incremental investment, if any. Determine basis differences for the entire investment. 	EM 5.3.1
<p>Prior accounting: Equity method (ASC 323)</p> <p>New accounting: Continue to apply equity method (ASC 323)</p>	<p>Recognize cost for incremental investment (cost accumulation), determine basis differences arising on acquisition of new "step" interest using fair values of underlying investee assets and liabilities on the acquisition date.</p> <p>Prospectively recognize investor's share of equity investee's earnings based on new ownership interest, adjusted for the effects of new and previous basis differences, and other items.</p>	EM 5.3.2
<p>Prior accounting: Equity method (ASC 323)</p> <p>Future accounting: Consolidate (ASC 810)</p>	<p>Remeasure the previously-held equity method investment (and any other previously-held interests) at fair value and recognize any difference to the carrying amount in net income.</p> <p>Recognize 100% of identifiable assets and liabilities, including the:</p> <ul style="list-style-type: none"> recognition of NCI, if any, at fair value recognition of 100% of goodwill or bargain purchase gain 	EM 5.3.3

5.2.2 Decrease in ownership or influence in an investee

The ownership interest of an investor may decrease when it sells shares to a third party, or as a result of capital transactions undertaken by an investee. Additionally, an investor may lose significant influence or control of an investee as a result of changes to the arrangement. Figure EM 5-2 outlines each of the possible scenarios that can occur when the ownership interest of an investor decreases, or the investor loses significant influence or control.

Figure EM 5-2

Accounting for a decrease in ownership or influence in an investee

Change in interest	Impact to investor	Discussed in
<p>Prior accounting: Consolidate (ASC 810)</p> <p>New accounting: Equity method (ASC 323)</p>	<p>Deconsolidate investment and remeasure retained investment (noncontrolling interest) at fair value. Gain or loss recognized in net income.</p> <p>Assuming fair value option not elected:</p> <ul style="list-style-type: none"> Retained investment (remeasured at fair value) forms initial cost basis of equity method investment. Determine basis differences. Prospectively recognize investor's share of equity investee's earnings based on retained interest, adjusted for the effects of basis differences, and other items. 	EM 5.4.1
<p>Prior accounting: Equity method (ASC 323)</p> <p>New accounting: Continue to apply equity method (ASC 323)</p>	<p>Recognize gain or loss for the difference between the proceeds from the sale and the investor's carrying amount of the equity method investment.</p> <p>OCI balances associated with the portion of the equity method investment that was disposed of must be recycled from OCI through net income.</p> <p>Prospectively recognize investor's share of equity investee's earnings based on new interest, adjusted for the effects of basis differences, and other items.</p>	EM 5.4.2
<p>Prior accounting: Equity method (ASC 323)</p> <p>New accounting: Fair value or measurement alternative (ASC 321)</p>	<p>Recognize gain or loss for the difference between the proceeds from the sale and the investor's carrying amount of the equity method investment.</p> <p>OCI balances associated with the equity method investment must be recycled from OCI through net income.</p> <p>The investor's initial carrying amount of any retained common stock or in-substance common stock investment would include its proportionate share of previously recognized earnings or losses of the investee.</p>	EM 5.4.3

Prior accounting: Equity method (ASC 323)	Recognize gain or loss for the difference between the proceeds from the sale and the investor's carrying amount of the equity method investment.	EM 5.4.4
New accounting: N/A. Investor disposes of entire interest	AOCI balances associated with the equity method investment must be recycled from OCI through net income.	

5.2.3 *Investee treasury transactions*

A change in interest can arise from an investee capital transaction, such as an issuance or purchase of shares by the investee. The issuance of additional shares by an investee results in a decrease in ownership by the investor and has the same accounting effect as a direct sale of investee shares by the investor. Conversely, a repurchase of shares by an investee results in an increase in ownership by the investor and has the same accounting effect as a direct purchase of investee shares by the investor.

ASC 323-10-35-15

A transaction of an investee of a capital nature that affects the investor's share of stockholders' equity of the investee shall be accounted for on a step-by-step basis.

Accordingly, an investor should consider capital transactions of an investee that result in a change in interest in a manner similar to how the investor evaluates its own purchases and sales of the investee stock. See EM 5.2.1 and EM 5.2.2 for an outline of possible scenarios.

Stock-based compensation awarded by an investee to its own employees is addressed in EM 4.3.6. The investor recognizes its portion of the investee's compensation expense through the investor's recognition of its portion of the investee's earnings. A basis difference would be created, as the investee's net equity would not be affected as a result of the stock award (i.e., dr. compensation expense, cr. APIC). Additionally, when an employee exercises its option, the employee consideration to the investee in return for the shares would include the total compensation expense previously recognized, along with the employee exercise price, and should be accounted for following the appropriate dilution scenario as described in EM 5.2.2.

Unique investee transactions, including those with noncontrolling shareholders, those with entities under common control, and those that do not result in a change in interest are addressed in EM 5.6.

5.2.4 *Noncash transactions*

An investor may increase its ownership interest through the contribution of noncash assets to the investee. See EM 3.2.4 for a discussion of when noncash assets are used to acquire an investment.

Similarly, when an investor transfers all or a portion of its equity method investment, the criteria in ASC 860-10-40-5 must be met in order to qualify for derecognition of the equity method investment and recognition of the associated gain or loss. This is because equity method investments are financial assets and therefore transfers of equity method investments are within the scope of ASC 860. The criteria in ASC 860 are further explained in TS 3. If the exchange is economically a dilution event, the issuer (investee) is deemed to have effectively issued additional shares to other investors. Such an

exchange is not in the scope of ASC 860 and the change in interest guidance outlined in EM 5.2.1 and EM 5.2.2 would be applicable.

5.2.5 **Fair value option**

ASC 825-10, *Financial Instruments*, allows entities to elect to account for certain financial instruments using the fair value option, as discussed in FV 5.

An entity electing to adopt the fair value option for any of its equity method investments is required to present those equity method investments at fair value at each reporting period, with changes in fair value reported in the income statement. In addition, certain disclosures are required in the investor's financial statements when it has elected the fair value option for an investment that otherwise would be accounted for under the equity method of accounting. See FSP 20.6.3.2 for these disclosure requirements.

The election of the fair value option is irrevocable unless an event creating a new election date occurs. Therefore, absent a qualifying event, a reporting entity that elects to adopt the fair value option to account for an equity method investment is precluded from subsequently applying the equity method of accounting to that investment.

5.2.5.1 **Eligibility to elect the fair value option**

As described in ASC 825-10-25-4, an investor may elect to apply the fair value option when an investment becomes subject to the equity method of accounting for the first time. For example, an investment would become subject to the equity method of accounting for the first time when an investor obtains significant influence by acquiring an additional investment in an investee, or when an investor loses control of an investee but retains an interest that provides it with the ability to exercise significant influence.

Excerpt from ASC 825-10-25-4

An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs...

d. The accounting treatment for an investment in another entity changes because the investment becomes subject to the equity method of accounting.

An investor may elect to apply the fair value option to an equity method investment irrespective of the types of assets held by the equity method investee.

An investor that elects the fair value option and subsequently loses the ability to exercise significant influence would be required to continue to account for its retained interest on a fair value basis. That is, if it were subject to ASC 321, the entity could not elect to apply the measurement alternative but must continue to account for the instrument using the fair value option. An investor is precluded from applying the fair value option for a consolidated entity.

A reporting entity can generally elect the fair value option for a single eligible investment without needing to elect the fair value option for identical types of investments in other investees. That is, an instrument-by-instrument election is allowed. However, when an investor elects to apply the fair value

option for an equity method investment, it must apply the fair value option to all of its eligible interests in the same investee (e.g., all tranches of equity, debt investments, guarantees), including any previously held interest.

Although equity method investments are generally eligible to be accounted for under the fair value option, doing so would not always be appropriate. Specifically, when an equity method interest includes a significant compensatory element and the investor is not required to separately account for the compensatory element, the investor should not elect the fair value option for its equity investment. For example, an equity method investment may include terms that provide one investor with a disproportionate allocation of returns in return for providing management services to the investee. In such cases, election of the fair value option would not be appropriate, as it could accelerate revenue that should be earned when future services are provided to the investee.

5.3 *Increase in ownership, influence, or control*

There are a number of potential scenarios in which the ownership interest of an investor increases or an investor gains significant influence or control over an investee. These may include an investment that was:

- previously accounted for by applying ASC 321, and will now qualify for the equity method for the first time (see EM 5.3.1),
- accounted for using the equity method, that will be adjusted to reflect an increase in interest, and will continue to be accounted for under the equity method (see EM 5.3.2), and
- previously accounted for under the equity method but which the investor should now consolidate (see EM 5.3.3).

5.3.1 *Previously applied ASC 321 and will now apply equity method*

An investor holding an investment that is accounted for in accordance with ASC 321 will be required to apply equity method accounting to that investment if it gains significant influence (see EM 2). In addition to obtaining significant influence through its own actions (e.g., purchasing additional common stock), an investor may also gain significant influence as a result of investee transactions, as further explained in EM 5.2.3.

An entity that is required to adopt the equity method of accounting should do so prospectively from the date significant influence is obtained. Under ASC 323-10-35-33, an investor should add the cost of acquiring the additional interest in the investee (if any) to the carrying amount of its previously held interest.

ASC 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. The current basis of the investor's previously held interest in the investee shall be remeasured in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable, immediately before adopting the equity method of accounting. For purposes of applying paragraph 321-10-35-2 to the investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or a similar investment of the same issuer that results in it applying Topic 323, the entity shall remeasure its previously held interest at fair value immediately before applying Topic 323.

An investor may have accounted for its previously held interest at fair value as further explained in LI 2.3. In such cases, the investor should remeasure its investment at fair value through earnings prior to adding the cost of the additional investment (if any) and accounting for the investment as an equity method investment.

Alternatively, an investor may have accounted for its previously-held interest using the measurement alternative described in ASC 321-10-35-2 (see LI 2.3.2 for an explanation of the measurement alternative). In such cases, prior to transitioning to equity method accounting, an entity should consider whether an orderly transaction exists that would necessitate a remeasurement of its existing ASC 321 investment. Shares purchased by an investor that cause it to account for its investment using the equity method represent an observable transaction if they were identical or similar to the existing investment that was accounted for using the measurement alternative and the shares were purchased in an orderly transaction. See LI 2.3.2.2 for a discussion of whether instruments should be deemed similar and what constitutes an orderly transaction. Only after considering whether remeasurement is warranted should the entity add the cost of the additional investment (if any) and account for the investment as an equity method investment.

ASU 2020-01 clarifies that a forward or option to purchase shares that will be accounted for as an equity method investment should be accounted for under ASC 321. A forward or an option with no intrinsic value at acquisition should be measured at fair value at exercise or settlement even if the measurement alternative is elected based on the guidance in ASC 815-10-35-6. While the scope of ASC 815-10-15-141 and ASC 815-10-15-141A does not include options with intrinsic value at acquisition, we generally believe the guidance should also be applied to options with intrinsic value. See LI 2.3.2.3 for a discussion of options or forwards accounted for under ASC 321.

ASC 323 does not provide specific guidance on how basis differences should be determined and allocated to the equity method investment when the investor had a previous interest that was accounted for in accordance with ASC 321. There are several reasonable and acceptable methods to determine and allocate any basis differences. For example, assume an investor that holds a 15% interest in the investee acquires an additional 10% interest resulting in the investor having significant influence over the investee. The investor may treat the total carrying value of its 25% investment in the investee as the cost of acquiring its 25% equity method investment and determine and allocate basis differences accordingly. Notwithstanding, when the fair value of the acquired assets is greater than the cost basis of the investment, a bargain purchase should not be recognized. See EM 3.3.7 for a discussion of how to treat situations that would result in a bargain purchase gain. See EM 4.3.1 for information on the subsequent accounting of basis differences.

5.3.2 Obtain additional interest and continue to apply equity method

An investor's proportional ownership in the investee may increase when the:

- investor buys additional shares from third parties (see EM 5.3.2.1),
- investee issues new shares and investor buys more than the proportion it previously held making it a "net purchaser" (see EM 5.3.2.2), or
- investee buys shares as treasury stock and the investor sells less than its proportionate ownership in the investee making it a "net purchaser" (see EM 5.3.2.3).

When an investor acquires an additional interest, either directly or indirectly, there will generally be a difference between (a) the cost of the investor's incremental share of the investee's net assets and (b) its interest in the investee's carrying value of those net assets. Whenever an investor increases its ownership interest in an investee, the investor should identify and recognize any new basis differences.

Any unassigned difference would be designated as equity method goodwill in the equity method memo accounts if the investee is a business. In some cases, the sum of the amounts assigned to assets acquired and liabilities assumed can exceed the cost of the acquired investee interest (excess over cost). In such cases, an investor should not recognize a bargain purchase gain (see EM 3.3.7 for further discussion).

The previously held interests and related equity method memo accounts are not revisited in connection with a step acquisition. Accordingly, the equity method memo account for each asset and liability will reflect the sum of the basis differences for each incremental acquisition associated with the equity method investment.

After the acquisition, the investor will adjust its share of earnings and losses of the investee not only for the impact of basis differences that arose from the initial investment but also those arising from each step (i.e., subsequent investment). See EM 4.3.1 for a discussion of subsequent accounting for basis differences.

Whenever an additional interest is obtained, the investor should first determine whether it has obtained a controlling financial interest, as further discussed in EM 5.3.3.

5.3.2.1 Investor purchases shares from third parties

An investor that applies the equity method of accounting may increase its ownership interest in the investee by purchasing additional shares. Incremental purchases of common stock or in-substance common stock from third parties are recorded at cost. Basis differences should be determined as described in EM 5.3.2.

5.3.2.2 Investee sells additional shares and investor is net purchaser

When the investee sells additional shares of its stock and the investor buys a greater proportion of the shares offered than its pre-sale proportionate ownership, the investor is a "net purchaser" as its post-transaction percentage ownership interest increases. Said differently, the investor has effectively purchased additional shares at a cost that is more or less than the investee book value. The investor would account for the net effect of the purchase in the same manner as if the shares were acquired

from a third party, which includes establishing any basis difference in its memo accounts (see EM 3.3.1).

Example EM 5-1 illustrates a scenario in which an investee sells shares and the investor is a net purchaser.

EXAMPLE EM 5-1

Investee sells additional shares and investor is a net purchaser

Investee has 120 shares of common stock outstanding. Investor A, Investor B, and Investor C each own 40 shares or 33% of the Investee. Investee issues 35 additional shares for cash consideration at a price greater than the Investee's carrying value per share. Investor A and B each purchase 10 shares and Investor C purchases 15 shares. Total outstanding shares after the transaction is 155 shares.

How should Investor C account for the acquisition of 15 shares?

Analysis

Investor C would reflect an increase in the carrying amount of its investment to reflect the cost of the first 10 of its 15 new shares. Investor C would not reflect any incremental basis difference for those shares as Investor A, Investor B, and Investor C each maintained their same ownership interest.

Investor C would record a new incremental basis difference to reflect the 3.2% interest (5 shares / 155 shares) it acquired in the Investee through the 5 shares it purchased in excess of the other investors. Investor C should determine the cost of the 5 shares and allocate that cost to its 3.2% incremental interest in the net assets of Investee. The difference between its cost and the carrying value of the investee's net assets should be reflected as an incremental basis difference.

5.3.2.3 Investee purchases shares and investor is net purchaser

When an investee buys treasury stock and the investor does not sell shares, the investor is a "net purchaser" as its ownership interest in the investee increases. This transaction is effectively an indirect acquisition by the investor and is similar to when an investor acquires shares of the investee directly from other investors. Accordingly, the investor will need to identify any basis differences created as a result of its ownership percentage increase.

One way to determine the basis difference is to consider the investee purchase of treasury stock and the increase in the investor's ownership percentage as two transactions. Any cash proceeds received from the investee would reduce the investor's investment balance. Subsequently, the investor will be deemed to have indirectly acquired an additional interest and should determine the applicable basis differences using that incremental cost.

Example EM 5-2 illustrates a scenario when an investee purchases its own shares at a price greater than their carrying amount, and the investor reflects a change in basis resulting from the decrease in the investee's carrying amount.

EXAMPLE EM 5-2

Investee purchases shares and investor is a net purchaser

Investor owns 40 common shares in Investee representing a 40% ownership interest (a total of 100 shares are outstanding). The carrying value of the investment on Investor's books is \$10 per share, which is also Investee's book value per share (i.e., no basis differences exist). Investee subsequently purchases 25 shares from third parties at \$12 per share in a treasury stock transaction. The price exceeds Investee's book value per share of \$10.

As a result of this transaction, Investor's ownership interest in Investee has increased from 40% to 53.3% (40 shares/75 shares). Investor, as a result of not selling any of its ownership interest has, in substance, purchased an additional interest in Investee. Investor does not obtain control of Investee.

How should Investor record the transaction?

Analysis

Investee's initial net assets of \$1,000 were reduced by the \$300 paid by Investee to purchase 25 shares from third parties at \$12 per share. Accordingly, the Investor's proportionate interest in the Investee's net assets is now \$373 ($53.3\% \times \700). As Investor's carrying amount of \$400 is unchanged, Investor will need to identify basis differences of \$27, which represents the amount by which its carrying amount exceeds the Investee's carrying amount.

This could also be determined by calculating the excess decrease in Investee's carrying amount attributable to the repurchase of the shares from third parties of \$50 ($\2 per share $(\$12 - \$10) \times 25$ shares) multiplied by Investor's proportionate interest of 53.3%, which results in a difference of \$27. The \$27 basis difference should be allocated to the newly acquired 13.3% interest in the net assets of the Investee.

Investee would reflect a treasury stock transaction in its stand-alone financials.

5.3.3 *Previously applied equity method and will now consolidate*

An investor should no longer apply the equity method of accounting to an investee entity if it gains a controlling financial interest over the investee. An investor could gain control of an investee entity as a result of:

- a direct or indirect change in its level of ownership interest,
- a change to a contractual arrangement or to the investee's governing documents, or
- the expiration of a contractual relationship or the resolution of a contingency.

The determination of whether consolidation is required in accordance with the variable interest entity (VIE) model is something that can change over the life of an investment. Even if the investee was not initially determined to be a VIE, an investor is required upon the occurrence of certain events to reassess whether or not an entity is, in fact, a VIE, as discussed in CG 4.8. Alternatively, if the investee was previously determined to be a VIE, but the investor was determined not to be the primary

beneficiary, the investor is required to perform the primary beneficiary analysis each subsequent reporting date, as discussed in CG 5.9.

When a reporting entity obtains control of a legal entity, the method of consolidation will vary depending on whether the entity is a VIE, or meets the definition of a business, as described in CG 6.1. See BCG 5.3 for information on the acquisition method when an investor gains control of a financial interest that is deemed a business combination.

5.4 *Decrease in ownership, influence, or control*

There are a number of potential scenarios in which the ownership interest of an investor decreases or the investor loses significant influence or control. These may include:

- an investment that was previously consolidated but will now qualify for the equity method (see EM 5.4.1),
- an existing equity method investment in which the investor's ownership interest decreased, however, it will continue to be accounted for under the equity method (see EM 5.4.2),
- an investment that was previously accounted for under the equity method, but it will now be accounted for under ASC 321 (see EM 5.4.3), or
- an investment that was previously accounted for under the equity method, but it has been fully disposed of (see EM 5.4.4).

5.4.1 *Previously consolidated but now applying equity method*

An investor should reassess, on an ongoing basis, whether it has lost control of an investee.

An investor may lose a controlling financial interest over the investee but retain a noncontrolling investment in common stock or in-substance common stock that gives it significant influence over that investee entity. In such situations the investor should apply the equity method to its retained interest.

Change of interest transactions that result in the investor losing control generally result in the recognition of a gain or loss in net income for the sale of the controlling interest and the remeasurement of any retained noncontrolling investment at fair value. See BCG 5.5 for a discussion of change in interest transactions that result in a loss of control. If the controlling interest is a nonfinancial asset or in substance a nonfinancial asset as described in PPE 6.2.2.5, then the criteria described in PPE 6.2.4 must also be met before the investee may be deconsolidated.

When an investor applies the equity method to a retained interest in a previously consolidated investee, the fair value of the retained interest forms the basis for the initial measurement. Basis differences arise if the fair value of the investment differs from the investor's proportionate share in the carrying amount of the investee's net assets.

When changing from consolidation to the equity method, the investee is consolidated until the point when control is lost, and the equity method is applied from that point forward.

5.4.2 Interest reduced but will continue to apply equity method

An investor that applies the equity method of accounting may reduce its ownership interest in the investee by selling a portion of its shares or through an investee transaction (see EM 5.2.3).

When an investor disposes of a portion of an equity method investment, the investor will need to determine the applicable gain or loss on disposition. A gain or loss on disposal is recorded when the selling price per share is more or less than the investor's carrying amount per share.

In determining the gain or loss, the carrying amount of shares sold should generally be calculated based on the average carrying amount of all shares held by the investor. Other methods have been applied in practice, such as the "identified certificate" or FIFO basis; however, the average carrying amount will often best reflect the economic substance of the disposition. For example, under the "identified certificate" method, the gain or loss on disposition will be impacted by the specific certificates that are selected for sale; therefore, this method is not often considered an appropriate method. It should also be noted that a temporary difference arises when the "identified certificate" or FIFO basis is used to compute taxable income and the average basis is used to determine the gain or loss for financial reporting.

No new basis differences would arise as a result of a disposal; basis differences only arise on the acquisition of an interest in an investee. Notwithstanding, an investor would eliminate the portion of a preexisting basis difference associated with the portion of the investment sold. The investor would prospectively adjust its share of earnings and losses of the investee only for the remaining basis difference.

An investor's equity method ownership interest in the investee that will continue to be accounted for using the equity method, will decrease when:

- the investor sells a portion of its shares to a third party (see EM 5.4.2.1),
- the investee issues new shares and the investor buys less than its proportionate ownership interest, making it a "net seller" (see EM 5.4.2.2), or
- the investee buys shares as treasury stock and the investor sells more than its proportionate ownership interest in the investee making it a "net seller" (see EM 5.4.2.3).

5.4.2.1 Investor sells a portion of its shares to a third party

An investor that applies the equity method may sell a portion of its interest in the investee to a third party. For such transactions, the investor should recognize a gain or loss equal to the difference between the selling price and the carrying value of the interest sold at the time of sale.

In determining the gain or loss in a partial disposition of an equity method investment, the carrying amount of shares sold should generally be calculated based on the average carrying amount of all shares held by the investor, as noted in EM 5.4.2.

5.4.2.2 Investee sells unissued shares and investor is a net seller

When an investee sells additional shares and an investor purchases no shares, or purchases less than its proportionate interest, the investor's ownership interest in the investee decreases. Such a

transaction is effectively an indirect disposal of part of the investor's ownership interest. Accordingly, the investor should recognize a gain or loss equal to the difference between the selling price per share and the investor's carrying amount per share.

Example EM 5-3 illustrates a transaction when the investee issues previously unissued shares at a price greater than the investor's carrying amount in the investment and the investor does not buy any additional shares.

EXAMPLE EM 5-3

Investor is a net seller in investee transaction

Investor owns 40 common shares in Investee representing a 40% ownership interest (a total of 100 shares are outstanding). The carrying value of the investment on Investor's books is \$10 per share, which is also Investee's book value per share (i.e., no basis differences exist). Investee subsequently issues 25 shares at \$20 to third parties. This price exceeds Investee's book value per share of \$10.

As a result of this transaction, Investor's ownership interest in Investee has declined from 40% to 32% (Investor's 40 shares/125 shares total shares outstanding).

How should Investor account for the issuance of shares by Investee?

Analysis

The ownership interest of Investor was reduced from 40% to 32% and Investor therefore has in substance sold a part of its interest in Investee.

Investor's gain can be calculated as the difference between (a) Investor's proportionate share of Investee's new carrying value ($32\% \times \$1,500 = \480) and (2) the carrying value of Investor's ownership interest in the Investee prior to the transaction (\$400). This would result in a gain of \$80, which could be reflected as a debit to equity method investment and a credit to gain.

Alternatively, Investor's gain can be thought of as the amount by which its investment increased as a result of Investee's issuance of shares to third parties.

Issuance price per share	\$20
Investor A's carrying value per share	10
Excess paid over carrying value per share	10
Shares issued	<u>x 25</u>
Total excess paid over carrying value per share	250
Investor's % ownership in Investee	<u>x 32%</u>
Investor's change in interest gain	\$80

In this example, there were no basis differences. However, if there were, Investor would have to adjust the memo accounts for the portion of the basis difference sold.

When the investee issues additional shares as a result of the exercise of employee stock options, the dilution gain/loss should be calculated similar to Example EM 5-3. However, the consideration received for the shares issued upon exercise includes any previously recognized compensation expense plus cash proceeds upon exercise (i.e., exercise price multiplied by the number of shares). See EM 4.3.6 for a discussion of stock compensation awarded by an investee to employees.

5.4.2.3 *Investee purchases shares and investor is net seller*

When the investee offers to purchase shares from all or some investors in a treasury stock transaction and the investor sells a proportion greater than its pre-transaction ownership interest, the investor is a “net seller” as its percentage ownership interest in the investee is decreased (i.e., investor effectively sells part of its ownership interest in the investee).

An investor may sell a portion of an equity method investment to the investee in an investee treasury stock transaction. The gain or loss recognized by the investor is equal to the difference between (1) the proceeds received by the investor in return for the stock sold and (2) the investor’s carrying amount for the stock sold. If there were basis differences, the investor would have to adjust the memo accounts for the portion of the basis difference sold.

Example EM 5-4 illustrates the determination of an investor’s gain or loss from an investee treasury stock transaction.

EXAMPLE EM 5-4

Gain or loss calculation in an investee treasury stock transaction

Investor A owns 200 common shares representing a 50% ownership interest in Investee and accounts for its investment under the equity method of accounting. The common shares have an aggregate carrying value on the books of Investor A of \$600 and a fair value of \$800. Investors B and C each own 25% of the outstanding common shares of Investee.

Investor A agrees to sell 100 of its shares in Investee (with a fair value of \$400) to Investee, which will be accounted for as a treasury stock transaction in Investee’s financial statements. Investor A has no basis differences between the carrying amount of its investment and its proportional interest in the carrying amount of Investee’s net assets.

Immediately prior to the sale by Investor A, the shareholdings of Investee can be summarized as follows:

	Shares	Fair value	Book value
Investor A	200 shares (50%)	\$800	\$600
Investor B	100 shares (25%)	400	300
Investor C	100 shares (25%)	400	300
Total		\$1,600	\$1,200

After the sale, Investors A, B, and C each own 100 shares in Investee, resulting in each having a 33% ownership interest. Investor A's ownership interest effectively declined from 50% to 33%. Investors B and C have effectively increased their respective ownership interest from 25% to 33%.

Investee's net assets have also declined from \$1,200 to \$800, as it paid Investor A \$400 to complete the transaction.

What is Investor A's gain on the sale of its shares?

Analysis

Investor A's gain is \$66 calculated as follows:

Proceeds received by Investor A	\$400
Carrying amount of Investor A's investment prior to the transaction	\$600
Carrying amount of Investor A's investment after the transaction (\$800 Investee's net assets post transaction/3)	266
Reduction in carrying amount	334
Investor's change in interest gain	\$66

An alternative way to consider the gain would be to consider a scenario in which rather than providing a \$400 payment to Investor A, Investee made a pro-rata distribution providing \$200 to Investor A, and \$100 each to Investor B and C. After the return of the proportionate share of net assets, the carrying value of Investor A's interest would have been reduced to \$400 (\$600-\$200).

Investor B and C would then use the cash they received in this hypothetical scenario to purchase shares from Investor A so that each investor would have a one-third interest. For this to occur, Investor A would need to sell 67 shares (rounded) for \$200, \$100 each from Investors B and C. That would represent 33.5% (67/200 shares) or \$134 of Investor A's basis (33.5% x \$400). The gain on sale recognized by Investor A as a result of the transaction would be \$66 (\$200 cash received from Investors B and C less the carrying amount of the shares surrendered which was \$134).

Example EM 5-4 was simplified as it presumes no basis difference. Accordingly, the investor's pre-transaction investment carrying amount is its proportionate share in the carrying amount of the investee's net assets.

In contrast, when the investor's carrying amount is more or less than its proportionate share in the carrying amount of the investee's net assets, additional consideration must be given to the unamortized basis difference when computing the gain or loss to be recognized in income. Example EM 5-5 illustrates the determination of a gain or loss when an investor is a net seller in an investee transaction and there are unamortized basis differences.

EXAMPLE EM 5-5

Investor is a net seller in an investee transaction

Investee has 100 shares outstanding and equity of \$1,000 or \$10 per share.

Investor owns 40% (40 of 100 outstanding shares) of Investee and the carrying amount of its investment is \$500. Accordingly, the carrying amount of Investor's investment exceeds its 40% share in the carrying amount of Investee's assets by \$100 (Investor's 40% of Investee's net assets of \$1,000 is a \$400 share of Investee net assets). The excess of \$100 has been assigned to fixed assets (\$60) and goodwill (\$40). See EM 3.3.1 for a discussion of basis differences.

Investee sells 25 newly-issued shares for \$500 (\$20 per share). Investor buys no shares and therefore its ownership interest declines from 40% to 32% (Investor's 40 shares/125 shares total shares outstanding). This represents a 20% decline in interest (8%/40%). No portion of the basis difference was amortized prior to the Investee's issuance of additional shares.

How should Investor account for the issuance of shares by Investee?

Analysis

Investor's gain would be computed as follows:

Investor's share of Investee's net assets after the transaction (40 shares/125 shares × \$1,500 = less)	\$480
Investor's share of Investee's net assets prior to transaction (40/100 × \$1,000)	(400)
Gain due to increase in Investee's net assets	\$80
Less pro rata write-off of unamortized difference between Investor's carrying amount and its interest in the Investee's carrying amount: \$100 × 20%	(20)
Change of interest gain	\$60

The adjustment of the unamortized excess cost should be applied (generally pro rata) to the unamortized components of the difference. Thus, the \$20 would be applied as follows to Investor's equity method memo accounts:

Excess assigned to:	Before	Pro rata adjustment	Pro rata percentage	After
Fixed assets	\$60	\$12	60%	\$48
Goodwill	40	8	40%	32
	\$100	\$20		\$80

Investor would continue to amortize the adjusted amounts of fixed assets prospectively over appropriate remaining periods.

5.4.3 *Previously applied equity method and will apply ASC 321*

An investor may lose significant influence over the investee entity due to the sale of a portion of its investment, the issuance or purchase of shares by the investee (see EM 5.2.3), or a change to the investee's governing documents. The reassessment of whether an investor has significant influence over the investee entity is an ongoing evaluation.

An investor may lose significant influence when an investee is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other government-imposed restrictions so severe that they limit the investor's ability to exert significant influence over the investee.

Equity method investments are financial assets; therefore, transfers of equity method investments are within the scope of ASC 860, as further discussed in EM 5.2.4.

If an investor loses significant influence, then the equity method of accounting should be discontinued. The investor would no longer accrue a share of earnings or losses of the investee from the point that significant influence is lost. As noted in ASC 323-10-35-36, previously accrued earnings or losses should not be retroactively adjusted.

ASC 323-10-35-36

An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. Upon the discontinuance of the equity method, an investor shall remeasure the retained investment in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable. For purposes of applying paragraph 321-10-35-2 to the investor's retained investment, if the investor identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer that results in it discontinuing the equity method, the entity shall remeasure its retained investment at fair value immediately after discontinuing the equity method. Topic 321 also addresses the subsequent accounting for investments in equity securities that are not consolidated or accounted for under the equity method.

Any of the investee's OCI recorded in the investor's financial statements would be reclassified to the investor's carrying value of its investment.

ASC 323-10-35-39

In the circumstances described in paragraph 323-10-35-37, an investor's proportionate share of an investee's equity adjustments for other comprehensive income shall be offset against the carrying value of the investment at the time significant influence is lost. To the extent that the offset results in a carrying value of the investment that is less than zero, an investor shall both:

- a. Reduce the carrying value of the investment to zero
- b. Record the remaining balance in income.

As discussed in ASC 323, the sale of investee shares by an investor generally results in gain or loss recognition.

ASC 323-10-35-35

Sales of stock of an investee by an investor shall be accounted for as gains or losses equal to the difference at the time of sale between the selling price and carrying amount of the stock sold.

For the purposes of calculating the gain or loss on the portion of the investment sold, the carrying amount of the stock sold would include a proportionate share of the investor's basis differences.

Refer to the financial instruments guidance for any remaining common stock (i.e., ASC 321) or in-substance common stock investments (i.e., ASC 320 or ASC 321) in the investee. See LI 2 for a discussion of accounting for equity instruments.

As discussed in ASC 321-10-30-1, the carrying amount of any retained equity interest in the investee forms the initial basis for which subsequent changes in fair value are measured. If the retained equity interest has a readily determinable fair value, it should be carried at fair value with changes in value recorded in net income. Any adjustment to the carrying amount of the retained interest upon the application of ASC 321 (i.e., to adjust the investment's carrying amount to fair value) should be recognized in net income. If the retained equity interest does not have a readily determinable fair value, it may be eligible for the measurement alternative, as discussed in LI 2.3.2. Entities applying the measurement alternative must consider all observable transactions, including those that required the investor to discontinue the equity method of accounting.

Example EM 5-6 illustrates the determination of a gain or loss recognized by an investor upon a sale of a portion of its interest that results in a loss of significant influence.

EXAMPLE EM 5-6

Loss of significant influence

Investor owns 25 shares representing a 25% ownership interest in Investee, a public entity. Investor paid \$250 for the investment (\$10 per share) and accounts for it under the equity method. No basis

differences arose at the time of the acquisition and Investee has had no net income since the acquisition.

In 20X0, Investee acquired a debt security that it accounted for as available for sale. Investee recognized a decrease in OCI of \$100 for the year due to a decline in the fair value of the security. Investor recorded its proportionate share of that decrease of \$25 (25% of the amount recorded within Investee's OCI). As a result, the net carrying value of Investor's investment in Investee at the end of the year, including the impact reflected in OCI, was \$225 million or \$9 per share.

In 20X1, Investor sold 10 shares in Investee to an unrelated third party for \$120. At the time of sale, Investee's publicly-traded share price was \$12 per share. As a result of the sale, Investor's ownership percentage decreased from 25% to 15% and it was determined to have lost significant influence. For illustrative purposes the tax impacts of the transaction have been ignored.

What is the gain or loss recognized by Investor?

Analysis

Investor would recognize a \$20 gain on the sale reflecting the difference between the consideration received and the associated carrying amount for the portion sold.

	Shares	Book value per share	Total value
Initial investment	25	\$10	\$250
Decrease in debt security value		(1)	(25)
Carrying value of investment prior to sale	25	\$9	225
Gain or loss calculation:			
Sale of portion of investment	(10)		\$120
Less: adjusted carrying amount (\$9 × 10)			(90)
Realization of loss classified in OCI			(10)
Gain on sale of investment			\$20

Since Investor has lost significant influence, it should discontinue accruing its share of earnings/losses in Investee. Its remaining proportionate share of Investee's OCI of \$15 (15 /25 shares × \$25 recorded in OCI) should be reclassified to the carrying value of the investment.

The remaining carrying amount of the investment at the time of the disposition would be \$135 (\$225 net carrying amount - \$90 carrying amount of interest sold). Investor would then need to mark its remaining investment to fair value in accordance with ASC 321, resulting in an additional gain of \$45 ((15 shares * \$12 fair value) - \$135).

The journal entries to reflect Investor's accounting for these events would be as follows:

Journal entries

20X0	Dr. Investment	\$250	
	Cr. Cash		\$250
<i>To record acquisition of investment</i>			
	Dr. OCI	\$25	
	Cr. Investment		\$25
<i>To record share of decline in fair value of debt security recorded by Investee in OCI (25% × \$100)</i>			
20X1	Dr. Cash	\$120	
	Cr. Investment		\$90
	Cr. Realized gain on sale		30
<i>To record sale of portion of investment</i>			
	Dr. Realized loss on sale	\$10	
	Cr. OCI		\$10
<i>To record recycling of portion of OCI Balance (10/25 * 25)</i>			
	Dr. Investment	\$15	
	Cr. OCI		\$15
<i>To record reclassification of remaining OCI balance on loss of significant influence ((15/25) * \$25)</i>			
	Dr. Investment	\$45	
	Cr. Gain		\$45
<i>To mark the investment to its fair value ((15 shares × \$12 fair value) - \$135 carrying value at transition)</i>			

5.4.4 Investor fully disposes of equity method investment

An investor may dispose of an equity method investment. Equity method investments are financial assets; therefore, transfers of equity method investments are within the scope of ASC 860, as further discussed in EM 5.2.4.

For the purposes of calculating the gain or loss of the investment sold, the carrying amount of the stock sold would include a proportionate share of the investor's basis differences.

5.5 *Investment after suspension of equity method losses*

An investor could make a subsequent investment in an investee after having suspended the recognition of its share of the losses of the investee. The question then arises whether this should be accounted for as an additional investment or treated as a funding of previous losses. This is addressed in ASC 323-10-35-29 and ASC 323-10-35-30.

ASC 323-10-35-29

If a subsequent investment in an investee does not result in the ownership interest increasing from one of significant influence to one of control and, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (see (b)). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances. Judgment is required in determining whether prior losses are being funded and all available information should be considered in performing the related analysis. All of the following factors shall be considered; however, no one factor shall be considered presumptive or determinative:

- a. Whether the additional investment is acquired from a third party or directly from the investee. If the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.
- b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.
- c. Whether the additional investment results in an increase in ownership percentage of the investee. If the investment is made directly with the investee, the investor shall consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.
- d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

ASC 323-10-35-30

Upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

5.6 *Other investee transactions*

An equity method investor may need to reflect the impact of investee transactions in the carrying amount of its investment. Treasury transactions are addressed in EM 5.2.3. Other transactions include:

- Investee spinoff and spit-offs (see EM 5.6.1)
- Common control transactions of the investee (see EM 5.6.2), and
- Investee transactions with noncontrolling shareholders (see EM 5.6.3)

5.6.1 *Investee spinoff and split-offs*

A pro rata distribution of shares by an investee to shareholders (e.g., in a spinoff or other form of reorganization or liquidation) should be accounted for as a deemed distribution to shareholders at the carrying amount of the investment. That is, an investor who receives the distribution would allocate its previous investment between the spinoff and the shares received in the spinoff.

A non-pro rata disposition of shares by an investee (e.g., a split-off) may give rise to a gain or loss to an investor that is a net seller. That gain or loss would be equal to the difference between the fair value of the investment received at the date of exchange and the investor's carrying amount of the proportionate share in the investee that was sold, including, if applicable, a proportionate share of any unamortized basis differences.

5.6.2 *Common control transactions of the investee*

An investee may receive assets from its parent or from a sister entity with which it shares a common parent in return for issuing additional shares. Since the transfer to the investee is considered a common control transfer, the investee would record the receipt of the assets at the parent's carrying basis. A question then arises as to how a third-party investor in the investee should account for the dilution effect of this transaction. This issue could also arise when an investee transfers assets to its parent or sister entity in return for investee shares.

For example, assume Investor has a 40% equity method investment in Investee. The remaining 60% interest in Investee is held by ParentCo, which consolidates Investee. ParentCo contributes additional assets to Investee in return for additional shares. The contribution by ParentCo dilutes Investor's interest in Investee. In this case, Investee would account for the contribution received from ParentCo as a common control transaction. However, Investor would determine its dilution gain or loss using the fair value of the assets contributed and the additional interest issued to ParentCo. Investor would track any basis differences using its memo accounts.

5.6.3 *Investee transactions with noncontrolling interest holders*

An investee may have a wholly-owned subsidiary and decide to sell a noncontrolling interest in the subsidiary to third parties. Similarly, an investee may have a partially-owned subsidiary and decide to sell an additional noncontrolling interest in the subsidiary to third parties, or acquire some or all of the existing noncontrolling interest from the noncontrolling interest holders. From the investee's perspective, these transactions are considered equity transactions and are accounted for in accordance with ASC 810, as the investee continues to have a controlling financial interest in the subsidiaries. The accounting standards do not provide guidance on how the equity method investor should account for these transactions.

If the investee sells a noncontrolling interest in its subsidiary, we believe the equity method investor may account for the transaction using one of the following methods.

- Account for the transaction as if it had sold a portion of its investment, similar to a dilution gain or loss, and record the gain or loss in its income statement. This method follows the guidance in ASC 323-10-40-1 on how an equity method investor records a dilution gain or loss for its equity method investment when the investee issues additional shares to another party. Under this method, the equity method investor has sold a portion of its investment in the investee even though its ownership percentage has not changed. This method is similar to the indirect sale approach when an investee sells shares to other investors and the equity method investor has a decrease in its ownership percentage in the investee. See EM 5.4.2.
- Account for the transaction as an equity transaction and record its portion of the investee's equity transaction directly to its additional paid in capital. This method follows the guidance in ASC 323-10-35-15 on how an equity method investor should record its portion of an investee's equity transaction in a similar manner.

If the investee acquires a noncontrolling interest in its subsidiary, we believe the equity method investor may account for the transaction using one of the following methods.

- Account for the transaction as if the equity method investor had acquired an additional interest in the investee similar to a step acquisition. This method follows the guidance in ASC 323-10-35-33 on how an equity method investor records a step acquisition for its equity method investment. Under this method, the equity method investor has effectively acquired an additional interest in the investee even though its ownership percentage has not changed. This method is similar to the step acquisition approach when an investee acquires shares from the other investors (treasury stock transaction) and the equity method investor has an increase in its ownership percentage in the investee. See EM 5.3.2. This method will likely result in the equity method investor having to account for new or additional basis differences in its memo accounts.
- Account for the transaction as an equity transaction and record its portion of the investee's equity transaction directly to its additional paid in capital. This method follows the guidance in ASC 323-10-35-15 on how an equity method investor should record its portion of an investee's equity transaction in a similar manner.

5.7 Gain or loss calculation on sale of in-substance common stock

A gain or loss could be recognized by the investor when it is a seller or net-seller of in-substance common stock. This treatment is considered acceptable because the in-substance common stock is determined to have risks and reward characteristics that are substantially the same as the entity's common stock. After the gain or loss is recognized, the investor should assess whether the investment is still in-substance common stock.

Gains and losses arising from investee transactions of a capital nature are not currently taxable events. Deferred taxes will have to be provided for the entire difference between the book and tax basis in the investment, including the portion that results from a change in interest gain for all investees unless:

- the entity is a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration; or
- an entity is a domestic subsidiary for which the basis difference is a permanent difference rather than a temporary difference.

If deferred taxes are provided on a change of interest gain reflected as a credit to investor paid-in capital, intraperiod tax allocation must be followed. See TX 11 for further information.

Chapter 6:
Joint ventures–updated
September 2023

6.1 Joint ventures—overview

Joint ventures are popular structures for creating alliances and gaining entry to or expanding business operations in various domestic and foreign markets. In some cases, arrangements may be referred to as joint ventures even though they do not meet the accounting definition of a joint venture. In other cases, an entity may be a variable interest entity (VIE) (see CG 2) and one investor, or another enterprise with a variable interest in the entity, may be the primary beneficiary required to consolidate the entity, in which case it does not meet the joint control requirements for joint venture accounting. Because joint ventures may be accounted for differently than other similarly-structured transactions and joint arrangements, it is important to properly distinguish arrangements that meet the accounting definition of a joint venture.

In connection with the accounting for joint ventures, two of the most significant and difficult issues are (1) the investor's/venturer's accounting for the formation of the joint venture (specifically, determining the gain or loss to recognize at formation for the contribution of noncash assets to the joint venture) and (2) accounting by the joint venture for the receipt of noncash assets at formation.

This chapter discusses (1) the accounting definition of a joint venture and (2) the accounting for the initial investment at formation by the investor and the joint venture. After formation of a joint venture, an investor generally applies the equity method of accounting for its investment, and the joint venture applies the relevant GAAP standards for its transactions just as any other operating entity would.

New guidance

In August 2023, the FASB issued ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*. The new guidance is addressed in EM 6.4.

6.2 Identifying a joint venture

In practice, the term “joint venture” is usually referred to rather loosely. Structures or transactions that are not joint ventures for accounting purposes are commonly called joint ventures.

A corporate joint venture is defined as follows.

Definition from ASC 323-10-20

Corporate joint venture: A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

This definition does not include investments in unincorporated joint ventures (including partnerships), although ASC 323-30 concludes that many of the provisions of ASC 323 are also appropriate in assessing investments in unincorporated joint ventures. Therefore, in practice, a joint venture is not restricted by the type or legal form of the entity. Joint venture accounting does not apply to arrangements between entities under common control.

At the formation of a new entity (or when an investor becomes involved with or acquires an interest in an existing entity), an investor in the entity is required to first determine if the entity is a variable interest entity (see CG 2). If the entity is a VIE and is required to be consolidated by one of the investors, it would not meet the definition of a joint venture. The VIE model provides a scope exception from the application of that model to an entity if the entity is a business and certain conditions are met, which is discussed in EM 6.2.1. On the other hand, if the entity is a VIE, but no party is required to consolidate it (including after giving effect to any related party considerations), the entity may meet the definition of a joint venture. An entity that is a VIE and meets the definition of a joint venture would be considered an entity over which power is shared among its equity investors, with no investor consolidating the joint venture. If the entity is not a VIE, then the investor should assess if it is required to consolidate the entity under the voting interest (VOE) model (see CG 7.1). If the investor is not required to consolidate the entity under either the VIE model or the VOE model, the investor would determine if the entity meets the definition of a joint venture, which is discussed further in EM 6.2.2 and EM 6.2.3.

6.2.1 *Applying the business scope exception to joint ventures*

ASC 810-10 provides for a scope exception from the application of the VIE model to an entity if the entity is a business and certain conditions are met. The scope exception is primarily an investor exception (versus an entity exception). Thus, each investor in the entity will have to assess whether it qualifies for the scope exception. One investor in the entity may qualify while another investor may not. The application of the scope exception necessitates judgment. Due to the characteristics of many joint ventures, qualification for the scope exception is expected to be infrequent, so investors will generally have to assess the entity under the VIE guidance.

An investor in an entity that initially meets the requirements for the scope exception should continually reassess that it qualifies for it. If an investor in an entity no longer meets the requirements for the scope exception, the VIE model would be applied prospectively.

There is no investor scope exception from the application of the VIE guidance to an entity if the entity is not a business.

Excerpt from ASC 810-10-15-17(d)

A legal entity that is deemed to be a business need not be evaluated by a reporting entity to determine if the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections unless any of the following conditions exist (however, for legal entities that are excluded by this provision, other GAAP should be applied):

1. The reporting entity, its related parties, or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee.

2. The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.
3. The reporting entity and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests in the legal entity.
4. The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

While the presence of any of the conditions in ASC 810-10-15-17(d) would disqualify an investor from applying the scope exception, conditions ASC 810-10-15-17(d)(2) and ASC 810-10-15-17(d)(3) are most commonly the provisions that prevent an investor from applying the business scope exception to a joint venture.

ASC 810-10-15-17(d)(2): Substantially all

An understanding of the purpose and design of the entity is required in order to evaluate whether substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties. Generally, investors form a joint venture for a specific purpose that will benefit all of the investors, as opposed to for the benefit of just one investor. However, some joint ventures have only two (or a few) investors, in which case it is not unusual for the substantially all of the activities to be on behalf of one of the investors. The assessment of the substantially all criteria is primarily qualitative, and the phrase “substantially all” does not indicate a quantitative guideline. See CG 2.3.4 for additional guidance.

ASC 810-10-15-17(d)(3): Subordinated financial support

Most variable interests in an entity are considered subordinated financial support. As a result, this scope exception would generally be available only when it is obvious that the investor would not absorb the majority of the economics of the entity on a fair value basis. For many 50:50 joint venture arrangements, it will be difficult to make this assertion. In a 50:50 joint venture, while the economics are intended to be shared evenly, this may not be the case. There are often commercial arrangements between the investors and the joint venture that may be variable interests and it becomes difficult to establish that the economics with respect to all the variable interests held by the investors are shared equally. This means it is likely the entity will need to be evaluated under the VIE model. See CG 2.3.4 for additional guidance.

Example EM 6-1 and Example EM 6-2 illustrate the application of the business scope exception guidance in ASC 810-10-15-17(d)(2) and ASC 810-10-15-17(d)(3).

EXAMPLE EM 6-1

Determining whether an investor in an entity can apply the business scope exception in ASC 810-10-15-17(d)

Company A and Company B form a new entity, Newco. Company A contributes one of its subsidiaries, a business with a fair value of \$100 million, in exchange for 50% of the equity of Newco. Company B contributes \$100 million cash in exchange for 50% of the equity of Newco. The cash contributed by Company B will remain in Newco for operating expenses to develop new products and markets.

Newco, which is deemed to be a business, was created so that all of its activities are conducted on behalf of Company A. Newco sells all of its output to Company A and all of Newco's employees are seconded from Company A. Newco obtains a \$120 million, six year, fixed 5% interest rate loan from a bank, which is guaranteed by Company A and Company B.

Company A and Company B each have two of the four board seats of Newco and unanimous approval from all board members is required for all decisions related to Newco.

Does Company A qualify for the business scope exception in ASC 810-10-15-17(d)?

Analysis

No. Newco is deemed to be a business. However, given that Newco sells all of its output to Company A and Company A provides all of the employees of Newco, all of the activities of Newco are deemed to be conducted on behalf of Company A. Therefore, the business scope exception is not available to Company A as the condition in ASC 810-10-15-17(d)(2) which precludes use of the exception exists. Company A would need to evaluate its investment in Newco under the VIE model. See CG 2.3 for additional guidance.

EXAMPLE EM 6-2

Determining whether an investor in an entity can apply the business scope exception in ASC 810-10-15-17(d)

Company A and Company B form a new entity, Newco, for the purpose of developing new products and accessing new markets. Company A contributes cash in exchange for 50% of the equity of Newco, and Company B contributes a division of its operations (that constitutes a business) in exchange for 50% of the equity of Newco. Company B also provides a loan to Newco to fund its working capital requirements.

Company A and Company B each have two of the four board seats of Newco and unanimous approval from all board members is required for all decisions related to Newco.

Does Company B qualify for the business scope exception in ASC 810-10-15-17(d)?

Analysis

No. Newco is deemed to be a business. However, Company B is providing more than half of the total subordinated financial support to Newco through its 50% equity interest and the working capital loan to Newco. Therefore, the business scope exception is not available to Company B as the condition in ASC 810-10-15-17(d)(3) that precludes use of the exception exists. Company B would need to evaluate its investment in Newco under the VIE model. See CG 4.1 for additional guidance.

6.2.2 Joint control

The most distinctive characteristic of a joint venture is the concept of joint control. An AcSEC Issue Paper, which is not authoritative guidance, describes the concept of joint control in its definition of a joint venture. This definition and the concept of joint control are widely applied in practice.

Definition from AcSEC Issue Paper, *Joint Venture Accounting* (7/17/79), Paragraph 51(b)

Joint venture: An arrangement whereby two or more parties (the venturers) jointly control a specific business undertaking and contribute resources towards its accomplishment. The life of the joint venture is limited to that of the undertaking which may be of short or long-term duration depending on the circumstances. A distinctive feature of a joint venture is that the relationship between the venturers is governed by an agreement (usually in writing) which establishes joint control. Decisions in all areas essential to the accomplishment of a joint venture require the consent of the venturers, as provided by the agreement; none of the individual venturers is in a position to unilaterally control the venture. This feature of joint control distinguishes investments in joint ventures from investments in other enterprises where control of decisions is related to the proportion of voting interest held.

The AcSEC definition establishes joint control over the decision-making process as the most significant attribute of joint ventures, regardless of the form of legal ownership or voting interest held. That is, the type of legal entity (e.g., corporation, partnership) is not relevant as long as the entity's governing documents provide for each venturer to exercise joint control. There is a distinction between "joint control over decision making" and a structure in which no single party has "control" over decision making. The latter does not meet the definition of a joint venture as all investors need not agree in order to approve an entity's action.

Joint control exists when the investors are able to participate in all of the significant decisions of an entity. An understanding of the governance structure of the entity is necessary to determine whether there is joint control over the significant decisions of the venture by all venturers. At times, power over the significant decisions of the entity may rest with the board of directors; however, the rights of all venturers should be considered in making the assessment as to whether joint control exists. The venturers, therefore, at a minimum, must be able to effectively participate in those significant decisions through substantive veto or approval rights. To be substantive, these rights must have no significant barriers to exercise (i.e., significant penalties or other hurdles making it difficult or unlikely they could be exercised).

Joint control can still exist when public shareholders own interests in a joint venture. The definition of a joint venture indicates that, while stock of a joint venture is usually not traded publicly, a noncontrolling interest held by public ownership does not preclude a corporation from being a corporate joint venture. In the unusual instance when the public has an equity interest in a joint venture, that interest is usually small relative to the other venturers' interests and does not provide the public shareholders with a means to actively participate in all significant decision-making of the joint venture. In such cases, joint control can still exist if control rests jointly with the venturers excluding the public shareholders.

Given that joint control requires unanimous consent over all significant decisions by all the venturers, it is not uncommon for venturers to disagree on certain significant decisions. In these cases, it is important to understand how disagreements are resolved. Sometimes, when the venturers cannot agree, no action is approved and no further action on that issue is taken by the venturers or venture. Other times, the dispute may go to arbitration for resolution. Settlement of disputes through arbitration does not preclude the investors from having joint control; however, if one investor has tie-breaking authority in the event of a dispute, joint control does not exist.

Some investors may also have unilateral control over decisions that are not significant to the joint venture's operations (e.g., selecting the auditor of the joint venture). Because these decisions are considered protective rather than participating, joint control over these decisions is not required. In these cases, the venturers would still be deemed to have joint control over the significant decisions.

Question EM 6-1, Question EM 6-2, and Question EM 6-3 discuss joint ventures that have more than two venturers. Question EM 6-4 addresses whether all venturers are required to have an equal ownership interest in the joint venture.

Question EM 6-1

Can a joint venture have more than two venturers?

PwC response

Yes, provided the joint venture satisfies all of the requirements in the definition of a joint venture, including the requirement for joint control by all venturers. Thus, each venturer in the joint venture would need to participate in the joint control over the joint venture.

Question EM 6-2

Assume three investors create a new entity, with each investor owning one-third of the equity of the new entity, and each having one-third of the investor votes. Investor approval over significant decisions of the new entity requires a simple majority of the investor votes. Does this qualify as joint control?

PwC response

No, although no investor controls the entity, a majority vote in this case means that only two of the three investors are needed to make the significant decisions of the new entity. This does not meet the concept of joint control. However, joint control would exist if investor approval over significant decisions required a unanimous decision by all three investors.

Question EM 6-3

Assume three investors create a new entity, with each investor owning one-third of the equity and significant decisions require unanimous approval of all three investors. If the investors cannot agree on a decision within 30 days after the initial disagreement, an independent arbitrator will be engaged to resolve the issue within 25 business days once engaged. Does this qualify as joint control?

PwC response

Yes, joint control exists as investor approval over significant decisions requires a unanimous vote of all investors. The use of an arbitrator to aid in the resolution of a potential disagreement does not negate the joint control terms as stipulated in the joint venture agreement. The arbitrator is only engaged and used when there is a disagreement among the three investors and generally would not be making the significant decisions on an ongoing basis.

Question EM 6-4

Are all venturers required to have an equal ownership interest in the joint venture (e.g., are two venturers in a joint venture required to each have a 50% ownership interest in the joint venture)?

PwC response

No, the definition of a joint venture does not require that each investor have an equal ownership interest in the joint venture. However, care should be exercised when evaluating a joint venture when there is not equal ownership among the investors as that might indicate the venture does not meet the definition of a joint venture (e.g., there may be a lack of joint control among the venturers). For instance, significant differences in ownership interests among investors may raise questions as to why an investor with proportionately greater economic interest would permit lower economic interest investors to have the same level of participation over the significant decisions of the entity.

6.2.3 Other characteristics

In addition to joint control, there are other characteristics that must be met for an entity to meet the definition of a joint venture, as described in ASC 323-10-20. That is, joint control alone is not sufficient to obtain joint venture accounting. At the 2014 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff stated that each of the characteristics in the definition of a joint venture should be met for an entity to be a joint venture, including that the purpose of the entity is consistent with that of a joint venture.

ASC 845-10-S99-2 states that the existence of joint control is not the only defining characteristic when determining whether an entity is a joint venture, rather, the other characteristics of a joint venture also need to be present. While the other characteristics might appear to be broad in nature and lacking specific guidance on how an entity would meet them (versus, for example, the joint control characteristic), an entity should exercise reasonable judgment in assessing whether it has met the additional characteristics. In making this assessment, the factors to consider include the purpose, nature, and operations of the entity.

For example, if the substance of a transaction is primarily to combine two or more existing operating businesses, which are either separate subsidiaries or divisions of a larger company, in an effort to generate synergies such as economies of scale or cost reductions and/or to generate future growth opportunities, such a transaction may be considered a merger that should be accounted for as a business combination under ASC 805 rather than as a joint venture. In this fact pattern, determining whether the purpose of the transaction is consistent with the definition of a joint venture as described in ASC 323 requires significant judgment.

Example EM 6-3, Example EM 6-4, Example EM 6-5, and Example EM 6-6 illustrate some of the accounting considerations when evaluating whether an entity meets the definition of a joint venture for accounting purposes.

EXAMPLE EM 6-3

Determining whether a joint venture is formed when each investor contributes its entire operations to a new entity

Company A, a holding company, owns Company B, which has a fair value of \$500 million, and represents all of Company A's operations. Company C, a holding company, owns Company D, which has a fair value of \$400 million, and represents all of Company C's operations. Company A and Company C agree to combine their operating businesses in a newly established entity, Newco. Company A contributes Company B in exchange for 55% equity and joint control of Newco. Company C contributes Company D in exchange for 45% equity and joint control of Newco. Company A and Company C each have two members on the four member board of directors and unanimous approval from all board members is required for all decisions related to Newco. Other than joint control, none of the other characteristics of a joint venture as described in ASC 323 exist.

Does this arrangement meet the definition of a joint venture for accounting purposes?

Analysis

No. Newco does not meet the definition of a joint venture. Although the investors appear to have joint control, both investors have contributed their entire operations, and therefore would likely not meet the aspect of the definition that describes the purpose of a joint venture. This transaction was likely for the purpose of achieving economies of scale or cost reductions as opposed to the purpose of sharing risks and rewards in developing a new market, product, or technology; combining complementary technological knowledge; or pooling resources in developing production or other facilities.

EXAMPLE EM 6-4

Determining whether a joint venture is formed when one investor contributes a business and the other investor contributes cash to a new entity

Company A, a holding company, owns various businesses including Company B, which has a fair value of \$500 million. Company A and Company C agree to form a joint venture, Newco, as they have plans for new product offerings and expansion into new markets. Company A contributes Company B in exchange for 50% equity and joint control of Newco. Company C contributes \$500 million cash in exchange for 50% equity and joint control of Newco. The cash will remain in Newco to be used for ongoing operating expenses, developing new products, and developing new production facilities. Company A and Company C each have two members on the four member board of directors and unanimous approval from all board members is required for all decisions related to Newco.

Does this arrangement meet the definition of a joint venture for accounting purposes?

Analysis

Yes. Newco meets the definition of a joint venture for accounting purposes. Company A and Company C have each made contributions in exchange for joint control of the new entity. The purpose for the entity is consistent with that of a joint venture as the venture will use the cash invested by Company C to gain access to new markets and to develop new products.

EXAMPLE EM 6-5

Whether a joint venture is formed when one investor sells 50% of an existing operating subsidiary

Company A, a holding company, owns Company B, which has a fair value of \$500 million, and represents all of Company A's operations. Company A has decided to cash out a portion of its existing business. To facilitate the transaction, Company A and Company C agree to form a new company, Newco, which the two investors will jointly own and jointly control. Company A contributes Company B in exchange for 100% of the equity of Newco. Company C pays \$250 million cash to Company A in exchange for 50% of its equity in Newco. Company A and Company C each have two members on the four member board of directors and unanimous approval from all board members is required for all decisions related to Newco.

Does this arrangement meet the definition of a joint venture for accounting purposes?

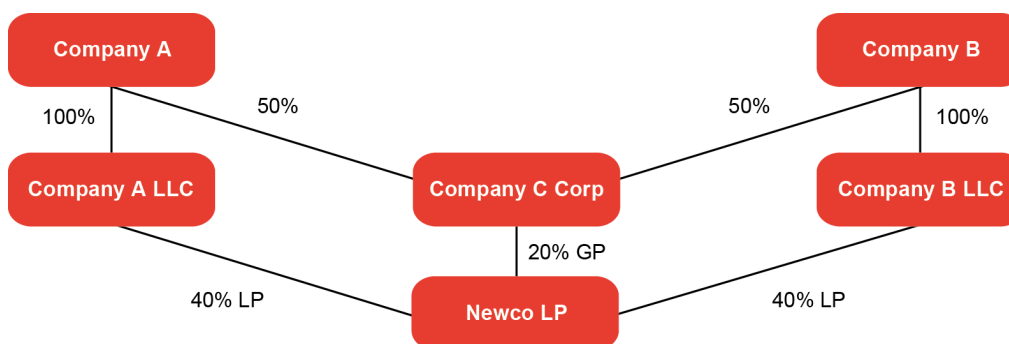
Analysis

No. While the investors have joint control over Newco, the substance of the transaction is that Company A has sold 50% of its business in exchange for cash. As the purpose of the transaction does not meet any of the other characteristics as described in ASC 323-10-20, this arrangement does not meet the definition of a joint venture for accounting purposes.

EXAMPLE EM 6-6

A joint venture structured in the form of a partnership

Company A and Company B form a new venture, Newco Partnership, a limited partnership. The general partner (GP) of Newco Partnership is Company C Corporation, a newly formed entity jointly owned and controlled by Company A and Company B. Company A owns 100% of Company A LLC, which has a 40% limited partnership interest in Newco Partnership. Company B owns 100% of Company B LLC, which has a 40% limited partnership interest in Newco Partnership. The GP owns the remaining 20% general partnership interest in Newco Partnership. The GP has the unilateral right to make all the decisions of Newco Partnership and the LPs do not have any participating rights or kick-out rights. Company A and Company B are not related parties.



Does Newco Partnership meet the definition of a joint venture?

Analysis

Yes. Assuming all of the other characteristics in ASC 323-10-20 are met, Newco Partnership would meet the definition of an accounting joint venture since Company A and Company B have joint control over the GP, which controls Newco Partnership. In this case, the substance of the arrangement is that the two companies have joint control over the joint venture.

6.2.4 Joint venture versus collaborative arrangements

Investors may enter into arrangements that are considered collaborative arrangements rather than joint ventures for accounting purposes. A collaborative arrangement is a series of contracts between two or more parties that involves a joint operating activity (e.g., marketing products), as described in ASC 808, *Collaborative Arrangements*. In many cases such arrangements do not include joint ownership in assets or a separate legal entity. Such arrangements are not joint ventures. See CG 8.3 for discussion of collaborative arrangements.

6.3 Accounting for the joint venture by the investor

Since definitionally a joint venture cannot be a subsidiary of any of its investors, and the investors all participate in the management of the joint venture, an investment in a joint venture is generally accounted for under the equity method of accounting pursuant to ASC 323.

In some cases, an investor may elect the fair value option to account for its investment in a joint venture or it may meet the requirements for proportionate consolidation, which are discussed in EM 1.4.5 and EM 1.4.6, respectively.

When an investor contributes a business or a group of assets that represents a business to a joint venture, the initial investment is generally recorded by the investor at fair value, as described in EM 6.3.1.1. Similarly, when an investor contributes nonfinancial assets that do not represent a business to a joint venture, the initial investment is generally recorded by the investor at fair value, as discussed in EM 6.3.1.2.

6.3.1 Investor accounting for an investment in a JV at formation

ASC 323 provides guidance regarding the initial measurement of an investment in a joint venture as follows.

ASC 323-10-30-2

Except as provided in the following sentence, an investor shall measure an investment in common stock of an investee (including a joint venture) initially at cost in accordance with the guidance in Section 805-50-30. An investor shall initially measure, at fair value, the following:

- a. A retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with paragraphs 810-10-40-3A through 40-5.

- b. An investment in the common stock of an investee (including a joint venture) recognized upon the derecognition of a distinct nonfinancial asset or distinct in substance nonfinancial asset in accordance with Subtopic 610-20.

6.3.1.1 *Contribution of a business*

ASC 805 defines a business as follows.

Definition from ASC 805-10-55-3A

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

See BCG 1 and ASC 805-10 for further information on what constitutes a business.

When an investor contributes a subsidiary or group of assets that constitute a business to a joint venture, the investor should apply the deconsolidation and derecognition guidance in ASC 810-10-40 and record any consideration received for its contribution at fair value (including its interest in the joint venture). This generally results in a gain or loss on the contribution.

Excerpt from ASC 810-10-40-5

A parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

- a. The aggregate of all of the following:
 1. The fair value of any consideration received.
 2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized.
 3. The carrying amount of any noncontrolling interest in the former subsidiary at the date the subsidiary is deconsolidated.
- b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.

This guidance does not apply if the investor's contribution is a conveyance of oil and gas mineral rights. An investor would apply the guidance in ASC 932 to account for these types of contributions to the joint venture.

Example EM 6-7 illustrates the accounting considerations when an investor contributes a business to a joint venture. See BCG 5.5 for examples of the accounting by an investor upon deconsolidation of a business.

EXAMPLE EM 6-7

Investor accounting for a contribution of a business to a joint venture

Company A has three reporting units, X, Y, and Z. Business B is one of several businesses within Company A's reporting unit X. Company A previously assigned goodwill from a prior acquisition to reporting unit X. Company A has entered into an agreement with an unrelated third party to form a 50:50 joint venture, Newco, and will contribute Business B to Newco. Assume Newco meets the definition of a joint venture, does not qualify as a variable interest entity under ASC 810-10, and will be accounted for as an equity investment in the financial statements of Company A under ASC 323.

How should Company A account for its investment in Newco?

Analysis

The guidance in ASC 810-10 should be followed when a subsidiary that is a business is transferred to a joint venture. Therefore, Company A should realize a gain or loss following the guidance in ASC 810-10-40-5. The carrying amount of Business B should include an allocation of reporting unit X's goodwill following the guidance in ASC 350-20-35-51 as the contribution of a business to a joint venture is analogous to other disposals (e.g., a sale, abandonment, spin-off).

The gain/loss would consist of two parts, the realized gain/loss on the effective sale of the 50% interest in Business B to the unrelated third party, and the unrealized gain/loss from the remeasurement to fair value of the 50% noncontrolling investment effectively retained in Business B.

6.3.1.2 Contribution of assets that do not represent a business

An investor may contribute a subsidiary (or group of assets) that is a nonfinancial asset or in substance nonfinancial asset and not a business to a joint venture. In these cases, the investor should record its joint venture investment in accordance with ASC 610-20 (provided other guidance is not applicable, e.g., ASC 932). See PPE 6.2 for guidance on the derecognition of nonfinancial assets and in substance nonfinancial assets.

An investor may also contribute to a joint venture financial assets (or a legal subsidiary holding financial assets) that are not considered in substance nonfinancial assets under ASC 610-20-15-5 through ASC 610-20-15-8. In this case, the investor should follow the guidance in ASC 860, *Transfers and Servicing*, for transfers of financial assets. See TS 1.3 and TS 3 for further guidance.

6.3.1.3 Contribution of services to a noncustomer

A gain should not be recognized on receipt of an interest in a joint venture if some or all of the investor's interest was received for future services to be rendered, as this implies continuing involvement through a future obligation, which would be recognized as the services are provided.

6.3.1.4 Differences in accounting

An investor and investee may apply different accounting principles (e.g., US GAAP, IFRS) and different accounting policies (e.g., LIFO or FIFO method of inventory costing) in the preparation of their financial statements. A public company investor may have an equity method investment in a private company investee that has elected a private company accounting alternative. Further, an

investor and an investee might adopt new accounting standards in different periods. See EM 4.3.4 for a discussion of these topics.

6.3.2 Restructuring and impairment charges

When joint ventures are created by contributing assets and/or businesses from existing entities, certain restructuring and impairment charges are often anticipated. For example, there may be plans to close certain operating plants or reduce personnel. Such restructurings and impairments are typically an integral part of the negotiations between the venture partners. See PPE 5 for a discussion of impairment under ASC 360-10 and PPE 6.4 for a discussion of costs associated with exit and disposal activities, including restructuring activities under ASC 420, *Exit or Disposal Cost Obligations*.

Question EM 6-5 discusses the accounting by an investor that contributes a facility (e.g., a plant) expected to be shut down at or shortly after formation of the joint venture.

Question EM 6-5

If an investor contributes a plant that is expected to be shut down at or shortly after formation of the joint venture, should expenses associated with shutting down the plant be recognized by the investor?

PwC response

Determining whether the investor or joint venture should bear the cost of restructuring activities related to assets being contributed to a joint venture that are initiated in anticipation of the formation of the joint venture and in agreement with the other joint venture partner requires significant judgment. An assessment should be made to determine whether the restructuring costs are more appropriately the responsibility of the investor or the joint venture.

An impairment of assets that would otherwise be required under US GAAP cannot be avoided by contributing the assets to a joint venture. This would apply, for example, to lower of cost and net realizable value write-downs for inventory or impairments of long-lived assets.

If after formation, the joint venture decides to restructure operations of the contributed plant and such restructuring was not contemplated in the joint venture formation, the restructuring costs should be recognized in the accounts of the joint venture.

6.3.3 Start-up and organization costs

Costs incurred by an investor directly related to the organization of a joint venture should be expensed as incurred in accordance with ASC 720-15-25-1, as they are considered akin to start-up costs incurred in the formation of a new entity.

6.3.4 Cumulative translation adjustment accounts

An investor may decide to contribute a portion or all of its foreign operations that constitute a business to a joint venture. This would result in the investor deconsolidating a portion or all of its foreign operations. In these cases, the investor needs to determine whether its investment in the joint venture results in a deconsolidation event within a foreign entity or a deconsolidation event of a foreign entity, as described in ASC 830-10. If it is deemed a deconsolidation event within a foreign entity, the

investor would not release any of its cumulative translation adjustments (“CTA”) into earnings unless such deconsolidation event represents a complete or substantially complete liquidation of the foreign entity. In contrast, if it is deemed a deconsolidation event of a foreign entity, the investor would release all of its CTAs related to the derecognized foreign entity, even when a noncontrolling investment is retained. See FX 8 for additional information regarding this determination.

6.3.5 Tax basis differences

Sometimes an investor may recognize its investment in a joint venture at fair value, while for tax purposes its investment in the joint venture was not deemed to be a taxable transaction. This would result in a difference in the book and tax basis of the investment. See TX 11 for further details regarding the impact to the investor when tax basis differences exist.

6.3.6 Dissolution of a joint venture

When a joint venture is terminated by its investors, the net assets of the joint venture may be distributed to the investors or sold to a third party. Example EM 6-8 illustrates the accounting by an investor for the receipt of the net assets of the joint venture upon its termination.

EXAMPLE EM 6-8

Accounting for an investor’s receipt of a distribution of net assets constituting a business from its joint venture

During 20X2, Company A and Company B established a joint venture, Newco, through the contribution of nonmonetary assets. Book values of the nonmonetary assets were equal to fair values at the time of the contribution. Since Company A and Company B have joint control over Newco and Newco meets the definition of an accounting joint venture, each investor accounts for its investment under the equity method of accounting.

During 20X4, the investors decide to end their joint venture in Newco and proceed with a plan to distribute the net assets of the venture to the investors in proportion to their 50:50 ownership interest. Newco distributes its assets such that each investor receives 50% of the total asset value. Each group of net assets received by the two investors constitutes a business as defined by ASC 805-10-20.

What is the accounting for the liquidating distribution of the net assets of Newco to the investors of Newco upon its termination?

Analysis

Each investor effectively owned a 50% noncontrolling equity interest in each business prior to the dissolution. In the dissolution, each investor would exchange its 50% equity investment in one of the businesses for a controlling financial interest in the other business. Therefore, given that each investor would obtain control of a business, the investor’s accounting is within the scope of ASC 805 and ASC 810-10, and should be accounted for using the guidance for a business combination achieved in stages. In this scenario, a gain (or loss) would be recognized on both the interest sold (which represents a business) and the remeasurement of the previously held equity interest effectively retained (which also represents a business). The transaction would be accounted for by Company A as follows.

At the time of the transaction, assume Newco's net assets have a fair value of \$400 million and a book value of \$300 million attributable evenly between the two businesses. As a result, Company A effectively sells its 50% in a business (with a fair value of \$200 million and book value of \$150 million) and acquires control of a business by purchasing the 50% interest in the other business (also with a fair value of \$200 million and book value of \$150 million) for which Company A had a previously held equity interest. Company A would record its basis in the acquired business based on the consideration transferred of \$200 million (fair value of business sold) and record the assets acquired and liabilities assumed, including the remeasurement of its previously held equity interest. Company A would recognize a total gain of \$50 million on the transaction as follows.

Dr. Net assets of business acquired	\$200 million	
Cr. Investment in Newco		\$150 million
Cr. Gain on previously held equity interest		\$ 25 million
Cr. Gain on sale of business to Company B		\$ 25 million

If the equity investment in Newco was exchanged for net assets that did not constitute a business, the transaction would not fall within the scope of ASC 805.

6.4 Accounting by the joint venture

The guidance in this section applies only to entities that meet the accounting definition of a joint venture as discussed in EM 6.2. Generally, the most significant accounting issue the joint venture will need to address is the amount at which to record contributions received from its investors.

New guidance

In August 2023, the FASB issued ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*. The new guidance requires a joint venture to apply a new basis of accounting for all contributions received upon its formation. This accounting will largely be consistent with ASC 805, *Business Combinations*, with some specific exceptions that are further discussed in EM 6.4.1.3.

The new guidance should be applied prospectively and is effective for all newly formed joint venture entities with a formation date on or after January 1, 2025. For joint venture entities formed before the effective date, an election can be made to apply the new guidance retrospectively if sufficient information is available to do so. Early adoption is permitted. The new guidance applies to the initial formation of a joint venture or corporate joint venture. It does not address accounting by the joint venture for transactions after the formation transaction.

Additionally, the new guidance does not apply to formations of joint ventures that are determined to be not-for-profit entities or entities that may be proportionally consolidated under certain specialized industry guidance (see EM 1.4.6). In addition, collaboration agreements are excluded from the scope of the new guidance unless there is a part of the collaboration that is conducted in a separate legal entity that meets the definition of a joint venture. In that case, the joint venture should apply the new guidance in its standalone financial statements.

Accounting by the investor is not impacted by the new guidance. As noted in EM 6.3.1, an investor is required to initially recognize its initial investment in the joint venture at fair value as of the date the entity loses control of those net assets as defined under ASC 610-20, *Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets*, or ASC 810, *Consolidation*, depending on whether a group of assets or a business is contributed. This treatment will not change under the new guidance. However, since the investors' accounting is based on a fair value model, it is expected that the new guidance eliminates or reduces many of the current basis differences between the joint venture's financial statements (if the joint venture had recorded the contributions at carryover basis) and the reported investment by the investors, thus reducing complexity. For further discussion of accounting by the investor, refer to EM 6.3. For initial and subsequent accounting of basis differences, refer to EM 3.3 and EM 4.3, respectively.

For accounting prior to the adoption of ASU 2023-05, refer to EM 6.4A.1.

6.4.1 Initial contributions to the joint venture (after adoption of ASU 2023-05)

The formation of a joint venture results in the creation of a new reporting entity, and none of the assets or businesses contributed survive as an independent entity or as the historical operations of the entity. Accordingly, unlike in a business combination, the formation of a joint venture does not result in the identification of an accounting acquirer or a determination that one party gained control over another party. Therefore, a newly formed joint venture should apply a new basis of accounting to all its contributed net assets, which results in the joint venture initially measuring its contributed net assets under ASC 805-20, *Business Combinations—Identifiable Assets and Liabilities, and any Noncontrolling Interest*, with certain exceptions highlighted in EM 6.4.1.3.

6.4.1.1 Recognition and measurement of the net assets contributed to the joint venture

A joint venture is required to measure the net assets contributed as of the formation date. ASC 805-60 defines formation date as follows.

Definition from Master Glossary

The formation date of a joint venture is the date on which an entity initially meets the definition of a joint venture, which is not necessarily the legal entity formation date. The formation date is the measurement date for the formation transaction. If multiple arrangements are accounted for as a single transaction that establishes the formation of a joint venture, the formation date is the measurement date for all arrangements that form part of the single formation transaction.

The formation date is meant to function similar to the acquisition date in a business combination; it is the relevant date at which the joint venture must measure all the contributed assets and liabilities that are determined to be part of the formation transaction. Determination of the formation date may be straightforward when only one arrangement comprises the formation transaction or all contributions are made at the same date. However, defining the formation date may require significant judgment when assets or liabilities are not all contributed at the same time or when multiple arrangements constitute the joint venture formation transaction.

To determine whether to account for multiple arrangements as a single transaction that establish the joint venture formation, the entity should consider the guidance in 805-60-24-4, which is consistent

with the guidance in ASC 810-10 for combining multiple transactions for the sale or derecognition of a business.

Excerpt from 805-60-25-4

Multiple arrangements may establish the formation of a joint venture and constitute the joint venture formation transaction. Circumstances sometimes indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the multiple arrangements as a single transaction that establishes the formation, a joint venture shall consider the terms and conditions of the arrangements and their economic effects. Any of the following may indicate that the joint venture should account for the multiple arrangements as a single transaction that established the formation of the joint venture:

- a. The multiple arrangements are entered into at the same time or in contemplation of one another.
- b. The multiple arrangements form a single transaction designed to achieve an overall commercial effect.
- c. The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- d. One arrangement considered on its own is not economically justified, but the multiple arrangements are economically justified when considered together.

All of the contributed net assets determined to be part of the formation should be measured as of the formation date. With the limited exceptions described in EM 6.4.1.3, the net assets should be recognized in accordance with the guidance in ASC 805-20. Therefore, most assets and liabilities are recognized at their fair values. However, similar to acquisition accounting, certain assets and liabilities, such as contract assets and contract liabilities, certain contingencies, pension and postretirement benefits, leases, and income taxes are recognized at amounts other than fair value. See further discussion of the measurement basis of acquired assets and assumed liabilities in BCG 2.5.

When the investor contributes financial assets to the joint venture, accounting by the joint venture will depend on whether or not the investor accounts for the derecognition of those financial assets under ASC 860, *Transfers and Servicing*. If the investor applies the accounting guidance within ASC 860, the joint venture should similarly determine if the transfer results in the recognition of the transferred financial assets by applying the guidance in ASC 860. This does not include scenarios in which an investor contributes a business (or group of assets) that contains financial assets if they are considered “in substance nonfinancial assets” under ASC 610-20. In this scenario, the investor would account for the disposition of all assets, including the financial assets, under ASC 810 or ASC 610-20, and therefore, the joint venture would similarly not apply ASC 860 when assessing how to record the financial assets in its financial statements.

A joint venture should measure its total net assets as the fair value of the joint venture entity as a whole immediately following formation. This includes any noncontrolling interest in the net assets recognized by the joint venture. Total net assets do not include the fair value of any contingent consideration or replacement share awards, as described in EM 6.4.1.2. As a result, total net assets do not simply reflect the sum of the individual groups of net assets contributed by each investor.

If the initial accounting for a joint venture formation is incomplete by the end of the reporting period, joint venture entities can apply the measurement period guidance in ASC 805, which allows entities up to one year after the formation date to obtain information necessary to identify and measure the total net assets of the joint venture, assets acquired, liabilities assumed, and any noncontrolling interest. During the measurement period, the joint venture may adjust the provisional amounts recognized for new information about facts and circumstances that existed as of the formation date.

6.4.1.2 *Determining what is part of the joint venture formation*

A joint venture and its investors may enter into multiple arrangements at or around the same time as the formation. For example, the joint venture may enter into a service contract with an investor to pay the investor for future services to be performed. To determine what is part of formation, the joint venture should follow the guidance for assessing what is part of a business combination in ASC 805-10-55-24 through ASC 805-10-55-26. This includes evaluating why the payments are included in the arrangement, which party initiated them, and when the parties entered into the arrangement. See BCG 2.7 for additional information.

As the formation of a joint venture is the formation of an entirely new entity, the joint venture should not apply or analogize to the guidance related to pre-existing relationships in a business combination. Additionally, a joint venture is prohibited from applying the guidance in ASC 805 related to accounting for acquisition-related costs and transactions that reimburse the acquiree for paying the acquirer's acquisition-related costs.

When share-based payment awards are issued at formation to replace awards held by grantees of the contributed entities, the joint venture should allocate the fair value of the awards at the formation date between pre-formation vesting and post formation compensation cost, similar to the accounting for share-based payment awards in a business combination, which is further described in BCG 3. However, instead of the portion of the fair value of the awards attributed to pre-formation vesting being accounted for as additional purchase price as it is in a business combination, this amount is accounted for as a reallocation of additional paid-in capital (or other similar equity account, such as members' equity) and does not impact the total amount of equity or goodwill recognized by the joint venture upon its formation. Similar to acquisition accounting, the joint venture should record the portion of the fair value of the awards attributable to post formation service as compensation cost over the applicable service period.

6.4.1.3 *Recognition of goodwill and in process research and development (IPR&D)*

Regardless of whether the contributions received by the joint venture upon formation represent a business or an asset group, accounting for goodwill and IPR&D largely follows the accounting model for business combinations.

- Goodwill should be recognized when the fair value of the joint venture entity as a whole exceeds the amount of identifiable net assets recognized.
- Negative goodwill should be recognized as an adjustment to equity, not as a bargain purchase gain as in a business combination.

Recognition of goodwill is not limited to joint venture entities that meet the definition of a business.

As it relates to IPR&D, all intangible research and development assets contributed to a joint venture at formation should be capitalized as indefinite-lived intangible assets, consistent with the accounting model for business combinations.

A joint venture that is a private company may apply the accounting alternatives related to the recognition of certain intangible assets and amortization and impairment of goodwill. Refer to BCG 4.7 and BCG 9.11, respectively.

Figure EM 6-1 compares accounting for joint venture formations under ASC 805-60 and accounting for business combinations or asset acquisitions under ASC 805-20 and ASC 805-50, respectively. The figure is intended to summarize certain key areas, not address all accounting similarities or differences.

Figure EM 6-1

Comparison of joint venture formations, business combinations and asset acquisitions.

Topic	Business combination (ASC 805-20) and/or asset acquisition (ASC 805-50)	JV formation (ASC 805-60)
Initial measurement	<p>In a business combination, assets and liabilities are measured at acquisition date fair value, with limited exceptions as described in BCG 2.5.</p> <p>In an asset acquisition, assets acquired are measured under a cost accumulation model, with cost allocated to acquired assets on a relative fair value basis.</p>	Assets and liabilities are measured at formation date fair value, with the same limited exceptions as business combinations.
Goodwill	<p>Goodwill is recognized in business combinations when the consideration paid is greater than the fair value of the net identifiable assets acquired.</p> <p>Goodwill is not recognized in asset acquisitions.</p>	<p>Goodwill is recognized when the total fair value of the JV exceeds the fair value of the net identifiable assets contributed.</p> <p>Goodwill is recognized regardless of whether the assets contributed represent a business or an asset group.</p>
Bargain purchase gain	<p>A bargain purchase gain is recognized in business combinations when the consideration paid is less than the fair value of the net assets acquired.</p> <p>A bargain purchase gain is not recognized in asset acquisitions.</p>	No bargain purchase gains are recognized. Negative goodwill is recognized as an adjustment to equity of the JV.
In process research and development (IPR&D)	IPR&D is capitalized as an indefinite-lived intangible asset in a business combination.	IPR&D is capitalized as an indefinite-lived intangible asset, regardless of whether the

	IPR&D is expensed in an asset acquisition.	assets contributed represent a business or an asset group.
Contingent consideration	<p>In a business combination, contingent consideration is recognized at estimated acquisition date fair value as additional purchase price.</p> <p>In an asset acquisition, contingent consideration that is not accounted for under other US GAAP (e.g., as a derivative) is generally recorded when probable and reasonably estimable. Any amount of contingent consideration recorded on the acquisition date is included in the initial cost of the assets acquired, and subsequent changes are generally recognized as an adjustment to the cost basis.</p>	Contingent consideration is accounted for as a liability (or asset) contributed at formation. It is not added to the total fair value of the JV.
Share-based payment awards	<p>In a business combination, the fair value of the awards is allocated between pre-acquisition vesting and post-acquisition compensation cost.</p> <ul style="list-style-type: none"> - Amounts attributed to pre-acquisition vesting are accounted for as additional purchase price. - Amounts attributable to post-acquisition services are recognized as compensation cost over the applicable service period <p>If an asset acquisition includes employees with share-based compensation awards that are replaced with awards of the acquirer, there may be diverse views as to whether a similar allocation should be made as in a business combination or if the full amount of the replacement awards would be considered new awards and be accounted for prospectively and recognized in the postcombination period.</p>	<p>The fair value of the awards is allocated between pre-formation vesting and post-formation compensation cost.</p> <ul style="list-style-type: none"> - Amounts attributed to pre-formation vesting are accounted for as a reallocation of additional paid in capital (or other similar equity account such as members' equity). - Amounts attributed to post-formation service are recognized as compensation cost over the applicable service period.
Acquisition-related costs	<p>Acquisition-related costs in a business combination should be expensed as incurred by the acquirer.</p> <p>In an asset acquisition, acquisition-related costs are included in the cost of the acquired assets.</p>	Not specifically addressed, other than that JVs cannot apply the guidance for business combinations or asset acquisitions

Reimbursement of acquisition-related costs	<p>In a business combination:</p> <ul style="list-style-type: none"> - Reimbursement of acquiree acquisition-related costs is accounted for by the acquirer as part of the consideration transferred. - Reimbursement of acquirer acquisition costs paid for by the acquiree are accounted for by the acquirer as an expense. <p>In an asset acquisition, all acquisition-related costs are included in the cost of the acquired asset.</p>	Not specifically addressed, other than that JVs cannot apply the guidance for business combinations
Pre-existing relationships	<p>In a business combination, if pre-existing relationships with the acquiree included favorable or unfavorable terms, the acquirer should recognize a gain or loss as an effective settlement.</p> <p>There is no guidance outside of a business combination on the settlement of a pre-existing relationship. In an asset acquisition, settlement gains and losses are generally recognized in the income statement, consistent with the guidance for business combinations.</p>	<p>Not specifically addressed, other than that JVs cannot apply the guidance for business combinations</p> <p>As a new entity, a JV would not be viewed to have pre-existing relationships with the venturers.</p>
Measurement period adjustments	<p>In a business combination, may obtain final valuation information for acquired assets and assumed liabilities, and total consideration issued, not to exceed one year after the acquisition date.</p> <p>In an asset acquisition, there is no concept of a measurement period.</p>	<p>May obtain final valuation information for contributed assets and liabilities, and total formation-date fair value of the JV, not to exceed one year after the formation date</p>

6.4.2 *Tax basis differences*

Noncash assets contributed to a joint venture that are recorded at fair value by the joint venture may have a lower tax basis that carries over from the investor to the venture. In these situations, the different bases of the assets for book vs. tax purposes would be a temporary difference for which deferred taxes should be recorded by the joint venture at the date of contribution, if the joint venture is a taxable entity. See TX 11 for further information.

6.4.3 *Conforming accounting policies*

At its inception, the joint venture establishes its own accounting policies. Typically, these are selected from those of the investors. Adoption of these accounting policies is not considered a change in the

joint venture's accounting policies under ASC 250-10 and Regulation S-X Rule 10-01; rather, it represents the initial selection by the joint venture of its own accounting policies.

6.4.4 *Joint venture's investment in a venturer*

A joint venture (investee) may hold an equity investment in one of its venturers (investors). See EM 4.3.5 for a discussion of the acceptable accounting methods in this scenario.

6.4A *Accounting by a joint venture (before adoption of ASU 2023-05)*

Prior to the issuance of ASU 2023-05, there was little authoritative guidance on accounting by a joint venture for contributed assets and liabilities. As a result, there has been diversity in practice, with some joint ventures accounting for contributions received at carryover basis and others at fair value.

6.4A.1 *Initial contributions to the joint venture*

Generally, noncash contributions to a joint venture are recognized by the joint venture at the lower of the investor's carryover basis or fair value.

Prior to the issuance of ASC 810, Consolidation and ASC 610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*, both the investor (venturer) and the joint venture applied carryover basis when recognizing transactions involving the exchange of noncash assets for equity at formation, except in certain limited circumstances. The issuance of ASC 810 and more recently ASC 610-20 changed the accounting by the investor. Because the exchange of a business for a noncontrolling equity investment results in a loss of control over the business, ASC 810 acknowledges that this is a significant economic realization event that changes the nature of the retained noncontrolling investment. As a result, as discussed in EM 6.3.1.1, investors that transfer a subsidiary (or a group of assets) meeting the definition of a business generally recognize the initial equity investment at fair value. Similarly, ASC 610-20 requires the investor to record its investment in the joint venture at fair value when contributing nonfinancial assets or in substance nonfinancial assets that do not meet the definition of a business to the joint venture.

The resulting asymmetry in accounting basis between the investor and the joint venture created by ASC 810 and ASC 610-20 evoked a debate about whether it may be appropriate for the joint venture to also record the contributed business or nonfinancial assets at fair value. Given the changes to the investor's accounting models, recent statements made by the standard setters have indicated that there may be instances when it may be appropriate to accept contributions being recorded at fair value at the joint venture level. As noted in EM 6.4, the FASB has an active project on this topic that may affect the accounting by the joint venture for the receipt of noncash assets at formation.

6.4A.2 *SEC registrant joint ventures*

The SEC staff has historically taken the view that the joint venture can elect to record the investor's contributions at fair value only when all of the following conditions are met.

- Noncash assets are contributed by an investor into a newly formed venture and, after the transaction, the investor does not control the venture.

- The other investor contributes cash in an amount equal to the fair value of the noncash assets (fair value must be objectively determinable) contributed by the first venturer, and such cash remains in the joint venture or is used by the joint venture in transactions with parties other than the venturers.
- The investors have joint control over the joint venture.
- The investors are unaffiliated.
- Neither investor in the joint venture has preference in the allocation of equity or profits or losses (i.e., the profit split conforms to the ownership arrangement).

The SEC staff has also stated that a partial step-up in basis (to the extent that property has been “acquired” by the investor contributing cash) may be permitted in the following circumstances:

- Investor B acquires for cash a one-half interest in certain assets directly from Investor A. Both investors then contribute their interests in the assets to a new entity. Assume the new entity meets the definition of a joint venture as described in ASC 323-10-20.
- Investor A contributes certain assets to a new entity. Investor B acquires for cash a one-half interest in the new entity directly from Investor A. Assume the new entity meets the definition of a joint venture as described in ASC 323-10-20. (In the SEC staff’s view, this transaction is, in substance, the same as the first transaction and should be accounted for in a consistent manner.)

In these circumstances, the contributed property would be recorded on the books of the joint venture at 50% carrying value (Investor A’s carrying basis) and 50% fair value (Investor B’s carrying basis). A 100% step-up in basis to fair value has historically not been permitted, since cash was not contributed to the venture. A partial step-up would also be permitted in a scenario economically similar to the second circumstance, but where Investor B contributes cash into the joint venture and the cash is then distributed from the joint venture to Investor A.

The SEC staff has indicated that in certain limited circumstances, an investor’s contribution of recently acquired property from an independent third party could serve to validate the fair value of the other investor’s contributions and justify recording the joint venture’s assets at fair value.

The SEC staff has also stated that application of the above accounting guidelines to a joint venture with other than equal ownership (but joint control) would have to be evaluated on a case-by-case basis.

Example EM 6-9 illustrates joint venture accounting for tangible and intangible assets received upon formation of the venture.

EXAMPLE EM 6-9

Joint venture accounting for tangible and intangible assets received upon formation of the venture

Company A and Company B are unaffiliated entities that form an SEC-registered joint venture. Each investor has a 50% equity interest and joint control over the joint venture. Company A contributes a business from one of its divisions that has a net carrying value of \$5 million and a fair value of \$10 million. The \$10 million includes \$9 million for tangible assets and \$1 million for identifiable

intangible assets. Company B contributes \$10 million in cash that will remain in the joint venture to fund operating expenses. The venture meets the other characteristics of a joint venture.

How should the contributed assets be recorded by the joint venture?

Analysis

Since the joint venture has met the SEC's conditions for recognizing the contributions at fair value, the joint venture may elect to record total assets of \$20 million — \$10 million in cash, \$9 million for tangible assets, and \$1 million for the identifiable intangible assets. The joint venture may also record total assets of \$15 million — \$10 million in cash and \$5 million for the business, since carryover basis is an acceptable measurement method upon formation of a joint venture.

Regardless of how the joint venture accounts for the contribution, Company A would record a gain upon losing control of a previously consolidated business following the guidance in ASC 810-10-40-5.

6.4A.3 Non-registrant joint ventures

Given the lack of guidance for the accounting for contributions received by a joint venture, entities generally look to the SEC guidance discussed in EM 6.4.1.1 in determining when fair value would be appropriate at the joint venture level.

Recording the investor contributions at carrying value in the nonregistrant joint venture financial statements continues to be appropriate, especially in the following scenarios:

- Noncash assets are contributed whose fair value is not readily determinable with a high degree of reliability, which may be the case when all investors contribute noncash assets.
- Noncash assets are contributed for which the recoverability of their fair value is in doubt. For example, internally developed intangible assets contributed to a joint venture will often be recorded at the investor's basis (usually zero).