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# **Overview**

Investments in other entities can take many forms. For example, the instrument may be legally structured as an equity interest or debt instrument. The investee's legal form may be a simple corporation that shares returns pro rata or may have many classes of equity with different rights and privileges. Alternatively, the investee might be structured as a limited partnership (LP) or limited liability company (LLC), which may have specific ownership accounts and preferential returns. The investor might have rights to participate in the investee's governance and policies (for example, a seat on the investee's board of directors or veto rights). The investor's level of influence can range from having limited protective rights to having the ability to unilaterally make decisions that significantly impact the investee's economic performance. The investor might be explicitly or implicitly committed to funding the investee's losses. The investment might have been entered with a strategic objective (for example, expanding a presence in a new market or vertically expanding the investor's supply or distribution chain) or solely for financial gain. Many such investments are potentially subject to the equity method of accounting.

This Blueprint focuses on the accounting for equity method investments, which is codified in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 323, *Investments — Equity Method and Joint Ventures*. This Blueprint also includes interpretive guidance, examples, and insights on applying ASC 323.

Other models in U.S. Generally Accepted Accounting Principles (GAAP) used to account for equity investments include:

- Consolidation, when the investor has a controlling financial interest in the legal entity (see our Blueprint, <u>Control and Consolidation Under ASC 810</u>).
- ▶ The proportional amortization method (PAM) for equity investments in which the investor receives tax credits and other benefits, if the investment meets specific criteria and elected (see Section 1.5.2).
- ▶ One of three measurement models for equity securities in ASC 321, Investments Equity Securities:
  - Equity securities with readily determinable fair values are measured at fair value each reporting period, with unrealized holding gains and losses (that is, changes in fair value) recognized in earnings.
  - Equity securities issued by specific entities that calculate net asset value per share (or its equivalent) are remeasured to that amount each reporting period, with changes recognized in earnings.
  - Equity securities without readily determinable fair values are measured at either (as an accounting policy choice for each investment):
    - Fair value, with changes in fair value recognized in earnings.
    - Cost minus impairment, if any. However, if an investor identifies an observable price change in an orderly transaction for an identical or similar investment in the same investee, the investor must remeasure the equity security to fair value as of that transaction date (referred to herein as the "ASC 321 measurement alternative").

The model that is applied depends on the facts and circumstances and, in some cases, elections made by the investor.

## **EQUITY METHOD ACCOUNTING IN A NUTSHELL**

The core principle of ASC 323 is that an investor accounts for its investment in a corporation's common stock or insubstance common stock when the investor has the ability to exercise significant influence over its investee's operating and financial policies but does not control the investee, as determined under ASC 810, *Consolidation*. The equity method also applies to equity investments in partnerships, LPs, LLCs that have specific ownership accounts, and other similar legal entities if the investor has more than virtually no influence over the investee.

ASC 323 requires an investor to initially measure an equity method investment at cost and present the investment on the balance sheet as a single line item. Subsequently, an investor recognizes its share of the investee's income (loss) and increases (decreases) the investment. An investor adjusts its share of the investee's income for basis differences identified at initial measurement. Proportionate consolidation is prohibited unless specific criteria are met.

An investor generally recognizes equity method losses only up to the carrying amount of its investment (and any actual or committed financial support). If the investee later recognizes income, the investor resumes recognizing equity method income only after its share of the investee's income equals the share of losses not recognized while the equity method was suspended. An investor impairs its equity method investment when it has an other than temporary loss in value; it remeasures the investment to fair value.

## SCOPE AND SIGNIFICANT INFLUENCE

ASC 323 applies to any investment in a corporation's common stock or in-substance common stock unless a scope exception applies. The equity method also applies to equity investments in partnerships, LPs, LLCs, and other similar legal entities.

Accordingly, the equity method may or may not apply to an arrangement referred to in practice as a "joint venture." Because U.S. GAAP defines the term "joint venture" (see Section 1.4), a contractual or legal reference to an arrangement being a joint venture does not determine whether the arrangement is in the scope of ASC 323.

ASC 323 has scope exceptions. For example, if an investor controls and consolidates an investee in accordance with ASC 810, the equity method does not apply (see our Blueprint, <u>Control and Consolidation Under ASC 810</u>). Investments in the scope of ASC 815, *Derivatives and Hedging*, and investments in common stock held by a nonbusiness entity such as an estate, trust, or individual are also outside the scope of ASC 323. See Section 1.5 for a full list of scope exceptions from ASC 323.

The table below lists the presumptions that apply to different equity investments, unless a scope exception applies.

INVESTMENT	GUIDANCE
Equity investment in a corporation's common stock or in-substance common stock	The investor applies the equity method if it has the ability to exercise significant influence over the investee's operating and financial policies. The investor
Equity investment in an LLC that does not have specific ownership accounts (other than the managing member interest)	is presumed to have significant influence if it holds 20% or more of the investee's common stock (or insubstance common stock). This presumption stands unless overcome by predominant evidence to the contrary. Conversely, an investor that holds less than 20% of a corporation's voting common stock is presumed not to have the ability to exercise significant influence over the investee's operating and financial policies unless such ability can be demonstrated. If not, the investment is a financial asset.
Equity investment in a corporation's preferred stock that is not in-substance common stock	The equity method does not apply, regardless of whether the investor otherwise has the ability to exercise significant influence. The investment is a financial asset.
Equity investment in an LP (other than the general partner interest), including investments with preferential returns	The investor applies the equity method if it has more than virtually no influence over the investee. The investor is presumed to have more than virtually no influence if it holds an interest of 3% to 5% or more.
Equity investment in an LLC that has specific ownership accounts (other than the managing member interest), including an investment with preferential returns	Other facts and circumstances can also indicate that the investor has more than virtually no influence over the investee.
General partner (GP) or managing member interest	The investor applies the equity method if it does not control and consolidate the investee.

As shown in the graphic below, significant influence over an investee is a lower threshold than control, which includes the ability to make the decisions that significantly impact the investee's economic financial performance (as discussed in the variable interest entity (VIE) model).



An investor's proportion of voting common stock is based on outstanding securities. Determining the proportion held can be complex when the investor holds indirect interests or potential voting rights in the investee.

An investor must continuously evaluate all facts and circumstances to determine whether it has the ability to exercise significant influence over an investee. A change in interest or other facts and circumstances can affect an investor's ability to exercise significant influence over the investee's operating and financial decisions.

See Chapters 1 and 2 for guidance on the scope of the equity method and identifying significant influence. All references to common stock in this Blueprint include in-substance common stock.

## INITIAL MEASUREMENT

The initial measurement of an equity method investment has two steps:

Step 1: Determine the investment's cost

Step 2: Identify basis differences and allocate the cost of the investment in the memo accounts as if the investee were a subsidiary

ASC 323 requires an investor to initially measure an equity method investment at cost and present the investment on the balance sheet as a single line item. Cost is determined in accordance with the cost accumulation model for asset acquisitions in ASC 805-50, *Business Combinations — Related Issues*. The cost basis of an equity method investment includes transaction costs directly related to the investment's acquisition, contingent consideration in specific circumstances, and commitments and guarantees the investor provided on the investee's behalf. The cost of an equity method investment also includes any other consideration paid. When the investor obtains the equity method investment in exchange for consideration other than cash, the investment's initial measurement often is in the scope of other U.S. GAAP and recognized at fair value.

The cost of an equity method investment can be summarized as follows:



The cost of an equity method investment typically differs from the investor's share of the carrying amounts of the investee's identifiable assets and liabilities (referred to as "net assets"). In Step 2, an investor must allocate this basis difference to the investee's identifiable net assets in separate accounts, referred to as "memo accounts," as if the investee were a consolidated subsidiary. If the investee meets the definition of business in ASC 805, *Business Combinations*, an investor accounts for any unallocated basis difference as equity method goodwill.

Other factors to consider when accounting for the basis difference include:

- ▶ The deferred tax consequences of basis differences related to identifiable net assets
- ▶ The investee's accumulated other comprehensive income (AOCI)
- Any in-process research and development (IPR&D)
- Noncontrolling interests (NCI) in the investee's subsidiaries.

See Chapter 3 for guidance on the initial measurement of an equity method investment.

## SUBSEQUENT MEASUREMENT

Under the equity method, an investor recognizes its share of the investee's income (loss) when recognized by the investee in its financial statements (rather than when an investee declares a dividend), which increases (decreases) the investment. An investor's share of the investee's income generally is based on the investor's share of the investee's common stock. However, determining an investor's share of an investee's income can be challenging when returns, distributions, or dividends are not shared pro rata. It can also be challenging to determine an investor's share of the investee's income when the investee is accounted for on a lag, or has a different fiscal year-end, accounting policies, or functional currency.

An investor adjusts its share of the investee's income to:

- Eliminate intra-entity profit
- Amortize basis differences
- ▶ Recognize the investor's share of changes in the investee's capital
- ▶ Report the investor's share of the investee's other comprehensive income (OCI).

In summary, an investor's equity method income is calculated as follows:



An investor generally recognizes equity method losses only up to the carrying amount of its investment. However, an investor continues recognizing losses to reduce its investment (and any other interests in the investee) below zero if it has guaranteed the investee's obligations; has provided, or is otherwise committed to provide, more financial support; or if the investee will imminently return to profitability. Otherwise, an investor accumulates any unrecognized equity method losses in its memo accounts. If the investee later recognizes income, the investor resumes recognizing equity method income only after its share of the investee's income equals the share of losses not recognized while the equity method was suspended.

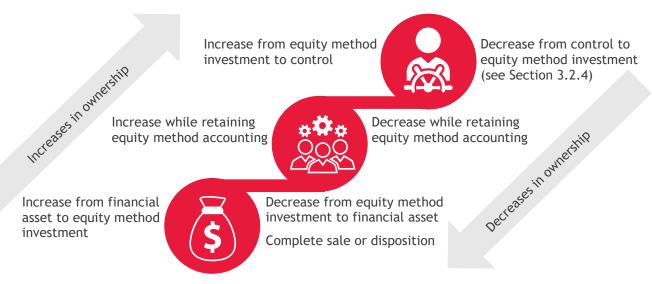
An investor impairs its equity method investment when it has an other than temporary loss in value; the investor remeasures the investment to fair value.

See Chapter 4 for guidance on the subsequent measurement of an equity method investment and measuring the investor's equity method income.

## CHANGES IN OWNERSHIP

An investor's ownership interest in an investee may increase or decrease and with that, the investor's level of influence over the investee may increase or decrease. Sometimes, such changes occur because of the investor's actions (like buying or selling the investee's voting common stock). At other times, those changes occur without any actions by the investor (for example, because the investee issues or repurchases shares). Chapter 5 addresses changes in an

investor's ownership in an investee when the investor has an equity investment in the investee before the transaction, as shown in the graphic below.



Other changes in ownership interests discussed in Chapter 5 include when an investee:

- Issues shares, including investee share-based payments and in common control transactions
- ▶ Repurchases shares, including treasury shares

## PRESENTATION AND DISCLOSURE

The table below summarizes presentation requirements for an equity method investment in ASC 323.

The table below summarizes presentation requirements for an equity method investment in ASC 323.		
	PRESENTATION REQUIREMENTS	
Balance Sheet	▶ An equity method investment is presented as a single line item in the investor's balance sheet.	
Income Statement	<ul> <li>Equity method income is presented as a single line item in the investor's income statement.</li> <li>An investor can combine its share of an equity method investee's OCI with its own OCI components in the statement of comprehensive income or separately present such amounts.</li> </ul>	
Cash Flow Statement	<ul> <li>Cash paid for an investment or cash received upon sale or disposal of an equity method investment are investing activities.</li> <li>When an investor uses the indirect method to prepare the cash flow statement, its equity method income is a reconciling item between net income and cash flows from operating activities.</li> <li>An equity method investor must elect a policy to determine whether dividends or distributions from its investee are operating or investing activities, and use either the cumulative earnings approach or nature of distribution approach in ASC 230, Statement of Cash Flows.</li> </ul>	

See Chapter 6 for guidance on the presentation and disclosure requirements in ASC 323.

## ABOUT THIS BLUEPRINT

This Blueprint summarizes ASC 323 after the adoption of the following accounting standards updates (ASUs):

- ▶ ASU 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method (see our Bulletin for the effective dates)
- ▶ ASU 2023-05, *Joint Venture Formations* (see Appendix D of our Blueprint, Business Combinations Under ASC 805, for the effective dates).

This publication collectively refers to that guidance as ASC 323.

This Blueprint summarizes key aspects of equity method accounting that commonly arise when applying ASC 323. It also includes practical examples and interpretive guidance to help companies and practitioners applying ASC 323. The facts and circumstances of actual investments and arrangements vary, so an investor's accounting conclusions may differ from the examples herein.

This Blueprint is divided into chapters and organized in the order an investor applies ASC 323. For example, Chapter 1 discusses whether an investment is within the scope of ASC 323; if it is, a reader moves to the next chapter, and so forth. The arrow below depicts this publication's organization.





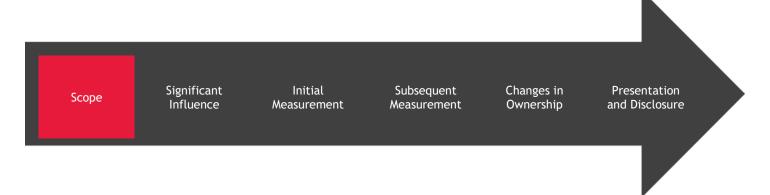
This Blueprint focuses on the accounting for equity method investments in U.S. GAAP. Information on equity method accounting for associates and joint ventures in International Financial Reporting Standards (IFRS) is available here.

## **ACKNOWLEDGEMENTS**

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- ▶ Smruthi M N
- Laura Breech

# Chapter 1: Scope



## 1.1 OVERVIEW: SCOPE

ASC 323 applies to any investment in a corporation's common stock or in-substance common stock unless a scope exception applies (see Section 1.2). If an investment in a corporation's common stock or in-substance common stock is in the scope of ASC 323, the investor evaluates whether it has the ability to exercise significant influence over the investee's operating and financial policies (see Chapter 2). If so, it applies the equity method to its investment.

The equity method also applies to equity investments in partnerships, LPs, LLCs that have specific ownership accounts, and other similar legal entities if the investor has **more than virtually no influence** over the investee. That is a much lower threshold than significant influence and is presumed to exist if the investor holds an interest of 3% to 5% or more in such an entity. Other facts and circumstances may also indicate the investor has more than virtually no influence over the investee (see Section 1.3).

Accordingly, the equity method may or may not apply to an arrangement referred to in practice as a "joint venture." Because U.S. GAAP defines the term "joint venture" (see Section 1.4), a contractual or legal reference to an arrangement being a joint venture does not determine whether the arrangement is in the scope of ASC 323.

ASC 323 has scope exceptions. For example, if an investor controls and consolidates an investee in accordance with ASC 810, the equity method does not apply (see our Blueprint, <u>Control and Consolidation Under ASC 810</u>). Derivatives and hedges in the scope of ASC 815, and investments in common stock held by a nonbusiness entity such as an estate, trust, or individual, are also outside the scope of ASC 323 (see Section 1.5 for a full list of scope exceptions).

An investor may elect the fair value option to measure an investment that would otherwise be in the scope of the equity method (see Section 1.6). An investor can use the steps below to determine whether the equity method applies.



**Step 1:** Determine whether a scope exception applies.



Step 2: Determine the nature of the equity investment (e.g., common stock, insubstance common stock, LP interest, units in an LLC).



**Step 3:** Determine the investor's ownership percentage.



Step 4: Evaluate other facts and circumstances to determine whether the investor has significant influence (corporations) or more than virtually no influence (LPs, LLCs, and similar entities).

The table below lists the presumptions that apply to different equity investments, unless a scope exception applies.

INVESTMENT	GUIDANCE
Equity investment in a corporation's common stock (see Section 1.2) or in-substance common stock (see Section 1.2.1)	The investor applies the equity method if it has the ability to exercise <b>significant influence</b> over the investee's operating and financial policies. The investor is presumed to have significant influence if it holds <b>20</b> %
Equity investment in an LLC that does <b>not</b> have specific ownership accounts (other than the managing member interest) (see Section 1.3.2)	or more of the investee's common stock (or insubstance common stock). This presumption stands unless overcome by predominant evidence to the contrary. Conversely, an investor that holds less than 20% of a corporation's voting common stock is presumed not to have the ability to exercise significant influence over the investee's operating and financial policies unless such ability can be demonstrated. If not, the investment is a financial asset.
Equity investment in a corporation's preferred stock that is not in-substance common stock (see Sections 1.2 and 1.2.1)	The equity method does not apply, regardless of whether the investor otherwise has the ability to exercise significant influence. The investment is a financial asset.
Equity investment in an LP (other than the GP interest) (see Section 1.3.1), including investments with preferential returns	The investor applies the equity method if it has more than virtually no influence over the investee. The investor is presumed to have more than virtually no influence if it holds an interest of 3% to 5% or more.
Equity investment in an LLC that has specific ownership accounts (other than the managing member interest) (see Section 1.3.2), including an investment with preferential returns	Other facts and circumstances can also indicate that the investor has more than virtually no influence over the investee.
General partner or managing member interest (see Section 1.3.3)	The investor applies the equity method if it does not control and consolidate the investee.
Forward contract or a call option to buy common stock that the investor will account for as an equity method investment upon settlement	Evaluate whether the instrument is in the scope of ASC 815. If the forward contract or call option does not meet the definition of a derivative, it likely is in the scope of ASC 321.1



## FIRST DETERMINE WHETHER THE INVESTOR CONTROLS AND CONSOLIDATES THE INVESTEE

For each of the investments listed in the table above, an investor must first determine whether it controls and consolidates the investee, even if it holds a minority interest (less than 50%), because the investee may be a VIE, and the investor might be its primary beneficiary (see our Blueprint, Control and Consolidation Under ASC 810).

<sup>&</sup>lt;sup>1</sup> That accounting differs from the accounting for a forward contract or call option to acquire a controlling financial interest that will be accounted for as a business combination; such a forward contract or call option are not in the scope of ASC 321. See BC25 of ASU 2020-01, Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815): Clarifying the Interactions Between Topic 321, Topic 323, and Topic 815.

## 1.2 CORPORATIONS



#### **FASB REFERENCES**

ASC 320-10-20: Debt Security, ASC 323-10-15-3, ASC 323-10-20: Common Stock, and ASC 323-10-35-26

Common stock (or shares) are equity instruments that are subordinate to all other stock issued by an investee. If an investor holds an investee's common stock and is in the scope of ASC 323, it must evaluate whether it has the ability to exercise significant influence over the investee. If so, the equity method applies unless the investor elects the fair value option to measure the investment (see Section 1.6).

An investment in a corporation's preferred stock is outside the scope of the equity method, regardless of whether the investor otherwise has the ability to exercise significant influence unless the preferred stock meets the definition of insubstance common stock (see Section 1.2.1).

Similarly, an investor does not apply the equity method to warrants, options, conversion rights, contracts, or other arrangements that give the holder the ability to acquire common stock unless they qualify as in-substance common stock (see Section 1.2.1). An investor accounts for such instruments in accordance with other U.S. GAAP.

#### BDO INSIGHTS: DISTINGUISHING EQUITY INVESTMENTS FROM DEBT INVESTMENTS IN A CORPORATION

Common stock is the most subordinate equity ownership interest in a corporation. Upon liquidation, the common stockholders would receive any remaining assets after creditors and preferred stockholders are paid. In contrast, ASC 320, *Investments — Debt Securities*, defines a debt security as a security that represents a creditor relationship with an investee. It includes preferred stock that must be redeemed by the issuer or is redeemable at the investor's option, as well as corporate bonds. Reaching a conclusion about whether an investment is equity or debt may require the application of professional judgment based on the facts and circumstances.

A debt investment in a corporation is outside the scope of ASC 323, regardless of whether the investor has the ability to exercise significant influence (see Chapter 2), unless the investment qualifies as in-substance common stock (see Section 1.2.1). However, in some scenarios, an investor might have to allocate equity method losses to its debt investment if the investor also holds an equity method investment in that investee. That requirement applies to any preferred stock, loans, or other instruments in the scope of ASC 310, *Receivables*, ASC 320, or ASC 321 (see Section 4.7).



## DIFFERENT GUIDANCE APPLIES TO LP INTERESTS AND SOME LLC INTERESTS

Although LP interests and LLC units economically function like common stock in a corporation, the presumptions used to determine whether the equity method applies are very different (see Section 1.3).

### 1.2.1 In-Substance Common Stock in a Corporation



#### **FASB REFERENCES**

ASC 323-10-15-13 through 15-15 and ASC 323-10-20: In-Substance Common Stock

When an investor holds preferred stock, options, warrants, or other financial instruments issued by a corporation, it must evaluate whether the investment meets the definition of in-substance common stock (unless another scope exception from ASC 323 applies). All references to common stock in this Blueprint include in-substance common stock.

If so, the investor evaluates whether it has the ability to exercise significant influence over the corporation (see Chapter 2). If the investment is not in-substance common stock or the investor does not have the ability to exercise significant influence over the corporation, the investment is accounted for in accordance with other U.S. GAAP.



## IN-SUBSTANCE COMMON STOCK GUIDANCE DOES NOT APPLY TO AN INTEREST IN A PARTNERSHIP OR LLC

The in-substance common stock guidance applies only to investments in a corporation and not to non-corporate entities such as LPs, LLCs that have specific ownership accounts, trusts, or other unincorporated entities.<sup>2</sup>

For example, preferred LP interests are not evaluated using the in-substance common guidance. Instead, an investor evaluates whether the equity method applies to an LP interest or an interest in an LLC that has specific ownership accounts using the 3% to 5% threshold discussed in Sections 1.3.1 and 1.3.2, respectively, regardless of whether the interest has preferential terms.

In-substance common stock is any investment in a corporation for which the characteristics of subordination, risks and rewards, and obligation to transfer value are **all** substantially similar to those of the corporation's common stock. If **any** characteristics are **not** substantially similar to the common stock's, the investment is not in-substance common stock. An investor can evaluate the characteristics in any order.

		In-substance common stock if all the following are true	Not in-substance common stock if any of the following are true
<b>S</b>	Subordination (see Section 1.2.1.1)	The investment does not have a substantive liquidation preference over the corporation's common stock.	The investment has a substantive liquidation preference over the corporation's common stock.
<b>S</b>	Risk and Rewards of Ownership (see Section 1.2.1.2)	The investment has substantially similar risks and rewards of ownership to those of the corporation's common stock.	The investment does not have substantially similar risks and rewards of ownership to those of the corporation's common stock.
	Obligation to Transfer Value (see Section 1.2.1.3)	The corporation is not expected to transfer substantive value to the investor (or, if it were, the common shareholders would participate in a similar manner).	The corporation is expected to transfer substantive value to the investor (and the common shareholders would not participate in a similar manner).

<sup>&</sup>lt;sup>2</sup> See Emerging Issues Task Force (EITF) Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock," at para. 5.

If the corporation has more than one class of common stock, the investor compares its investment to all classes of the common stock. If it is not clear whether the investment is substantially similar to the common stock using solely the above indicators (for example, if two characteristics are met, but the third is unclear), the investor must analyze whether changes in the investment's fair value are expected to vary directly with changes in the common stock's fair value. If not, the investment is not in-substance common stock.

An investor determines whether its investment meets the definition of in-substance common stock when it obtains the investment (see Section 1.3.4).

#### BDO INSIGHTS: DETERMINING WHETHER AN INVESTMENT IS IN-SUBSTANCE COMMON STOCK

A qualitative approach generally suffices to determine whether an investment meets the definition of in-substance common stock. Rarely, a quantitative determination might be necessary. Reaching a conclusion about whether an investment meets the definition of in-substance common stock requires the application of professional judgment based on the facts and circumstances.

#### 1.2.1.1 Subordination



## **FASB REFERENCES**

ASC 323-10-15-13(a) and ASC 323-10-55-3 through 55-6

An investment that has a substantive liquidation preference over the corporation's common stock is **not** similar in subordination to the common stock and therefore is **not** in-substance common stock. A substantive liquidation preference means that upon liquidation, the investor would receive proceeds before common stockholders.

Sometimes, the investment's terms state that it has a liquidation preference over common stock, but those terms are not substantive. For example, the liquidation preference is **not** substantive if:

- The investment has a stated liquidation preference that is not significant compared to its purchase price.
- ▶ The corporation's common stock has little or no fair value, because upon liquidation, the investment will share in substantially all the corporation's losses.

#### BDO INSIGHTS: DETERMINING WHETHER A LIQUIDATION PREFERENCE IS SUBSTANTIVE

ASC 323 requires an investor to determine whether a stated liquidation preference is substantive. While we believe written terms and arrangements generally are substantive, in this context, a liquidation preference is not substantive if the corporation has little or no common stock from a fair value perspective.

ASC 323 includes an example (adapted below in Example 1-1) in which the common stock's fair value is only 1% of the preferred stock's fair value and concludes that the liquidation preference is **not** substantive. In contrast, another example (adapted below in Example 1-2) in which the common stock's fair value exceeds that of the preferred stock and concludes that the liquidation preference **is** substantive. To determine whether the liquidation preference is substantive when the common stock's fair value exceeds 1% of the preferred stock's fair value, we believe an investor must evaluate the facts and circumstances (including, for example, the reasons the investors designed the investee's capital structure in such manner and whether the investors paid cash for their interests or received them as compensation).

Estimating the common stock's fair value may be complex because of the assumptions involved. Determining whether the liquidation preference is substantive may require professional judgment and valuation expertise. An investor often cannot rely on the common stock's carrying amount.



## ALL CHARACTERISTICS OF AN INVESTMENT MUST BE SIMILAR TO BE IN-SUBSTANCE COMMON STOCK

If the investment's subordination characteristics are substantially similar to those of common stock, the investor must still evaluate whether the investment's other characteristics also are substantially similar to the common stock's to determine whether the investment meets the definition of in-substance common stock.

# EXAMPLE 1-1 (ADAPTED FROM ASC 323-10-55-3 AND 55-4): SUBORDINATION IS SIMILAR TO COMMON STOCK

#### **FACTS**

- On January 1, 20X1, an investor bought 100,000 shares of a corporation's preferred stock for \$10 million (\$100 par value; liquidation preference of \$100 per share).
- On that date, the fair value of the corporation's common stock was \$100,000.

#### CONCLUSION

The preferred stock's subordination characteristics are substantially similar to those of the corporation's common stock.

#### **ANALYSIS**

- ▶ The stated liquidation preference (\$100) is significant compared to the per share purchase price (\$100).
- ▶ However, the common stock's fair value (\$100,000) is not significant compared to the preferred stock's fair value (\$10 million); therefore, the liquidation preference is not substantive.
- ▶ Because the stated liquidation preference is not substantive, the preferred stock's subordination characteristics are substantially similar to those of the common stock. The investor must determine whether the preferred stock meets the other characteristics of in-substance common stock. If it does, the investor would apply the equity method to the preferred stock if the investor has the ability to exercise significant influence over the corporation.

# EXAMPLE 1-2 (ADAPTED FROM ASC 323-10-55-5 AND 55-6): SUBORDINATION IS NOT SIMILAR TO COMMON STOCK FACTS

Assume the same facts as in Example 1-1 except that the fair value of the corporation's common stock is \$15 million on January 1, 20X1.

#### CONCLUSION

The preferred stock's subordination characteristics are **not** substantially similar to those of the corporation's common stock.

#### **ANALYSIS**

- ▶ As discussed in Example 1-1, the stated liquidation preference is significant compared to the purchase price.
- In contrast to Example 1-1, the common stock's fair value (\$15 million) is significant compared to the preferred stock's fair value (\$10 million); therefore, the liquidation preference is substantive.
- ▶ Because the stated liquidation preference is substantive, the preferred stock's subordination characteristics are not substantially similar to those of the common stock. Therefore, the preferred stock is not in-substance common stock.

## 1.2.1.2 Risks and Rewards of Ownership



## **FASB REFERENCES**

ASC 323-10-15-13(b) and ASC 323-10-55-7 through 55-14

An investment must have substantially similar risks and rewards of ownership to an investment in the corporation's common stock to meet the definition of in-substance common stock. An investor must expect the investment to participate in the corporation's earnings and losses, and capital appreciation and depreciation in a manner substantially similar to the corporation's common stock.

The table below lists indicators to consider when determining whether an investment has risks and rewards substantially similar to those of the corporation's common stock.

INDICATOR	BDO INSIGHTS
The investment's current dividend rights are similar to the common stock's dividend rights.	<ul> <li>If the investor does not expect the corporation to pay dividends before the investment would convert to common stock, differences between the dividend rights are not considered.</li> <li>If the investor expects the corporation to pay dividends before the investment would convert to common stock, differences between the dividend rights are relevant.</li> </ul>
The investor is able to convert the investment into common stock without significant restrictions or contingencies that prevent the investor from participating in the capital appreciation of the corporation's common stock.	<ul> <li>An investment that is exchangeable or exercisable at any time may participate in the corporation's capital appreciation substantially similarly to common stock. Investments with exercise restrictions or contingencies require further evaluation.</li> <li>The requirement for the holder to pay a substantive exercise price to convert or exchange the investment into common stock generally is not considered a restriction or contingency that prevents an investment from participating in the corporation's capital appreciation substantially similarly to common stock.</li> </ul>
The investment participates in the corporation's earnings and losses and capital appreciation and depreciation in a manner substantially similar to the corporation's common stock.	<ul> <li>An investor can compare the fair values of the investment and common stock on a per-share basis to evaluate this characteristic. If their fair values are similar, the two instruments will likely participate in the capital appreciation (and depreciation) on a similar basis.</li> <li>ASC 323 includes an example in which the investment's fair value is more than 95% of the common stock's fair value on a per-share basis, concluding that this attribute is met (see Example 1-3 below). While this benchmark is informative, an investor must evaluate all facts and circumstances before reaching a conclusion.</li> </ul>

# EXAMPLE 1-3 (ADAPTED FROM ASC 323-10-55-7 THROUGH 55-9): RISKS AND REWARDS ARE SIMILAR TO COMMON STOCK

#### **FACTS**

- ▶ On January 1, 20X1, an investor purchased for \$2,003,900 a warrant for 100,000 shares of a corporation's common stock at \$1 per share (\$100,000 in total) by June 30, 20X2. The warrant does not participate in dividends and is exercisable at any time.
- ▶ The common stock's fair value is \$21 per share; the investor does not expect the corporation to declare dividends before exercise.

#### CONCLUSION

The warrant's risks and reward characteristics are substantially similar to those of the corporation's common stock.

#### **ANALYSIS**

- ▶ While the warrant does not participate in dividends, the investor does not expect the corporation to declare dividends before exercise and can exercise the warrant (convert into common stock) at any time. Also, the warrant is exercisable into common stock and is designed to participate equally with the common stock in increases in the corporation's fair value. Therefore, the warrant participates in the corporation's earnings and capital appreciation substantially similarly to the common stock.
- ▶ The common stock's fair value of \$21 is substantially similar to each warrant's fair value of \$20.04 (on an equivalent unit basis). Therefore, the warrant participates in the corporation's capital depreciation substantially similarly to the common stock.
- ▶ Because the warrant is expected to participate in the corporation's earnings and losses and capital appreciation and depreciation substantially similarly to the corporation's common stock, the warrant's risk and reward characteristics are substantially similar to those of the corporation's common stock. The investor must determine whether the warrant meets the other characteristics of in-substance common stock. If so, the investor would apply the equity method to the warrant if it has the ability to exercise significant influence over the corporation.

# EXAMPLE 1-4 (ADAPTED FROM ASC 323-10-55-11 THROUGH 55-14): RISKS AND REWARDS ARE NOT SIMILAR TO COMMON STOCK

#### **FACTS**

- ▶ On January 1, 20X1, an investor purchased a warrant for \$288,820 that enables the investor to buy 100,000 shares of a corporation's common stock for \$21 per share (\$2.1 million in total) by June 30, 20X2. The warrant does not participate in dividends and is exercisable at any time.
- ▶ The common stock's fair value is \$21 per share and the investor does not expect the corporation to declare dividends before exercise.

#### **CONCLUSION**

The warrant's risks and reward characteristics are not substantially similar to those of the corporation's common stock, so the warrant is not in-substance common stock.

#### **ANALYSIS**

- ▶ While the warrant does not participate in dividends, the investor does not expect the corporation to declare dividends before exercise and can exercise the warrant (convert into common stock) at any time. Also, the warrant is exercisable into common stock and is designed to participate equally with the common stock in increases in the corporation's fair value. Therefore, the warrant participates in the corporation's earnings and capital appreciation substantially similarly to the common stock.
- ▶ The common stock's fair value of \$21 substantially differs from each warrant's fair value of \$2.88 (on an equivalent unit basis). Therefore, the warrant's expected participation in the corporation's capital depreciation is not substantially similar to that of the common stock.

▶ Because the expected participation in the corporation's capital depreciation is not substantially similar to that of the corporation's common stock, the warrant's risk and reward characteristics are not substantially similar to those of the common stock. Accordingly, the warrants are not in-substance common stock and are in the scope of other U.S. GAAP.

## 1.2.1.3 Obligation to Transfer Value



### **FASB REFERENCES**

ASC 323-10-15-13(c) and ASC 323-10-55-15 through 55-18

An investment is not substantially similar to the corporation's common stock if the corporation must transfer substantive value to the investor and the common shareholders do not participate in a similar manner. For example, if the investment has a substantive redemption feature (such as a mandatory redemption feature or a non-fair-value put option) that is not available to the common stockholders, the investment is not substantially similar to the corporation's common stock.

#### BDO INSIGHTS: DETERMINING WHETHER A REDEMPTION FEATURE IS SUBSTANTIVE

ASC 323 requires an investor to determine whether a redemption feature is substantive. While we believe written terms and arrangements generally are substantive, when making this determination, an investor should evaluate all the facts and circumstances, including:

- ▶ **Timing:** A redemption payment that would occur only in remote circumstances likely is not substantive. For example, preferred stock with mandatory redemption in 100 years is **not** substantive.
- ▶ Amount: A very small redemption payment as a proportion of the investment's fair value (for example, less than 1%), exercised at the investor's option, likely is **not** substantive.
- ▶ **Collectability at the investment date:** A redemption payment the corporation does not have the ability to pay at the investment date likely is **not** substantive.

Other facts and circumstances also might be relevant to the evaluation (for example, contingent features). Reaching a conclusion about whether a redemption feature is substantive requires the application of professional judgment based on the facts and circumstances.

# EXAMPLE 1-5 (ADAPTED FROM ASC 323-10-55-15 AND 55-16): OBLIGATION TO TRANSFER VALUE IS SIMILAR TO COMMON STOCK

#### **FACTS**

- ▶ On January 1, 20X1, an investor paid \$2 million for redeemable convertible preferred stock in a corporation.
- ▶ On January 1, 20X2, the preferred stock can be converted into common stock valued at \$2 million or be redeemed for \$10,000 at the investor's option.
- ▶ The common stock does not have a similar redemption feature.

## **CONCLUSION**

The corporation is **not** obligated to transfer substantive value to the preferred stock investor differently from how it would transfer value to the common stockholders.

#### **ANALYSIS**

- ▶ The redemption feature is not substantive because upon exercise, the investor would receive less than 1% of its initial investment (\$10,000 versus \$2 million).
- ▶ Because the stated redemption feature is not substantive, the corporation is not obligated to transfer substantive value to the redeemable convertible preferred stock investor differently from how it would transfer value to the common stockholders. The investor must determine whether the redeemable convertible preferred stock meets the other characteristics of in-substance common stock. If so, the investor would apply the equity method to the preferred stock if it has the ability to exercise significant influence over the corporation.

# EXAMPLE 1-6 (ADAPTED FROM ASC 323-10-55-3 AND 55-4); OBLIGATION TO TRANSFER VALUE IS NOT SIMILAR TO COMMON STOCK

#### **FACTS**

Assume the same facts as in Example 1-5 except that the preferred stock is redeemable for \$2 million on January 1, 20X2. The investor expects the corporation to have the ability to pay the redemption amount.

#### CONCLUSION

The corporation is obligated to transfer substantive value to the preferred stock investor differently from how it would transfer value to the common stockholders.

#### **ANALYSIS**

- ▶ The redemption feature is substantive because the investor would receive 100% of its initial investment, and on the investment date, the investor expects the corporation to be able to pay the redemption amount.
- ▶ Because the stated redemption feature is substantive, the corporation is obligated to transfer substantive value to the preferred stock investor differently from how it would transfer value to the common stockholders. Accordingly, the redeemable convertible preferred stock is not in-substance common stock.

### 1.2.1.4 Reconsideration Events for In-Substance Common Stock



#### **FASB REFERENCES**

ASC 323-10-15-16 through 15-18

An investor initially determines whether an investment is substantially similar to the corporation's common stock when it obtains the investment. An investor reconsiders that determination upon any of the events below.



A change in the contractual terms or in the investment's form (for example, from debt to equity, preferred stock to another series of stock).



A significant change in the corporation's capital structure (including the receipt of additional subordinated financing).



The investor obtains an additional interest in the corporation.



The investor gains the ability to exercise significant influence over the corporation's operating and financial policies after first obtaining its investment.

Upon such an event, an investor reassesses whether the investment meets the definition of in-substance common stock based on the facts and circumstances on that date. See Section 2.5 on reevaluating significant influence.

#### BDO INSIGHTS: LOSSES ALONE DO NOT CHANGE IN-SUBSTANCE COMMON STOCK CONCLUSIONS

An investment that previously was not in-substance common stock does not become in-substance common stock simply because the corporation incurs losses. However, if an investor subsequently gains the ability to exercise significant influence over an investee, the investor must assess whether the investment meets the definition of insubstance common stock based on the facts and circumstances at that date. Losses might lead to other changes in facts and circumstances that affect whether an investment meets the definition of in-substance common stock.

For example, losses might lead an investor and investee to enter a contact in which the investor provides managerial personnel to the investee. If such a change gives the investor the ability to exercise significant influence over the investee's operating and financial policies (see Section 2.3), the investor would reconsider whether its investment meets the definition of in-substance common stock based on the current facts and circumstances. A previously substantive redemption feature may no longer be substantive if the investee does not have the ability to pay (see Section 1.2.1.3), thereby changing the in-substance common stock conclusion.

Reaching a conclusion about whether an investment becomes in-substance common stock after the initial investment requires the application of professional judgment based on the facts and circumstances. Upon such changes in facts and circumstances, an investor may also need to reconsider whether the investee is a VIE and, if so, whether the investor has become the VIE's primary beneficiary (see our Blueprint, Control and Consolidation Under ASC 810).

## 1.3 PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND SIMILAR ENTITIES



## **FASB REFERENCES**

ASC 323-10-15-5, ASC 320-10-20: Debt Security and Security, ASC 323-30-15-4, ASC 323-30-25-1, and ASC 860-20-35-2

An investor applies the equity method to noncontrolling equity investments in LPs and LLCs that have specific ownership accounts if it has **more than virtually no influence** over the investee, as discussed in Section 1.3.1 and Section 1.3.2, respectively.<sup>3</sup> That threshold is much lower than the requirement for an investor to have the ability to exercise significant influence over a corporation's operating and financial policies (see Chapter 2).

General partners in LPs and managing members of LLCs also apply the equity method to investments they do not control and consolidate (see Section 1.3.3). Similarly, partners in general partnerships also apply the equity method to equity investments they do not control and consolidate (see Section 1.3.4).



#### IN-SUBSTANCE COMMON STOCK GUIDANCE DOES NOT APPLY TO AN INTEREST IN A PARTNERSHIP OR LLC

Although ASC 323 requires an investor to evaluate whether investments in a corporation are in-substance common stock (see Section 1.2.1), that guidance does not apply to investments in noncorporate entities such as partnerships, LLCs that have specific ownership accounts, trusts, or other unincorporated entities.<sup>4</sup>

<sup>&</sup>lt;sup>3</sup> Although ASC 323-10-15-5 indicates that ASC 323-10 does not apply to an investment in a partnership, unincorporated joint venture, or LLC that maintains specific ownership accounts for each investor, ASC 323-30-25-1 states that investors in unincorporated entities such as partnerships and other unincorporated joint ventures generally apply the equity method to their investments if the investor has the ability to exercise significant influence over the investee's operating and financial decisions. That guidance is then further modified as discussed in Sections 1.3.1 to 1.3.3.

<sup>&</sup>lt;sup>4</sup> EITF Issue No. 02-14, para. 5.

For example, preferred LP interests are **not** evaluated using the in-substance common guidance. Instead, an investor evaluates whether the equity method applies to a partnership interest or an interest in an LLC that has specific ownership accounts using the 3% to 5% threshold discussed in Sections 1.3.1 and 1.3.2, regardless of whether the interest has preferential terms.

#### BDO INSIGHTS: DISTINGUISHING EQUITY INVESTMENTS FROM DEBT INVESTMENTS IN LPS AND LLCS

ASC 323-30 does not define an equity investment when describing the scope of the equity method. However, it does explicitly exclude investments in LLCs that must be accounted for as debt securities under ASC 860-20-35-2 (financial assets, except for instruments that are within the scope of ASC 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment). That raises the question whether other legal-form equity interests in LPs or LLCs that have debt-like characteristics are also outside the scope of the equity method.

We understand that some practitioners believe that legal-form equity interests in LPs and LLCs are always evaluated using the 3% to 5% threshold (that is, they are always considered to be equity investments in the scope of the equity method). That view is based in part on the fact that such interests were specifically excluded from the scope of the in-substance common stock guidance (see Section 1.2.1). We believe that view is acceptable.

However, we believe another view is also acceptable. An investor could first evaluate whether the legal-form equity meets the definition of a debt security. If so, the investment would be outside the scope of ASC 323.

ASC 320 defines a debt security as:

Any security representing a creditor relationship with an entity. The term debt security also includes ...[p]referred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

ASC 320 further defines a security as:

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Under that view, if the legal-form equity meets the definition of a debt security, we believe the investor should also evaluate other facts and circumstances to determine whether the instrument is debt-like in nature, including, for example:

- ▶ Redemption and put features: Legal-form equity that is mandatorily redeemable at a fixed date could be considered debt-like in nature.
- **Entitlement to distributions and returns:** Legal-form equity that receives a fixed, debt-like return on the initial investment could be considered debt-like in nature.
- **Seniority in liquidation:** Legal-form equity that is senior to other more residual substantive classes of equity and has the ability to block or prevent the investee from issuing other debt or equity that is more senior to itself could be considered debt-like in nature.
- **Governance provisions:** Legal-form equity that grants only veto or consent rights that are typically given to a lender could be considered debt-like in nature.

Determining whether legal-form equity is debt-like requires the application of professional judgment based on the facts and circumstances, particularly when the characteristics differ from those stated above.

An investor might be required to allocate equity method losses to a debt security if it also holds an equity method investment in that investee, if its share of losses exceed the equity investment's carrying amount (see Section 4.7).

## 1.3.1 Limited Partnerships



#### **FASB REFERENCES**

ASC 323-30-25-1, ASC 970-323-25-5 through 25-8, and ASC 970-810-25-3

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.

A limited partner must apply the equity method to its investment in an LP unless its interest is **so minor** that the limited partner has **virtually no influence** over the partnership's operating and financial policies. The SEC staff has said that practice generally has viewed investments of 3% to 5% to be more than minor, and those remarks are considered authoritative. It is irrelevant whether a limited partner has the ability to exercise significant influence over the investee (see Chapter 2) because the threshold for applying the equity method to an LP interest is much lower, as shown below.

Less than 3% to 5% interest in an LP: The equity method does not apply unless other evidence indicates that the investor has more than virtually no influence.

3% to 5% interest

Interest of 3% to 5% or more in an LP: The equity method is required unless the investor can demonstrate that it has virtually no influence.

Although the SEC's guidance originally was provided to the real estate industry, it is applied across all industries by both private and public companies. It also applies regardless of whether the partnership interests have preferential returns. In other words, preferred LP interests are **not** evaluated using the in-substance common stock guidance discussed in Section 1.2.1. Instead, an investor evaluates whether the equity method applies to any partnership interest using the 3% to 5% threshold, regardless of whether the interest has preferential terms.

However, before applying the equity method, a limited partner must first determine whether it controls and consolidates the LP (see our Blueprint, <u>Control and Consolidation Under ASC 810</u>). A limited partner also must evaluate whether any other scope exceptions from ASC 323 apply (see Section 1.5).

Only if a limited partner has **virtually no influence** over an investee (less than a 3% to 5% interest and no other facts and circumstances indicate that it has more than virtually no influence) does it account for that interest as a financial asset in the scope of ASC 321.

## BDO INSIGHTS: APPLYING THE EQUITY METHOD TO AN LP INTEREST

In practice, an investor may set a point within the range (for example, 4%), over which it generally applies the equity method and under which it generally accounts for an investment as a financial asset. However, such investors cannot ignore other facts and circumstance that indicate they have more than virtually no influence (for example, the limited partner is a member of an advisory committee or has the ability to vote on some operating policies).

An investor generally applies the equity method only to its current equity interest (and not, for example, to debt interests or call options unless its share of losses exceed the equity investment's carrying amount as discussed in Section 4.7). However, we believe an investor must consider all facts and circumstances, including current rights held through other financial interests in the investee and the indicators of significant influence listed in Section 2.3, when determining whether it has more than virtually no influence over the investee. Our view is consistent with the SEC staff views discussed in Section 2.2.

We believe a limited partner that has an interest of 3% to 5% or more rarely would conclude that it has virtually no influence over the investee (that is, it would rarely conclude that the equity method is not required). However, reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

In the speech excerpted below, the SEC staff reaffirmed its previous observation that practice generally has viewed interests of 3% to 5% or more to be more than minor (so the equity method accounting is required for such interests).



## **SEC STAFF GUIDANCE**

### Remarks Before the 2019 AICPA Conference on Current SEC and PCAOB Developments

Erin Bennett, Professional Accounting Fellow, SEC Office of the Chief Accountant December 9, 2019

The equity method generally applies when an investor does not control an investee, but instead is able to exert significant influence over the operating and financial policies of an investee. The levels of ownership and threshold for applying the equity method vary depending on the nature of the investee. For example, for investments in corporations, it is generally presumed that a 20% or more voting interest results in the ability to exercise significant influence. For investments in limited partnerships, the SEC staff has stated that the equity method should be applied unless the investor's interest is so minor that the investor may have virtually no influence over partnership operating and financial policies, with practice generally viewing investments of more than 3-5% to be more than minor. [Footnotes omitted.]

#### 1.3.2 Limited Liability Companies, Trusts, and Other Similar Entities



### **FASB REFERENCES**

ASC 323-30-35-3

Equity investments in an LLC, trust, or similar entity are often in the scope of the equity method. LLCs generally have characteristics of both corporations and LPs. Like the equity holders in a corporation, members of an LLC generally are not personally liable for the LLC's liabilities. On the other hand, an LLC may elect to be treated as a nontaxable entity, in which case, its profits and losses are passed through to its members, which are taxed on their share of the LLC's earnings like limited partners in an LP. For this purpose, LLCs generally have specific ownership accounts (for example, specific capital accounts). The existence (or lack) of specific ownership accounts is the **only** relevant feature when determining whether the LLC is evaluated like a corporation or like an LP when determining whether the equity method applies.

LLC (or other legal entity) has specific ownership accounts

The LLC is evaluated like an LP when determining whether to apply the equity method (see Section 1.3.1). The investor determines whether it has more than virtually no influence over the LLC's operating and financial policies (which is presumed to be the case when the investor holds an interest of 3% to 5% or more in the LLC). An investor evaluates whether the equity method applies to any interest in an LLC that has specific ownership accounts using the 3% to 5% threshold, regardless of whether the interest has preferential terms. That is, preferred LLC interests are **not** evaluated using the in-substance common stock guidance discussed in Section 1.2.1.

LLC (or other legal entity) does not have specific ownership accounts



The LLC is evaluated like a corporation when determining whether to apply the equity method (see Chapter 2). The investor determines whether it has the ability to exercise significant influence over the LLC's operating and financial policies (which is presumed to be the case when the investor holds 20% or more of the LLC's interests).



#### GOVERNANCE IS NOT RELEVANT WHEN DETERMINING WHICH PRESUMPTION APPLIES TO AN LLC

Some LLCs are governed like corporations (with a board of managers or by the members), while others are governed like LPs (with managing members). The governance of an LLC is **not** relevant when determining whether the equity method applies. The existence (or lack) of specific ownership accounts is the **only** relevant feature when determining whether the LLC is evaluated like a corporation or like an LP when determining whether the equity method applies. However, the governance features of an LLC (and the rights held by an investor) are relevant when determining whether the investor has more than virtually no influence (or the ability to exercise significant influence) over the LLC's operating and financial policies, as appliable.

Governance features also are relevant when determining whether an investor controls and consolidates the LLC (see our Blueprint, <u>Control and Consolidation Under ASC 810</u>). Accordingly, an investor might conclude that an LLC has governance features like those of a corporation when determining whether it controls the LLC, but if it does not control the LLC, evaluate that LLC like an LP when determining whether to apply the equity method because it has specific ownership accounts, as shown in Example 1-7.

We believe an investor that has an interest of 3% to 5% or more in an LLC that has specific ownership accounts rarely would conclude that it has virtually no influence over the investee (that is, it would rarely conclude the equity method is not required). However, reaching a conclusion about whether the investor has more than virtually no influence requires the application of professional judgment based on the facts and circumstances.

In the speech excerpted below, the SEC staff affirmed its previous observation that ASC 323 applies to an investment in an LLC that maintains specific ownership accounts, regardless of preferential terms and conditions.



#### **SEC STAFF GUIDANCE**

## Remarks Before the 2019 AICPA Conference on Current SEC and PCAOB Developments

Erin Bennett, Professional Accounting Fellow, SEC Office of the Chief Accountant December 9, 2019

A recent consultation with OCA focused on whether the equity method should be applied to a registrant's investment in a limited liability company (LLC). The registrant held over 25% of the LLC's member units, which were entitled to a preferential allocation of profits. The registrant did not have board representation or voting rights over key operating and financial decisions, but did have certain limited rights, most of which were protective in nature. Furthermore, the registrant had significant ongoing commercial arrangements with the LLC.

In performing its evaluation of whether the equity method applied to its investment, the registrant first concluded that its investment in the LLC was similar to an investment in a limited partnership because the LLC was required to maintain specific ownership accounts for each member. The registrant noted that the limited partnership guidance states that investors in partnerships should apply the equity method if the investor has the ability to exercise significant influence. The registrant also considered the staff's position that the application of the equity method to investments in limited partnerships should be applied unless the investor's interest is so minor that the limited partner may have virtually no influence over partnership operating and financial policies. The registrant observed that the "virtually no influence" guidance cited in the SEC staff's position was originally written in the context of investments in real estate companies with less complicated fact patterns than the registrant's facts. The registrant believed that the nature and intent of its investment was truly passive, such that an assessment of the overall significant influence indicators was more relevant, irrespective of the form of the ownership. Therefore, based on the complex terms of its investment, including no voting rights and a preferential profit allocation, the registrant concluded that it did not have significant influence and the equity method did not apply. The registrant also believed that not applying the equity method would better reflect the economics of its investment.

In this fact pattern, the staff objected to the registrant's conclusion that the equity method did not apply. The staff concluded that the staff's longstanding position on the application of the equity method to investments in limited partnerships should be applied. Given the registrant's significant ownership interest, certain limited rights other than protective rights, and ongoing commercial arrangements, the staff concluded the registrant had more than "virtually no influence" over the LLC. [Footnotes omitted.]

#### EXAMPLE 1-7: DETERMINING WHETHER AN LLC IS LIKE A CORPORATION OR LP

#### **FACTS**

- Four investors formed an LLC to buy, lease, and operate retail stores.
- ▶ The LLC has specific ownership accounts (separate capital accounts for tax purposes).
- Investor A is the managing member, holds a 35% interest, and appoints a member to the board of managers.
- ▶ Investors B and C each hold a 30% interest, and each appoints a member to the board of managers.
- ▶ Investor D holds only a 5% interest and does not appoint a member to the board of managers.
- ▶ The board of directors votes on all significant financial and operating policies based on a majority vote.

The table shows the LLC's activities and significant operating and financial policies, as well as how decisions are made, according to its governing documents.

DECISION	SIGNIFICANT?	BOARD OF MANAGERS	MANAGING MEMBER
Buy retail stores	Yes	✓	
Choose tenants and negotiate leases	Yes	✓	
Hire, fire, and determine compensation of the LLC's management	Yes	✓	
Determine the annual operating and capital budgets	Yes	✓	
Tax matters	No		✓
Administrative matters	No		✓

#### CONCLUSION

All investors evaluate the LLC like an LP when applying ASC 323 and apply the equity method to their interests unless they can demonstrate that they have virtually no influence over the LLC's operating and financial policies.

#### **ANALYSIS**

- ▶ The investors would each first evaluate whether they control and consolidate the LLC in accordance with ASC 810. The board of managers makes the LLC's significant operating and financial decisions. The managing member's role is limited to tax and administrative matters. Therefore, the LLC has a governance structure like a corporation and is evaluated as such for the control and consolidation analysis when determining whether the holders of the equity at risk collectively lack power.
- Assuming that each investor individually concludes that it does not control and consolidate the LLC, they each determine whether the equity method applies. The LLC has specific ownership accounts; therefore, the investors would evaluate the LLC using the 3% to 5% threshold (see Section 1.3.1). The existence (or lack) of specific ownership accounts is the only relevant feature when determining whether the LLC is evaluated like a corporation or like an LP when applying ASC 323.
- Investors A, B, and C each appoint a board member, so they clearly have more than virtually no influence over the LLC. Therefore, they account for their interests in the LLC using the equity method.
- ▶ Although Investor D does not appoint a board member, it is presumed to have more than virtually no influence because it holds a 5% interest. Therefore, unless it can demonstrate that it does not, Investor D would apply the equity method. In other words, the lack of a board seat is not determinative.

## 1.3.3 General Partners in LPs and Managing Members in LLCs



#### **FASB REFERENCES**

ASC 323-30-25-1

Because of its decision-making rights, a GP or managing member applies the equity method to its interest if it does not control and consolidate the investee. See our Blueprint, <u>Control and Consolidation Under ASC 810</u>, for guidance on identifying a controlling financial interest.

### 1.3.4 Other Partnerships



#### **FASB REFERENCES**

ASC 970-323-20: General Partnership and ASC 970-323-25-2 through 25-4

As defined in U.S. GAAP, a general partnership is an association in which each partner has unlimited liability (that is, joint and several liability). Liabilities are not capped, as they are in an LP or LLC. Partners are responsible for the partnership's debts; the seizure of a partner's assets is a possibility and any partner can be sued for the partnership's debts. General partnerships are unincorporated businesses between two or more people and are not always required to register with a jurisdiction to legally function. A general partnership is a pass-through entity for tax purposes; the partnership itself is not taxed. For example, some law firms, medical practices, architectural firms and family-run businesses are organized as general partnerships.

A noncontrolling GP in a general partnership applies the equity method to its interest. See our Blueprint, **Control and Consolidation Under ASC 810**, for guidance on identifying a controlling financial interest.

## 1.4 JOINT VENTURES



### **FASB REFERENCES**

ASC 323-10-20: Corporate Joint Venture and Joint Venture, ASC 970-323-25-9 through 25-11, ASC 805-10-S99-8, and ASC 845-10-S99-2

An investor generally applies the equity method to an investment in a joint venture (as defined in U.S. GAAP). In practice, the term "joint venture" is often used loosely to refer to arrangements that do not meet the definition of a joint venture in U.S. GAAP.

To be a joint venture in U.S. GAAP, the investee must exhibit all the characteristics below.

	CHARACTERISTICS OF A JOINT VENTURE
	It is a separate legal entity.
	The venturers have joint control over the legal entity.
<u>\$</u>	A small group of investors (the joint venturers) own and run the legal entity as a separate and specific business or project for their mutual benefit.
<b>S</b>	Its purpose is to share risks and rewards in developing a new market, product, or technology; combine complementary technological knowledge; or pool resources in developing production or other facilities.
5 6 8	Each joint venturer has rights to participate in the joint venture's management directly or indirectly.
******	Joint venturers have an interest or relationship other than as passive investors.

Also, a joint venture's ownership seldom changes, and its equity interests are usually not traded publicly. However, a minority public ownership does not preclude an investee from being a joint venture (a minority public owner would not apply the equity method unless its investment otherwise is in the scope of ASC 323).

#### BDO INSIGHTS: JOINT CONTROL AND THE DEFINITION OF A JOINT VENTURE

Joint control is required for an investee to be a joint venture. Joint control occurs when unanimous consent or agreement is required for decisions about all activities that significantly impact the legal entity's economic performance.

Although the master glossary definition of a joint venture does not explicitly require joint control, the SEC staff has said it "would object to a conclusion that joint control is the only defining characteristic of a joint venture," implying that joint control is required. The FASB acknowledged in BC90 of ASU 2023-05 that joint control is a characteristic of a joint venture. See our Blueprint, Control and Consolidation Under ASC 810, for guidance on determining whether the investors have joint control over an investee.



## JOINT VENTURES ARE RARE IN U.S. GAAP

The term "joint venture" is used loosely in practice and may refer to a structure conducted in at least one legal entity or to an arrangement between two parties that does not involve a separate legal entity. Many such entities and arrangements do not exhibit all the characteristics of a joint venture in U.S. GAAP. Reaching a conclusion that an investee meets the definition of a joint venture requires the application of professional judgment based on the facts and circumstances. However, even if the investee is not a joint venture, an investor would apply ASC 323 if the investment otherwise is in the scope of ASC 323 (for example, if the investor in a corporation has the ability to exercise significant influence over the investee or an investor in an LP has more than virtually no influence).

Although an investor applies the equity method in ASC 323 to an investment in a joint venture, ASC 323 does not apply to the joint venture's own financial statements. Historically, there was no specific authoritative guidance for the accounting by a joint venture upon its formation, so there was diversity in practice, with some joint ventures initially measuring their net assets at carryover basis and others measuring them at fair value.

In August 2023, the FASB issued ASU 2023-05, which provides the accounting by a joint venture at its formation date. ASC 805-60 requires a joint venture (as defined in U.S. GAAP) to apply a new basis of accounting at its formation date, when it recognizes and initially measures its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance). See our Blueprint, **Business Combinations Under ASC 805**, for guidance on ASC 805-60 for the joint venture's financial statements. However, ASC 805-60 was not intended to affect the investor's accounting for its investment in a joint venture.<sup>5</sup>

## 1.5 SCOPE EXCEPTIONS



#### **FASB REFERENCES**

ASC 323-10-15-4, ASC 323-30-15-4, ASC 860-20-35-2, ASC 954-810-15-4(h)-(i), and ASC 958-810-15-4(c)-(d)

The investments below are outside the scope of ASC 323 and are not accounted for using the equity method.

	EXCEPTIONS	GUIDANCE
	Loans generally are outside the scope of ASC 323; however, some acquisition, development, and construction (ADC) arrangements are accounted for using the equity method.	Generally, apply ASC 310 (see Section 1.5.1).
1/5	Some investments in tax credit structures.	May elect the proportional amortization method as discussed in ASC 323-740 if criteria are met (see Section 1.5.2).
	Collaborative arrangements, except for any separate legal entities part of the collaborative arrangements that are otherwise in the scope of the equity method.	Apply ASC 323 to the investment in the scope of ASC 323 and apply ASC 808, <i>Collaborative Arrangements</i> , to the rest of the arrangement.

<sup>&</sup>lt;sup>5</sup> BC3 of ASU 2023-05.

	EXCEPTIONS	GUIDANCE
	Investments that result in the investor controlling and consolidating the investee.	Apply ASC 810 (see our Blueprint, Control and Consolidation Under ASC 810).
\$	Investments in derivatives and hedges.	Apply ASC 815.
<b>≥</b>	Investments for which the fair value option has been elected.	Apply ASC 825, Financial Instruments (see Section 1.6).
	Investments in LLCs accounted for as debt securities (for example, securitizations, such as interest-only strips).	Apply ASC 860, <i>Transfers and Servicing</i> , and ASC 320, <i>Investments — Debt Securities</i> .
	Most investments held by an investment company (as defined in U.S. GAAP).	Apply ASC 946, Financial Services — Investment Companies (Section 1.5.3).
	Investments in for-profit entities measured at fair value using the election available to a not-for-profit (NFP) business-oriented healthcare entity in the scope of ASC 954, <i>Health Care Entities</i> .	See ASC 954-810-15-4(h)-(i).
	Investments in for-profit entities measured at fair value using the election available to an NFP entity in the scope of ASC 958, <i>Not-for-Profit Entities</i> .	See ASC 958-810-15-4(c)-(d).
<b>%</b>	Investments in some entities that hold undivided interests.	Proportionate consolidation is permitted if criteria are met (see Section 1.5.4).
\$	Investments in common stock held by a nonbusiness entity such as an estate, trust, or individual.	Apply other U.S. GAAP. However, real estate investment trusts (REITs) generally are considered business entities and must apply ASC 974, <i>Real Estate — Real Estate Investment Trusts</i> (see Section 1.5.5).

## 1.5.1 Acquisition, Development, and Construction Loan Arrangements



## **FASB REFERENCES**

ASC 310-10-25-14 through 25-30

Loans generally are outside the scope of ASC 323 and in the scope of ASC 310. However, some ADC arrangements in which the lender participates in expected residual profits are accounted for using the equity method. To determine the accounting for an ADC arrangement, the first step is to estimate the lender's expected residual profit.

The lender expects to receive more than 50% of expected residual profit.



Account for the ADC arrangement as a real estate investment and apply the equity method.

The lender expects to receive 50% or less of the expected residual profit.



Evaluate the ADC arrangement's risk and reward characteristics using the table below to determine whether the arrangement has the characteristics of an investment in real estate (in which case, apply the equity method) or of a loan.

If the lender expects to receive 50% or less of the expected residual profit, the ADC arrangement must have at least one characteristic of a loan, or a qualifying personal guarantee must be present, to be accounted for as a loan. Otherwise, the equity method is appropriate.

## **CHARACTERISTICS OF AN INVESTMENT**

## The lender:

- Provides all (or substantially all) the funds to acquire, develop, or construct the property. The borrower has title to but little (or no) equity in the underlying property.
- Funds the commitment fees, origination fees, or both by including them in the loan balance.
- Funds all (or substantially all) interest and fees during the loan term by adding them to the loan balance.
- Is secured only by the ADC project. The lender has no recourse to the borrower's other assets, and the borrower does not guarantee the loan.
- Can recover its investment only by selling the property to third parties, refinancing the loan with another source, or placing the property in service and generating sufficient net cash flow to service the loan.
- Is unlikely to foreclose on the loan during project development because the borrower does not have to make any payments until project completion.

### **CHARACTERISTICS OF A LOAN**

- ▶ The borrower has substantial equity (not funded by the lender) from the contribution of cash, land (excluding any value from future development or construction), or other assets.
- The lender has either:
  - Recourse to the borrower's substantial tangible, saleable assets that have determinable sales values (other than the ADC project), that are not pledged as collateral in other loans.
  - An irrevocable letter of credit from a creditworthy third party provided by the borrower to the lender for a substantial amount of the loan over the entire loan term.
- A creditworthy third party provided the take-out commitment for the full amount of the loans.
- Noncancelable sales contracts or lease commitments from creditworthy third parties will provide sufficient net cash flow upon project completion to service the loan.

See ASC 310 for guidance on evaluating these characteristics and estimating expected residual profits.

## 1.5.2 Investments in Tax Credit Structures



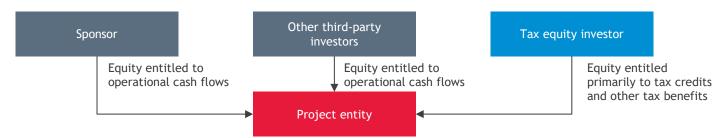
#### **FASB REFERENCES**

ASC 323-740-05-04 and ASC 323-740-S99-2

Income tax credits are used to encourage investments in qualified affordable housing projects (QAHP), also referred to as "low-income housing tax credits" (LIHTC) or investments in other areas, such as New Markets Tax Credits (NMTC) and Renewable Energy Tax Credits (RETC).

Often, project sponsors that develop projects that qualify for those kinds of tax credits create separate legal entities that hold title to the projects (the tangible and real property). The legal entities generally are LPs or LLCs that have specific ownership accounts, which collectively are pass-through entities because they do not directly pay income taxes. The sponsor generally retains some (or all) of the legal entity's equity that is entitled to operating cash flows from the project.

A sponsor that does not plan to use the tax credit often sells some of the legal entity's equity to a third party (the tax equity investor), which entitles that party to use the tax credits received by the project entity. Tax equity investors buy those equity investments to reduce taxes payable while providing cash to the sponsors (which in many cases they use to develop the projects). Sometimes, a sponsor also sells some of the project entity's equity to other third parties in exchange for a share of future cash flows. These structures are designed to meet tax requirements when directly selling or transferring the tax credit is prohibited. The diagram below illustrates a common simplified structure.



The accounting for the equity investments in the project entity depends on the equity's voting and economic rights, as well as other contractual agreements between the entities involved.

- ▶ Sponsor: The sponsor must first determine whether it controls and consolidates the project entity (see our Blueprint, Control and Consolidation Under ASC 810). If the sponsor does not control and consolidate the project entity, it generally would have more than virtually no influence over the project entity and would apply the equity method to its investment (see Section 1.3).
- ▶ Tax equity investor: If the tax equity investment meets the criteria discussed in Section 1.5.2.1, it is eligible for the PAM.
  - ASU 2023-02 expanded the PAM to more tax credit equity investments that meet specific (revised) criteria (see Section 1.5.2.1). For guidance on the PAM before adopting ASU 2023-02, see ASC 323-740, *Investments Equity Method and Joint Ventures Income Taxes*. Previously, the PAM was available only for LIHTC investments.
  - If the criteria are not met, or if the tax equity investor does not elect the PAM, the investor would determine whether it has more than virtually no influence over the project entity (see Section 1.3). If it does, it would apply the equity method to the investment. Otherwise, the investment is a financial asset in the scope of ASC 321.
- ▶ Third-party investors: Other third-party investors in the project entity would also first determine whether they control and consolidate the project entity. If they do not, they must determine whether they have more than virtually no influence over the project entity (see Section 1.3). If they do, they would apply the equity method to their investments. Generally, these investments do not meet the criteria for the PAM.

#### 1.5.2.1 Proportional Amortization Method After Adopting ASU 2023-02



## **FASB REFERENCES**

ASC 323-740-25-1 through 25-1B, ASC 323-740-25-4, ASC 323-740-35-2, ASC 323-740-45-2, and ASC 323-740-65-2

For a tax equity investor to elect the PAM for an equity investment after adopting ASU 2023-02, it must meet **all** the following criteria:

- It is probable that the income tax credits allocable to the tax equity investor will be available.
- ▶ The tax equity investor does **not** have the **ability to exercise significant influence** over the operating and financial policies of the underlying project (see Chapter 2).
- Substantially all the projected benefits to the tax equity investor are from income tax credits and other income tax benefits.
- ▶ The tax equity investor's projected yield is positive using solely cash flows from the income tax credits and other income tax benefits.
- ► The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the tax equity investor's liability is limited to its capital investment.

When determining whether the tax equity investor has the ability to exercise significant influence over the underlying project's operating and financial policies, the investor considers the operations, financial decisions, and related objectives of the project as a whole. The investor does **not** consider other transactions between the investor and project entity (for example, bank loans), if **all** the following criteria are met:

- The tax equity investor is in the business of entering those transactions (for example, a bank that regularly extends loans to other projects).
- ▶ The terms of those other transactions are consistent with arm's-length transactions.
- ▶ The tax equity investor does not have the ability to exercise significant influence over the project entity's operating and financial policies from those other transactions.



### **EVALUATING SIGNIFICANT INFLUENCE FOR A TAX EQUITY INVESTMENT**

When determining whether the tax equity investor has the ability to exercise significant influence over the project entity and whether the equity investment is eligible for the PAM, the tax equity investor is **not** required to evaluate whether it has more than virtually no influence over the project entity, even though the investment is in an LP or LLC that has specific ownership accounts (as would otherwise be required, as discussed in Section 1.3). Instead, the tax equity investor evaluates significant influence using the indicators of significant influence discussed in Section 2.3.

However, if the criteria are not met, or if the PAM is not elected, the tax equity investor would determine whether it has more than virtually no influence over the project entity (see Section 1.3). If it does, it would apply the equity method to the investment.

A tax equity investor must elect the PAM for each tax credit program (that is, it must consistently apply the PAM to all investments in an elected tax credit program) rather than electing the PAM for the entire reporting entity or for individual investments.

A tax equity investor evaluates whether it meets the criteria to use the PAM upon its initial equity investment in the project entity based on the facts and circumstances. That conclusion is reevaluated upon **either** of the following:

- A change in the investment's nature (for example, if the project entity is no longer a flow-through entity for taxes).
- A change in the relationship with the project entity that could cause the investment to be ineligible for the PAM.

If an investor qualifies for and elects to apply the PAM, it amortizes the equity investment (less the property's salvage value) each period in proportion to its share of income tax benefits for such period over its share of total expected income tax benefits for the life of the investment. Amortization, income tax credits, and other income tax benefits (such as depreciation) are presented in the income tax line in the income statement.

ASU 2023-02 was effective for public business entities in fiscal years beginning after December 15, 2023. All other entities must adopt ASU 2023-02 for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Tax equity investors may choose between retrospective or modified retrospective transition when adopting ASU 2023-02.

For guidance on the PAM, disclosure requirements, and transition, see our Bulletin, <u>Investments in Tax Credit Structures Using the Proportional Amortization Method</u>.

#### BDO INSIGHTS: THE PAM APPLIES ONLY TO ELIGIBLE UNCONSOLIDATED EQUITY INVESTMENTS

As discussed in BC12 of ASU 2023-02, the PAM applies only to equity investments otherwise in the scope of ASC 323. An investor must first evaluate any intermediary entities for consolidation in accordance with ASC 810 to determine whether it has an equity investment that would be consolidated. Whether an investor controls and consolidates such entities depends on the facts and circumstances (see our Blueprint, Control and Consolidation Under ASC 810).

Consolidated investments in common stock are not in the scope of ASC 323 (as discussed in Section 1.5). Therefore, if a tax equity investor consolidates an intermediary entity, the investment in the intermediary entity is not eligible for the PAM. Debt investments (including after any intercompany eliminations with consolidated intermediary entities), also are not eligible for the PAM. An investor cannot apply the PAM to an investment if it is not an eligible tax equity investment.

## 1.5.3 Investments Held by Investment Companies



#### **FASB REFERENCES**

ASC 323-10-15-4(d) and ASC 946-323-45-1 through 45-2

An investment company (as defined in ASC 946, often referred to as a "fund") generally is outside the scope of ASC 323 and does not apply the equity method to its investments in portfolio companies. Instead, an investment company generally measures its investments in portfolio companies (including those over which it has significant influence) at fair value.

However, that fair value measurement principle does not apply to an investment company's equity investment in an investee that provides services to the investment company (for example, an investment advisor or transfer agent, referred to as the "operating entity"). Unlike investments in portfolio companies (which are held to generate returns from capital appreciation (including a gain on sale), interest income, or both), an operating entity's purpose is to provide services to the investment company.

Instead, an investment company must determine the accounting for an equity investment in an operating entity using the framework discussed in Section 1.1. In other words, it would consolidate operating entities that it controls and apply the equity method to investments in the scope of ASC 323. See our Blueprint, Control and Consolidation Under ASC 810, for guidance on the definition of an investment company and determining whether an investment company controls and consolidates an operating entity.

## 1.5.4 Undivided Interests and Proportionate Consolidation



#### **FASB REFERENCES**

Master Glossary: Undivided Interest

An ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

U.S. GAAP allows exceptions from applying the equity method in some industries when the investor holds an undivided interest through an investment in a legal entity **and** meets other specific criteria. If the investor is not in the real estate, construction, or specific extractive industries, or the criteria for proportionate consolidation are not met, an equity investment is in the scope of ASC 323 and evaluated accordingly.

Proportionate consolidation (also referred to as "proportionate gross financial statement presentation") is when an investor recognizes its proportionate share of assets, liabilities, revenue, and expenses gross on the balance sheet and income statement. In contrast, in the equity method, an investor recognizes its share of the investee's income using one-line presentation (see Chapter 3).

Proportionate consolidation is an **optional election** for investors in the real estate, construction, or specific extractive industries for investments that meet the criteria discussed in Sections 1.5.4.1 and 1.5.4.2.

#### BDO INSIGHTS: ACCOUNTING FOR UNDIVIDED INTERESTS IN OTHER INDUSTRIES

Undivided interests are one method parties can use to jointly hold title to an asset; for example, real estate; buildings; or exploration rights related to oil, gas, minerals, and other natural resources (see Sections 1.5.4.1 and 1.5.4.2). Undivided interests are sometimes also used to own fractional interests in airplanes and other property, plant, and equipment.

U.S. GAAP does not address undivided interests except as discussed in Sections 1.5.4.1 and 1.5.4.2. The equity method does not apply to undivided interests (except as discussed in Sections 1.5.4.1 and 1.5.4.2) because the owner legally holds (joint) title to the asset rather than holding an equity interest in a legal entity.

In the absence of specific guidance, in practice, an entity that directly holds an undivided interest that is outside the scope of the guidance discussed in Sections 1.5.4.1 and 1.5.4.2 generally accounts for its share of the asset in accordance with ASC 360, *Property*, *Plant and Equipment*. For example, an entity that directly owns legal title to a fractional interest in a plane would recognize its share of the plane on its balance sheet and its share of the depreciation on its income statement. The result is often similar to proportionate consolidation.

However, because entities own and share assets in many ways, it is important to analyze the facts and circumstances to determine whether an entity holds an undivided interest in an asset before applying the accounting described above. Sometimes, an entity might enter a lease or another arrangement that gives it a similar right to use the asset but has different economic and legal rights and obligations that result in different accounting. As such, determining the accounting for such arrangements requires the application of professional judgment based on the facts and circumstances. See our Blueprint, <a href="Accounting for Leases Under ASC 842">Accounting for Leases Under ASC 842</a>, for guidance on identifying and accounting for leases.

#### 1.5.4.1 Real Estate Investors



#### **FASB REFERENCES**

ASC 970-10-15-3, ASC 970-10-15-3, ASC 970-323-05-2, ASC 970-323-25-12, and ASC 970-810-45-1

An **investor** in the scope of ASC 970, *Real Estate*, may proportionately consolidate an investment in real property only if **all** the following criteria are met:

- ▶ The investor holds an undivided interest in the real property.
- ▶ A single party or owner makes decisions on financing, developing, selling, and operating the real estate.
- Each investor is entitled only to its proportional share of income.
- Each investor is responsible for paying only its proportional share of expenses.
- Each investor is severally liable only for indebtedness it incurs in connection with its interest in the property.

If the investors jointly control the real property owned by undivided interests, they cannot proportionately consolidate the asset. Because most undivided interests in real estate are subject to joint control, they generally are accounted for using the equity method. See our Blueprint, <u>Control and Consolidation Under ASC 810</u>, for guidance on determining whether the investors have joint control over the real estate's financing, development, sale, or operations.

#### 1.5.4.2 Construction and Extractive Industries



## **FASB REFERENCES**

ASC 810-10-45-14, ASC 910-10-15-2 through 15-4, ASC 910-810-45-1, ASC 930-810-45-1, and ASC 932-810-45-1

An investor may proportionately consolidate an investment only when the investor meets all the following criteria:

- It owns an undivided interest in each asset held by the legal entity.
- It is proportionately liable for its share of each liability.
- It holds an investment in an unincorporated legal entity that otherwise meets the criteria for the equity method.
- ▶ Both the investor and investee must be in either the construction industry (as defined in ASC 910, Contractors Construction), or an extractive industry in the scope of ASC 930, Extractive Activities Mining or ASC 932 Extractive Activities Oil and Gas. For this purpose, an entity is in an extractive industry only if its activities are limited to extracting mineral resources (such as oil and gas exploration and production) and excludes related activities like refining, marketing, or transporting extracted mineral resources.

#### 1.5.5 Investments Held by Real Estate Investment Trusts



## **FASB REFERENCES**

ASC 323-10-60-4, ASC 974-323-25-1, and ASC 974-323-10-20: Real Estate Investment Trust and Service Corporation

Investments in common stock held by a nonbusiness entity such as an estate, trust, or individual are excluded from the scope of ASC 323. A REIT makes real estate loans and investments using equity and debt financing. It must distribute substantially all its taxable income to its shareholders annually to keep its favorable tax status. While a REIT is a trust, it generally is considered a business entity and therefore must determine whether its investments are in the scope of ASC 323 (using the other guidance in Chapters 1 and 2).

A REIT also may create a corporation to perform services for it or third parties. Service corporations may provide property management and leasing services, as well as services to buy, develop, construct, finance, or sell real estate projects. In accordance with ASC 810, a REIT must first evaluate whether it controls and consolidates the service corporation (see our Blueprint, Control and Consolidation Under ASC 810).

If the REIT does not control and consolidate an equity investment in a service corporation, it evaluates whether it has the ability to exercise significant influence over the service corporation's significant operating and financial policies in accordance with ASC 323 based on the facts and circumstances (see Chapter 2). ASC 974-323 provides several factors (in addition to those in Chapter 2) that may indicate the REIT has the ability to exercise significant influence over a service corporation.

- ▶ The service corporation performs activities primarily for the REIT.
- ▶ Substantially all the service corporation's economic benefits flow to the REIT.
- ▶ The REIT has the ability to designate a director on the service corporation's board.
- The REIT and service corporation have common board members.
- ▶ The REIT and service corporation have common officers or employees.
- The service corporation's majority owners did not contribute substantial equity.
- ▶ The views of the REIT's management influence the service corporation's operations.
- ▶ The REIT can obtain financial information from the service corporation to apply the equity method.

However, if the service entity is an LP or LLC that has specific ownership accounts, the REIT would determine whether it has more than virtually no influence over the investee, as discussed in Section 1.3.

# 1.6 FAIR VALUE OPTION



#### **FASB REFERENCES**

ASC 321-10-35-2, ASC 825-10-05-6, ASC 825-10-15-4, ASC 825-10-25-2 through 25-7, and ASC 825-10-20: Financial Asset

An investor generally may elect the fair value option for any recognized financial assets (other than a controlling interest), which includes common stock, LP interests, and LLC units. Therefore, an investor generally may elect the fair value option when it otherwise would have an equity method investment.

An investor generally may elect the fair value option instrument by instrument (for example, for one investee but not another). However, if an investor elects the fair value option for an equity method investee, it must measure all its eligible financial interests in that investee (for example, common stock, preferred stock, and debt) at fair value.

Electing the fair value option is **irrevocable** (unless a new election date occurs). An investor that elects the fair value option for an investment cannot "un-elect" the fair value option if the investment no longer qualifies for the equity method (for example, because of losing the ability to exercise significant influence or a partial sale). An investor may elect the fair value option for an eligible item when the investor first recognizes the eligible item, or the investment otherwise becomes subject to the equity method.



# THE ASC 321 MEASUREMENT ALTERNATIVE IS NOT AVAILABLE UNDER THE FAIR VALUE OPTION

References to the fair value option in ASC 825 refer to fair value as defined in ASC 820, *Fair Value Measurements*. Therefore, if an investor elects the fair value option, it **cannot** use the ASC 321 measurement alternative to measure financial instruments at cost minus impairment, adjusted for observable price changes in orderly transactions for an identical or similar investment of the same issuer. The measurement alternative is available only for equity investments that would **not** otherwise be equity method investments (that is, for specific equity investments in the scope of ASC 321).

Measuring the fair value of an equity investment in a private company is challenging because of the assumptions and estimates involved. It requires applying professional judgment and often requires valuation expertise.



# **FASB PROJECT: CODIFICATION IMPROVEMENTS**

In July 2025, the FASB decided as part of its codification improvements project to clarify that it would not be appropriate for an investor to elect the fair value option for an equity method investment upon recording an other than temporary impairment for that investment (see Section 4.8).

The amendment will be applied either retrospectively or prospectively and will be effective for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026, for all entities. Early adoption will be allowed. See the <u>FASB website</u> for more information.

Judgment may be required to determine whether an investor may elect the fair value option when a substantive performance obligation is embedded in an equity investment, as discussed in the SEC staff speech excerpted below.



# **SEC STAFF GUIDANCE**

#### Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

Sandie E. Kim, Professional Accounting Fellow, SEC Office of the Chief Accountant December 10, 2007

Before a company considers applying the fair value option to a particular item, we believe that the company should carefully analyze whether a substantive non-financial performance obligation is embedded in that item. The existence of such an embedded feature highlights the need to consider the interplay of applying a fair value measurement attribute and other areas of GAAP, such as revenue recognition. The intersection of [ASC 825] and revenue recognition is put under stress when the appropriate revenue recognition criteria are not met under other applicable GAAP but revenue is otherwise accelerated when an item is measured at fair value.

For example, an investor may have an equity interest in another entity that is accounted for under the equity method of accounting. That equity interest may also have an embedded feature that provides the investor with a disproportionate allocation of returns. This scenario often occurs in certain partnership agreements, in which the general partner's interest includes an embedded feature commonly known as a "carried interest." If the general partner measured its investment at fair value, the carried interest might be included in that measurement. However, if the general partner's investment includes a substantive performance obligation to the equity method investee, such as management services, the carried interest may represent compensation for services to be performed. If so, measuring the investment at fair value may result in a gain recognized for profits associated with future performance obligations.

In another example, a company may have a recognized receivable related to a customer arrangement that also includes a variable fee component related to future performance obligations. In that example, the company may have recognized a receivable related to services already performed. However, the variable fees may not have been recognized because the appropriate revenue recognition criteria were not met. Additionally, even if there were no future performance obligations, there may be features in the arrangement that would also preclude revenue recognition. In this example, the variable fees may also not have been recognized because the consideration may not be fixed or determinable. If the receivable is measured at fair value, such fair value might incorporate the variable fees related to the future performance obligations or otherwise accelerate the recognition of revenue that would have been prohibited under other applicable GAAP.

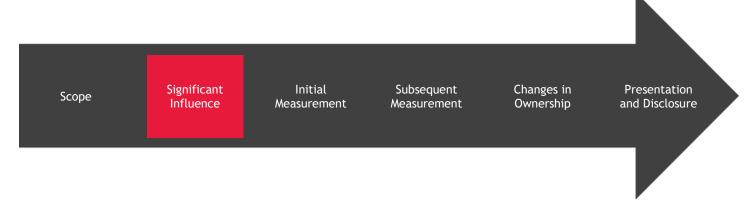
In these scenarios and others, until the FASB addresses the fair value option for items that are not currently eligible under [ASC 825], the staff believes careful consideration is required to determine whether the fair value option under [ASC 825] is even available. [Footnotes omitted.]

# **BDO INSIGHTS: ACCOUNTING FOR CARRIED INTERESTS**

As discussed in Section 1.2.1 of our Blueprint, Revenue Recognition Under ASC 606, the SEC staff said at an April 2016 meeting of the Joint Transition Resource Group for Revenue Recognition that it would accept treatment of carried interest as a revenue transaction within the scope of ASC 606, Revenue From Contracts With Customers. However, the SEC staff also said there could be a basis for applying an ownership model to account for carried interest. If an entity were to apply an ownership model to account for carried interest, the SEC staff said it would expect full application of the ownership model, including an analysis of the consolidation model under ASC 810, the equity method of accounting under ASC 323, or other relevant guidance.

If an entity applies an ownership model to account for carried interest and concludes that it does not control the investee (as determined in accordance with ASC 810), such interest may be within the scope of the equity method. However, based on the views expressed in the SEC speech above, we believe it would be inappropriate to elect the fair value option for an equity method investment with carried interest. See our Blueprint, <a href="Control and Consolidation Under ASC 810">Control and Consolidation Under ASC 810</a>, for guidance on determining whether an entity controls an investee.

# Chapter 2: Significant Influence

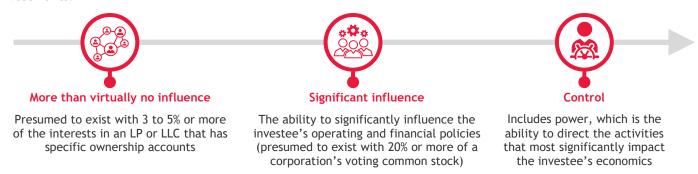


# 2.1 OVERVIEW: SIGNIFICANT INFLUENCE

The equity method applies to an investment in a corporation's common stock when an investor has the ability to exercise **significant influence** over the investee's operating and financial policies (unless a scope exception applies, as discussed in Section 1.5). Significant influence is a **lower threshold** than control, which includes the ability to make the decisions that most significantly impact the investee's economic financial performance (as discussed in the VIE model in our Blueprint, **Control and Consolidation Under ASC 810**).

An investor that has 20% or more of a corporation's voting common stock is **presumed** to have the ability to exercise significant influence over the investee's operating and financial policies. That presumption stands until overcome by predominant evidence to the contrary (see Section 2.2). Conversely, an investor that holds **less than 20%** of a corporation's voting common stock is presumed **not** to have the ability to exercise significant influence over the investee's operating and financial policies unless such ability can be demonstrated. An investor must evaluate all facts and circumstances to determine whether significant influence exists (see Section 2.3).

The evaluation of significant influence does **not** apply to interests in LPs or LLCs that have specific ownership accounts. As discussed in Section 1.3, for such investments, the equity method applies if the investor has **more than virtually no influence** over the investee, which is a much lower threshold than significant influence and is presumed to exist if the investor holds an interest of 3% to 5% or more. Accordingly, the guidance in this chapter does not apply to such investments.



An investor's proportion of voting common stock is based on outstanding securities. Determining the proportion held can be complex when the investor holds indirect interests or potential voting rights in the investee (see Section 2.4).

An investor must continuously assess whether it has the ability to exercise significant influence over an investee. A change in interest or other facts and circumstances can affect an investor's ability to exercise significant influence over the investee's operating and financial policies (see Section 2.5).

The equity method does **not** apply to preferred stock or other interests in a corporation unless the investment meets the definition of in-substance common stock (see Section 1.2.1), regardless of whether the investor has the ability to exercise significant influence over the investee.

# 2.2 SIGNIFICANT INFLUENCE: 20% OR MORE OF THE VOTING COMMON STOCK



# **FASB REFERENCES**

ASC 323-10-15-7 through 15-11

An investor that holds 20% or more of a corporation's voting common stock is **presumed** to have the ability to exercise significant influence over the investee's operating and financial policies. An investor applies the equity method to such an investment. The graphic below illustrates the presumptions of significant influence in ASC 323.

Less than 20%: Presumed not to have the ability to exercise significant influence unless voting common that ability can be demonstrated

20% of the stock

20% or more: Presumed to have the ability to exercise significant influence absent predominant evidence to the contrary

Sometimes, an investor holds 20% or more of a corporation's voting common stock but does not have the ability to exercise significant influence over the operating and financial policies. ASC 323 states that "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." It lists several indicators that an investor might not have the ability to exercise significant influence over the investee's operating and financial policies, as shown below.

	INDICATOR	CONSIDERATIONS
<b></b>	Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.	An investee also might operate under foreign exchange restrictions or other government-imposed uncertainties so severe that the investor lacks the ability to exercise significant influence.
	The investor and investee sign an agreement in which the investor surrenders significant rights as a shareholder, compared to an investor without such an agreement.	A standstill agreement in which an investor agrees to not increase its holdings could indicate that the investor lacks the ability to exercise significant influence.
	Majority ownership of the investee is concentrated among a small group of shareholders that operate the investee without regard to the investor's views.	Evaluating whether such evidence exists requires the application of judgment (see the BDO Insights below).
	The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders, tries to obtain that information, and fails.	For example, an investor might want quarterly financial information from an investee that reports only annually. However, an investor must consider that it may account for the investee on a lag or using a different fiscal yearend from the investee when evaluating this indicator (see Sections 4.2.2 and 4.2.3).
	The investor <b>tries</b> and <b>fails</b> to obtain representation on the investee's board of directors.	The mere absence of board representation does not mean the investor lacks significant influence. The investor must have evidence that it tried and failed to obtain such representation.

The above list of indicators is not exhaustive; other facts and circumstances may provide predominant evidence that the investor does not have the ability to exercise significant influence. Further, no indicator is determinative; an investor must evaluate all facts and circumstances. For example, an investor must also consider any indicators that the investor has the ability to exercise significant influence (see Section 2.3).



# NO BRIGHT LINES AND NO INTENT REQUIRED

Although ASC 323 sets a presumption at 20% of a corporation's voting common stock, there are no bright lines when evaluating whether the investor has the ability to exercise significant influence. For example, the SEC staff has said it would view 19.9% to be similar to 20% (see the SEC staff speech excerpted below).

Some investors mistakenly believe that the lack of intent to exercise significant influence is relevant to the analysis. However, ASC 323 focuses on an investor's ability to exercise significant influence, not the investor's intent or success in getting its way (see BDO Insights below).

Because an investor needs predominant evidence to overcome the presumption, it generally applies the equity method while gathering such evidence. The analysis is not optional; an investor cannot avoid it. In other words, the evaluation of whether the investor's ability to exercise significant influence can be demonstrated is a matter of judgment that must be completed based on an evaluation of all facts and circumstances.

An investor's proportion of voting common stock is based on outstanding securities, including direct and indirect interests. Potential voting rights are disregarded. See Section 2.4 for guidance on determining the proportion held.

#### BDO INSIGHTS: OBTAINING PREDOMINANT EVIDENCE TO OVERCOME THE PRESUMPTION

ASC 323 states that an investor might not have the ability to exercise significant influence if a small group of stockholders operate the investee without regard to the investor's views. However, as discussed in Section 2.3, ASC 323 also states that an investor's ownership of an investee compared to that of other stockholders is one factor to consider when evaluating whether the investor has the ability to exercise significant influence over the investee and that substantial or majority ownership of the investee by another investor does not necessarily preclude the investor's ability to exercise significant influence. Those statements can be hard to reconcile and interpret in practice.

Some mistakenly interpret this guidance to mean that simply being outvoted or overruled demonstrates that the investor does not have the ability to exercise significant influence over an investee. However, ASC 323 requires predominant evidence to the contrary to overcome the presumption of significant influence. Being outvoted or overruled does not necessarily mean the investor lacks the ability to exercise significant influence; it simply proves that the investor does not control the investee (because the outvoted investor cannot unilaterally make decisions).

We believe an investor generally has the ability to exercise significant influence if it has a seat at the table, whether through official board representation or as indicated by other facts and circumstances (for example, observer seats or committee representation). Reaching a conclusion about whether other investors are operating the investee without regard to the investor's views (and therefore about whether predominant evidence exists that the investor does not have significant influence) requires the application of professional judgment based on the facts and circumstances. It generally requires gathering evidence over a period of time.

In the speech excerpted below, the SEC staff said that when evaluating whether an investor has the ability to exercise significant influence, there are no bright lines and all facts and circumstances are considered.



# **SEC STAFF GUIDANCE**

# Remarks During the 27th Annual National AICPA Conference on Current SEC Developments

Paul R. Kepple, Professional Accounting Fellow, SEC Office of the Chief Accountant December 7, 1999

The staff continues to receive and address questions regarding the application of the equity method of accounting. Many of these questions revolve around whether the equity method... is appropriate in a given set of circumstances. In particular, fact patterns such as an investment in common stock just under the 20 percent threshold established in [ASC 323] regarding a presumption of significant influence, or an investment in common stock of less than 20 percent coupled with one or more contractually provided board of directors seats, give rise to questions of whether the staff applies "bright line" tests to the application of [ASC 323].

In short, the staff does not apply a bright line test to the application of [ASC 323]. When considering whether the application of the equity method of accounting is required for an investment in common stock, the staff has evaluated:

- ▶ The nature and significance of the investments, in any form, made in the investee. The staff does not consider the difference between a 20 percent common stock investment versus a 19.9 percent investment to be substantive, as some have asserted in applying [ASC 323]. In addition, the staff will consider whether the investor has other forms of investments or advances, such as preferred or debt securities, in the investee in determining whether significant influence results.
- ▶ The capitalization structure of the investee. The analysis would consider whether the investee effectively is being funded by common or non-common stock investments and how critical the investments made by the investor are to the investee's capitalization structure (e.g., is the investor the sole funding source).
- Voting rights, veto rights, and other protective and participating rights held by the investor. The greater the ability of the investor to participate in the financial, operating, or governance decisions made by the investee, via any form of governance rights, the greater the likelihood that significant influence exists.
- Participation on the investee's board of directors (or equivalent), whether through contractual agreement or not. The staff will consider, in particular, whether any representation is disproportionate to the investment held. For example, an investor that is contractually granted 2 of 5 board seats, coupled with a 15 percent common stock investment, will likely be viewed to have significant influence over the investee.

Other factors as [codified in ASC 323]

In summary, evaluating the existence of significant influence is often a judgment call. While the starting point in any evaluation of significant influence is the investor's common stock ownership level in the investee, the staff does not believe that a "bright line" approach is appropriate and will consider and weigh all of the factors noted above in concluding on any given set of facts and circumstances. [Footnotes omitted.]

# 2.3 SIGNIFICANT INFLUENCE: LESS THAN 20% OF THE VOTING COMMON STOCK



# **FASB REFERENCES**

ASC 323-10-15-6 through 15-11

An investor that holds less than 20% of a corporation's voting common stock is presumed **not** to have the ability to exercise significant influence over an investee's operating and financial policies unless that ability can be demonstrated. If an investor's ability to exercise significant influence can be demonstrated based on an evaluation of the facts and circumstances, the investor applies the equity method. The graphic below illustrates the presumptions of significant influence in ASC 323.

Less than 20%: Presumed not to have the ability to exercise significant influence unless voting common that ability can be demonstrated

20% of the stock

20% or more: Presumed to have the ability to exercise significant influence absent predominant evidence to the contrary

An investor's ability to exercise significant influence over the investee's operating and financial policies may be demonstrated in several ways, including those shown below.

	INDICATOR	BDO INSIGHTS
	Representation on the investee's board of directors	We believe any board representation (including observer seats) generally indicates the ability to exercise significant influence (see the BDO Insights below).
	Participation in policy- making processes	See our Blueprint, <u>Control and Consolidation Under ASC 810</u> , for guidance on evaluating participating rights. We believe such guidance also is relevant when evaluating this indicator.
, (C),	Interchange of management	This factor refers to the exchange or trading of management; for example, when management from the investor also serves as management of the investee. Factors to consider in this evaluation include:  Roles and responsibilities Interaction with or independence from board
	Material intra-entity transactions	Factors to consider include:  Nature (for example, unique vs. readily available) of the items
	Technological dependency	<ul> <li>Materiality and importance to each party</li> <li>Concentration, alternatives, and switching costs</li> <li>Contractual termination provisions</li> </ul>
	Investor's ownership compared to other stockholders	Substantial or majority ownership by another investor does not prevent an investor from having the ability to exercise significant influence (see BDO Insights below).
\$	Investor's other interests in the investee and financial importance to the investee	The SEC staff would consider the investor's other interests in the investee (including preferred stock and debt) and how critical the investor is as a source of funding to the investee (see Section 2.2).

The above list of indicators is not exhaustive; other facts and circumstances may overcome the presumption and demonstrate that the investor has the ability to exercise significant influence over the investee. Further, no single indicator is determinative; an investor must evaluate all facts and circumstances. For example, an investor must also consider any indicators that the investor does not have significant influence (see Section 2.2). Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.



# NO BRIGHT LINES AND NO INTENT OR ACTIVE EXERCISE REQUIRED

Although ASC 323 sets a presumption at 20% of a corporation's voting common stock, as discussed in Section 2.2, there are no bright lines when evaluating whether the investor has the ability to exercise significant influence. For example, the SEC staff stated that it would view 19.9% to be similar to 20%.

Some investors mistakenly believe that the lack of **intent** to exercise significant influence is relevant to the analysis. However, ASC 323 focuses on an investor's **ability** to exercise significant influence, not the investor's intent or success in getting its way (see the BDO Insights below).

This analysis is not optional; an investor cannot avoid it. In other words, whether the investor's ability to exercise significant influence can be demonstrated is a matter of judgment that must be evaluated based on all facts and circumstances.

#### BDO INSIGHTS: A BOARD SEAT GENERALLY INDICATES THE ABILITY TO EXERCISE SIGNIFICANT INFLUENCE

Board representation is one indicator that the investor has the ability to exercise significant influence. We believe any board representation (that is, one seat) generally indicates the ability to exercise significant influence. An investor does not need 20% or more of the board seats to have that ability. However, guaranteed board seats and a higher proportion of board seats are stronger indicators of the ability to exercise significant influence than non-guaranteed board seats and a lower proportion of board seats.

In the rare cases of an extremely large board (for example, 19 seats), an investor with the right to appoint a single board member might conclude it does not have the ability to exercise significant influence over the investee (in the absence of other indicators). However, before reaching such a conclusion, the investor should consider its participation on board committees, unique areas of expertise, and other facts and circumstances. For example, an investor that holds one of 19 board seats, but one of only six seats on a bank's risk committee (which is considered a strategically important committee) likely would have the ability to exercise significant influence. Similarly, if the investor is the only board member with specific expertise relevant to the investee's business, we believe the investor likely has the ability to exercise significant influence.

We believe that observer and non-voting board seats generally also indicate that the investor has the ability to exercise significant influence. An observer or non-voting member generally has the ability to obtain investee information that other investors might not have and to interact informally with management and voting board members, even if the observer cannot speak or vote during the board meeting.

Reaching a conclusion about whether board seats (or observer or non-voting board seats) give an investor the ability to exercise significant influence over the investee's financial and operating decisions requires the application of professional judgment based on the facts and circumstances.

# BDO INSIGHTS: EVALUATING AN INVESTOR'S OWNERSHIP COMPARED TO OTHER STOCKHOLDERS

ASC 323 states that an investor's ownership of an investee compared to other stockholders is one factor to consider when evaluating whether the investor has the ability to exercise significant influence over the investee. While substantial or majority ownership of the investee by another investor does not necessarily preclude the first investor's ability to exercise significant influence, ASC 323 also states that an investor might not have the ability to exercise significant influence over an investee if a small group of stockholders operates the investee without regard to the investor's views.

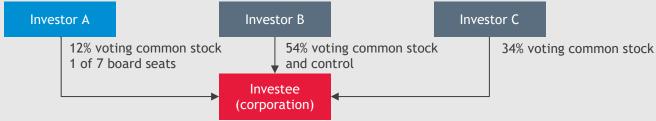
Some practitioners mistakenly interpret that guidance to mean that simply being outvoted or overruled demonstrates that the investor does not have the ability to exercise significant influence over an investee. However, ASC 323 focuses on **demonstrating** the **ability** to exercise significant influence when an investor holds less than 20% of a corporation's voting common stock. Being outvoted or overruled does not necessarily mean the investor lacks the ability to exercise significant influence; it simply proves that the investor does not control the investee (because the outvoted investor cannot unilaterally make decisions).

We believe an investor has the **ability** to exercise significant influence if the investor has a seat at the table, whether through official board representation or as indicated by other facts and circumstances (for example, observer seats or committee representation). If an investor holds a significant (but less than 20%) interest in an investee's voting common stock, it also may have the ability to exercise significant influence over the investee if no one else holds more than a 1-2% interest. Reaching a conclusion about whether an investor has the ability to exercise significant influence over an investee's financial and operating decisions requires the application of professional judgment based on the facts and circumstances.

#### EXAMPLE 2-1: SIGNIFICANT INFLUENCE WITH LESS THAN A 20% INTEREST AND A BOARD SEAT

#### **FACTS**

- ▶ Investor A holds 12% of the voting common stock of Investee, which is a corporation.
- ▶ Investors B and C hold 54% and 34% of Investee's voting common stock, respectively.
- Investor B controls and consolidates Investee. However, no evidence indicates that Investor B operates without regard to Investor A's views.
- Investor A holds one of seven seats on Investee's board of directors.



# CONCLUSION

Investor A has the ability to exercise significant influence over Investee.

# **ANALYSIS**

- Investor A holds 12% of Investee's voting common stock and therefore is presumed not to have the ability to exercise significant influence over Investee unless predominant evidence demonstrates otherwise.
- Investor A has the ability to exercise significant influence over Investee through its board seat.
- Investor A evaluates whether any facts or evidence demonstrates that Investor B is operating without regards to Investor A's views; however, by itself, Investor B's control over Investee does not prevent Investor A from having the ability to exercise significant influence over Investee.

# 2.4 DETERMINING THE PROPORTION HELD



# **FASB REFERENCES**

ASC 323-10-15-8 through 15-9

To determine which presumption applies (that is, whether it holds 20% or more of a corporation's common stock), an investor considers only currently outstanding securities, including indirect interests in the investee. Potential voting rights (for example, those attributable to a currently exercisable option or warrant) are disregarded in this step unless the instrument meets the definition of in-substance common stock (see Section 1.2.1).

Once an investor determines its proportion of voting common stock (including in-substance common stock), it considers all facts and circumstances, including rights held through other interests that do not meet the definition of insubstance common stock, to determine whether it has the ability to exercise significant influence.



# THERE ARE NO BRIGHT LINES!

Although ASC 323 refers to a specific threshold (20% of a corporation's voting common stock), the SEC staff has emphasized that there are no bright lines when evaluating whether the investor has the ability to exercise significant influence (see Section 2.2).

# EXAMPLE 2-2: SIGNIFICANT INFLUENCE WITH LESS THAN A 20% INTEREST AND RIGHTS THROUGH ANOTHER INTEREST

#### **FACTS**

Investor acquires:

- ▶ 18% of the voting common stock of Investee, which is a corporation.
- ▶ 100% of Investee's preferred stock, which is not in-substance common stock (see Section 1.2.1). Investor is guaranteed one of seven seats on Investee's board of directors as long as the preferred stock is outstanding.

Investor does not elect the fair value option and a scope exception from ASC 323 does not apply.

# **CONCLUSION**

Investor has the ability to exercise significant influence over Investee and applies the equity method to account for the common stock (but not the preferred stock).

#### **ANALYSIS**

- Investor holds 18% of Investee's voting common stock and therefore is presumed not to have the ability to exercise significant influence over Investee unless evidence demonstrates otherwise.
- Investor has a board seat, which, absent other contrary evidence, generally indicates that it has the ability to exercise significant influence over Investee. It is irrelevant that the board seat is a contractual right related to the preferred stock (and not the common stock).
- ▶ The equity method applies to common stock and in-substance common stock investments in a corporation (regardless of whether the rights that provide an investor with the ability to exercise significant influence stem from another interest in the investee). Therefore, Investor applies the equity method to the common stock investment. The preferred stock is not in-substance common stock but is in the scope of ASC 321.
- If Investor lost its board seat (for example, because the preferred stock is redeemed), it would reevaluate whether it has the ability to exercise significant influence at that date (see Section 2.5).

# EXAMPLE 2-3: SIGNIFICANT INFLUENCE WITH LESS THAN A 20% INTEREST AND POTENTIAL OTHER INTERESTS

Investor acquires:

**FACTS** 

- ▶ 5% of the voting common stock of Investee, which is a corporation.
- ▶ A call option, which is not in-substance common stock (see Section 1.2.1), to buy an additional 16% of the voting common stock at its then-current fair value on the exercise date.

No other facts and circumstances indicate that Investor has the ability to exercise significant influence over Investee (see Section 2.3). Investor does not elect the fair value option and a scope exception from ASC 323 does not apply.

# CONCLUSION

Investor does not have the ability to exercise significant influence over Investee and accounts for its common stock as a financial asset in accordance with ASC 321.

#### **ANALYSIS**

- Investor holds 5% of Investee's voting common stock and therefore is presumed not to have the ability to exercise significant influence over Investee unless evidence demonstrates otherwise.
- ▶ Even though Investor would hold 21% of Investee's voting common stock upon exercising the call option, those securities are not currently outstanding. Therefore, Investor excludes such potential voting rights when determining whether it holds 20% or more of Investee's common stock.
- ▶ Because Investor is presumed **not** to have the ability to exercise significant influence over Investee, and no other facts and circumstances demonstrate otherwise, the equity method does not apply to the 5% voting common stock.
- If Investor exercises the call option, it would reevaluate whether it has the ability to exercise significant influence at that date (see Section 2.5) and would be presumed to do so given it would hold a 21% interest in Investee's common stock.

# 2.4.1 Indirect Interests: Evaluating Significant Influence



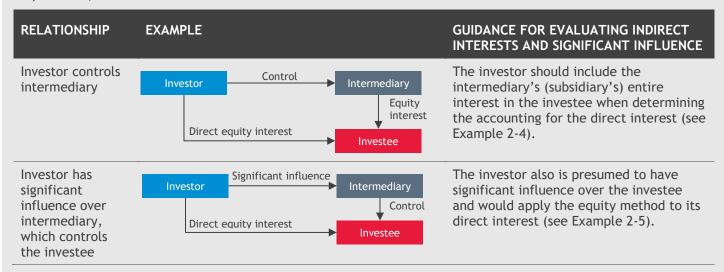
# **FASB REFERENCES**

ASC 323-10-15-8

To determine whether it holds 20% or more of a corporation's common stock, an investor considers both its direct and indirect interests in the investee. An indirect interest is one in which the investor has economics in an investee through another legal entity (for example, a subsidiary or another equity method investee).

# BDO INSIGHTS: CONSIDERING DIRECT AND INDIRECT INTERESTS WHEN EVALUATING SIGNIFICANT INFLUENCE

ASC 323 requires an investor to consider direct and indirect investments when determining whether it has the ability to exercise significant influence over an investee. However, it does not state how direct and indirect interests are considered in the analysis. We believe the effect of direct and indirect interests on the investor's evaluation depends on the investor's relationship (for example, control or significant influence) with the intermediary, and the intermediary's relationship with the investee. The table below summarizes our views when the investor, intermediary, and investee are all corporations (see Section 1.3 when the entities involved are not corporations).



To reach a conclusion when the investor has significant influence over an intermediary entity, but that intermediary entity does **not** control the investee, we believe an investor must consider all facts and circumstances, including:

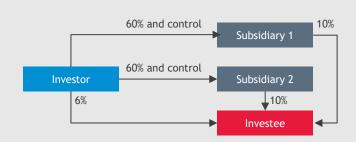
- ▶ The investor's ability to affect the intermediary's interactions with the investee, which may depend on factors such as the investee's materiality or strategic importance to the intermediary.
- The reasons the investor and investee each obtained (or retained) an interest in the investee.
- ▶ The other evidence that the investor has (or does not have) the ability to exercise significant influence over the investee (see Sections 2.2 and 2.3).

Reaching a conclusion about whether an investor has the ability to exercise significant influence over an investee's financial and operating decisions requires the application of professional judgment based on the facts and circumstances. If the investor has that ability, Section 4.2.5 provides guidance on applying the equity method when indirect interests are present.

# EXAMPLE 2-4: DIRECT INTEREST AND INDIRECT INTEREST THROUGH SUBSIDIARIES: EVALUATING SIGNIFICANT INFLUENCE

# **FACTS**

- ▶ On 1 January, 20X1, Investor acquired 6% of the voting common stock of Investee, which is a corporation.
- ▶ Investor controls and consolidates Subsidiaries 1 and 2 and holds 60% of each corporation's voting common stock.
- ▶ Also on 1 January 20X1, Subsidiaries 1 and 2 each acquired 10% of Investee's voting common stock.
- No other facts and circumstances provide predominant evidence that Investor does not have the ability to exercise significant influence over Investee.
- Investor does not elect the fair value option and a scope exception from ASC 323 does not apply.



#### CONCLUSION

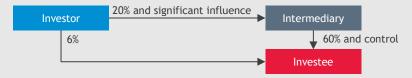
We believe Investor has the ability to exercise significant influence over Investee and should apply the equity method to its direct interest (6%). Subsidiaries 1 and 2 would also apply the equity method to their 10% interests in Investee for Investor's consolidated financial statements.

#### **ANALYSIS**

- Investor controls and consolidates Subsidiaries 1 and 2. Therefore, we believe Investor must include the subsidiaries' entire voting common stock interest (10% each) when determining whether it has the ability to exercise significant influence over Investee.
- ▶ Investor holds 26% (10% + 10% + 6%) of Investee's voting common stock. Therefore, we believe Investor is presumed to have the ability to exercise significant influence over Investee. Because Investor controls and consolidates Subsidiaries 1 and 2, we believe it is irrelevant that Investor's proportionate economic interest in Investee is only 18% (60%\*10% + 60%\*10% + 6%) when determining which presumption applies.
- ▶ Because no other facts and circumstances provide predominant evidence that Investor does not have the ability to exercise significant influence over Investee, Investor applies the equity method to each of the interests.

# EXAMPLE 2-5: DIRECT INTEREST AND INDIRECT INTEREST THROUGH AN EQUITY METHOD INVESTEE'S SUBSIDIARY FACTS

- ▶ On January 1, 20X1, Investor acquired 6% of Investee's voting common stock, which is a corporation.
- Also on January 1, 20X1, Investor obtained the ability to exercise significant influence over Intermediary, also a corporation, by acquiring a 20% voting common stock interest in Intermediary.
- ▶ Intermediary controls and consolidates Investee and holds 60% of Investee's voting common stock.
- No other facts and circumstances provide predominant evidence that Investor does not have the ability to exercise significant influence over Investee.
- Investor does not elect the fair value option and a scope exception from ASC 323 does not apply.



#### CONCLUSION

We believe Investor has the ability to exercise significant influence over Investee.

# **ANALYSIS**

- Investor has significant influence over Intermediary. Therefore, we believe Investor is presumed to also have significant influence over Investee because Intermediary controls and consolidates Investee.
- ▶ We believe it is irrelevant that Investor's proportionate interest in Investee is only 18% (20%\*60% + 6%) when determining which presumption applies because Investor has the ability to exercise significant influence over Intermediary and Intermediary controls and consolidates Investee.
- ▶ Because no other facts and circumstances provide evidence that Investor does not have the ability to exercise significant influence over Investee, Investor applies the equity method to its 6% direct interest.

# 2.5 REEVALUATING SIGNIFICANT INFLUENCE



# **FASB REFERENCES**

ASC 323-10-35-33

An investor must continuously assess whether it has the ability to exercise significant influence over an investee. When an investor buys or sells an interest in the investee, it must reevaluate that conclusion. Other changes in facts and circumstances can also affect an investor's ability to exercise significant influence over an investee.

# BDO INSIGHTS: IDENTIFYING CHANGES IN THE INVESTOR'S ABILITY TO EXERCISE SIGNIFICANT INFLUENCE

An investor should develop processes and internal controls over financial reporting to monitor changes in facts and circumstances related to the investee (including changes without any action by the investor) that could affect the investor's ability to exercise significant influence over an investee's operating and financial policies. For example, an investor's ability to exercise significant influence might be affected by the following:

- Issuances, modifications, redemptions, or repurchases of the investee's equity
- Amendments to the investee's governing documents (for example, articles of incorporation, bylaws, partnership agreements, membership agreements, operating agreements, voting agreements, and standstill agreements)
- ▶ Changes in the composition of the investee's board
- Expiration of agreements with other investors or rights held by other investors in the investee
- ▶ Changes in significant service, managerial, or intra-entity agreements related to the investee
- Changes in the investee's business, such as a change in technological dependence
- ▶ Defaults by the investee on its loan covenants
- ▶ Bankruptcy (or the emergence therefrom) of the investee.

The examples listed above are illustrative, not exhaustive. Reaching a conclusion about whether the investor has the ability to exercise significant influence over the investee requires the application of professional judgment based on the new facts and circumstances. An investor may also need to reconsider whether the investee is a VIE and, if so, whether it has become the VIE's primary beneficiary (see Sections 3.7 and 4.5 our Blueprint, Control and Consolidation Under ASC 810).

If the investor loses the ability to exercise significant influence over an investee, it stops applying the equity method to its investment (see Section 5.3). See Section 1.2.1.4 for guidance on reconsidering whether an instrument meets the definition of in-substance common stock.



# LOSSES ALONE DO NOT CHANGE SIGNIFICANT INFLUENCE CONCLUSIONS

An investor does not reevaluate whether it has the ability to exercise significant influence over an investee simply because the investee incurs losses. However, losses might lead to a change in facts and circumstances that affect whether an investor has the ability to exercise significant influence over an investee. For example, losses might lead an investee to obtain more funding from the investor or other parties. If such a change affects the investor's ability to exercise significant influence over the investee's operating and financial policies or proportionate ownership in the investee, the investor would reevaluate whether the equity method is still appropriate.

# Chapter 3: Initial Measurement



# 3.1 OVERVIEW: INITIAL MEASUREMENT

The initial measurement of an equity method investment has two steps:

Step 1: Determine the investment's cost (Section 3.2)

Step 2: Identify basis differences and allocate the cost of the investment in the memo accounts as if the investee were a subsidiary (Section 3.3)

ASC 323 requires an investor to initially measure an equity method investment at cost and present the investment on the balance sheet as a single line item. In Step 1, cost is determined in accordance with the cost accumulation model for asset acquisitions in ASC 805-50 (see Section 3.2). The cost basis of an equity method investment includes transaction costs directly related to the investment's acquisition, contingent consideration in specific circumstances, and commitments and guarantees the investor provided on the investee's behalf (see Sections 3.2.1 through 3.2.3). The cost of an equity method investment also includes any other consideration paid. When the investor obtains the equity method investment in exchange for consideration other than cash, the investment's initial measurement often is in the scope of other U.S. GAAP and recognized at fair value (see Section 3.2.4).

The cost of an equity method investment can be summarized as follows:



The cost of an equity method investment typically differs from the investor's share of the carrying amounts of the investee's identifiable assets and liabilities (referred to as "net assets"). In Step 2, an investor must allocate the basis difference to the investee's identifiable net assets in separate accounts, referred to as "memo accounts," as if the investee were a consolidated subsidiary (see Section 3.3). If the investee meets the definition of business in ASC 805, an investor accounts for any unallocated basis difference as equity method goodwill (see Section 3.3.1 for the private company accounting alternatives). If the investor's share of the investee's net assets exceeds the cost, the investor must allocate that negative basis difference or recognize a bargain purchase gain (see Section 3.3.2).

Other factors to consider when accounting for the basis difference include:

- ▶ The deferred tax consequences of basis differences related to identifiable net assets (see Section 3.3.3)
- Assets or liabilities for which the investee has recognized related amounts in AOCI (see Section 3.3.4)
- ► IPR&D assets (see Section 3.3.5)
- ▶ NCI in the investee's subsidiaries (see Section 3.3.6).

# 3.2 COST OF AN EQUITY METHOD INVESTMENT



# **FASB REFERENCES**

ASC 323-10-30-2

Except as provided in the following sentence, an investor shall measure an investment in the 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.

ASC 805-50-30-1

Paragraph 805-50-25-1 discusses exchange transactions that trigger the initial recognition of assets acquired and liabilities assumed. Assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the fair value of noncash assets given as consideration differs from the assets' carrying amounts on the acquiring entity's books. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

ASC 805-50-30-2

Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued) and no other generally accepted accounting principles (GAAP) apply (for example, Topic 845 on nonmonetary transactions or Subtopic 610-20), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

As discussed above, the initial measurement of an equity method investment has two steps:

Step 1: Determine the investment's cost (Section 3.2)

Step 2: Identify basis differences and allocate the cost of the investment in the memo accounts as if the investee were a subsidiary (Section 3.3)

In Step 1, an investor determines the cost of an equity method investment in accordance with the asset acquisition guidance in ASC 805-50-30, adjusted as follows:



The cost of an equity method investment includes the consideration paid and transaction costs that directly relate to acquiring the investment, contingent consideration in specific circumstances, and commitments and guarantees that the investor provided on the investee's behalf (see Sections 3.2.1 through 3.2.3). Such measurement generally occurs on the date the investor obtains the equity method investment (referred to as the "acquisition date").

The cost of an equity method investment also includes any other consideration paid. When the investor obtains the equity method investment in exchange for consideration other than cash, the investment's initial measurement often is in the scope of other U.S. GAAP (for example, ASC 810 when losing control of and deconsolidating a business or ASC 610-20, Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets, when derecognizing nonfinancial assets that are not a business). Many of those standards require recognizing the investment at fair value. For transactions involving nonmonetary consideration that are within the scope of ASC 845, Nonmonetary Transactions, an acquirer must first determine if any of the exceptions from fair value measurement in that topic apply. See Section 3.2.4 for the initial measurement of an equity method investment when the consideration is other than cash.

# 3.2.1 Transaction Costs Related to Obtaining an Equity Method Investment



An investor determines the cost of an equity method investment in accordance with the asset acquisition guidance in ASC 805-50-30, adjusted as follows:



The cost of an equity method investment includes the direct and incremental transaction costs incurred to acquire the investment and excludes any internal costs incurred.

Debt and equity issuance costs used to finance the investment are excluded from the cost of the investment. Instead, the investor recognizes such costs in accordance with other U.S. GAAP. For example, debt issuance costs generally are recognized as a discount against the debt and amortized as interest expense in accordance with ASC 835, *Interest*. Similarly, direct and incremental costs of issuing equity generally are recognized by reducing the gross offering proceeds in accordance with Staff Accounting Bulletin (SAB) Topic 5.A. See Chapter 6 of our Blueprint, <u>Issuer's Accounting for Complex Financial Instruments</u>, for the initial measurement of debt and equity.

The table below lists fees and other expenses an investor might incur and whether they are included in the cost of an equity method investment.

# DIRECT AND INCREMENTAL COSTS (INCLUDED)

# **INTERNAL AND INDIRECT COSTS (EXCLUDED)**

- Broker finder's fees
- External legal and accounting fees
- External valuation and appraisal fees
- Internal costs, such as salaries, general, and administrative expenses
- ▶ Costs of issuing debt or equity to finance investments
- Other external costs payable regardless of whether the investment occurs (for example, retainer fees)



#### ACCOUNTING FOR TRANSACTION COSTS DIFFERS FROM A BUSINESS COMBINATION

Although equity method accounting is similar in some respects to consolidating a subsidiary, transaction costs incurred to acquire an equity method investment are treated differently from transaction costs in a business combination, which must be expensed (see Section 6.3 of our Blueprint, **Business Combinations Under ASC 805**).

For the accounting for costs incurred by an investor on an investee's behalf, see Section 4.5.4.

# EXAMPLE 3-1: TRANSACTION COSTS RELATED TO ACQUIRING AN EQUITY METHOD INVESTMENT

#### **FACTS**

- Investor acquired 20% of Investee's voting common stock for \$100,000. Investor accounts for the investment using the equity method.
- Investor incurred the following costs in connection with the transaction:
  - \$2,000 in external legal fees directly related to the investment
  - \$500 in debt issuance costs to finance the investment
  - \$3,000 in finder's fees payable to the broker
  - \$1,000 bonus payable to Investor's CEO upon closing.

#### CONCLUSION

Investor initially measures its investment at \$105,000.

### **ANALYSIS**

The cost of an equity method investment includes the cash and incremental direct costs payable to third parties. The legal fees of \$2,000 and the broker finder's fees of \$3,000 are incremental costs, paid to third parties, and directly related to the investment.

Investor excludes the debt issuance costs from the cost of the investment and accounts for them in accordance with other U.S. GAAP. The CEO's bonus is an internal cost and is accounted for in accordance with other U.S. GAAP (for example, ASC 710, *Compensation — General*), even though it is incremental and relates to the investment.

# 3.2.2 Contingent Consideration Related to an Equity Method Investment



### **FASB REFERENCES**

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).

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.

An investor determines the cost of an equity method investment in accordance with the asset acquisition guidance in ASC 805-50-30, adjusted as follows:



An investor and seller may enter a contingent consideration arrangement to resolve differences in views about the value of an equity method investment. Contingent consideration arrangements generally state that the investor will pay the investee if events occur or conditions are met (for example, if the investee reaches a specific revenue threshold, income target, or product development milestone).

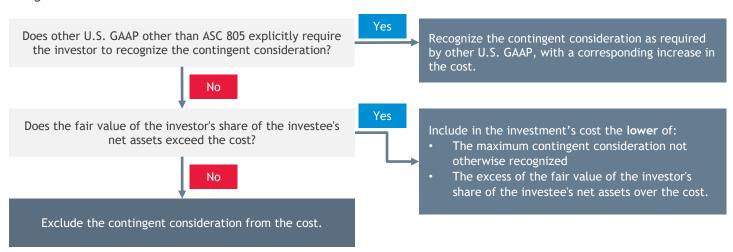
If authoritative guidance other than ASC 805 requires an investor to recognize the contingent consideration, the investor includes that amount in the cost of the investment. For example, if the contingent consideration qualifies as a derivative in accordance with ASC 815, *Derivatives and Hedging*, the amount recognized is part of the total cost. However, any remeasurement of the contingent consideration does **not** affect the investment's carrying amount. Instead, the investor remeasures the contingent consideration in accordance with other U.S. GAAP (for example, through earnings). Contingent consideration might also be in the scope of ASC 480, *Distinguishing Liabilities From Equity*, or ASC 610-20. See our Blueprint, <u>Issuer's Accounting for Complex Financial Instruments</u>, for the scope of ASC 480 and Appendix A of our Blueprint, <u>Revenue Recognition Under ASC 606</u>, for guidance on ASC 610-20.

If **no** authoritative guidance other than ASC 805 applies to the contingent consideration, the investor includes the contingent consideration in the cost of the investment and recognizes a corresponding liability **only** if the fair value of the investor's share of the investee's net assets exceeds the cost of the investment (excluding the contingent consideration). In other words, the investor recognizes contingent consideration only if there otherwise would be a bargain purchase. In this case, the contingent consideration is the **lower** of:



- ▶ The maximum contingent consideration not otherwise recognized
- ▶ The excess of the fair value of the investor's share of the investee's net assets over the cost

The guidance above is summarized in the flowchart.



If the fair value of the investor's share of the investee's net assets exceeds the cost of the investment, the investor recognizes an offsetting liability. When the contingency is later resolved and the consideration is issued or becomes issuable, the investor adjusts the consideration paid to fair value by adjusting the investment's cost (which may be upward or downward). In other words, the investor does not adjust the contingent consideration liability through earnings and does **not** recognize a bargain purchase gain (even if the fair value of the investor's share of the investee's net assets exceeds the investment's cost). That approach differs from the remeasurement of contingent consideration recognized in accordance with other U.S. GAAP (for example, as a derivative in accordance with ASC 815), for which the remeasurement does not affect the investment's carrying amount.

# BDO INSIGHTS: USE THE FAIR VALUE OF THE INVESTEE'S IDENTIFIABLE NET ASSETS (EXCLUDING GOODWILL)

As discussed above, if no authoritative guidance applies to contingent consideration payable for an equity method investment (other than ASC 805), an investor evaluates whether its share of the investee's net assets exceeds the cost of the investment to determine whether to recognize any contingent consideration.

We believe an investor excludes any goodwill when calculating the fair value of its share of the investee's net assets. EITF Issue No. 08-6, "Equity Method Accounting Considerations," which was the source of this guidance, was issued in part to retain guidance from the asset acquisition model in Statement of Financial Accounting Standards No. 141, Business Combinations (June 2001). That guidance required a pro rata reduction of the assets acquired when their fair value exceeded the cost, and could never result in goodwill. Therefore, we believe an investor includes only its share of the fair values of the investee's identifiable net assets when recognizing a contingent consideration liability pursuant to ASC 323.



# CONTINGENT CONSIDERATION GUIDANCE IN ASC 323 DOES NOT CONSIDER PROBABILITY

When other U.S. GAAP does not require recognition of contingent consideration payable with respect to acquiring an equity method investment, an investor must use the formula in ASC 323. That formula does not include any evaluation of whether it is probable that the investor will be required to make the payment. Instead, the investor must wait until the contingency is resolved and if the amount previously recognized as a liability is not paid, the investor reverses the contingent consideration liability and reduces the investment's cost (the investor cannot recognize a gain). In addition, we believe the investor should consider the effects on the remaining equity method basis differences in the investor's memo accounts (see Sections 3.3 and 4.4 for the initial recognition and subsequent measurement of equity method basis differences, respectively).



# ACCOUNTING FOR CONTINGENT CONSIDERATION DIFFERS FROM A BUSINESS COMBINATION

Although equity method accounting is similar to consolidating a subsidiary, the accounting for contingent consideration related to an equity method investment differs from the accounting for contingent consideration related to a business combination (see Section 5.4.5 of our Blueprint, Business Combinations Under ASC 805).



# **FASB PROJECT: DERIVATIVES SCOPE REFINEMENTS**

In April 2025, the FASB completed its deliberations on a proposal to expand the scope exceptions from the definition of a derivative in ASC 815, which would result in fewer contracts being accounted for as derivatives. The amendments would be applied on a modified retrospective or prospective basis. The amendments will be effective for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026, for all entities. Early adoption would be allowed. See the FASB website for more information.

# EXAMPLE 3-2: CONTINGENT CONSIDERATION SUBJECT TO AUTHORITATIVE GUIDANCE OTHER THAN ASC 805 **FACTS**

- ▶ Investor acquires from Seller 30% of Investee's voting common stock for \$250,000 and accounts for the investment using the equity method. For simplicity, assume there were no transaction costs.
- Investor and Seller also entered a contingent consideration arrangement that meets the definition of a derivative in ASC 815. The derivative's fair value was \$40,000 on the acquisition date.

#### CONCLUSION

Investor initially measures its investment at \$290,000.

# **ANALYSIS**

- The contingent consideration arrangement meets the definition of a derivative in accordance with ASC 815 and is recognized as a liability at fair value. Therefore, the cost of the equity method investment includes the \$250,000 and the derivative's acquisition-date fair value of \$40,000.
- Changes in the derivative's fair value are recognized in earnings and do not affect the investment.

#### EXAMPLE 3-3: CONTINGENT CONSIDERATION NOT SUBJECT TO OTHER AUTHORITATIVE GUIDANCE

#### **FACTS**

- Investor acquired 30% of Investee's voting common stock for \$180,000 and accounts for the investment using the equity method. For simplicity, assume there were no transaction costs.
- ▶ Also, Investor agreed to pay contingent consideration of \$30,000 if Investee meets specified revenue targets. The contingent consideration qualifies for the derivative scope exception in ASC 815-10-15-59 and does not otherwise have to be recognized in accordance with U.S. GAAP other than ASC 805. The fair value of Investor's share of Investee's identifiable net assets as of the acquisition date is \$190,000.

#### **CONCLUSION**

Investor initially measures its investment at \$190,000.

#### **ANALYSIS**

- The contingent consideration is not subject to any other authoritative guidance that requires Investor to recognize it as a liability, so it is subject to ASC 323.
- ▶ The fair value of Investor's share of Investee's identifiable net assets of \$190,000 exceeds the cost of \$180,000 by \$10,000. That amount is lower than the maximum contingent consideration of \$30,000 not otherwise recognized. Therefore, Investor initially measures the investment at \$190,000 (\$180,000 + \$10,000), regardless of whether it is probable that Investor will pay at least \$10,000.
- ▶ Once the contingency is resolved, Investor adjusts the investment's cost for any differences between the fair value of the contingent consideration paid and the \$10,000 initially recognized. That adjustment could be upward or downward. We believe Investor also should adjust the equity method basis differences for any change in the investment's cost (see Sections 3.3 and 4.4 for the accounting for basis differences).

# 3.2.3 Commitments and Guarantees Related to Obtaining an Equity Method Investment



# **FASB REFERENCES**

ASC 460-10-25-4 and ASC 460-10-55-23

An investor determines the cost of an equity method investment in accordance with the asset acquisition guidance in ASC 805-50-30, adjusted as follows:



The cost of an equity method investment excludes any commitments by the investor to contribute future capital to the investee unless required by other U.S. GAAP. If no other U.S. GAAP requires the investor to recognize a liability for the commitment, the investor includes it in the cost of the investment only when the investor makes the contribution.<sup>6</sup>

<sup>&</sup>lt;sup>6</sup> ASC 323-740, *Investments — Equity Method and Joint Ventures*, requires an investor in a tax credit structure that applies the PAM to recognize a liability for delayed equity contributions that are unconditional and legally binding or for those contingent on a future event when that contingent event becomes probable. However, as discussed in BC25 of ASU 2023-02, an equity method investor (that is not using the PAM) cannot apply that guidance by analogy after adopting ASU 2023-02 (see Section 1.5.2).

If an investor issues a guarantee to the investee or on the investee's behalf when acquiring the equity method investment, and such guarantee is in the scope of ASC 460, *Guarantees*, the investor recognizes a liability for the guarantee at its acquisition-date fair value, as an increase to the equity method investment. An investor accounts for changes in the guarantee's fair value or any payments in accordance with ASC 460; they do not affect the investment's carrying amount. If the guarantee is outside the scope of ASC 460, an investor recognizes a liability only if explicitly required by other U.S. GAAP.

# **EXAMPLE 3-4: GUARANTEE ON BEHALF OF AN EQUITY METHOD INVESTEE**

#### **FACTS**

- Investor acquired 20% of Investee's voting common stock for \$250,000 and accounts for the investment using the equity method. For simplicity, assume there were no transaction costs.
- In connection with the acquisition, Investor issued a guarantee in the scope of ASC 460 to an unrelated lender on Investee's behalf that requires Investor to make payments to the lender if Investee defaults on the loan. The guarantee's fair value was \$1,500 on the acquisition date.

#### CONCLUSION

Investor initially measures its investment at \$251,500.

#### **ANALYSIS**

- Investor issued a financial guarantee within the scope of ASC 460 when acquiring an equity method investment. Therefore, the cost of the equity method investment includes \$250,000 and the guarantee's acquisition-date fair value of \$1,500.
- ▶ Changes in the guarantee's carrying amount or any payments are accounted for in accordance with ASC 460 and do not affect the investment.

# 3.2.4 Other Consideration Exchanged for an Equity Method Investment



### **FASB REFERENCES**

ASC 323-10-30-2, ASC 610-20-15-10, and ASC 805-50-30-1 through 30-2

An investor determines the cost of an equity method investment in accordance with the asset acquisition guidance in ASC 805-50-30, adjusted as follows:

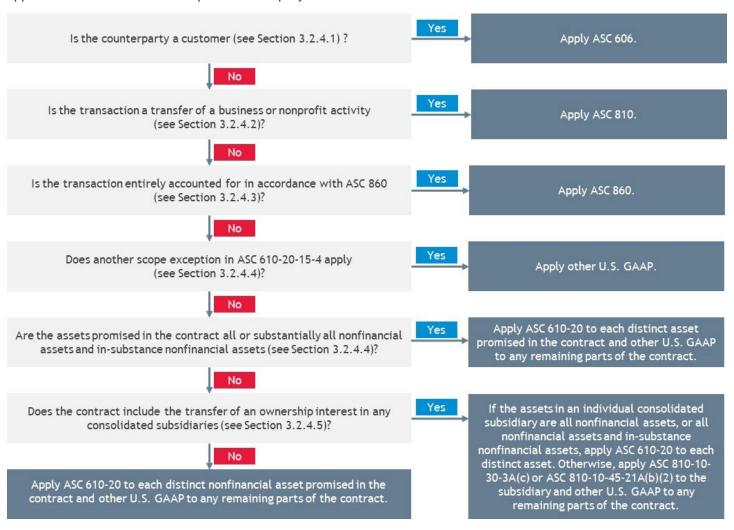


An investor may obtain an equity method investment in a transaction in which the consideration paid includes elements other than cash. For example, the investor may transfer noncash assets, incur or assume liabilities, or issue equity.

An investor might also enter or change arrangements (or existing arrangements could lapse or expire), resulting in the initial measurement of an equity method investment. For example, an investor's ownership interest or influence over an investee may increase, causing a financial asset to become subject to the equity method for the first time. Sometimes, such changes occur because of the investor's actions (like buying the investee's voting common stock); other times, they occur without any actions by the investor (for example, because the investee issues shares or repurchases shares in transactions with other investors) (see Chapter 5).

When the consideration paid for an equity method investment is other than cash, and **if no other U.S. GAAP applies**, an investor initially measures the equity method investment at the fair value of the consideration paid or the fair value of the investment received, whichever is more clearly evident and therefore reliably measurable.

An investor can use the flowchart below (adapted from ASC 610-20-15-10) to help determine whether other U.S. GAAP applies when the consideration paid for an equity method investment is other than cash.



See our Blueprint, <u>Revenue Recognition Under ASC 606</u>, for the scope and application of ASC 606 and ASC 610-20. See Chapter 3 of our Blueprint, <u>Business Combinations Under ASC 805</u>, for the definition of a business.

# BDO INSIGHTS: COMPARING THE SCOPES OF ASC 610-20 AND ASC 845

As discussed in Section A.2.1 of our Blueprint, <u>Revenue Recognition Under ASC 606</u>, we believe that ASC 845 rarely will apply to transfers of nonfinancial assets in exchange for receiving or retaining an equity method investment. For example, a transfer of real estate in exchange for receiving (or retaining) an equity method investment in an entity that holds real estate is within the scope of ASC 610-20, not ASC 845.

# 3.2.4.1 Initial Measurement of an Equity Method Investment in a Transaction With a Customer (ASC 606)



# **FASB REFERENCES**

ASC 323-10-30-2 and ASC 606-10-15-2(c)(3)

An investor may receive an equity method investment in exchange for a promise to provide goods or services. The counterparty might be the investee itself or a third party. Regardless of the investor's relationship with the counterparty, when the goods or services are an output of its ordinary activities, the investor accounts for the transfer as a contract with a customer in accordance with ASC 606 (unless another scope exception from ASC 606 applies). In accordance with ASC 606, the investor initially measures the equity method investment (which is noncash consideration) at its fair value at contract inception (see our Blueprint, Revenue Recognition Under ASC 606).

If the customer in the transaction is the investee (rather than a third party), the investor must then determine how much intra-entity profit to eliminate, if any (see Section 4.3).

3.2.4.2 Initial Measurement of an Equity Method Investment Upon Losing Control of a Business (ASC 810)



# **FASB REFERENCES**

ASC 323-10-30-2, ASC 460-10-25-1(f), ASC 810-10-40-3A, ASC 810-10-40-4, ASC 810-10-55-1A, and ASC 810-10-S99-5

A parent may lose control of and deconsolidate a subsidiary (or a group of assets) that meets the definition of a business in ASC 805 and retain an equity method investment in that entity. Alternatively, a parent may contribute the shares of such a subsidiary (or group of assets) to another entity in exchange for an equity method investment in that same entity or in a different entity.

In those fact patterns, the parent (now equity method investor) initially measures the investment at fair value upon losing control of and deconsolidating the business and recognizes a gain or loss from deconsolidation in accordance with ASC 810. However, ASC 810 does not apply to transactions with customers in the scope of ASC 606 (see Section 3.2.4.1) or to the loss of control and deconsolidation of a business that is the conveyance of oil and mineral gas rights in the scope of ASC 932.

See Chapter 3 of our Blueprint, <u>Business Combinations Under ASC 805</u>, for the definition of a business and our Blueprint, <u>Control and Consolidation Under ASC 810</u>, for identifying a controlling financial interest.

# BDO INSIGHTS: DIFFERENT ACCOUNTING FOR GUARANTEES UPON DECONSOLIDATION UNDER ASC 810

When an investor issues a guarantee in the scope of ASC 460 to an equity method investee or to another party on the investee's behalf upon forming the investee or acquiring the investment, the investor increases the investment's cost and recognizes a liability (see Section 3.2.3).

However, if the investor obtains the equity method investment upon deconsolidating a business, we believe the investor recognizes any such guarantees by reducing the gain (or increasing the loss) upon deconsolidation, instead of by increasing the investment's cost, regardless of whether the investor issued the guarantee upon losing control or while it still consolidated the investee. In the latter case, even though the guarantee was not recognized before deconsolidation (in accordance with the scope exception in ASC 460-10-25-1(f)), upon deconsolidating the investee, the investor must recognize the guarantee because the scope exception in ASC 460 for entities under common control no longer applies. ASC 810-10-S99-5 establishes that the recognition of such a guarantee is included when calculating the gain or loss. Although the fact pattern in that guidance does not include a retained equity method investment, we believe such an analogy is appropriate.

# 3.2.4.3 Initial Measurement of an Equity Method Investment Upon Loss of Control of Financial Assets (ASC 860)



# **FASB REFERENCES**

ASC 845-10-15-4(h), ASC 860-10-15-4, ASC 860-10-20: Transfer, ASC 860-20-25-1, ASC 860-20-30-1, ASC 860-10-40-5, and ASC 860-10-55-3

An investor may obtain an equity method investment in exchange for transferring a financial asset such as equity or debt securities (including transferring a different equity method investment).

An investor accounts for the transfer of a financial asset that is within the scope of ASC 860, *Transfers and Servicing of Financial Assets*, in accordance with that standard. ASC 860 includes scope exceptions. Therefore, when an investor receives an equity method investment in exchange for transferring a financial asset (including another equity method investment), the investor must evaluate whether the transaction is in the scope of ASC 860. If the financial asset transferred is outside the scope of ASC 860, the transaction may be in the scope of ASC 845. Also, in some cases, a financial asset might be an in-substance nonfinancial asset in the scope of ASC 610-20 (see Section 3.2.4.4 and Example 3-6).

# BDO INSIGHTS: CONSIDER THE SUBSTANCE OF AN EXCHANGE OF EQUITY METHOD INVESTMENTS

An investor might exchange an existing equity method investment for equity of another entity (that would also be accounted for under the equity method) that in substance may represent a decrease in the investor's ownership interest in the previously held investment rather than an exchange of equity method investments.

For example, consider a scenario in which Investors A, B, and C each hold 33% of Investee's common stock. The investors form a new company (NewCo) that has no other assets or activities. Investors A and B each contribute cash and their equity method investments (shares) in Investee to NewCo. Investor C contributes only its investment in Investee to NewCo (that is, no cash) and receives only 20% of Newco's voting common stock.

The investors must apply judgment when determining whether such a transaction is in the scope of ASC 860 (that is, whether it meets the definition of a transfer, and whether the scope exception for investments by owners or distributions to owners of a business entity applies). Additionally, we believe an investor should evaluate the nature of its rights, including voting, dividends, liquidation, and preemptive (veto) rights, as well as restrictions upon the sale of its equity investment.<sup>7</sup>

- If the investor's rights generally are the same (on a proportionate or per share basis) before and after the exchange, we believe the investor generally should account for the exchange as a decrease in ownership in its existing equity method investment (see Section 5.3.2).
- If the investor's rights are substantively different before and after the exchange, we believe the investor generally should account for the transaction in accordance with ASC 860 as discussed in Section 5.3.1 (unless a scope exception applies).

Reaching a conclusion about the substance of the transaction depends on the facts and circumstances.

If the transaction is a transfer in the scope of ASC 860, it must satisfy all the conditions for sale accounting in ASC 860 to qualify for derecognition (see Section 5.3.1). The investor accounts for the transaction as follows:

▶ If it satisfies the conditions for sale accounting: The investor recognizes a gain or loss for the difference between the carrying amount of the financial asset transferred and the fair value of the equity method investment received. In other words, an investor initially measures an equity method investment received in exchange for a transfer of a financial asset at fair value (if the transfer is within the scope of ASC 860 and meets the criteria for sale accounting).

<sup>&</sup>lt;sup>7</sup> The FASB staff included those factors in response to "Identical Common Shares for a Pooling of Interests" in FASB Technical Bulletin No. 85-5, "Issues Relating to Accounting for Business Combinations." Although that guidance has been superseded and did not apply to an exchange of equity method investments, we believe such factors may be relevant in evaluating the substance of an exchange transaction.

- ▶ If it does not satisfy both conditions for sale accounting: The investor accounts for the transaction as a secured borrowing. In other words, the "transferred" financial asset stays on the investor's books, and no gain or loss is recognized. Instead, the investor recognizes the received equity method investment at fair value and an offsetting liability (as a secured borrowing).
- 3.2.4.4 Initial Measurement of an Equity Method Investment Upon Derecognizing Nonfinancial Assets (ASC 610-20)



# **FASB REFERENCES**

ASC 323-10-30-2, ASC 606-10-32-21 through 32-22, ASC 610-20-05-2, ASC 610-20-15-2 through 15-10, ASC 610-20-32-2 through 32-4, and ASC 970-323-30-3 through 30-6

An investor generally applies ASC 610-20 if it obtains an equity method investment in exchange for transferring nonfinancial assets or in-substance nonfinancial assets (unless other U.S. GAAP applies).

Nonfinancial assets in the scope of ASC 610-20 include real estate, such as land and buildings, property, equipment, and intangible assets. An in-substance nonfinancial asset is a financial asset (for example, a receivable) promised to a counterparty in a transaction in which **substantially all** the fair value of the assets promised to the counterparty is concentrated in nonfinancial assets.

The scope of ASC 610-20 also includes the transfer of an ownership interest in a subsidiary that does not meet the definition of a business or nonprofit activity if substantially all the subsidiary's assets are nonfinancial assets. Similarly, it also includes a transaction in which a parent loses control of and deconsolidates a subsidiary that includes only nonfinancial assets (and in-substance nonfinancial assets) because of a change in facts and circumstances.

ASC 610-20 relies heavily on ASC 606. Under ASC 606, when an entity promises to provide goods or services in a contract with a customer, it measures any noncash consideration at its fair value at contract inception. Therefore, when an entity transfers a nonfinancial asset or in-substance nonfinancial asset in the scope of ASC 610-20 in exchange for receiving (or retaining) an equity method investment, the entity initially measures the investment at its fair value at contract inception. Such transactions generally are **not** in the scope of ASC 845. See Section A.2.1 of our Blueprint, **Revenue Recognition Under ASC 606**, for guidance on ASC 610-20 and the principles in ASC 606. See our Blueprint, **Control and Consolidation Under ASC 810**, for guidance evaluating control under the VIE and voting models.



#### CONSIDER IMPAIRMENT WHEN DERECOGNIZING ASSETS

An investor cannot avoid recognizing an impairment that is otherwise required in accordance with U.S. GAAP by contributing an asset to an equity method investee (or upon forming such an investee). The investor must apply other U.S. GAAP (for example, ASC 360) when determining whether to recognize any impairments before transfer.

# EXAMPLE 3-5: TRANSFER OF A NONFINANCIAL ASSET IN EXCHANGE FOR AN EQUITY METHOD INVESTMENT FACTS

- ▶ On January 1, 20X1, Investors A and B formed Investee.
- Investor A acquired 30% of Investee's voting common stock in exchange for contributing a building to Investee. Investor A accounts for the investment using the equity method.
- ► The building had a carrying value of \$375,000 and a fair value of \$600,000. The building is not an output of Investor A's ordinary activities and does not meet the definition of a business or a nonprofit activity.
- Investor B contributed \$1,400,000 to Investee in exchange for a 70% interest therein.

Investor A determined that the fair value of its 30% interest was \$600,000. (In this example, the fair value of the equity received equals the proportionate interest in the sum of the individual fair values of the contributed assets [30% \* (\$600,000 + \$1,400,000)]. However, that might not always be the case, depending on the synergies among the contributed assets and the rights and privileges of the equity interests). Investor A also determined that the transaction was at arm's length.

#### **CONCLUSION**

Investor A initially measures its investment at \$600,000 and recognizes a \$225,000 gain upon derecognizing the building.

# **ANALYSIS**

- Investor A obtained its investment in a transaction that resulted from derecognizing a nonfinancial asset that does not meet the definition of a business or a nonprofit activity. Also, because the building is not an output of Investor A's ordinary activities, Investee is not a customer of Investor A.
- Assuming no other scope exceptions in ASC 610-20 apply, the transaction is within the scope of ASC 610-20 for Investor A because all the fair value of the transferred assets is concentrated in nonfinancial assets.
- ▶ Therefore, Investor A initially measures the investment in accordance with ASC 610-20 as noncash consideration. It initially measures its investment at the fair value at contract inception of \$600,000, derecognizes the building (which has a carrying value of \$375,000), and recognizes a gain for the difference of \$225,000.
- ▶ Because the transaction is a downstream transaction in the scope of ASC 610-20, no intra-entity profit is eliminated (see Section 4.3).

# EXAMPLE 3-6: LOSS OF CONTROL OF A SUBSIDIARY THAT IS SUBSTANTIALLY ALL NONFINANCIAL ASSETS AND RETAINING AN EQUITY METHOD INVESTMENT

#### **FACTS**

- Assume the same facts as in Example 3-5 except that Investor A previously held the building in a wholly owned subsidiary. Investor A transferred a 70% interest in the subsidiary to Investor B and lost control of and deconsolidated the subsidiary (Investee) while retaining 30% of the subsidiary's voting common stock. Investor A accounts for the retained investment using the equity method.
- ▶ Also assume that at contract inception, the carrying amounts and fair values of Investee's assets were:

	ASSET TYPE	CARRYIN	CARRYING AMOUNT		R VALUE	PERCENTAGE (%)	
Investments	Financial	\$	25,000	\$	25,000	4%	
Buildings	Nonfinancial		375,000		575,000	96%	
Total		\$	400,000	\$	600,000	100%	

- Investor B contributed \$1,400,000 to Investee in exchange for a 70% interest therein.
- ▶ At contract inception, the fair value of the retained equity method investment received by Investor A was \$600,000. (In this example, the fair value of the equity received equals the proportionate interest in the sum of the individual fair values of the contributed assets [30% \* (\$600,000 + \$1,400,000)]. However, that might not always be the case depending on the synergies among the contributed assets and the rights and privileges of the equity interests).

#### CONCLUSION

Investor A measures its investment at its fair value of \$600,000 and recognizes a \$200,000 gain upon deconsolidating the subsidiary and derecognizing the building and investments.

# **ANALYSIS**

- Investor A retained its equity method investment in the subsidiary in a transaction that resulted from deconsolidating and derecognizing a subsidiary that does not meet the definition of a business or a nonprofit activity. Also, because the investments and buildings are not outputs of Investor A's ordinary activities, Investee is not a customer of Investor A.
- Assuming no other scope exceptions in ASC 610-20 apply, the transaction is within the scope of ASC 610-20 for Investor A because at contract inception, substantially all (96%) of the fair value of the subsidiary's assets is concentrated in nonfinancial assets. Accordingly, the financial assets (the investments) are in-substance nonfinancial assets.
- ▶ Therefore, Investor A initially measures the investment in accordance with ASC 610-20 as noncash consideration. It initially measures its investment at the fair value at contract inception of \$600,000, derecognizes the net assets of the subsidiary of \$400,000, and recognizes a gain for the difference of \$200,000.
- ▶ Because the transaction is a downstream transaction in the scope of ASC 610-20, no intra-entity profit is eliminated (see Section 4.3).

# 3.2.4.5 Initial Measurement of an Equity Method Investment Upon Loss of Control of a Subsidiary Not Addressed by Other U.S. GAAP (ASC 810)



# **FASB REFERENCES**

ASC 610-20-15-4, ASC 610-20-15-8, ASC 810-10-40-3A, and ASC 810-10-40-4

A parent may lose control of and deconsolidate a subsidiary that does **not** meet the definition of a business and retain an equity method investment in that entity. Alternatively, the parent may contribute the shares of such a subsidiary to another entity and in exchange obtain an equity method investment in the transferee or a different entity. If **no other U.S. GAAP applies**, the investor accounts for the transaction in accordance with ASC 810.

In such a transaction, the parent (now equity method investor) initially measures the investment at its fair value when it ceases to have a controlling financial interest in the subsidiary and recognizes a gain or loss upon deconsolidation in accordance with ASC 810.

As discussed above, the guidance in ASC 810 on deconsolidating a subsidiary that does not meet the definition of a business does not apply to transactions in the scope of other U.S. GAAP, which may include the following:



ASC 606
Revenue from contracts with customers (see Section 3.2.4.1)



ASC 845 Nonmonetary exchanges



ASC 610-20 Derecognition of nonfinancial assets (see Section 3.2.4.4)



ASC 860 Transfers of financial asset (see Section 3.2.4.3)



ASC 932 Conveyances of mineral rights and related transactions

For example, if a parent transfers a subsidiary to a counterparty in exchange for an equity method investment, and all the assets in the subsidiary are nonfinancial assets and in-substance financial assets, the investor accounts for the transaction in accordance with ASC 610-20 (see Section 3.2.4.4).

# EXAMPLE 3-7: LOSS OF CONTROL OF A SUBSIDIARY IN THE SCOPE OF ASC 810 AND RETAINING AN EQUITY METHOD INVESTMENT

#### **FACTS**

- ▶ On January 1, 20X1, Investors A and B formed Investee.
- Investor A acquired 30% of Investee's voting common stock and received cash in exchange for contributing to Investee a wholly owned subsidiary that held investments and a building with the carrying amounts and fair values shown in the table below.

	ASSET TYPE	CARRYING AMOUNT		FAIR VALUE		PERCENTAGE (%)	
Investments	Financial	\$	200,000	\$	200,000	33%	
Buildings	Nonfinancial		375,000		400,000	67%	
Total		\$	575,000	\$	600,000	100%	

- ▶ The building is not an output of Investor A's ordinary activities and does not meet the definition of a business or a nonprofit activity.
- Investor A received \$420,000 from Investor B and received an equity method investment in Investee that had a fair value of \$180,000. (In this example, the fair value of the equity method investment equals the proportionate interest in the sum of the individual fair values of the contributed assets (30% \* \$600,000). However, that might not always be the case depending on the synergies among the contributed assets and the rights and privileges of the equity interests).

#### CONCLUSION

Investor A measures its investment at its fair value of \$180,000 and recognizes the cash of \$420,000 and a \$25,000 gain upon deconsolidating the subsidiary.

#### **ANALYSIS**

- Investor A lost control of and deconsolidated the subsidiary, which does not meet the definition of a business. Also, because the investments and buildings are not outputs of Investor A's ordinary activities, Investee is not a customer of Investor A.
- The transaction is not within the scope of ASC 610-20 for Investor A because substantially all the fair value of the subsidiary's assets is **not** concentrated in nonfinancial assets (only 67%). The transaction is **not** within the scope of ASC 845 for Investor A because 70% of the consideration received (\$420,000 / (\$420,000 + \$180,000)) is monetary (cash). Therefore, if no other U.S. GAAP applies, the transaction is within the scope of ASC 810.
- ▶ Therefore, Investor A initially measures its investment at its fair value of \$180,000, recognizes the cash of \$420,000, derecognizes the subsidiary's net assets of \$575,000, and recognizes a gain of \$25,000.
- ▶ Because the transaction is a downstream transaction in the scope of ASC 810, no intra-entity profit is eliminated (see Section 4.3).

In this fact pattern, Investor A contributed its subsidiary to the equity method investee. The analysis would be the same if Investor A had retained an equity method investment in the existing entity (former subsidiary) and lost control of and deconsolidated that subsidiary upon the issuance of new shares by that former subsidiary.

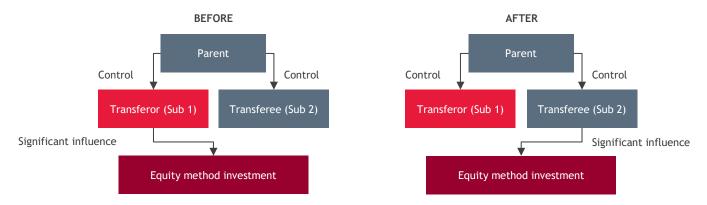
# 3.2.4.6 Initial Measurement of an Equity Method Investment in a Common Control Transaction



# **FASB REFERENCES**

ASC 805-50-30-5, ASC 860-10-40-5, ASC 860-10-55-3, ASC 860-10-55-78, ASC 860-10-55-17D, and ASC 860-20-30-2

A parent may direct one of its subsidiaries (the transferor) to transfer an equity method investment to another subsidiary (the transferee) in a common control transaction, as shown in the diagram below.



ASC 805-50 generally requires the receiving entity in a common control transaction to initially recognize the assets received at the ultimate parent's carrying amounts at the transfer date. However, ASC 860 also applies to common control transfers of equity method investments from one subsidiary to another. Therefore, if the transferee does not obtain control of the equity method investee and all the conditions for recognizing a sale in ASC 860 are met (see Section 5.3.1), a common control transfer of an equity method investment is accounted for as a sale (at fair value) in the subsidiaries' separate financial statements. The transferor does not consider its parent's involvement with the transferred financial assets when applying ASC 860.

The guidance in ASC 860 described above does not apply to common control transfers of an equity method investment from a parent to its subsidiary. That is, ASC 860 prohibits the recognition of a sale by the transferor parent. However, ASC 860 allows the transferee to recognize the transferred equity method investment at fair value in the transferee's separate financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral.

In accordance with ASC 805-50:

- An asset received in a common control transaction is recognized at the transfer date and accounted for prospectively.
- ▶ A business received in a common control transaction is recognized retrospectively.

Because an equity method investment is an asset, the receipt of an equity method investment in a common control transaction generally is accounted for prospectively, regardless of whether the investee meets the definition of a business.

# BDO INSIGHTS: TRANSFER OF AN EQUITY METHOD INVESTEE IN A LARGER COMMON CONTROL TRANSACTION

Sometimes, a transferee receives an equity method investment as part of a larger integrated common control transaction that also includes receiving a business (such as in some roll-up transactions). In these cases, we believe it might be appropriate to retrospectively account for the equity method investment with any other businesses received.

For guidance on common control transactions and on determining what is part of, or separate from, a business combination, see our Blueprint, <u>Business Combinations Under ASC 805</u>. We believe this guidance can be applied by analogy to determine whether two common control transactions are accounted for as a single transaction.

# 3.2.4.7 Initial Measurement of an Equity Method Investment in a Business Combination



# **FASB REFERENCES**

ASC 805-20-30-1

An acquirer may obtain an equity method investment as one of the acquired assets in a business combination. An acquirer recognizes an acquired equity method investment at fair value at the acquisition date (see our Blueprint, **Business Combinations Under ASC 805**).

# 3.3 EQUITY METHOD BASIS DIFFERENCES



# **FASB REFERENCES**

ASC 323-10-35-13, ASC 323-10-35-34, ASC 350-20-35-58 through 20-59, and ASC 805-50-30-3 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. Paragraph 350-20-35-58 requires that the portion of that difference that is recognized as goodwill not be amortized. However, if an entity within the scope of paragraph 350-20-15-4 elects the accounting alternative for amortizing goodwill in Subtopic 350-20, the portion of that difference that is recognized as goodwill shall be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. Paragraph 350-20-35-59 explains that equity method goodwill shall not be reviewed for impairment in accordance with paragraph 350-20-35-58. However, equity method investments shall continue to be reviewed for impairment in accordance with paragraph 323-10-35-32.

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.

As discussed in Section 3.1, the second step at initial measurement is to identify basis differences:

Step 1: Determine the investment's cost (Section 3.2)

Step 2: Identify basis differences and allocate the cost of the investment in the memo accounts as if the investee were a subsidiary (Section 3.3)

Basis differences between the investor's share of the carrying amounts of an investee's net assets and the cost of the investment are common. They may arise from measurement differences between the carrying amount of an investee's identifiable assets and liabilities in the investee's financial statements and their fair values. The consideration paid for an investment also may reflect unrecognized assets (for example, internally developed intangible assets) or goodwill. A basis difference can also be negative; for example, because the carrying amount of an investee's asset is higher than its fair value but is not impaired, or because of a bargain purchase (see Section 3.3.2).

An investor identifies and allocates basis differences as if the investee were a subsidiary. For example, if the investee meets the definition of a business in ASC 805, the investor identifies and allocates basis differences as if it acquired the investee in a business combination. However, an investor tracks those basis differences only in its memo accounts (that is, off-balance sheet); the investor still presents the investment as a single line item on the balance sheet. Basis differences affect the calculation of equity method income, as discussed in Section 4.4.

# BDO INSIGHTS: ACCOUNTING FOR BASIS DIFFERENCES IS CHALLENGING; THERE IS ANOTHER OPTION

Accounting for basis differences is complex and requires estimating the fair value of the investee's assets upon initial recognition of the investment. The investor also has to amortize the basis differences each reporting period and monitor investee level events that could affect the basis differences, such as impairments, sales of assets, transactions that affect NCI in the investee's subsidiaries, and share issuances and repurchases.

To avoid those complexities, an investor can elect the fair value option, as discussed in Section 1.6. While electing that option requires estimating the investment's fair value at the end of each reporting period and could create volatility in earnings, it also may better reflect the investor's economics. The fair value option is irrevocable and can be elected only at initial recognition.

An investor can use the steps below to identify and allocate equity method basis differences.



**STEP 2A:** Measure the identifiable assets and liabilities, including any unrecognized assets, at their fair values upon initial recognition of the investment.



**STEP 2B:** Calculate the investor's share of the carrying amounts and fair values for each of the identifiable assets and liabilities, each identifiable basis difference, and the sum of those amounts.



**STEP 2C:** Determine the total basis difference by comparing the cost of the investment and the investor's share of the carrying amounts of the investee's net assets.



**STEP 2D:** Allocate any excess of the total basis difference from Step 2C over the sum of the identifiable basis differences from Step 2B as follows:

- If the investee meets the definition of a business in ASC 805, to equity method goodwill (see Section 3.3.1 for the private company accounting alternatives).
- ▶ If the investee does not meet the definition a business, to the qualifying identifiable assets on a relative fair value basis, consistent with the guidance in ASC 805-50 on asset acquisitions.

See Section 3.3.2 for guidance on negative basis differences and bargain purchases. See Chapter 3 and Appendix C.4 of our Blueprint, <u>Business Combinations Under ASC 805</u>, for guidance on the definition of a business and asset acquisitions, respectively.

When identifying basis differences, challenging areas include:

- The deferred tax consequences of basis differences related to identifiable net assets (see Section 3.3.3)
- Assets or liabilities for which the investee has recognized related amounts in AOCI (see Section 3.3.4)
- ► IPR&D assets (see Section 3.3.5)
- ▶ NCI in the investee's subsidiaries (see Section 3.3.6).



# INVESTEE'S FINANCIAL STATEMENTS MUST USE U.S. GAAP WHEN IDENTIFYING BASIS DIFFERENCES

An investee may prepare its financial statements using a basis of accounting other than U.S. GAAP (for example, IFRS). If so, the investor must convert the investee's financial statements to U.S. GAAP before calculating any basis differences.



# IDENTIFY ALL BASIS DIFFERENCES BEFORE RECOGNIZING EQUITY METHOD GOODWILL

An equity method investor must calculate the basis differences for each of the investee's identifiable assets and liabilities before allocating any of the excess basis difference to equity method goodwill, including basis differences related to assets not recognized by the investee (for example, internally developed intangible assets).

An investor does not amortize equity method goodwill unless it elects the private company accounting alternative discussed in Section 3.3.1. Also, the investor does not separately review equity method goodwill for impairment (which differs from the accounting for goodwill recognized in a business combination). Instead, the investor evaluates the equity method investment as a whole for impairment, as discussed in Section 4.8.

Example 3-8 illustrates the identification and allocation of equity method basis differences.

# **EXAMPLE 3-8: EQUITY METHOD BASIS DIFFERENCES**

#### **FACTS**

- ▶ On January 1, 20X1, Investor acquired 40% of Investee's voting common stock for \$800,000, which it accounts for using the equity method. For simplicity, assume there were no transaction costs. Investee meets the definition of a business in ASC 805.
- As of January 1, 20X1, the carrying amount and fair values of Investee's net assets were:

	CARRYIN	IG AMOUNT	FAIR VALUE		
Cash	\$	380,000	\$	380,000	
Accounts receivable		300,000		300,000	
Buildings		1,250,000		1,230,000	
Customer list		_		15,000	
IPR&D asset		_		60,000	
Payables		(80,000)		(80,000)	
Total identifiable net assets	\$	1,850,000	\$	1,905,000	

- Investor determined the fair values of Investee's identifiable assets and liabilities as follows:
  - The buildings have a fair value of \$1,230,000 and a 20-year useful life. Investee evaluates the buildings for impairment in accordance with ASC 360, and determines, based on their undiscounted cash flows, that the buildings are not impaired because they are recoverable.
  - The internally developed customer list has a fair value of \$15,000 and a three-year useful life.
  - The IPR&D asset was developed internally and therefore not recognized by Investee. It is indefinite-lived and is not amortized.
  - The carrying amounts of accounts receivable and payables approximate their fair values.
- For simplicity, this example ignores the effect of income taxes (see Section 3.3.3).

#### CONCLUSION

Investor initially measures the investment at \$800,000, which includes a total basis difference of \$60,000 (inclusive of \$38,000 of equity method goodwill).

#### **ANALYSIS**

- ▶ **Step 1:** The cost of the investment is \$800,000.
- **Steps 2A and 2B:** The table below illustrates how Investor calculated the identifiable basis differences in the equity method memo accounts.

	INVESTOR'S SHAF CARRYING AMOUI (40%) [A]		INVESTOR'S SHARE OF FAIR VALUE (40%) [B]		IDENTIFIABL DIFFERENCE	
Cash	\$	152,000	\$	152,000	\$	_
Accounts receivable		120,000		120,000		_
Buildings		500,000		492,000		(8,000)
Customer list		_		6,000		6,000
IPR&D asset		_		24,000		24,000
Payables		(32,000)		(32,000)		
Total identifiable net assets	\$	740,000	\$	762,000	\$	22,000

- Because Investee meets the definition of a business in ASC 805, Investor recognizes the IPR&D asset in the memo accounts and measures it at its fair value on the acquisition date, consistent with the accounting for business combinations (see Section 3.3.5).
- ▶ **Step 2C:** The total basis difference is \$60,000, which is the difference between the investment's cost of \$800,000 and Investor's share of the carrying amounts of Investee's net assets of \$740,000.
- ▶ **Step 2D:** Because Investee meets the definition of a business in ASC 805, Investor recognizes the excess basis difference of \$38,000 (\$60,000 − \$22,000) as equity method goodwill in its memo accounts.

See Example 4-16 for the amortization of equity method basis differences and the equity method income.

# 3.3.1 Private Company Accounting Alternatives for Intangible Assets and Goodwill for Equity Method Investments



# **FASB REFERENCES**

ASC 323-10-35-13, ASC 350-20-15-4 through 15-6, ASC 805-20-15-2 through 15-4, and ASC 805-20-25-30

When identifying basis differences for an equity method investee that meets the definition of a business, a private company (as defined in U.S. GAAP) may elect an accounting alternative to **not** recognize the following intangible assets:

- Customer-related intangibles **not** capable of being sold or licensed independently
- Noncompetition agreements

Instead, if a private company investor elects the intangible asset accounting alternative, it recognizes basis differences related to those intangible assets as equity method goodwill. An investor that elects the intangible asset accounting alternative must apply it consistently for all equity method investments and all business combinations.

A private company may also elect an accounting alternative to amortize goodwill on a straight-line basis over 10 years without justifying whether 10 years is an appropriate life. An investor that elects the intangible asset accounting alternative must also elect the goodwill amortization accounting alternative, but the inverse is not required. In other words, an investor may elect the goodwill amortization accounting alternative even if it does not elect the intangible asset accounting alternative.

As further discussed in Section 4.8, the investor evaluates equity method goodwill for impairment only as part of evaluating the equity method investment for impairment as a whole. In other words, an investor does not separately evaluate equity method goodwill for impairment. That differs from the accounting for goodwill recognized by a business combination, which is separately reviewed for impairment. The requirement to evaluate the equity method investment as a whole for impairment is not affected by electing either private company alternative.



## INVESTORS SHOULD BE CAUTIOUS WHEN ADOPTING PRIVATE COMPANY ACCOUNTING ALTERNATIVES

Before electing a private company accounting alternative, an investor should consider whether it will become a public business entity in the future. If so, it would have to unwind any private company accounting alternatives and retrospectively adjust its historical financial statements to apply U.S. GAAP for public business entities. That exercise may be costly and complex as time passes.

For example, on becoming a public business entity, an investor that previously adopted the alternative to amortize equity method goodwill would need to unwind the effects on its equity method investment income and reevaluate the timing and amounts of any impairments of its investment (or lack thereof) absent the accounting alternative. See Section 7.2 of our Blueprint, <u>Business Combinations Under ASC 805</u>, for guidance on those private company accounting alternatives.

# 3.3.2 Negative Basis Difference and Bargain Purchases



# **FASB REFERENCES**

ASC 323-10-35-13, ASC 323-10-35-34, ASC 805-30-25-2 through 25-4, and ASC 805-50-30-3 through 30-4

If the cost of an equity method investment (see Section 3.2) exceeds the investor's share of the fair value of the investee's identifiable net assets, and if the investee meets the definition of a business, that results in equity method goodwill, as discussed in Section 3.3.

However, sometimes the cost of an equity method investment is **less** than the investor's share of the carrying amount of the investee's identifiable net assets, resulting in a **negative basis difference**. That could result from a bargain purchase caused by, for example:

- ▶ A forced or distressed sale of the equity method investment
- ▶ A transaction that did not involve competitive bidding
- An increase in the fair value of the investee's net assets before the initial measurement of the investment

If the cost of an equity method investment is less than the investor's share of the carrying amount of the investee's net assets, the investor must reassess whether it correctly identified and measured all of the following:

- ▶ The investee's identifiable assets and liabilities
- ▶ The consideration transferred and transferable (for example, contingent consideration (see Section 3.2.2))
- ▶ Other transaction elements (for example, commitments issued on the investee's behalf and contingencies (see Section 3.2.3)).

The purpose of this reassessment is to determine whether the measurements appropriately reflect all available information as of the measurement date. If a negative basis difference persists after the reassessment, the investor must determine the appropriate accounting.

Aside from the general requirement for an investor to account for any basis differences for an equity method investee as if it were a subsidiary, ASC 323 does not specifically address negative basis differences. The EITF discussed this issue when deliberating EITF Issue No. 08-6 but did not reach a consensus.

#### **BDO INSIGHTS: ACCOUNTING FOR A NEGATIVE BASIS DIFFERENCE**

Diversity in practice exists in accounting for negative basis differences. There are two approaches applied in practice:

- ▶ The asset acquisition approach: This approach allocates the excess of the investor's share of the carrying amount of the investee's net assets over the cost of the investment (the negative basis difference) to the investee's qualifying assets on a relative fair value basis in the memo accounts. This approach is consistent with the cost accumulation model for asset acquisitions in ASC 805-50 and is acceptable even if the investee meets the definition of a business. See Appendix C.4.1 of our Blueprint, Business Combinations Under ASC 805, for guidance on this approach.
- ▶ The bargain purchase gain approach: This approach analogizes to the accounting for a business combination in ASC 805. We believe this approach is acceptable only when the investee meets the definition of a business and there is no contingent consideration in the arrangement (see Section 3.2.2) because ASC 323 discusses accounting for an equity method investment as if it were a subsidiary, and such approach would be acceptable if it met the definition of a business and were a subsidiary. Under this approach, the investor recognizes a bargain purchase gain upon recognition of the equity method investment but also recognizes more depreciation and amortization on higher basis differences when recognizing its equity method income (see Section 4.4).

An investor must consistently apply its accounting policy for negative basis differences.

# 3.3.3 Deferred Taxes on Equity Method Basis Differences



# **FASB REFERENCES**

ASC 323-10-35-13, ASC 740-10-25-49 through 25-52, and ASC 805-740-30-3

The phrase "basis difference" can be confusing when used in relation to equity method investments because the investor and investee use the term with other similar meanings:

- An investor recognizes deferred taxes in its financial statements in accordance with ASC 740, *Income Taxes*, for any temporary difference between the carrying amount and tax basis of its equity method investment of the investment as a whole. This "outside basis difference" changes each reporting period for corporate equity method investments, because the investor adjusts the U.S. GAAP carrying amount of its investment for its equity method income (see Chapter 4).
- An investee recognizes deferred taxes (subject to realizability for deferred tax assets) in its financial statements in accordance with ASC 740 for any temporary differences between the carrying amounts of its assets and liabilities and their tax bases (the "inside basis differences").
- An investor also identifies an "equity method basis difference" as if the investee were a consolidated subsidiary and allocates it to the investee's identifiable net assets in the memo accounts, as discussed in Section 3.3.

# BDO INSIGHTS: RECOGNIZING THE TAX EFFECTS OF EQUITY METHOD BASIS DIFFERENCES

Although not specifically addressed in ASC 323 or ASC 740, we believe an investor is implicitly required to also recognize the deferred tax consequences of equity method basis differences in the memo accounts rather than as separate deferred tax assets and liabilities in the investor's balance sheet, consistent with the one-line presentation of equity method investments.

We believe the offsetting entry in the memo accounts should be recognized as follows:

- ▶ If the investee meets the definition of a business in ASC 805, the offsetting adjustment is to equity method goodwill in the memo accounts (by analogy to ASC 805 and ASC 740).
- ▶ If the investee does **not** meet the definition of a business in ASC 805 (then by analogy to ASC 740-10-25-49 through 25-52), the offsetting adjustment is to qualifying assets (see Section 3.3.2) based on the relative fair values of those assets, similar to the accounting in an asset acquisition. However, this approach results in a circular equation because adjusting the qualifying assets changes the basis differences, which then changes the related deferred taxes. Therefore, the investor solves the circular equation by analogy to the simultaneous equation method in ASC 740.

# EXAMPLE 3-9: DEFERRED TAXES ON EQUITY METHOD BASIS DIFFERENCES WHEN INVESTEE IS A BUSINESS FACTS

Assume the same facts as in Example 3-8:

- ▶ On January 1, 20X1, Investor acquired 40% of Investee's voting common stock for \$800,000, which it accounts for using the equity method. For simplicity, assume there were no transaction costs. Investee meets the definition of a business in ASC 805.
- As of January 1, 20X1, the carrying amount and fair value of Investee's net assets were:

	CARRYIN	IG AMOUNT	FA	IR VALUE
Cash	\$	380,000	\$	380,000
Accounts receivable		300,000		300,000
Buildings		1,250,000		1,230,000
Customer list		_		15,000
IPR&D asset		_		60,000
Payables		(80,000)		(80,000)
Total identifiable net assets	\$	1,850,000	\$	1,905,000

- Investor does not have an outside basis difference between the investment's carrying amount and its tax basis.
- Investee does not have any deferred tax assets related to any inside basis differences in its financial statements.
- Investor and Investee have an effective tax rate of 18%.
- Investor treats the equity method goodwill as if it were goodwill acquired in a business combination for tax purposes.

# **CONCLUSION**

Investor initially measures the investment at \$800,000, which includes a deferred tax liability of \$3,960 and goodwill of \$41,960 in the memo accounts.

### **ANALYSIS**

- ▶ **Step 1:** The cost of the investment is \$800,000.
- Steps 2A and 2B: The table below illustrates how Investor calculated the identifiable basis differences in the equity method memo accounts.

	OF CARE	DR'S SHARE RYING Γ (40%) [A]	INVESTO OF FAIR (40%) [E		INVESTO DIFFERE [C]=[B-A		DEFERRI LIABILIT [D] = [C	Υ
Cash	\$	152,000	\$	152,000	\$	_	\$	_
Accounts receivable		120,000		120,000		_		_
Buildings		500,000		492,000		(8,000)		1,440
Customer list		_		6,000		6,000		(1,080)
IPR&D asset		_		24,000		24,000		(4,320)
Accounts payable		(32,000)		(32,000)		_		
Total	\$	740,000	\$	762,000	\$	22,000	\$	(3,960)

- **Step 2C:** The total basis difference is \$60,000, which is the difference between the cost of the investment of \$800,000 and Investor's share of the carrying amounts of Investee's net assets of \$740,000.
- **Step 2D:** Because Investee meets the definition of a business in ASC 805, Investor treats the equity method goodwill as if it were goodwill acquired in a nontaxable business combination:
  - Investor first recognizes the excess basis difference of \$38,000 (\$60,000 \$22,000) as equity method goodwill in its memo accounts.
  - Investor then recognizes a deferred tax liability of \$3,960 in the memo accounts, calculated by multiplying the identifiable basis differences of \$22,000 by the effective tax rate of 18%, which increases the equity method goodwill. Therefore, the total equity method goodwill is \$41,960 (\$38,000 + \$3,960).

# 3.3.4 Accumulated Other Comprehensive Income



# **FASB REFERENCES**

ASC 323-10-35-13 and ASC 323-10-35-18

As discussed in Section 3.3, an investor identifies basis differences and allocates the cost of the investment in the memo accounts as if the investee were a subsidiary. Thereafter, when recognizing its equity method income, the investor recognizes its share of the investee's income, adjusted for those basis differences (as applicable), as discussed in Section 4.4.

The investee may have assets or liabilities for which it recognizes changes in their carrying amounts in AOCI. For example, the investee might have available-for-sale (AFS) debt securities and derivatives designated as cash flow hedges. An investor generally recognizes its share of the investee's OCI each reporting period, as discussed in Section 4.6.

### BDO INSIGHTS: INVESTEE'S ACCUMULATED OTHER COMPREHENSIVE INCOME AND BASIS DIFFERENCES

Because the fair values of the investee's identifiable net assets in the investor's memo accounts at initial measurement already reflect any unrealized gains and losses previously recognized in the investee's AOCI, the investor does not recognize its share of the AOCI in the memo accounts at initial measurement. Rather, the investor separately tracks those unrealized gains and losses in its memo accounts and adjust its share of the investee's OCI.

## EXAMPLE 3-10: INVESTEE'S ACCUMULATED OTHER COMPREHENSIVE INCOME

## **FACTS**

- On January 1, 20X1, Investor acquired 30% of Investee's voting common stock for \$800,000, which it accounts for using the equity method. For simplicity, assume there were no transaction costs.
- Investee previously paid \$135,000 for an AFS debt security that has a fair value of \$160,000 at the Investor's acquisition date. Investee presents unrealized gains and losses on the AFS debt security in OCI until realized. Therefore, on the acquisition date, the carrying amount of the AFS debt security was \$160,000 and Investee's AOCI includes an unrealized gain of \$25,000.
- Investor determined there are no basis differences (the fair value of Investee's net assets equaled their carrying amounts).
- On June 30, 20X1, Investee sells the AFS debt security for \$160,000 and recognizes the unrealized gain of \$25,000 from AOCI in earnings (net income).
- For simplicity, this example ignores the effect of income taxes.

#### CONCLUSION

Investor initially measures its investment at \$800,000 and does not recognize its share of Investee's AOCI as a separate item in the memo accounts or in its financial statements. However, the unrealized gain affects Investor's equity method income when Investee sells the AFS debt security and realizes the gain.

#### **ANALYSIS**

- **Step 1:** The cost of the investment is \$800,000.
- ▶ Steps 2A 2D: There are no basis differences because Investor's share of the carrying amounts and fair values for Investee's AFS debt security are both \$48,000 (\$160,000 \* 30%), and there are no other basis differences.
  - However, because Investee previously recognized in AOCI the increase in the debt security's fair value, Investor must track that unrealized gain in the memo accounts (that is, \$7,500, which is the unrealized gain of \$25,000 \* 30%) so that it does not inadvertently recognize any part of the gain when realized.
- ▶ Therefore, upon Investee's sale of the AFS debt security, Investor does not recognize any part of the realized gain. Instead, Investor reduces its share of Investee's income by \$7,500 when recognizing its equity method income in the period when the AFS debt security is sold.

# 3.3.5 In-Process Research and Development



#### **FASB REFERENCES**

ASC 323-10-35-13, ASC 730-10-55-1 through 55-2, ASC 805-20-30-1

As discussed in Section 3.3, an investor identifies basis differences between its share of the carrying amounts and fair values for each of the investee's identifiable assets and liabilities, and allocates the cost of the investment in the memo accounts as if the investee were a subsidiary. That process includes identifying any basis differences related to assets not recognized by the investee but that would qualify for recognition (in the memo accounts) by the investor as if the investee were a subsidiary.

An investee may have IPR&D. An investor's accounting for its share of an investee's IPR&D at the acquisition date depends on several factors:

▶ Whether the investee meets the definition of a business in ASC 805: In a business combination, acquired IPR&D generally meets the separability criterion and is therefore recognized as an identifiable intangible asset at its acquisition-date fair value.

- ▶ Whether the IPR&D has an alternative future use: Acquired IPR&D in an asset acquisition is accounted for in accordance with ASC 730, Research and Development, which indicates that the amounts allocated to IPR&D are capitalized as an intangible asset and amortized as research and development expense only if the acquired IPR&D has an alternative future use. Conversely, if acquired IPR&D in an asset acquisition does not have an alternative future use, it must be expensed immediately.
- ▶ Whether the investee meets the definition of a joint venture in ASC 323: ASC 805-60 requires a joint venture (as defined in U.S. GAAP (see Section 1.4)) to recognize an IPR&D asset if it meets the separability criterion as an intangible asset at the date of the venture's formation, regardless of whether the joint venture meets the definition of a business. 8 However, that accounting applies only to IPR&D that exists on the joint venture's formation date; it does not apply to IPR&D developed by the joint venture after formation or to any increase in the IPR&D's fair value after joint venture formation. Investees that do not meet the definition of a joint venture cannot analogize to ASC 805-60.

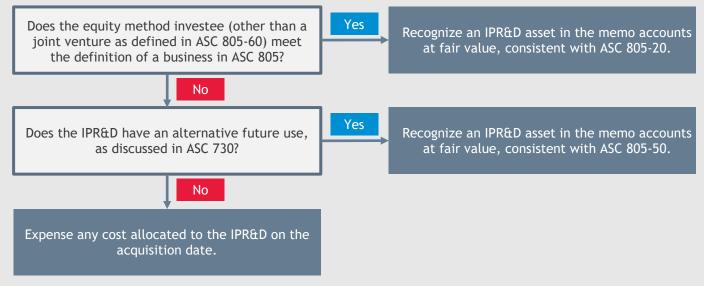
See our Blueprint, <u>Business Combinations Under ASC 805</u>, for guidance on the definition of a business, measuring and valuing IPR&D in a business combination and in an asset acquisition, and a joint venture's accounting at formation when applying ASC 805-60.

## BDO INSIGHTS: ACCOUNTING FOR BASIS DIFFERENCES RELATED TO IN-PROCESS RESEARCH AND DEVELOPMENT

Because ASC 805-60 creates unique IPR&D guidance for joint ventures that does not apply to other equity method investees, we believe the accounting for basis differences related to IPR&D depends on the investee's nature.

# Equity Method Investees (Excluding Joint Ventures as Defined in U.S. GAAP)

If an equity method investee that does not meet the definition of a joint venture has IPR&D (recognized or unrecognized), the investor's accounting for the IPR&D in the memo accounts depends on (1) whether the investee meets the definition of a business and (2) the IPR&D's characteristics, as discussed above. We believe an investor should apply that guidance as follows:



# Joint Ventures (as Defined in U.S. GAAP)

As discussed above, ASC 805-60 requires a joint venture to recognize an IPR&D asset at its formation date, regardless of whether it meets the definition of a business. Accordingly, when the joint venture meets the definition of a business, the investor also recognizes an IPR&D asset in the memo accounts at fair value, regardless of its alternative future use.

<sup>&</sup>lt;sup>8</sup> BC45 of ASU 2023-05. ASC 805-60 was effective prospectively for all joint ventures with a formation date on or after January 1, 2025. Early adoption is allowed in any interim or annual period in which financial statements have not been issued (or made available for issuance).

When the joint venture does **not** meet the definition of a business, we believe two views are acceptable:

- ▶ The investor recognizes an IPR&D asset in the memo accounts at fair value, regardless of its alternative future use. This view is based on the premise that the joint venture appropriately recognizes the IPR&D in its financial statements in accordance with ASC 805-60 and ASC 805-20 and the investor recognizes its share of that asset in the memo accounts.
- ▶ The investor uses the guidance in the flowchart above to determine whether to recognize an IPR&D asset in the memo accounts as it would for other equity method investments that do not meet the definition of a joint venture. This view is based on the premise that the FASB did not intend to change the accounting for investors when it issued ASC 805-60, and that before issuance of ASC 805-60, investors would have used the guidance in the flowchart to determine their accounting.

We believe an investor must consistently apply its accounting policy to all joint ventures that both (1) do not meet the definition of a business and (2) applied ASC 805-60.

# 3.3.6 Noncontrolling Interests in the Investee's Subsidiaries



## **FASB REFERENCES**

ASC 323-10-35-13 and ASC 810-10-45-15 through 45-16

An equity method investee may consolidate a non-wholly owned subsidiary for which the investee presents an NCI and 100% of the subsidiary's net assets in its consolidated financial statements, in accordance with ASC 810.

In that scenario, an investor has the right to share only in the investee's net assets attributable to the controlling interest (that is, to the parent, which is also the investee), not to the NCI.

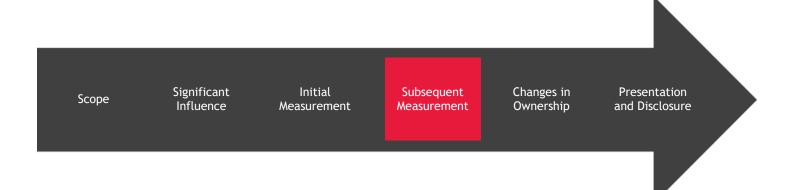
# BDO INSIGHTS: EXCLUDE NCI WHEN CALCULATING SHARE OF INVESTEE'S NET ASSETS

An investor must consider the NCI's share in the net assets of an investee's subsidiaries when determining the investor's share of the investee's net assets (both their carrying amounts and fair values).

For example, if an investor acquired 35% of an investee's voting common stock and accounts for that investment using the equity method, and that investee owned 70% of a subsidiary that held one asset with a carrying amount of \$3 million, the investor would calculate its share of the asset's carrying amount to be \$735,000 (35% \* \$3 million \* 70% (that is, the investor's share of the investee's equity, excluding the NCI)).

<sup>&</sup>lt;sup>9</sup> BC3 of ASU 2023-05.

# Chapter 4: Subsequent Measurement



# 4.1 OVERVIEW: SUBSEQUENT MEASUREMENT

Under the equity method, an investor recognizes its share of the investee's income (loss) when recognized by the investee in its financial statements (rather than when an investee declares a dividend), which increases (decreases) the investment. An investor's share of the investee's income generally is based on the investor's share of the investee's common stock. However, determining an investor's share of an investee's income can be challenging when returns, distributions, or dividends are not shared pro rata. It can also be challenging to determine an investor's share of the investee's income when the investee is accounted for on a lag, or has a different fiscal year-end, accounting policies, or functional currency (see Section 4.2).

An investor adjusts its share of the investee's income to:

- Eliminate intra-entity profit (see Section 4.3)
- ▶ Amortize basis differences (see Section 4.4)
- Recognize the investor's share of changes in the investee's capital (see Section 4.5)
- ▶ Report the investor's share of the investee's OCI (see Section 4.6).

In summary, an investor's equity method income is calculated as follows:



An investor generally recognizes equity method losses only up to the carrying amount of its investment. However, an investor continues recognizing losses to reduce its investment (and any other interests in the investee) below zero if it has guaranteed the investee's obligations; has provided, or is otherwise committed to provide, more financial support; or if the investee will imminently return to profitability. Otherwise, an investor accumulates any unrecognized equity method losses in its memo accounts. If the investee later recognizes income, the investor resumes recognizing equity method income only after its share of the investee's income equals the share of losses not recognized while the equity method was suspended (see Section 4.7).

An investor impairs its equity method investment when it has an other than temporary loss in value, even if the impairment is more than what the investor would otherwise recognize by applying the equity method. If there is an other than temporary impairment (OTTI), the investor remeasures the investment to fair value. Impairing an equity method investment can be even more challenging when there are basis differences, the investee recognizes an impairment or has a different functional currency, or the investor recognizes the investee's income on a lag. Determining whether an investment is other than temporarily impaired requires the application of professional judgment based on the facts and circumstances (see Section 4.8).

# 4.2 SHARE OF INVESTEE'S INCOME



#### **FASB REFERENCES**

ASC 323-10-20, Dividends and Earnings or Losses of an Investee, ASC 323-10-35-4, ASC 323-10-35-16, ASC 323-10-45-1 through 45-2, ASC 830-10-15-5, ASC 970-323-35-2, and ASC 970-323-35-8 through 35-10

ASC 323-10-20

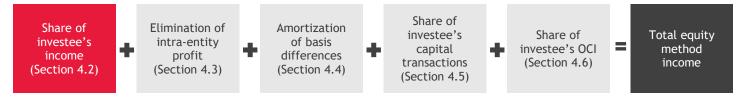
Dividends

Dividends paid or payable in cash, other assets, or another class of stock and does not include stock dividends or stock splits.

Earnings or Losses of an Investee

Net income (or net loss) of an investee determined in accordance with U.S. generally accepted accounting principles (GAAP).

As discussed in Section 4.1, an investor's equity method income is calculated as follows:



Under the equity method, an investor recognizes its share of the investee's income when recognized by the investee in its financial statements (rather than when an investee declares a dividend), which increases the investment. Similarly, when the investee recognizes a loss, the investor decreases the equity method investment for its share of the loss.

An investor's share of the investee's income generally is based on the investor's share of the investee's common stock. However, determining an investor's share of an investee's income can be challenging when returns, distributions, or dividends are not shared pro rata (see Section 4.2.1).

If an investor obtains an equity method investment during the middle of a reporting period, it begins recognizing equity method income from that date and does not retrospectively revise prior reporting periods. See Section 4.2.2 for reporting equity method income on a lag, and Section 4.2.3 when the investor and investee have differing fiscal year-ends. See Section 4.2.4 when the investee's accounting policies differ from those of the investor.

When the investee's functional currency differs from the investor's reporting currency, the investor translates the investee's financial statements into the investor's reporting currency as if the investee were a subsidiary in accordance with ASC 830, Foreign Currency Matters, before the investor recognizes any equity method income.

Under the equity method, an investor recognizes its share of the investee's income, as determined in accordance with U.S. GAAP, regardless of any unrealized increases in the fair values of the investee's assets (unless U.S. GAAP allows or requires the investee to recognize such unrealized gains in its own financial statements). However, an investor considers whether any unrealized decreases in the fair values of the investee's assets indicate the equity method investment as a whole is other than temporarily impaired (see Section 4.8), even if the investee is not required to recognize such decreases in accordance with U.S. GAAP.

An investor does not consider the effects of warrants, options, conversion rights, contracts, or other instruments that give the holder the ability to acquire common stock unless they qualify as in-substance common stock (see Section 1.2.1) when determining its share of the investee's income. In other words, an investor does not adjust its share of the investee's income to reflect additional ownership interests until exercising or converting such instruments. If the investee has outstanding cumulative preferred stock, an investor determines its share of income after deducting the preferred dividends, regardless of whether such dividends are declared or are payable in cash or stock.

Calculating an investor's share of an investee's income can also be challenging when the investor has an indirect interest in the investee (see Section 4.2.5).

An investor presents its share of income as a **single** amount in the income statement (see Section 1.5.4 for guidance on proportionate consolidation). However, the investor's share of accounting changes reported in the investee's financial statements is classified separately. In other words, if an investee recognizes a change in accounting principle and that change is separately presented on the investee's income statement, the investor would separately present its share of that change on its income statement. Similarly, if the investee recognizes a cumulative effect of adopting a new accounting principle as an adjustment to its retained earnings, the investor would separately present its share of that change (by adjusting the carrying amount of the equity method investment and the investor's retained earnings).

See Section 4.6 for guidance on recognizing the investor's share of the investee's OCI.

## EXAMPLE 4-1: CALCULATING AN INVESTOR'S EQUITY METHOD INCOME

#### **FACTS**

- On January 1, 20X1, Investor acquired 35% of Investee's voting common stock for \$1,000,000, which it accounts for using the equity method.
- ▶ Investee's net income for 20X1 is \$1,100,000 (determined in accordance with U.S. GAAP).
- For simplicity, assume there are no intra-entity transactions, basis differences, income taxes, or OCI.

### CONCLUSION

Investor's equity method income for 20X1 is \$385,000.

#### **ANALYSIS**

Investor's share of Investee's net income is \$385,000 (35% of \$1,100,000), which increases the equity method investment to \$1,385,000 (\$1,000,000 investment + \$385,000 equity method income).

# EXAMPLE 4-2: CALCULATING AN INVESTOR'S EQUITY METHOD INCOME WHEN INVESTEE HAS PREFERRED STOCK

## **FACTS**

Assume the same facts as in Example 4-1, except Investee also issued to other investors non-voting cumulative preferred stock that entitles those preferred investors to receive dividends of \$300,000 annually. The preferred stock is not in-substance common stock.

## **CONCLUSION**

Investor's equity method income for 20X1 is \$280,000.

# **ANALYSIS**

▶ Investor's share of Investee's net income is \$280,000 (35% of (\$1,100,000 — \$300,000)) after deducting cumulative preferred dividends due to the preferred investors. Therefore, Investor increases the equity method investment to \$1,280,000 (\$1,000,000 investment + \$280,000 equity method income).

# 4.2.1 Non-Pro-Rata Substantive Profit-Sharing and Hypothetical Liquidation at Book Value



## **FASB REFERENCES**

ASC 970-323-35-16

Venture agreements may designate different allocations among the investors for any of the following:

- a. Profits and losses
- b. Specified costs and expenses
- c. Distributions of cash from operations
- d. Distributions of cash proceeds from liquidation.

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. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

As discussed in Section 4.2, an equity method investor recognizes its share of the investee's income, which generally is based on the investor's share of the investee's equity, assuming the equity investors share in the income pro rata.

However, investees may issue classes or types of equity with differing voting or economic rights that are not pro rata. For example, an investee's contractual agreements (such as its preferred stock, LP, or LLC agreements) might have varying formulas for allocating income, specified costs and expenses, distributions of cash from operations, and distributions upon liquidation (that is, other than pro rata). Equity with preferential returns or liquidation provisions are common in LPs and LLCs with specific ownership accounts. For example, profit-sharing arrangements are common in (but not limited to) the industries below.



ASSET MANAGEMENT (see Section 4.2.1.2)



RENEWABLE ENERGY INVESTMENTS (see Section 4.2.1.3)



REAL ESTATE AND CONSTRUCTION



**EXTRACTIVE INDUSTRIES** 

When determining its equity method income, an investor must evaluate the substance of the arrangements to understand how changes in the investee's net assets (determined in accordance with U.S. GAAP) affect payments to the investor during the investee's life and upon its liquidation. For example, it may be inappropriate for the investor to use specified profit ratios to determine its equity method income if operating distributions and liquidating distributions are determined differently from those stated profit ratios. Likewise, if an investee's agreements allocate depreciation only to one investor but allocate all revenues, other expenses, and distributions to the investors equally, it generally is inappropriate to allocate depreciation using the stated ratios if they lack substance (given that distributions are equal).

## **BDO INSIGHTS: IDENTIFYING SUBSTANTIVE PROFIT-SHARING ARRANGEMENTS**

Reaching a conclusion about which waterfall provisions have substance and should be used when recognizing equity method income requires the application of professional judgment based on the facts and circumstances when the agreement has different waterfall provisions.

Additional complexity arises when the terms or provisions allocate profits using formulas that change over time or as various thresholds are reached, for example:

- ▶ 15% of profits in years 1 through 3 of the arrangement, then 5% thereafter.
- ▶ 20% of profits until a cumulative total is reached, then 2% thereafter.
- ▶ All profits until an 8% internal rate of return is reached, then pro rata thereafter.

When the formula used to allocate profits is not static, it is **inappropriate** to estimate a single blended rate or otherwise estimate profits that might be received in the future and consider the effects of those profits when calculating how much equity method income to recognize in the current period. To do so would account for events that have not occurred yet and could result in recognizing unearned income in the current period. Rather, an investor must determine which provisions are substantive and calculate equity method income using those stated provisions without forecasting or estimating future returns, as shown in Example 4-4.

U.S. GAAP does not specify how to calculate equity method income when investors disproportionately share income or net assets. However, an investor must consistently account for similar arrangements. One method used in practice is the hypothetical liquidation at book value (HLBV) method; other methods may be acceptable.

## BDO INSIGHTS: THE HLBV METHOD IS WIDELY USED IN PRACTICE, REGARDLESS OF INDUSTRY

HLBV was popularized in the proposed statement of position (the Proposed SOP), *Accounting for Investors' Interests in Unconsolidated Real Estate investments*. In the absence of other authoritative guidance, even though the method is not codified, it is widely used in practice to calculate equity method income when investors disproportionately share in profits or net assets for investees in many industries (not just real estate).

An investor calculates its equity method income using the HLBV method by asking: how much better (or worse) off is the investor at the end of the period than at the beginning of the period, considering only transactions and events recognized by the investee under U.S. GAAP? To answer that question, the investor first calculates what it would receive if the investee liquidated its assets at the balance sheet date at the amounts in its U.S. GAAP financial statements and distributed the resulting cash to creditors and investors in accordance with the substantive terms of the agreements. In that calculation, the investor does not include any costs that would be incurred upon such actions (for example, debt prepayment penalties). The amount an investor would receive from the process is the investor's claim on the investee's book value, the investor calculates its equity method income as follows:



<sup>&</sup>lt;sup>10</sup> Paragraph 19 of the Proposed SOP.

# EXAMPLE 4-3: (ADAPTED FROM EXAMPLE 2 OF THE PROPOSED SOP): HLBV METHOD WHEN ONE INVESTOR RECEIVES A PRIORITY RETURN

#### **FACTS**

- ▶ On December 31, 20X0, Investors A and B formed Investee (an LP), and acquired 50% of Investee's GP interests.
- Investor A acquired all the LP interests for \$4,000 and is entitled to a priority return of that capital and an annual return of 10% thereon (\$400). Thereafter, the GP interests share returns pro rata.
- Investee's equity in its U.S. GAAP financial statements on January 1, 20X1, and December 31, 20X1, was \$4,000 and \$6,000, respectively, because Investee's net income for 20X1 was \$2,000.
- Investee's net assets had a fair value of \$6,500 as of December 31, 20X1.
- ▶ The voting rights are pro rata with the GP interests. Neither Investor A nor Investor B controls the LP, so they each account for their interests using the equity method, as discussed in Section 1.3.1. Investors A and B also each determined that the profit-sharing provisions have substance.
- Neither investor received distributions nor contributed capital during 20X1.
- For simplicity, assume there are no intra-entity transactions, basis differences, income taxes, or OCI.

#### CONCLUSION

For 20X1, Investor A's equity method income is \$1,200 and Investor B's equity method income is \$800.

#### **ANALYSIS**

If Investee liquidated its net assets on December 31, 20X1, at the amounts in its U.S. GAAP financial statements, it would have \$6,000 available to distribute to its owners. The table below shows how such cash would have been distributed to the owners (that is, their claim on the investee's book value using its U.S. GAAP financial statements) based on the substantive terms and agreements.

	NET ASSETS		INVESTOR A		INVES	TOR B
Total net assets available to distribute	\$	6,000				
First, to the LP capital investment		(4,000)	\$	4,000	\$	_
Second, to the LP priority return		(400)		400		_
Third, pro rata to the GP interests		(1,600)		800		800
Total claim on book value at year-end	\$	_	\$	5,200	\$	800

▶ If Investee liquidated its net assets on January 1, 20X1, at the amounts in its U.S. GAAP financial statements, it would have \$4,000 available for its owners. The table below shows how such cash would have been distributed to the owners, based on the substantive terms of terms and agreements.

	NET ASSETS	INVESTOR A	INVESTOR B
Total net assets available to distribute	\$ 4,000		
First, to the LP capital investment	(4,000)	\$ 4,000	\$ -
Second, to the LP priority return (none, because 20X1 had not yet started)	_	_	_
Third, pro rata to the GP interests	_	_	_
Total claim on book value at beginning of year	\$ -	\$ 4,000	\$ -

- ▶ Investor A's equity method income is \$1,200 (its claim on Investee's book value of \$5,200 at the end of the period + \$0 distributions received \$0 capital contributions \$4,000 claim on Investee's book value at the beginning of the period).
- ▶ Investor B's equity method income is \$800 (its claim of \$800 on Investee's book value at the end of the period + \$0 distributions received \$0 capital contributions \$0 claim on Investee's book value at the beginning of the period).
- The fair value of Investee's net assets is irrelevant when applying the HLBV method.

# EXAMPLE 4-4: RECOGNIZING EQUITY METHOD INCOME WHEN RETURNS CHANGE OVER TIME

#### **FACTS**

- Assume the same facts as in Example 4-3, except Investor A's priority return of 10% applies only to 20X1. Thereafter, the priority return is 5% annually (\$200), regardless of the actual return in 20X1 (that is, the return is not cumulative).
- ▶ Investee's equity on December 31, 20X2, was \$6,500 because its net income for 20X2 was \$500.
- ▶ Neither Investor A nor Investor B received distributions nor contributed capital during 20X2.

#### CONCLUSION

For 20X1, Investor A's equity method income is \$1,200 and Investor B's equity method income is \$800. For 20X2, Investor A's equity method income is \$350 and Investor B's equity method income is \$150.

## **ANALYSIS**

- See Example 4-3 for the calculation of the investors' claim on book value on January 1, 20X1, and December 31, 20X1, and the equity method income during 20X1. Investor A's 10% priority return in 20X1 is respected and not blended with the 5% priority return in 20X2 because the provisions have substance and are not cumulative.
  - It would be inappropriate for either investor to estimate future equity method income to be received over Investee's life or a blended rate. For example, even though Investor A's average equity method income was \$750 per year ((\$1,200 in 20X1 + \$300 in 20X2) / 2), it would be inappropriate for Investor A to defer any equity method income from 20X1 to 20X2 or calculate a blended return.
- ▶ If Investee liquidated its net assets on December 31, 20X2, at the amounts in its U.S. GAAP financial statements, it would have \$6,500 available to distribution to its owners. The table below shows how such cash would have been distributed to the owners (that is, their claim on the investee's book value using its U.S. GAAP financial statements) based on the substantive terms and agreements.

	NET	ASSETS	INVE	STOR A	INVE	STOR B
Total net assets available to distribute	\$	6,500				
First, to the LP capital investment		(4,000)	\$	4,000	\$	_
Second, to the LP priority return (\$400 for 20X1 and \$200 for 20X2)		(600)		600		_
Third, pro rata to the GP interests		(1,900)		950		950
Total claim on book value at year-end	\$	_	\$	5,550	\$	950

- ▶ Investor A's equity method income in 20X2 is \$350 (its claim on Investee's book value of \$5,550 at the end of the period + \$0 distributions received \$0 capital contributions \$5,200 claim on Investee's book value at the beginning of the period from Example 4-3).
- ▶ Investor B's equity method income is \$150 (its claim on Investee's book value of \$950 at the end of the period + \$0 distributions received \$0 capital contributions \$800 claim on Investee's book value at the beginning of the period from Example 4-3).

### 4.2.1.1 HLBV: Basis Differences



## **FASB REFERENCES**

ASC 323-10-35-13

As discussed in Section 4.1, an investor's equity method income is calculated as follows:



As discussed in Sections 3.3 and 4.4, an investor accounts for the basis difference between the investor's share of the investee's net assets and the cost of an equity method investment as if the investee were a subsidiary. The investor then depreciates or amortizes the basis difference as an adjustment to equity method income over the assets' useful lives, if applicable.<sup>11</sup>

#### BDO INSIGHTS: ACCOUNTING FOR BASIS DIFFERENCES WHEN USING HLBV

Two approaches used to account for basis differences under the HLBV method are:

- ▶ The recast approach: The investor "recasts" the investee's financial statements to show the investor's basis, which it uses when applying the HLBV method. An investor may use the recast approach when the investee has a negative net worth under U.S. GAAP, or the investment has a liquidation preference. ¹²
- The two-component approach: The investor accounts for the investment as if it consists of two components: (1) the investor's claim on the investee's book value, and (2) the basis difference (the difference between the first component and the total investment). An investor cannot use this approach when the investee has negative net worth under U.S. GAAP, or the investment has a liquidation preference. Because of those limitations, this Blueprint does not discuss the two-component approach, but the proposed SOP includes an example.<sup>13</sup>

Other approaches might be acceptable.

# EXAMPLE 4-5: (ADAPTED FROM EXAMPLE 8 OF THE PROPOSED SOP): HLBV METHOD AND THE RECAST APPROACH FACTS

- Investee is an LP, which, before Investor A's involvement, was a wholly owned subsidiary of Investor B and held only a building.
- ▶ On January 1, 20X1, Investor A acquired 50% of Investee's GP interests for \$0. Investor A also acquired all the LP interests for \$10,000 and is entitled to a priority return of that capital and an annual return of 10% thereon (\$1,000). Thereafter, the GP interests share returns pro rata.
- ▶ The voting rights are pro rata with the GP interests. Neither Investor A nor Investor B controls the LP, so they each account for their interests using the equity method, as discussed in Section 1.3.1. Investors A and B also each determined the profit-sharing provisions have substance.
- ▶ Neither investor received distributions nor contributed any other capital during 20X1.
- For simplicity, assume there are no intra-entity transactions, income taxes, or OCI.

<sup>&</sup>lt;sup>11</sup> If the basis difference is negative, the investor accretes such amount over the assets' useful lives, if applicable (see Section 4.4).

<sup>&</sup>lt;sup>12</sup> Paragraphs 30-32 of the Proposed SOP.

<sup>&</sup>lt;sup>13</sup> Paragraphs 33-35 of the Proposed SOP.

▶ The book values and fair values of Investee's assets on January 1, 20X1, were:

JANUARY 1, 20X1	BOOK VALUE		FAIR VA	LUE
Cash	\$	10,000	\$	10,000
Building (10-year useful life)		6,000		10,000
Equity	\$	16,000	\$	20,000

▶ Before the \$600 of building depreciation (over a 10-year useful life), Investee's income for 20X1 was \$2,000. That results in net income of \$1,400, which brings Investee's total cash to \$12,000 (\$10,000 + \$2,000) on December 31, 20X1. Accordingly, the book values of Investee's assets on December 31, 20X1, were:

DECEMBER 31, 20X1	BOOK VALUE	
Cash	\$ 12	2,000
Building	Ę	5,400
Equity	\$ 17	7,400

## CONCLUSION

For 20X1, Investor A's equity method income is \$1,000 and Investor B's equity method income is \$0.

## **ANALYSIS**

First, Investor A would recast Investee's balance sheet as of December 31, 20X1, as:

DECEMBER 31, 20X1	RECAST	AMOUNTS
Cash	\$	12,000
Building (fair value of \$10,000 - depreciation of \$1,000 using a 10-year useful life)		9,000
Equity	\$	21,000

- Therefore, Investee's recast net income for 20X1 is \$1,000 (income before depreciation of \$2,000 depreciation of \$1,000).
- If Investee liquidated its net assets on December 31, 20X1, at the recast amounts, it would have \$21,000 available to distribute to its owners. The table below shows how such cash would have been distributed to the owners (that is, their claim on Investee's book value using its recast U.S. GAAP financial statements) based on the substantive terms and agreements.

DECEMBER 31, 20X1	NET AS	SETS	INVESTO	R A	INVESTO	R B
Net assets available to distribute	\$	21,000				
First, to the LP capital investment		(10,000)	\$	10,000	\$	_
Second, to the LP priority return (10%)		(1,000)		1,000		_
Third, pro rata to the GP interests		(10,000)		5,000		5,000
Claim on book value at year-end	\$	_	\$	16,000	\$	5,000

If Investee liquidated its net assets on January 1, 20X1, at the recast amounts, it would have \$20,000 available to distribute to its owners. The table below shows how that cash would have been distributed to the investors based on the substantive terms and agreements.

JANUARY 1, 20X1	NET ASSETS		INVESTOR A		INVESTO	R B
Net assets available to distribute	\$	20,000				
First, to the LP capital investment		(10,000)	\$	10,000	\$	_
Second, to the LP priority return (none, because 20X1 had not yet started)		_		_		_
Third, pro rata to the GP interests		(10,000)		5,000		5,000
Claim on book value at beginning of year	\$	_	\$	15,000	\$	5,000

- ▶ Investor A's equity method income is \$1,000 (Investor A's claim on Investee's book value at the end of the period of \$16,000 + \$0 distributions received \$0 capital contributions \$15,000 claim on Investee's book value at the beginning of the period).
- ▶ Investor B's equity method income is \$0 (Investor B's claim on Investee's book value at the end of the period of \$5,000 + \$0 distributions received \$0 capital contributions \$5,000 claim on Investee's book value at the beginning of the period).

### 4,2,1,2 HLBV: Carried Interest and Incentive-Based Capital Allocations

#### BDO INSIGHTS: ACCOUNTING FOR INCENTIVE-BASED CAPITAL ALLOCATIONS SUCH AS CARRIED INTEREST

In some industries (such as asset management and private equity) a GP receives carried interest, which are fees that compensate the GP based on the investee's (fund's) performance for services and performance in managing the funds. In those arrangements, the GP generally receives disproportionately more of the investee's returns after the LPs receive a stated return. For example, a GP may receive 20% of the investee's returns after the LPs receive a 10% return on their investments. Terms and structures vary: The carried interest may be stated in the fee arrangement or embedded in the GP's equity. In many cases, the GP receives those performance-based returns as an increase to its capital account.

At its April 2016 meeting, the FASB and International Accounting Standards Board Joint Transition Resource Group for Revenue Recognition (TRG) discussed whether such carried interest is within the scope of ASC 606. Multiple TRG members and FASB staff and members concluded that those fees are within the scope of ASC 606 because they are compensation for services provided and hence are revenue.

However, some TRG members held an alternate view that a carried interest could be considered an equity arrangement outside the scope of ASC 606 because it is, in form, an ownership interest in an entity. Under that view, an entity receiving a carried interest would apply the consolidation model in ASC 810, equity method accounting in ASC 323, or other U.S. GAAP to determine the appropriate accounting treatment for the ownership interest held in another entity.

At that meeting, the SEC staff observer indicated that the SEC staff would accept treatment of carried interest as revenue within the scope of ASC 606. However, the SEC staff observer said there may also be a basis for applying an ownership model. If an entity were to apply an ownership model, the SEC staff would expect full application of the ownership model, including an analysis of control in accordance with ASC 810, the equity method (if the GP does not control the investee, as discussed in Section 1.3.3), or other relevant guidance.

We believe determining whether to account for a carried interest as revenue or as an equity arrangement is an accounting policy election that must be consistently applied and fully disclosed.

See our Blueprints, Revenue Recognition Under ASC 606, for guidance on carried interests under that standard, and Control and Consolidation Under ASC 810, for guidance on identifying a controlling financial interest in a fund. If a GP does not control a fund and applies the equity method to its GP interests as discussed in Section 1.3.4, it must determine an appropriate method (for example, HLBV) for measuring its equity method income, considering the non-pro-rata profit sharing attributable to the carried interest. Accounting for carried interests requires the application of professional judgment based on the facts and circumstances.

### 4.2.1.3 HLBV: Tax Equity Investments

## BDO INSIGHTS: ACCOUNTING FOR TAX EQUITY INVESTMENTS USING HLBV

As discussed in Section 1.5.2, income tax credits may be used to encourage investments in specific industries (for example, renewable energy projects). If the project entity is eligible for a tax credit (or other tax benefit) but the sponsor does not plan to use the credit, the sponsor may sell some of the project entity's equity to a third party (the tax equity investor), which entitles that party to use the credits received by the project entity.

The sponsor, tax equity investor, and other investors must first determine the applicable accounting model (for example, whether they control the project entity or are eligible to elect the proportional amortization method). If

the sponsor, tax equity investor, or other investor applies the equity method (considering the guidance in Chapters 1 and 2), it must then determine an appropriate method (for example, HLBV) for measuring equity method income, considering the non-pro-rata profit sharing attributable to its equity interests.

In our experience, the GP (sponsor) generally receives disproportionately more of the investee's (project entity's) operational cash flows, and the tax equity investor receives its return mostly through the sole right to claim the tax credit (or other tax benefits). However, terms and structures vary. The rights to the operational cash flows may "flip" from one party to the other after the tax equity investor receives a stated return (hence the name "partnership flip structures").

Because of the disproportionate sharing of operational cash flows and tax credits and other tax benefits, it may be appropriate for an investor to use HLBV if it has an equity method investment. Reaching a conclusion about whether the arrangements are substantive and determining the accounting requires the application of professional judgment based on the facts and circumstances. An investor also must consider the interaction between the equity method and tax accounting, which can be complex.

# 4.2.2 Equity Method Accounting on a Lag



## **FASB REFERENCES**

ASC 323-10-35-6 and ASC 810-10-45-12 through 45-13

If an investee's financial statements are not available in time for an investor to apply the equity method, the investor may use the investee's most recent financial statements to determine its share of the investee's income. In other words, an investor may recognize its equity method income on a lag. The reporting lag must be consistent from period to period for an equity method investment but may vary across investees. By analogy to the guidance for consolidating subsidiaries on a lag, the longest acceptable lag is about three months.

An investor cannot recognize equity method income for any investee's reporting period before the investor acquired the investment. Therefore, in the first period after acquisition, an investor may not recognize equity method income when reporting on a lag. Similarly, an investor also cannot recognize equity method income for the investee's reporting periods after it stops equity method accounting (whether because of sale or loss of significant influence). Therefore, an investor cannot recognize equity method income for the investee's last reporting period when reporting on a lag. Example 4-6 illustrates those concepts.

Any change to a previously existing reporting lag for an equity method investee is a change in accounting principle. Although ASC 250, *Accounting Changes and Error Corrections*, generally requires retrospective application of a voluntary change in accounting principle, retrospective application is not necessary if impracticable (as defined in ASC 250).

## BDO INSIGHTS: EVALUATING INTERVENING EVENTS WHEN ACCOUNTING FOR AN INVESTEE ON A LAG

When a parent consolidates a subsidiary with a different fiscal year-end, ASC 810 specifies that any intervening events that materially affect the subsidiary must be recognized by disclosure or otherwise. By analogy, we believe an investor may elect a policy of whether to disclose or recognize intervening events for its equity method investments, which it must consistently apply.

That said, an investor must be careful not to double count the effects of intervening events when the investee recognizes such events, and those financial statements are included (on a lag) in the investor's equity method income in the next reporting period. An investor that elects to recognize intervening events would therefore need to adjust its share of the investee's income to avoid recognizing the same event twice. Accordingly, a disclosure (only) policy may be easier to apply in practice. Regardless of which policy it chooses, an investor evaluates whether the investment is other than temporarily impaired based on its balance sheet date (see Section 4.8.3).



# CONSIDER THE ABILITY TO REPORT ON A LAG WHEN EVALUATING SIGNIFICANT INFLUENCE

As discussed in Section 2.2, if an investor needs more financial information to apply the equity method or tries to obtain that information and fails, it might lack the ability to exercise significant influence over an investee, in which case the investor would not apply the equity method. However, when evaluating whether it lacks the ability to exercise significant influence because of the inability to get (timely) financial information, the investor must consider the fact that ASC 323 allows the investor to apply the equity method on a lag of up to about three months.

# EXAMPLE 4-6: REPORTING EQUITY METHOD INCOME ON A LAG

#### **FACTS**

- Investor has a December 31 year-end and must issue annual and interim U.S. GAAP financial statements by a specified date.
- ▶ On June 30, 20X1, Investor acquires an equity method investment in Investee, which also has a December 31 year-end. However, Investee will not provide U.S. GAAP financial statements for the period ending December 31 in time for Investor to meet its deadline. Therefore, Investor elects to apply the equity method using a three-month lag.
- ▶ On March 31, 20X2, Investor sells the equity method investment.

## **CONCLUSION AND ANALYSIS**

- For its quarter ended September 30, 20X1, Investor presents the equity method investment on its balance sheet but does not include any equity method income for that quarter. That is because it did not have an investment for Investee's quarter ended June 30, 20X1, and is using a three-month lag.
- ▶ For its quarter ended December 31, 20X1, Investor presents the equity method investment on its balance sheet and recognizes equity method income based on Investee's quarter ended September 30, 20X1.
- For its quarter ended March 31, 20X2, Investor does not present the equity method investment on its balance sheet because it sold the investment on that date. However, it recognizes equity method income based on the Investee's quarter ended December 31, 20X1, as well as any gain or loss on selling the investment (see Section 5.3.4).
- ▶ For its quarter ended June 30, 20X2, Investor does not recognize any equity method income for Investee's quarter ended March 31, 20X2, even though Investor never reported those results because it sold the investment on March 31, 20X2.

# 4.2.3 Different Fiscal Year-Ends for an Equity Method Investment



# **FASB REFERENCES**

ASC 810-10-45-12 and 45-13

An investee and investor may have different fiscal year-ends. While ASC 323 does not address that situation, ASC 810 states that if the difference between a parent' and subsidiary's year-ends is no more than about three months, it generally is acceptable for the parent to perform its consolidation using the subsidiary's financial statements. By analogy, when an investor and investee have different fiscal year-ends, the information used by the investor to apply the equity method must have a difference of no more than about three months.

For example, consider a fact pattern in which the investee and investor have year-ends of December 31 and March 31, respectively. The investee provides quarterly and annual financial statements to the investor.

- If the investee's March 30 quarterly financial statements are available to the investor on a timely basis, the investor uses that information (and the three preceding quarters) to calculate its equity method income for the year ended March 30.
- If the investee's March 30 quarterly financial statements **are not** available to the investor on a timely basis, the investor use the investee's financial statements for the quarter ended December 31 (and the three preceding quarters) to calculate its equity method income for the year ended March 30.

See Section 4.2.2 for discussion of the effects of such differences in the periods of acquisition and sale.

Any change to an **investee's** fiscal year-end is a change in accounting principle. Although ASC 250 generally requires retrospective application of a voluntary change in accounting principle, retrospective application is not necessary if impracticable (as defined in ASC 250). However, this guidance does not apply when the **investor** changes its fiscal year-end (see ASC 250 provides separate guidance for that circumstance).

#### BDO INSIGHTS: EVALUATING INTERVENING EVENTS WHEN AN INVESTEE HAS A DIFFERENT FISCAL YEAR-END

When a parent consolidates a subsidiary with a different fiscal year-end, ASC 810 states that any intervening events that materially affect the subsidiary must be recognized by disclosure or otherwise. By analogy, we believe an investor may elect a policy of whether to disclose or recognize intervening events for its equity method investments, which it must consistently apply.

That said, an investor must be careful not to double count the effects of intervening events when the investee recognizes such events, and those financial statements are included (on a lag) in the investor's equity method income in the next reporting period. An investor that elects to recognize intervening events would therefore need to adjust its share of the investee's income to avoid recognizing the same event twice, so electing a disclosure (only) policy may be easier to apply in practice. Regardless of which policy it chooses, an investor evaluates whether the investment is other than temporarily impaired at its balance sheet date (see Section 4.8.3).



# CONSIDER ABILITY TO USE DIFFERENT FISCAL YEAR-ENDS WHEN EVALUATING SIGNIFICANT INFLUENCE

As discussed in Section 2.2, if an investor needs more financial information to apply the equity method or tries to obtain that information and fails, it might lack the ability to exercise significant influence over an investee, in which case it does not apply the equity method. However, when evaluating whether the investor lacks the ability to exercise significant influence because of the inability to get (timely) financial information, the investor must consider the fact that it can use the equity method investee's financial statements when the investee has a different fiscal year-end if that difference is no more than about three months.

# 4.2.4 Different Accounting Policies



# **FASB REFERENCES**

ASC 323-10-20: Earnings or Losses of an Investee, ASC 323-10-25-7, and ASC 970-323-35-20

ASC 323 defines an investee's earnings or losses as an investee's net income (or net loss) determined in accordance with U.S. GAAP. Therefore, an investor and investee are not required to have the same accounting policies (for example, last-in, first-out (LIFO) versus first-in, first-out (FIFO) if those policies comply with U.S. GAAP. An investor also retains any industry-specific guidance applied by its investee.

In fact, an investor generally **cannot** conform its investee's accounting policies to its own policies, except for in some fact patterns with respect to private company accounting alternatives (see Section 4.2.4.1). Similarly, an investor **cannot** adjust the timing of an investee's adoption of an accounting standard (see Section 4.2.4.2).

However, if an investee does not prepare financial statements in accordance with U.S. GAAP (for example, it applies IFRS or tax basis accounting), the investor must adjust the investee's financial statements to conform to U.S. GAAP before applying the equity method and recognizing equity method income.

# 4.2.4.1 Private Company Accounting Alternatives



## **FASB REFERENCES**

ASC 323-10-20: Private Company

An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

ASC 323-10-20: Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

The table below describes some private company accounting alternatives (PCAAs).

#### TOPIC DESCRIPTION OF PRIVATE COMPANY ACCOUNTING ALTERNATIVE **GUIDANCE** Amortization of goodwill on a straight-line basis over 10 years See Section 7.2 of our Goodwill and (or less than 10 years if the investor demonstrates that another Blueprint, Business Intangible useful life is more appropriate) **Combinations Under ASC 805** Assets Evaluation of goodwill impairment triggering events only as of the end of each reporting period, whether the reporting period is an interim or annual period Nonseparation of specific customer-related intangible assets and noncompetition agreements from goodwill Consolidation Nonapplication of the VIE model to legal entities if specific See Section 1.4.5 of our conditions are met Blueprint, Control and **Consolidation Under ASC 810**

When an investee elects a PCAA, the investor must determine whether it is a public business entity (PBE) and, if so, under which criterion of that definition. That determination affects whether the investor must (or can) conform the investee's accounting policies to its own, as shown in the chart below, which is adapted from AICPA guidance.<sup>14</sup>

		INVESTOR	
	PBE UNDER CRITERION (A)	PBE UNDER ANY OF CRITERIA (B) THROUGH (E)	NOT A PBE
PBE Investee	Neither the investor nor inve	stee can elect a PCAA.	<ul> <li>The investor can elect a PCAA.</li> <li>The investee cannot elect a PCAA.</li> <li>The investor cannot conform the investee's accounting policy to its own when applying the equity method.</li> </ul>
	The investee may elect a PC	AA in its own financial stateme	ents.
Non-PBE Investee	An investor that meets the definition of a PBE in criterion (A) must adjust the investee's income to reverse the effects of the PCAA when recognizing its equity method income.	An investor that meets the definition of a PBE in criteria (B) through (E) that is not a PBE may (but is not required to) conform the investee's accounting policies to the investor's own policies only when reversing the PCAA election. In other words, an investor that did not (or was not eligible to) elect a PCAA may reverse the PCAA's effects in the investee' financial statements when calculating its equity method income. However, the investor cannot conform any of the investee's other accounting policies to its own policies (for example, the investor could not conform the investee's policies for revenue recognition to its own revenue recognition policies). 15	

An investee may meet the definition of a PBE in criterion (A) even if it is not itself a registrant with the SEC or does not issue publicly traded securities. An investor or investee may be a PBE solely because its financial statements or financial information are included in a filing with the SEC. For example, an investee is a PBE under criterion (A) when an investor provides the investee's financial statements or financial information in the investor's SEC filings because of one or any of the following:

<sup>&</sup>lt;sup>14</sup> AICPA Q&A 7100.08, "Application of the Definition of a Public Business Entity When Entities Are Organized in Tiered Organizational Structures (Parent, Consolidated Subsidiaries, Nonconsolidated Entities, Guarantors, Equity Method Investees)" <sup>15</sup> Also, an investor that is not a PBE and that elected a PCAA may not calculate its equity method income as if the investee had elected a PCAA (that is, the investor may not conform the investee's policy to its own policy) if the investee itself did not elect a PCAA in its own financial statements.

- ▶ The equity method investee is significant in accordance with Rule 3-09 of Regulation S-X
- ▶ The acquisition of an equity method investment is significant in accordance with Rule 3-05 of Regulation S-X
- The equity method investee is significant (individually or in the aggregate with other equity method investments) in accordance with Rule 4-08(g) of Regulation S-X.

An investor and investee must determine whether they meet the definition of a PBE and whether the election (or reversal of elections) of a PCAA is allowed or required.



# REVERSING AN INVESTEE'S ELECTION OF A PRIVATE COMPANY ACCOUNTING ALTERNATIVE

A private company that becomes a PBE (as defined in U.S. GAAP) can no longer apply a PCAA, with no transition relief. An investor recognizes such a change in accordance with ASC 250 and retrospectively adjusts its financial statements to reverse the effects of electing a PCAA, which could be complex. Accordingly, a private company should consider this possibility and the effort that would be involved when electing alternatives and deciding whether to conform an investee's policies.

# 4.2.4.2 Effective Dates for Adopting Accounting Standards Updates



# **FASB REFERENCES**

ASC 323-10-20: Private Company, Public Business Entity

Most accounting standards updates include a deferred effective date for private companies (as defined in U.S. GAAP) compared to the date required for PBEs. Accordingly, whether an investor and investee meet the definition of a PBE (and, if so, under which criterion) determines their effective dates for adopting an accounting standard update. See Section 4.2.4.1 for the definitions of private company and PBE.

The chart below, adapted from AICPA guidance, <sup>16</sup> describes various scenarios.

			INVESTOR
	PBE UNDER CRITERION (A)	PBE UNDER ANY OF CRITERIA (B) THROUGH (E)	NOT A PBE
PBE Investee	The investor and use deferred eff	I investee generally cannot ective dates. <sup>17</sup>	<ul> <li>The investee is a PBE and generally cannot use deferred effective dates. <sup>17</sup></li> <li>The non-PBE investor can use the deferred effective date but cannot conform the investee's PBE effective date to the investor's date when recognizing equity method income.</li> </ul>
Non-PBE investee			nvestee's financial statements and the investor's recognitic quired or allowed even if the investor meets the definition

<sup>&</sup>lt;sup>16</sup> See Note 14.

<sup>&</sup>lt;sup>17</sup> Emerging growth companies can defer adopting accounting standards updates until non-PBEs must comply.

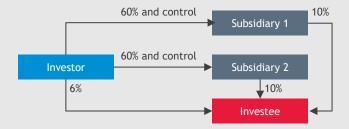
# 4.2.5 Indirect Interests: Applying the Equity Method

As discussed in Section 2.4.1, an indirect interest is one in which the investor has an economic interest from an investee through another legal entity (for example, a subsidiary or an equity method investee). If an investor has the ability to exercise significant influence over the investee, it uses the equity method to account for those indirect interests.

# EXAMPLE 4-7: DIRECT INTEREST AND INDIRECT INTEREST THROUGH SUBSIDIARIES: APPLYING THE EQUITY METHOD

#### **FACTS**

- ▶ On 1 January, 20X1, Investor acquired 6% of the voting common stock of Investee, a corporation.
- Investor controls Subsidiaries 1 and 2 and holds 60% of each corporation's voting common stock.
- ▶ Also on 1 January 20X1, Subsidiaries 1 and 2 each acquired 10% of Investee's voting common stock.
- Investor accounts for its interest in Investee using the equity method (see Example 2-4).
- Investee's net income for 20X1 is \$3,000,000.
- For simplicity, assume there are no intra-entity transactions, basis differences, income taxes, or OCI.



# **CONCLUSION**

Investor's equity method income is \$780,000.

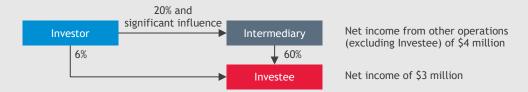
## **ANALYSIS**

- ▶ Investor controls 26% (10% + 10% + 6%) of Investee's voting common stock. Therefore, its equity method income from Investee is \$780,000 (\$3,000,000 \* 26%) before attribution to the NCI in Subsidiaries 1 and 2 because it consolidates 100% of the subsidiaries' equity method income.
- ▶ However, Investor includes \$120,000 for each of the subsidiaries (40% \* \$3,000,000 \* 10%), or \$240,000 in total, in the net income attributable to the NCI.

			ATTRIBUTABLE TO			
	TOTAL		NCI	(40%)	CONTROLLING INTE	REST (60%)
Subsidiary 1's equity method income from Investee (\$3,000,000 * 10% = \$300,000)	\$	300,000	\$	120,000	\$	180,000
Subsidiary 2's equity method income from Investee (\$3,000,000 * 10% = \$300,000)		300,000		120,000		180,000
Investor's direct equity method income from Investee (\$3,000,000 * 6% = \$180,000)		180,000		_		180,000
Total	\$	780,000	\$	240,000	\$	540,000
			•			

# EXAMPLE 4-8: DIRECT INTEREST AND INDIRECT INTEREST THROUGH AN EQUITY METHOD INVESTEE'S SUBSIDIARY FACTS

- ▶ On January 1, 20X1, Investor acquired 6% of the voting common stock of Investee, a corporation.
- Also on January 1, 20X1, Investor acquired 20% of Intermediary's voting common stock, which it accounts for using the equity method. Intermediary controls Investee and holds 60% of Investee's voting common stock.
- Investor accounts for its interest in Investee using the equity method (see Example 2-5).
- Investee's net income for 20X1 was \$3,000,000 and Intermediary's net income from its other operations (excluding Investee) is \$4,000,000. Therefore, Intermediary's total net income is \$7,000,000.
  - \$1,200,000 (\$3,000,000 \* 40%) is attributable to the NCI in Investee (including the 6% held by Investor).
  - \$5,800,000 (\$3,000,000 \* 60% from Investee = \$1,800,000 + \$4,000,000 from Intermediary's other operations) is attributable to the controlling interest in Intermediary.
- For simplicity, assume there are no intra-entity transactions, basis differences, income taxes, or OCI.



#### CONCLUSION

Investor's equity method income directly from Investee and from Intermediary (inclusive of the indirect interest in Investee) are \$180,000 and \$1,160,000, respectively.

### **ANALYSIS**

- Investor directly holds 6% of Investee's voting common stock; therefore, its equity method income from Investee is \$180,000 (\$3,000,000 \* 6%), excluding the indirect interest held through Intermediary.
- Intermediary's net income attributable to the controlling interest includes its 60% interest in Investee. Investor's equity method income from Intermediary is \$1,160,000 (\$5,800,000 \* 20%). Intermediary's results require no adjustment.

# 4.3 ELIMINATION OF INTRA-ENTITY PROFIT



As discussed in Section 4.1, an investor's equity method income is calculated as follows:



Intra-entity transactions between an investor and investee may downstream (a sale by the investor to the investee) or upstream (a sale by the investee to the investor).

An investor generally must eliminate intra-entity profit for an equity method investment as if the investee were consolidated, but only until the profit is realized. Therefore, an investor generally only eliminates intra-entity profit on assets still held by the investor or the investee. Once the asset is sold to a third party, the investor can recognize the intra-entity profit. However, there are exceptions to this principle. An investor can use the steps below in determining how much intra-entity profit to eliminate.



# STEP 1

Apply the relevant guidance and recognize any profit in the investor and investee's separate financial statements (see Section 4.3.1).



## STEP 2

Determine how much intra-entity profit to eliminate, if any (see Section 4.3.2).



## STEP 3

Determine how to present the eliminated intra-entity profit (see Section 4.3.3).



## DEVELOP PROCESSES AND CONTROLS TO IDENTIFY INTRA-ENTITY TRANSACTIONS

When acquiring an equity method investment, an investor should consider what information is needed from the investee to eliminate intra-entity profit and develop processes and controls accordingly.

## BDO INSIGHTS: THE NEED FOR INTRA-ENTITY PROFIT ELIMINATIONS ON ASSETS STILL HELD BY EITHER PARTY

Sometimes practitioners wonder why an investor must eliminate intra-entity profit only when the assets remain on the books of **either** party, and not for service transactions or assets that are sold through to other third parties.

The reason is that when an asset remains on the books of either party, the profit has not been realized outside the group. In contrast, when one party provides services to the other, the party that receives the services reflects the price it was charged (which reflects the service provider's profit) as an expense. In other words, the recipient's own profit will be lower because it consumed the services. Similarly, if the party that receives the asset sells it through to a third party, that party reflects the price it was charged (which reflects the seller's profit) as cost of goods sold. The elimination of profit when an asset remains on the books prevents the seller from recognizing profit that is not yet realized.

# 4.3.1 Step 1: Apply the Relevant Guidance in the Separate Financial Statements



# **FASB REFERENCES**

ASC 360-10-40-3A through 40-3B and ASC 970-323-35-15

In Step 1, the investor and investee first account for the transaction in their separate financial statements in accordance with the relevant U.S. GAAP (for example, in accordance with the guidance below).



ASC 606 Revenue transactions related to the sale of inventory



ASC 606 Revenue transactions related to the sale of services



ASC 360 and ASC 610-20 Sales of nonfinancial assets, such as property, that are outside the scope of ASC 606



ASC 810
Loss of control of a
business or a change
in interest
transaction



ASC 860
Sale of a financial asset (including another equity method investment)

Sometimes in practice an investor jumps to eliminating profit before determining whether (and when) it can recognize any profit in the separate financial statements (that is, confusing Steps 1 and 2). See Section 4.3.4 for examples.

# 4.3.2 Step 2: Determine How Much Intra-Entity Profit to Eliminate, If Any



# **FASB REFERENCES**

ASC 323-30-25-2, ASC 323-10-35-7 through 35-11, and ASC 970-323-30-7 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.

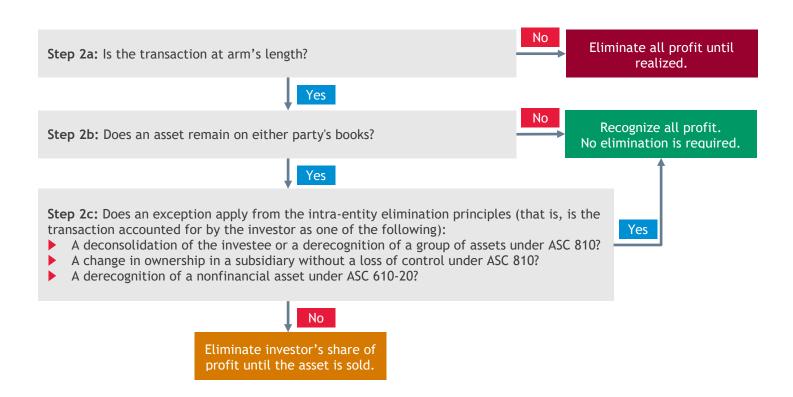
# ASC 323-10-35-10

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).

After the investee and investor account for the transaction in their separate financial statements, the investor determines how much intra-entity profit, if any, to eliminate. Depending on the facts and circumstances and the relevant guidance described below, that could result in the investor eliminating all, none, or only its share of the intra-entity profit. An investee does not eliminate any intra-entity profit in its separate financial statements. An investor determines how much intra-entity profit to eliminate as shown in the flowchart and table below.



STEP	CONSIDERATIONS	ELIMINATION
Step 2a	Is the transaction at arm's length?  An investor cannot assume the transaction is at arm's length just because it does not control the investee. See the BDO Insights below for considerations in making this judgment.	Eliminate all profit in transactions that are not at arm's length until realized.
Step 2b	Does an asset remain on either party's books?  An investor must determine whether either party still holds (recognizes) the assets (or liabilities), including inventory, property, equipment, real estate, intangibles, and deferred revenue.	Recognize all profit if no asset remains on the books and the transaction is at arm's length.
Step 2c	<ul> <li>Does an exception apply from the intra-entity elimination principles?         An investor does not eliminate intra-entity profit from the following downstream transactions:         The deconsolidation of the investee or a derecognition of a group of assets (for example, a business) in accordance with ASC 810-10-40-3A through 40-5.         </li> <li>A change in ownership transaction without loss of control, in accordance with ASC 810-10-45-21A through 45-24.</li> <li>The derecognition of a nonfinancial asset in accordance with ASC 610-20.</li> <li>If an exception applies (and the transaction is at arm's length), no profit is eliminated.</li> </ul>	If no exceptions apply, eliminate the investor's share of profit until the asset is sold (or realized, including through depreciation or amortization).

If applicable, the investor's share of profit that is eliminated in Step 2C is the investor's share of profit used to calculate its share of the investee's income (which is generally its share of the investee's common stock). For example,

if the investor owns 30% of the investee's common stock, and uses 30% to determine its share of the investee's income, and the investor determines that it must eliminate profit on an intra-entity transaction, it would eliminate 30% of that profit. See Section 4.2 for guidance on determining an investor's share of an investee's income. See Section 4.3.4 for examples of intra-entity profit elimination.

An investor must eliminate intra-entity profit even if it would otherwise result in a negative equity method investment. See Section 4.3.3 for guidance on presenting the elimination of intra-entity profit.

Even though an investor eliminates intra-entity profit, it must still recognize the current and deferred income tax effects of intra-entity transactions (see ASC 740).



# **EXCEPTIONS FROM INTRA-ENTITY ELIMINATIONS APPLY ONLY TO DOWNSTREAM TRANSACTIONS**

The exceptions from the principle in ASC 323 (that profit must be eliminated if an asset remains on either party's books) apply only to **downstream** transactions in the scope of ASC 610-20 and ASC 810. The exceptions **do not apply for upstream** transactions in the scope of ASC 610-20 and ASC 810. In other words, the investor eliminates its share of the investee's intra-entity profit when the investee sells a business or a nonfinancial asset (such as property or real estate) in the scope of ASC 610-20 to an investor in an upstream sale, if the business or asset remains on the investor's books. <sup>18</sup>

#### BDO INSIGHTS: EVALUATING WHETHER AN INTRA-ENTITY TRANSACTION IS AT ARM'S LENGTH

When determining whether a transaction is at arm's length, we believe the investor should consider the following: 19

- ▶ The timing, form, and amount of consideration paid
- The ability to collect the promised consideration
- ▶ The seller's implicit or explicit performance obligations or guarantees with respect to the asset
- ▶ The transaction's economic substance, including other elements (for example, capital contributions or distributions) embedded within the transaction.

An intra-entity **loss** might indicate that the transaction was not at arm's length or that the seller's similar assets are impaired (for example, inventory or equipment). Accordingly, the investor and investee must consider the relevant guidance (for example, ASC 330 for inventory and ASC 360 for property, plant, and equipment) upon a loss transaction.

#### **BDO INSIGHTS: INTRA-ENTITY PROFIT ELIMINATIONS FOR LEASES**

It is unclear whether an investor must eliminate any profit on an intra-entity lease. Some practitioners believe an intra-entity arm's-length operating lease is analogous to a consumed service transaction, in which no asset remains on either party's books. They also believe that because the lessor owns and recognizes the underlying asset, and because the lessee's right of use asset and lease liability do not result from either party recognizing intra-entity profit, no intra-entity profit is eliminated. Reaching a conclusion about whether to eliminate intra-entity profit on a lease may depend on the lease classification and requires the application of professional judgment based on the facts and circumstances.

<sup>&</sup>lt;sup>18</sup> See BC17 of ASU 2010-02 "Accounting and Reporting for Decreases in Ownership of a Subsidiary — A Scope Clarification" and BC66-67 of ASU 2017-05 "Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets."

<sup>&</sup>lt;sup>19</sup> The terms of the arrangement also affect revenue recognition (see our Blueprint, Revenue Recognition Under ASC 606).

# 4.3.3 Step 3: Determine How to Present the Eliminated Intra-Entity Profit



## **FASB REFERENCES**

ASC 323-10-55-27 through 55-29; ASC 970-323-30-7

ASC 323 does not prescribe how to present the eliminated intra-entity profit. In two examples it states:

- For a downstream transaction: "The elimination of intra-entity profit might be reflected in the investor's balance sheet in various ways. The income statement and balance sheet presentations will depend on what is the most meaningful in the circumstances."
- For an upstream transaction: The profit "would thereby be eliminated from the investor's equity income. Usually, the investor's investment account would also reflect the... intra-entity profit elimination, but the elimination might also be reflected in various other ways."

ASC 970 includes the following guidance:

- An investor cannot present its share of an investee's profit from a sale of real estate to the investor as income. Instead, the investor must eliminate its share of the investee's profit against the real estate and recognize the eliminated profit as income as the real estate is depreciated or when sold to a third party.
- An investor cannot present its share of an investee's profit from performing services for the investor as income if the investor capitalizes the cost of those services. Instead, the investor must eliminate the intra-entity profit against the capitalized asset and recognize the eliminated profit into income as the capitalized asset is amortized or when sold to a third party.

See Section 4.3.4 for examples of intra-entity profit elimination.

# BDO INSIGHTS: INTRA-ENTITY PROFIT ELIMINATION SHOULD BE CONSISTENTLY PRESENTED AND DISCLOSED

Given the lack of guidance in ASC 323, we believe an investor outside the scope of ASC 970 should eliminate intraentity profit in a manner that is "most meaningful in the circumstances." For example:

- If an investor buys inventory from its investee and the equity method investment would otherwise have a negative carrying amount, it may be most appropriate to eliminate that profit by reducing the inventory's carrying amount.
- If the investor sells inventory to its investee and the equity method investment would otherwise have a negative carrying amount, it may be most appropriate to eliminate that profit by presenting such amount as a liability.

The investor must consistently apply and disclose its policy and the intra-entity transactions in accordance with ASC 850, *Related Party Disclosures* (see Section 6.3.1). Reaching a conclusion about which presentation is most meaningful in the circumstances requires the application of professional judgment.

# 4.3.4 Examples of Intra-Entity Transactions



# **FASB REFERENCES**

ASC 323-10-55-27 through 29

As discussed in Section 4.3.2, the elimination of intra-entity profit depends on whether the transaction is:

- ▶ Related to an asset that is realized through a later sale or through use (for example, consumption or depreciation)
- Upstream or downstream
- For downstream transactions only, within the scope of ASC 810, ASC 610-20, or other U.S. GAAP.



## SCOPING AFFECTS INTRA-ENTITY PROFIT ELIMINATION

ASC 610-20 relies on the principles in ASC 606, as discussed in Appendix A of our Blueprint, Revenue Recognition Under ASC 606. However, because the exception from intra-entity profit elimination applies only to downstream ASC 610-20 transactions, and not to downstream ASC 606 transactions, an investor must determine which standard applies to any intra-entity downstream transactions. In other words, an investor selling a long-lived asset (such as equipment) must determine whether that asset is an output of its ordinary activities (in which case, the buyer meets the definition of a customer, and the transaction is within the scope of ASC 606) or not (and in the scope of ASC 610-20). In the former case, the investor's share of intra-entity profit is eliminated and realized over time as the asset is depreciated; in the latter case, no intra-entity profit is eliminated if the transaction is at arm's length.

Examples 4-9 through 4-14 illustrate intra-entity profit elimination in an arm's-length transaction.

	EXAMPLE OF INTRA-ENTITY PROFIT ELIMINATION	EXAMPLE
1	Downstream sale of inventory or asset in the scope of ASC 606	Example 4-9
1	Upstream sale of inventory or asset in the scope of ASC 606	Example 4-10
•	Downstream service transaction in the scope of ASC 606 that is not capitalized by the investee	Example 4-11
1	Downstream service transaction in the scope of ASC 606 that is capitalized by the investee	Example 4-12
•	Downstream sale of property, plant, or equipment or an intangible asset in the scope of ASC 610-20	Example 4-13
1	Upstream sale of property, plant, or equipment or an intangible asset in the scope of ASC 610-20 that remains on the investor's books	Example 4-14
1	Downstream sale of property, plant, or equipment or asset in the scope of ASC 606 (realized over time)	Similar to Example 4-12 (capitalized downstream service transaction in the scope of ASC 606)
•	Downstream sale of a business (ASC 805)	Similar to Example 4-13 (downstream sale in the scope of ASC 610-20) once the derecognition conditions in ASC 810 are met
1	Upstream sale of a business (ASC 805)	Similar to Example 4-14 (upstream sale in the scope of ASC 610-20) once the derecognition conditions in ASC 810 are met
•	Downstream or upstream sale of a financial asset, including an equity method investment	Similar to Example 4-9 (downstream sale in the scope of ASC 606) once the derecognition (sale accounting) conditions in ASC 860 are met

# EXAMPLE 4-9 (ADAPTED FROM ASC 323-10-55-27 AND 55-28): INTRA-ENTITY PROFIT ELIMINATION — DOWNSTREAM SALE OF INVENTORY OR ASSET IN THE SCOPE OF ASC 606

#### **FACTS**

- Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- The income tax rate for both Investor and Investee is 40%.
- During 20X1, Investor sold 100 inventory units to Investee (a downstream transaction), which was determined to be at arm's length, for \$14,000 per unit (\$1,400,000 in total). Investor recognized revenue for that amount in accordance with ASC 606.
- Investor's cost for each unit was \$10,000 (\$1,000,000 in total), generating intra-entity profit of \$4,000 per unit (\$400,000 in total).
- Investee sold 75 units to a third party by December 31, 20X1, and had 25 units left in inventory.

#### **CONCLUSION**

Investor eliminates \$18,000 of intra-entity profit.

# **ANALYSIS**

- ▶ **Step 1:** Apply the relevant guidance in the separate financial statements The sale of inventory is in the scope of ASC 606. Investor recognized revenue of \$1,400,000 and \$1,000,000 in cost of sales.
- ▶ **Step 2:** Determine how much intra-entity profit to eliminate, if any
  - Step 2a: Is the transaction at arm's length? Yes.
  - Step 2b: Does an asset remain on either party's books? Yes, 25 units are left in Investee's inventory.
  - Step 2c: Does an exception apply from the intra-entity elimination principles? No, because the transaction is in the scope of ASC 606. Therefore, Investor eliminates its share of unrealized profit of \$30,000 ((\$14,000 revenue per unit \$10,000 cost per unit) \* 25 remaining units \* 30% interest in Investee). Investor also considered the income tax expense of \$12,000 (Investor's deferred profit of \$30,000 \* 40% income tax rate); therefore, the net effect is \$18,000 (\$30,000 gross profit \$12,000 income tax expense). Investor does not eliminate the 70% of profit on those units attributable to other investors or any profit on the 75 units Investee sold to third parties during the year.
- ▶ Step 3: Determine how to present the eliminated intra-entity profit Investor may eliminate the intra-entity profit in various ways depending on what is the most meaningful in the circumstances (for example, by reducing its equity method investment).

# EXAMPLE 4-10 (ADAPTED FROM ASC 323-10-55-27 AND 55-29): INTRA-ENTITY PROFIT ELIMINATION — UPSTREAM SALE OF INVENTORY OR ASSET IN THE SCOPE OF ASC 606

## **FACTS**

- Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- The income tax rate for both Investor and Investee is 40%.
- ▶ During 20X1, Investor bought 100 inventory units from Investee (an upstream transaction), which was determined to be at arm's length, for \$14,000 per unit (\$1,400,000 in total). Investee recognized revenue for that amount in accordance with ASC 606.
- Investee's cost for each unit was \$10,000 (\$1,000,000 in total), generating intra-entity profit of \$4,000 per unit (\$400,000 in total).
- Investor sold 75 units to a third party by December 31, 20X1, and had 25 units left in inventory.

### **CONCLUSION**

Investor eliminates \$18,000 of intra-entity profit.

## **ANALYSIS**

- ▶ Step 1: Apply the relevant guidance in the separate financial statements The sale of inventory is in the scope of ASC 606. Investee recognized revenue of \$1,400,000 and \$1,000,000 in cost of sales.
- Step 2: Determine how much intra-entity profit to eliminate, if any
  - Step 2a: Is the transaction at arm's length? Yes.
  - Step 2b: Does an asset remain on either party's books? Yes, 25 units are left in Investor's inventory.
  - **Step 2c:** Does an exception apply from the intra-entity elimination principles? No, because the transaction is in the scope of ASC 606. Therefore, Investor eliminates its share of unrealized profit of \$30,000 ((\$14,000 revenue per unit \$10,000 cost per unit) \* 25 remaining units \* 30% interest in Investee). Investor also considered the income tax expense of \$12,000 (Investee's deferred profit of \$30,000 \* 40% income tax rate); therefore, the net effect is \$18,000 (\$30,000 gross profit \$12,000 income tax expense). Investor does not eliminate the 70% of profit on those units attributable to other investors or any profit on the 75 units that Investor sold to third parties during the year.
- ▶ Step 3: Determine how to present the eliminated intra-entity profit Investor may eliminate the intra-entity profit in various ways depending on what is the most meaningful in the circumstances (for example, by reducing its equity method investment or inventory).

# EXAMPLE 4-11: INTRA-ENTITY PROFIT ELIMINATION — DOWNSTREAM SERVICE TRANSACTION IN THE SCOPE OF ASC 606 THAT IS NOT CAPITALIZED

## **FACTS**

- Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ The income tax rate for both Investor and Investee is 40%.
- During 20X1, Investor provided IT services to Investee (a downstream transaction) for \$200,000, which was determined to be at arm's length. Investor recognized revenue for that amount in accordance with ASC 606.
- Investor's cost of providing the services was \$150,000, generating intra-entity profit of \$50,000.
- Investee expensed (did not capitalize) the \$200,000 for the services received.

# CONCLUSION

Investor does not eliminate any intra-entity profit from the service transaction.

#### **ANALYSIS**

- ▶ Step 1: Apply the relevant guidance in the separate financial statements The IT services were in the scope of ASC 606. Investor recognized revenue of \$200,000, as well as \$150,000 in cost of services. Investee expensed the services in accordance with other U.S. GAAP.
- ▶ Step 2: Determine how much intra-entity profit to eliminate, if any
  - **Step 2a:** Is the transaction at arm's length? Yes.
  - **Step 2b:** Does an asset remain on either party's books? No. Investee consumed the service transaction (that is, it did not capitalize the services). Therefore, Investor does not eliminate any intra-entity profit from the service transaction.
- The accounting would be the same if the roles were reversed and the transaction were upstream because no asset remains on either party's books.

# EXAMPLE 4-12: INTRA-ENTITY PROFIT ELIMINATION — DOWNSTREAM SERVICE TRANSACTION IN THE SCOPE OF ASC 606 THAT IS CAPITALIZED

#### **FACTS**

- Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- The income tax rate for both Investor and Investee is 40%.
- During 20X1, Investor provided software development services to Investee (a downstream transaction) for \$200,000, which was determined to be at arm's length. Investor recognized revenue for that amount in accordance with ASC 606.
- Investor's cost of providing the services was \$150,000, generating an intra-entity profit of \$50,000.
- Investee capitalizes the software development services and amortizes them over the software's five-year useful life.

#### CONCLUSION

Investor eliminates \$9,000 of intra-entity profit during 20X1 and recognizes the eliminated profit over the capitalized software's five-year useful life, or \$1,800 each year (net of income tax).

### **ANALYSIS**

- ▶ **Step 1:** Apply the relevant guidance in the separate financial statements The software development services were in the scope of ASC 606. Investor recognized revenue of \$200,000, as well as \$150,000 in cost of services. Investee capitalized the services in accordance with other U.S. GAAP.
- ▶ **Step 2:** Determine how much intra-entity profit to eliminate, if any
  - Step 2a: Is the transaction at arm's length? Yes.
  - **Step 2b:** Does an asset remain on either party's books? Yes. Investee capitalized the software services, which were not fully amortized as of December 31, 20X1.
  - Step 2c: Does an exception apply from the intra-entity elimination principles? No, because the transaction is in the scope of ASC 606. Therefore, for 20X1, Investor eliminates the unrealized share of intra-entity profit of \$15,000 ((\$200,000 revenue \$150,000 cost) \* 30% share). Investor also considered the income tax expense of \$6,000 (investor's deferred profit of \$15,000 \* 40% income tax rate); therefore, the net effect is \$9,000 (\$15,000 \$6,000). Investor does not eliminate the 70% of profit on the services attributable to other investors. Thereafter, Investor recognizes the deferred profit of \$15,000 over the capitalized software's five-year useful life, or \$3,000, offset by income tax expense of \$1,200 (40%), for a net of \$1,800 each year.
- ▶ Step 3: Determine how to present the eliminated intra-entity profit Investor may eliminate the intra-entity profit in various ways depending on what is the most meaningful in the circumstances (for example, by reducing the investment).

# EXAMPLE 4-13: INTRA-ENTITY PROFIT ELIMINATION — DOWNSTREAM SALE OF A NONFINANCIAL ASSET WITHIN THE SCOPE OF ASC 610-20

### **FACTS**

- ▶ Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- On December 31, 20X1, Investor sold equipment to Investee (a downstream transaction), which was determined to be at arm's length, for \$20,000.
- ► The equipment, which was not an output of Investor's ordinary activities, had a carrying amount of \$16,000. Investor recognized intra-entity profit of \$4,000 as a gain in accordance with ASC 610-20.
- ▶ As of December 31, 20X1, Investee still owns the equipment, which has a five-year useful life.

## **CONCLUSION**

Investor does not eliminate any profit from the intra-entity transaction.

#### **ANALYSIS**

- ▶ Step 1: Apply the relevant guidance in the separate financial statements Investee is not a customer as defined in ASC 606 because selling equipment is not an output of Investor's ordinary activities. The sale of the equipment is in the scope of ASC 610-20. Investor derecognized the equipment and recognized a \$4,000 gain.
- ▶ **Step 2:** Determine how much intra-entity profit to eliminate, if any
  - Step 2a: Is the transaction at arm's length? Yes.
  - Step 2b: Does an asset remain on the books of either party? Yes, Investee still owns the equipment.
  - **Step 2c:** Does an exception apply from the intra-entity elimination principles? Yes, because the transaction is a derecognition of a nonfinancial asset within the scope of ASC 610-20. Therefore, Investor does not eliminate the intra-entity profit.

Accounting for a downstream sale of an intangible asset in the scope of ASC 610-20 is consistent with Example 4-13.

# EXAMPLE 4-14: INTRA-ENTITY PROFIT ELIMINATION — UPSTREAM SALE OF A NONFINANCIAL ASSET WITHIN THE SCOPE OF ASC 610-20

#### **FACTS**

- Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ The income tax rate for both Investor and Investee is 40%.
- On December 31, 20X1, Investee sold a building to Investor (an upstream transaction) for \$10,000,000, in a transaction determined to be at arm's length.
- ▶ The building, which was not an output of Investee's ordinary activities, had a carrying amount of \$8,500,000, resulting in intra-entity profit of \$1,500,000, which Investee recognized as a gain under ASC 610-20.
- ▶ As of December 31, 20X1, Investor still owns the building, which has a 15-year useful life.

# **CONCLUSION**

Investor eliminates \$270,000 of intra-entity profit during 20X1 and recognizes the eliminated profit over the building's 15-year useful life, or \$18,000 each year (net of income tax).

## **ANALYSIS**

- ▶ Step 1: Apply the relevant guidance in the separate financial statements Investor is not a customer as defined in ASC 606 because selling a building is not an output of Investee's ordinary activities. The sale of the building is in the scope of ASC 610-20. Investee derecognized the building and recognized a \$1,500,000 gain.
- ▶ **Step 2:** Determine how much intra-entity profit to eliminate, if any
  - Step 2a: Is the transaction at arm's length? Yes.
  - Step 2b: Does an asset remain on the books of either party? Yes, Investor still owns the building.
  - Step 2c: Does an exception apply from the intra-entity elimination principles? No, the transaction is an upstream transaction within the scope of ASC 610-20. The exception for transactions in the scope of ASC 610-20 applies only to downstream transactions. Therefore, for 20X1, Investor eliminates its share of Investee's gain of \$1,500,000. Investor also considered the income tax expense of \$600,000 (profit of \$1,500,000 \* 40% income tax rate) for a net of \$900,000, of which Investor's share is 30%, or \$270,000. Investor does not eliminate the 70% of profit on the transaction attributable to other investors. Thereafter, Investor recognizes the deferred profit of \$270,000 over the building's 15-year useful life, or \$18,000 each year.
- ▶ **Step 3:** Determine how to present the eliminated intra-entity profit Investor may eliminate the intra-entity profit in various ways depending on what is the most meaningful in the circumstances (for example, by reducing the investment or building).

# 4.3.5 Intra-Entity Transactions: Interest Costs



#### **FASB REFERENCES**

ASC 835-20-15-2 through 15-6, ASC 835-20-30-6, ASC 835-20-35-2, ASC 835-20-55-2, ASC 970-835-35-1, and ASC 970-323-35-22

Investors may borrow from third parties to finance their equity method investments (that is, to buy the investee's equity) or borrow so they can extend loans to their investees, in both cases incurring interest due to the third-party lenders. Alternatively, investors may lend cash on hand to their investees, resulting in intra-entity interest. In other cases, investees may recognize interest on loans from third parties. The accounting for these transactions depends on how funds are used and the investee's activities. This section discusses considerations for intra-entity loans and third-party loans capitalized as part of the cost of an equity method investment.

#### Step 1: Apply the Relevant Guidance in the Separate Financial Statements

As discussed in Section 4.3.1, Step 1 is to apply the relevant guidance in the separate financial statements. An investor and investee first determine whether interest qualifies for capitalization in accordance with ASC 835.



An equity method investee that has a loan (from the equity method investor or a third party) capitalizes the interest in its separate financial statements if it is using funds to buy or construct qualifying assets, which are either:

- Assets constructed for an entity's own use (for example, property, plant, and equipment)
- Assets intended for sale or lease constructed as discrete projects (e.g., real estate).



An investor capitalizes interest in its separate financial statements if it used a loan to finance its investment **and** the equity method investment qualifies for interest capitalization, which occurs if **both** criteria are met:

- The investee has activities in progress needed to start its planned principal operations
- The investee is using funds to buy or construct qualifying assets (as discussed above).

When applying ASC 835 in the investor's separate financial statements, the qualifying asset is the investment, not the investee's individual assets or projects.



Not a qualifying asset

An investment does **not** qualify for interest capitalization if the investee has already begun its **planned principal operations**. For example, if an investee is constructing a new plant but already has another operating plant, the investor cannot capitalize any interest.

Reaching a conclusion about whether an investee has started planned principal operations requires the application of professional judgment, based on the facts and circumstances. Planned principal operations may **not** have begun if the investee is devoting substantially all its efforts to starting a new business, through activities such as those listed below.



Financial planning and raising capital



Research and development



Exploring for and developing natural resources



Buying property, plant, and equipment or other assets



Sourcing supplies



Recruiting and training personnel



Developing markets



Starting production

If an investor capitalizes interest on its investment in accordance with ASC 835 (because the criteria above are met), it amortizes the capitalized interest over the useful lives of the investee's assets as a basis differences (see Section 4.4).

An investor accounts for interest received on in-substance capital contributions (for example, when all investors lend and advance funds proportionately to their equity interests) as a distribution rather than as interest. Such interest does not qualify for capitalization.

However, an investor cannot capitalize more interest than it (including its subsidiaries but excluding its equity method investees) incurred during a reporting period. Similarly, an investee cannot capitalize interest incurred by an investor unless the investee also has a loan or advance that qualifies for interest capitalization in accordance with ASC 835.

## Step 2: Determine How Much Intra-Entity Profit to Eliminate, If Any

When determining how much intra-entity profit to eliminate (using the flowchart and steps in Section 4.3.2), the considerations below also are relevant.

STEP	CONSIDERATIONS	ELIMINATION				
Step 2a	<ul> <li>Is the transaction at arm's length?</li> <li>When determining whether a transaction is at arm's length, an investor considers whether:</li> <li>The collectability of the principal or interest is in doubt (for example, because of insufficient collateral or because terms generally required by an independent lender were omitted).</li> <li>There is reasonable doubt that other investors will cover their share of losses, creating uncertainty about the lender's share of the investee's interest expense.</li> <li>The loan or advance is in substance a capital contribution (for example, because all investors contributed proportionately to their interests).</li> </ul>	Eliminate all profit in transactions that are not arm's length until realized.  Recognize interest received on in-substance capital contributions as a distribution (rather than as interest income) and reduce the equity method investment (see Section 4.5.1).				
Step 2b	Does an asset remain on the books of either party? When determining whether an asset remains on the books of either party, an investor considers whether the investee recognized interest expense or capitalized the interest in accordance with ASC 835.	Recognize interest income and do not adjust equity method income if no asset remains on the books (because the investee expensed the interest costs) and the transaction is at arm's length.  Eliminate unrealized share of interest income if an asset remains on the investee's books (because the investee capitalized the interest cost, and assuming no exception discussed in Step 2c applies), consistent with other unrealized upstream transactions. Account for resulting basis differences (see Section 4.4).				

#### Step 3: Determine How to Present the Eliminated Intra-Entity Profit

The investor may eliminate the intra-entity profit in various ways, depending on what is the most meaningful in the circumstances (for example, by reducing its equity method income or interest income).

#### EXAMPLE 4-15: INTRA-ENTITY PROFIT ELIMINATION — INTEREST CAPITALIZED BY AN INVESTEE

#### **FACTS**

- ▶ Investor owns 30% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ On January 1, 20X1, Investor loaned \$3,000,000 to Investee to build a plant (that is, Investor did not borrow the money). The loan is for 10 years with a 10% interest rate and determined to be at arm's length and not an insubstance capital contribution. Investee does not have any other outstanding loans.
- ▶ Plant construction is expected to be completed in two years; production will start thereafter.
- ▶ As of January 1, 20X1, Investee had started its planned principal operations.
- Investee's net income for 20X1 before interest was \$1,200,000.
- ▶ For simplicity, assume there are no other intra-entity transactions, basis differences, income taxes, or OCI.

#### **CONCLUSION**

Investee capitalizes interest on the loan of \$300,000. Investor recognizes equity method income of \$270,000.

#### **ANALYSIS**

- ▶ **Step 1:** Apply the relevant guidance in the separate financial statements
  - **Investee:** Because the plant is under construction, the interest qualifies for capitalization. Therefore, Investee capitalizes interest on the loan of \$300,000 (\$3,000,000 \* 10%).
  - **Investor:** Whether Investee started its planned principal operations is irrelevant because Investor did not incur any interest. Therefore, Investor does not recognize any interest expense but does recognize interest income of \$300,000.
- ▶ Step 2: Determine how much intra-entity profit to eliminate, if any
  - Step 2a: Is the transaction at arm's length? Yes.
  - Step 2b: Does an asset remain on the books of either party? Yes, because Investee capitalized the interest.
  - Step 2c: Does an exception apply from the intra-entity elimination principles? No. Therefore, Investor eliminates its share of unrealized income. Investee's net income of \$1,200,000 does not include any interest because Investee capitalized the interest. Investor's share of Investee's net income is \$360,000 (\$1,200,000 \* 30%). Investor adjusts its equity method income so that it does not recognize its share of the capitalized interest of \$90,000 (\$300,000 \* 30%). Therefore, Investor's equity method income for 20X1 is \$270,000 (\$360,000 \$90,000). Investor must consider the basis differences from the \$90,000 deferred interest income, which must be amortized consistently with ASC 323-10-35-13 (see Section 4.4).
- ▶ **Step 3:** Determine how to present the eliminated intra-entity profit Investor may eliminate the intra-entity profit in various ways depending on what is the most meaningful in the circumstances (for example, by reducing its equity method income or interest income).

# 4.4 AMORTIZATION OF BASIS DIFFERENCES



#### **FASB REFERENCES**

ASC 323-10-35-5(b) and ASC 323-10-35-13 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.

As discussed in Section 4.1, an investor's equity method income is calculated as follows:



As discussed in Section 3.3, an investor identifies basis differences and allocates the cost of the investment in the memo accounts as if the investee were a subsidiary. An investor recognizes any excess not attributable to the investee's identifiable assets and liabilities as equity method goodwill if the investee meets the definition of a business in ASC 805. In determining its equity method income, an investor adjusts for basis differences identified at the initial measurement (for example, by recognizing more depreciation, amortization, or accretion over the assets' useful lives, if applicable). Because basis differences can be positive or negative, the adjustments can also be positive or negative.

An investor generally does not amortize equity method goodwill. However, private companies (as defined in U.S. GAAP) may choose to amortize goodwill on a straight-line basis over 10 years (or less if the investor concludes that another useful life is more appropriate (see Section 3.3.1)).

#### **EXAMPLE 4-16: AMORTIZATION OF EQUITY METHOD BASIS DIFFERENCES**

### **FACTS**

Assume the same facts as in Example 3-8.

- On January 1, 20X1, Investor acquired 40% of Investee's voting common stock for \$800,000, which it accounts for using the equity method. For simplicity, assume there were no transaction costs. Investee meets the ASC 805 definition of a business.
- ▶ As of January 1, 20X1, the carrying amount and fair values of Investee's net assets were:

	CARRYING AMOUN		FAIR VA	ALUE	
Cash	\$	380,000	\$	380,000	
Accounts receivable		300,000		300,000	
Buildings		1,250,000		1,230,000	
Customer list		_		15,000	
IPR&D asset		_		60,000	
Payables		(80,000)	_	(80,000)	
Total identifiable net assets	\$	1,850,000	\$	1,905,000	

- Investor determined the fair values of Investee's identifiable assets and liabilities as follows:
  - The buildings have a fair value of \$1,230,000 and a 20-year useful life. Investee evaluates the buildings for impairment in accordance with ASC 360; the buildings are not impaired because they are recoverable based on their undiscounted cash flows.
  - The internally developed customer list has a fair value of \$15,000 and a 3-year useful life.
  - The IPR&D asset was developed internally and therefore not recognized by Investee. It is indefinite-lived and not amortized. No impairment indicators have been identified.
  - The carrying amounts of accounts receivable and payables approximate their fair values.
- For simplicity, assume there are no intra-entity transactions, income taxes, or OCI.
- Investee's net income for 20X1 was \$500,000.
- ▶ Neither Investee nor Investor elects to amortize goodwill.

#### CONCLUSION

Investor recognizes equity method income of \$198,400, bringing the equity method investment to \$998,400.

#### **ANALYSIS**

- ▶ **Step 1:** The cost of the investment is \$800,000.
- ▶ Steps 2A to 2E: The table below illustrates how Investor calculated the identifiable basis differences in the equity method memo accounts (see Example 3-8 for the calculation for equity method goodwill).

	INVESTOR'S SHARE OF CARRYING AMOUNT (40%) [A]	INVESTOR'S SHARE (40%) OF FAIR VALUE [B]	INVESTOR'S BASIS DIFFERENCES [B-A]
Cash	\$ 152,000	\$ 152,000	\$ -
Accounts receivable	120,000	120,000	_
Buildings	500,000	492,000	(8,000)
Customer list	_	6,000	6,000
IPR&D asset	_	24,000	24,000
Payables	(32,000)	(32,000)	_
Equity method goodwill	_	_	38,000
Total identifiable net assets	\$ 740,000	\$ 762,000	\$ 60,000

Investor's equity method income from Investee for 20X1 is:

	AMOUNT	г
Investor's share of Investee's net income (\$500,000 * 40%)	\$	200,000
Depreciation of the basis difference on the buildings (\$8,000 / 20 years)		400
Amortization of the basis difference on the customer list (\$6,000 / 3 years)		(2,000)
Investor's equity method income from Investee	\$	198,400

- ▶ When calculating its equity method income, Investor adjusts its share of Investee's depreciation expense on the buildings by \$400 to amortize the negative basis difference. Investor also amortizes the positive basis difference on the customer list by adjusting its equity method income by \$2,000.
- ▶ Investor does not amortize the equity method goodwill in the memo accounts because it did not elect the private company accounting alternative. Investor evaluates only the equity method investment as a whole for impairment (see Section 4.8).
- As of December 31, 20X1, the carrying amount of Investor's equity method investment is \$998,400 (\$800,000 initial investment + equity method income of \$198,400). That amount equals Investor's share of Investee's assets

of \$740,000 at the acquisition date + \$200,000 share of Investee's net income for 20X1 + \$58,400 unamortized basis difference (\$60,000 - \$2,000 + \$400).

#### BDO INSIGHTS: PUSHDOWN ACCOUNTING AND THE EFFECT ON BASIS DIFFERENCES

When a business combination occurs, ASC 805-50 allows an acquiree to elect pushdown accounting in its separate financial statements by recognizing its assets and liabilities at the acquirer's basis (that is, at their acquisition-date fair values).

If an investor other than the one that obtained control of the acquiree (investee) has an existing equity method investment in that acquiree, such an election should not directly affect the equity method investment or equity method income, assuming no change in the investor's ownership interest in the investee or level of influence. Said differently, an investor does not remeasure its equity method investment if its ownership interest does not change. However, the investee's election of pushdown accounting after an investor already holds an equity method investment might cause the investor's accounting to become more operationally challenging because the investor must continue to calculate its share of investee's income as if investee had not applied pushdown accounting. Because the investee adjusted its financial statements, the investor must adjust its basis differences so that the investor's equity method income is not affected by the change in basis recognized by the investee. In other words, the investor effectively needs to unwind the pushdown accounting in the memo accounts, and then amortize the basis differences identified upon its own investment.

However, if the investor is diluted or increases its ownership in the investee when the third party obtains control of the investee, or if the composition of the investee's net assets change (for example, due to distributing assets), the investor must consider the facts and circumstances to determine the appropriate accounting. See Chapter 5 for the accounting for increases or decreases in the ownership of an investee.

See Appendix A of our Blueprint, Business Combinations Under ASC 805, for guidance on pushdown accounting.

# 4.4.1 Investee Sells Assets or a Business to Third Party



#### **FASB REFERENCES**

ASC 323-10-35-5(b) and ASC 323-10-35-13

When an investee sells assets or a business to a third party, the investor recognizes its share of any gain or loss as part of its equity method income, adjusted for any unamortized basis differences on the assets sold (or liabilities derecognized). Section 4.3 describes intra-entity profit elimination when the investor is the buyer in the transaction.

#### EXAMPLE 4-17: INVESTEE SELLS ASSET SUBJECT TO A BASIS DIFFERENCE TO A THIRD PARTY

# **FACTS**

Assume the same facts as in Example 4-16, except:

- On December 31, 20X1, Investee decided to lease space instead and sold all its buildings with carrying amounts of \$1,187,500 to a third party for \$1,190,000 for a gain of \$2,500.
- ▶ For simplicity, assume there are no income taxes and that the fair values of the buildings were properly determined at acquisition (the subsequent sale did not indicate an error in the amounts recognized in the Investor's memo accounts).

#### CONCLUSION

Investor's equity method income for 20X1 is \$207,000, which includes its share of Investee's gain of \$1,000 and derecognizing the unamortized basis difference of \$7,600 related to the buildings.

#### **ANALYSIS**

- ▶ During 20X1, Investee recognized depreciation of \$62,500 on the buildings (\$1,250,000 / 20 years). Of that, Investor's share was \$25,000, which it included when recognizing its share of Investee's net income of \$200,000.
- ▶ However, because the buildings' fair value was \$1,230,000 when Investor obtained the equity method investment, it identified a basis difference of \$8,000 in its memo accounts (see Example 3-8).
  - Investee's carrying amount for the buildings was \$1,187,500 (\$1,250,000 depreciation of \$62,500). The buildings' carrying amount in the memo accounts was \$1,168,500 (which can be calculated by rolling forward as shown in the table below as \$1,230,000 fair value depreciation of \$61,500).
  - On December 31, 20X1, investor's share of Investee's carrying amount for the buildings was therefore \$475,000 (40% \*\$1,187,500). The carrying amount in the memo accounts was \$467,400 (which can be calculated by rolling forward its share of the fair value as shown in the table below), or as its share of Investee's carrying amount, plus the unamortized basis difference (\$475,000 \$8,000 original basis difference + \$400 depreciation adjustment during 20X1).
- ▶ Upon selling the buildings, Investee recognized a gain of \$2,500 (\$1,190,000 \$1,187,500), of which Investor's share is \$1,000 (\$2,500 \* 40%). However, Investor must adjust the gain for the unamortized negative basis difference attributed to the buildings sold, which was \$7,600 after the depreciation adjustment of \$400. Therefore, Investor's total gain on the building was \$8,600 (calculated as \$1,000 + unamortized basis difference of \$7,600, or as investor's share of the sales proceeds of \$476,000 (40% \* \$1,190,000) compared to its share of the buildings in the memo accounts of \$467,400).
- Investor's basis difference on the buildings and calculation of gain on sale is:

	CARRYING AMOUNT		INVESTOR'S SHARE (40%)		FAIR VALUE		INVESTOR'S SHARE (40%)		INVESTOR'S BASIS DIFFERENCE	
January 1, 20X1 (acquisition)	\$	1,250,000	\$	500,000	\$	1,230,000	\$	492,000	\$	(8,000)
Depreciation (20-year life)		(62,500)		(25,000)		(61,500)		(24,600)		400
December 31, 20X1 (sale)		1,187,000		475,000		1,168,500	1	467,400		(7,600)
Sales price		1,190,000		476,000		1,190,000		476,000		_
Gain on sale	\$	2,500	\$	1,000	\$	21,500	\$	8,600	\$	7,600

- ▶ Investor increases its equity method income by \$7,600 for the negative basis difference related to buildings sold. Therefore, Investor's equity method income for 20X1 is \$207,000 (\$198,400 from Example 4-16 + \$7,600 + its share of Investee's gain, which is 40% \* \$2,500, or \$1,000).
- Note: In this example, Investor increases the gain on sale over the amount recognized by Investee because the buildings had a negative basis difference (the balance in the memo accounts was less than in Investee's financial statements). If the basis difference had been positive, Investor would have reduced the gain on sale when writing off the unamortized basis difference.



#### DEVELOP PROCESSES AND CONTROLS TO IDENTIFY AN INVESTEE'S MATERIAL TRANSACTIONS

In Example 4-17, the investee sold an entire class of assets at the end of a reporting period, which may be unrealistic. An investor should develop processes and controls to obtain the necessary information from its investee when a material asset is sold.

# 4.5 SHARE OF INVESTEE'S CAPITAL TRANSACTIONS



#### **FASB REFERENCES**

ASC 323-10-35-5

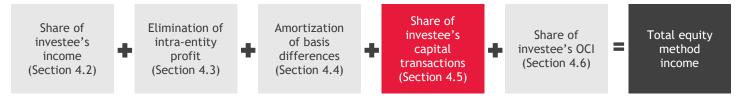
The amount of the adjustment of the carrying amount shall be included in the determination of net income by the investor, and such amount shall reflect adjustments similar to those made in preparing consolidated statements including the following adjustments....

c. Investee capital transactions. Adjustments to reflect the investor's share of changes in the investee's capital....

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.

As discussed in Section 4.1, an investor's equity method income is calculated as follows:



An investor accounts for each investee capital transaction. See the sections below for guidance on common capital transactions.

INVESTEE CAPITAL TRANSACTION	GUIDANCE
Dividends and distributions	Section 4.5.1
Capital contributions	Section 4.5.2
Stock-based compensation granted by an investor to investee's employees	Section 4.5.3
Investee costs paid by investor	Section 4.5.4
Investee transactions with its NCI	Section 4.5.5
Share issuances, including investee share-based payments	Section 5.4
Share repurchases, including treasury shares	Section 5.5



# **IDENTIFYING AN INVESTEE'S CAPITAL TRANSACTIONS**

An investor should develop processes and internal controls over financial reporting to identify an investee's capital transactions, particularly transactions that do not involve the investor (for example, share issuances to other investors).

#### 4.5.1 Distributions and Dividends



# **FASB REFERENCES**

ASC 230-10-45-21D, ASC 323-10-35-17, and ASC 970-323-35-22

An equity method investor generally recognizes a distribution by reducing its investment, rather than as dividend income. See ASC 230 for guidance on classifying dividends and distributions from an equity method investee in the cash flow statement.

An investor accounts for interest received on in-substance capital contributions (for example, when all investors lend and advance funds proportionate to their equity interests) as a distribution rather than as interest income.

#### BDO INSIGHTS: DIVIDENDS AND DISTRIBUTIONS THAT WOULD REDUCE THE CARRYING AMOUNT BELOW ZERO

ASC 323 does not address the accounting when distributions received from an investee exceed the investment's carrying amount (that is, when recognizing the distribution would reduce the investment below zero).

We believe the investor must evaluate the facts and circumstances, including whether:

- The excess distributions might be refundable by law or agreement (for example, the LP or LLC agreement or any loan covenants). GPs often have unlimited liability and obligations, while a limited partner might not.
- The investor has an implicit or explicit commitment to fund the investee (see Section 4.7 for guidance on identifying implicit commitments) or a history of refunding distributions.

If the investor is not liable for the investee's obligations, cannot be forced to refund the distributions, and has no implicit or explicit commitment to financially support the investee, we believe the investor should recognize the excess distribution as equity method income.<sup>20</sup> We believe that policy is consistent with ASC 323-10-35-19 through 35-22 on the accounting once an investor's equity method investment has been reduced to zero (see Section 4.7). However, recognizing the excess distributions as a negative investment (liability) may also be acceptable, depending on the facts and circumstances.

If the investor elects to recognize the excess distribution as equity method income, it cannot recognize subsequent equity method income until the unrecognized income equals the equity method income recognized from the excess distribution (consistent with the approach required when an investor resumes the equity method after suspending losses once its investment has been reduced to zero (see Section 4.7)). An investor must consistently apply and disclose its policy and develop processes and controls to track unrecognized equity method income.

Alternatively, if the investor recognizes a negative equity method investment (either because of a policy election or because facts and circumstances indicate it might need to refund the excess distribution), there is no effect on its equity method income.

<sup>&</sup>lt;sup>20</sup> Recognizing the excess distribution in these circumstances is consistent with AICPA Accounting Standards Executive Committee issues paper, Accounting by Investors for Distributions Received in Excess of Their Investment in a Joint Venture (Oct. 8,1979), and AICPA Technical Practice Aid Section 2200.15.

In a 2008 speech excerpted below, the SEC staff said it would not object to the policy of recognizing equity method income for excess distributions described above.



#### **SEC STAFF GUIDANCE**

#### Remarks before the 2008 AICPA Conference on Current SEC and PCAOB Developments

Robert B. Malhotra, Professional Accounting Fellow, SEC Office of the Chief Accountant

I would next like to cover an equity method accounting issue where an equity method investee may enter into a refinancing transaction. After repayment of the existing financing, and other expenses, it is not uncommon for the investee to distribute the remaining proceeds from the refinancing to its investors.

If the cash distribution received by an equity method investor is in excess of the investor's carrying value of the investment, questions have existed for some time as to whether it would be appropriate for the investor to recognize the excess as a gain in certain circumstances.

Although this is not a new issue, I would like to confirm that the staff would not object to gain recognition in these circumstances, provided that the investor is not liable for the obligations of the investee nor otherwise committed to provide financial support. The staff believes that its view is consistent with the guidance in [ASC 323-10-35-19 through 35-22], which requires an investor to discontinue application of the equity method of accounting when the investment is reduced to zero, unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further support. The staff also believes that a similar conclusion was reached in AICPA Technical Practice Aids Section 2200.15. [Footnotes omitted.]

# 4.5.2 Capital Contributions



# **FASB REFERENCES**

ASC 323-10-35-5(c), ASC 323-10-35-15 through 35-15A, and ASC 323-10-35-29

As discussed in Section 4.5, an investor accounts for an investee's capital transactions (that is, those that affect the investor's share of the investee's equity). An investor increases its investment for a proportionate contribution to the investee unless the contribution is funding prior losses, as discussed in Section 4.7.4.

See Section 5.4 for capital contributed upon a share issuance and Section 5.1 for other changes in ownership interests.

#### BDO INSIGHTS: DETERMINING THE ACCOUNTING FOR DISPROPORTIONATE CONTRIBUTIONS TO AN INVESTEE

When investors appear to disproportionately contribute capital (other than because of buying more shares), they must evaluate the transaction's substance to determine the appropriate accounting. For example, one investor may contribute cash because another investor is contributing nonmonetary assets or services, providing share-based payments to the investee's employees (see Section 4.5.3), or paying other costs on the investee's behalf (see Section 4.5.4).

If the contributions actually are disproportionate, we believe an investor should increase its equity method investment if it is the noncontributing investor for any increase in its share of the investee's net assets and recognize equity method income (or, if it is the contributing investor, expense any excess contribution).

# 4.5.3 Share-Based Payments Granted by an Investor to Investee's Employees



#### **FASB REFERENCES**

ASC 323-10-25-3 through 25-6, ASC 323-10-30-3, ASC 323-10-55-19 through 26, ASC 323-10-S45-1, ASC 323-10-S99-4, and ASC 718-10-15-3A through 15-4

An investor may issue to an employee or nonemployee of an equity method investee a share-based payment award based on the investor's own equity in exchange for goods or services provided by the employee or nonemployee to the investee. ASC 323 applies to that type of share-based payment award if all the following conditions are met:

- No proportionate funding by the other investors occurs
- ▶ The investor's relative ownership percentage in the investee does not increase
- ▶ The share-based payment award was not agreed to be issued in connection with the investor's acquisition of its interest in the investee.

The table below summarizes the accounting in accordance with ASC 323 and ASC 718, Compensation — Stock Compensation, by the investee, contributing investor, and other investors (unless the transfer is clearly for a purpose other than compensation for goods or services provided to the investee and not in the scope of such standards, and assuming all the conditions listed above are met for such arrangements).

INVESTEE	The investee recognizes the compensation cost of the award and a credit to equity, which represents a capital contribution from the investor. The award's cost is measured at fair value and recognized in accordance with ASC 718.
CONTRIBUTING INVESTOR	The contributing investor recognizes compensation cost in the same period the investee recognizes the costs. The award's cost is measured at fair value based on the guidance in ASC 718. The offsetting entry is recognized in equity. The contributing investor recognizes an increase in its equity method investment for its share of the investee's cost and an expense for the portion of the cost attributable to the noncontributing investors.  Also, when recognizing its equity method income, the contributing investor recognizes its share of the investee's net income (inclusive of any compensation cost recognized by the investee).
NONCONTRIBUTING INVESTOR	The noncontributing investor recognizes income for its share of the increase in the investee's net book value (that is, the noncontributing investor's share of the contributed capital recognized by the investee).  Also, when recognizing its equity method income, the noncontributing investor recognizes its share of the investee's net income (inclusive of any compensation cost recognized by the investee).

See our Blueprint, <u>Share-based Payments Under ASC 718</u>, when measuring an award's fair value and recognizing the compensation cost of awards an investor grants to its investee.

#### BDO INSIGHTS: ACCOUNTING WHEN THE INVESTEE REIMBURSES THE CONTRIBUTING INVESTOR

The equity method accounting described above applies only when there is no proportional funding by the other investors and the other conditions are met.

When an equity method investor grants share-based payments to the investee's employees and the investee agrees to reimburse the grantor, we believe all investors are proportionately funding the grant through a proportionate decrease in their share of the investee's net assets upon reimbursement. Therefore, we believe the investor accounting described above does not apply. Instead, we believe the investor (grantor) would simply recognize its share of the investee's accounting for the share-based payments (in accordance with ASC 718) as part of its recurring equity method accounting in which it recognizes its share of the investee's net income, with an adjustment to its equity method investment.

A slightly different scenario could arise if an equity method investee grants to its employees awards that are both:

- Settled in the stock of the equity method investor or in cash based on the share price of the equity method investor's stock
- Granted and fulfilled by the equity method investee, either by directly purchasing the investor's stock or buying the shares on the open market, if publicly traded.

In that scenario, the equity method investee is the grantor and must first determine the awards' appropriate accounting and classification (for example, whether the awards meet the definition of a derivative in ASC 815 or are liability-classified in accordance with ASC 718). Like the reimbursement scenario described above, we believe the equity method investor recognizes its share of the investee's net income (inclusive of the accounting for the award), with an adjustment to its equity method investment.

In all scenarios, contributing and noncontributing investors that are SEC registrants present any income or expense from applying ASC 323 in the same income statement caption as the equity method income. We believe it is appropriate for other entities that are not SEC registrants to consider using the same presentation.

# EXAMPLE 4-18 (ADAPTED FROM ASC 323-10-55-19 THROUGH 55-26); SHARE-BASED PAYMENTS GRANTED BY AND INVESTOR TO INVESTEE'S EMPLOYEES

#### **FACTS**

- Investor A owns 40% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ On January 1, 20X1, Investor A granted 10,000 stock options (in the stock of Investor A) that cliff-vest over three years to employees of Investee for providing services to Investee. If an employee of Investee does not vest in a stock option, the option expires unexercised (that is, Investee gives up the underlying stock).
  - The other investors do not share in funding the stock options, and Investor A was not compelled to grant the stock options under any pre-existing agreements.
  - The stock options' grant date fair value was \$120,000 measured in accordance with ASC 718.
- ▶ Before granting the stock options, the carrying amount of Investor A's investment was \$800,000, and its share of Investee's net assets was \$2,000,000; therefore, there was no basis difference (\$2,000,000 \* 40% = \$800,000).
- Investee capitalized the 20X1 share-based payment expense in an internally constructed fixed asset. Construction was completed December 31, 20X1; therefore, Investee did not recognize any depreciation for this asset during 20X1.
  - For 20X2 and 20X3, Investee recognized depreciation (on the internally constructed fixed asset) and compensation expense (for the stock options that vested during Years 2 and 3).
  - After recognizing those expenses, Investee had net income of \$200,000 for the years ended December 31, 20X1, 20X2, and 20X3. That is, the net income in 20X2 and 20X3 includes (is net of) compensation expense for the awards granted by Investor A and depreciation on the fixed asset.

- Investor B also owns 40% interest of Investee's voting common stock, which it accounts for using the equity method. On January 1, 20X1, Investor B's investment also was \$800,000.
- For simplicity, assume there are no forfeitures or income taxes.

#### **CONCLUSION AND ANALYSIS**

The following journal entries were recognized each year:

#### Investee

		20X1	20X2	20X3
Debit	Fixed asset	\$ 40,000	\$ _	\$ _
Debit	Expense	_	40,000	40,000
Credit	Additional paid-in capital (APIC)	(40,000)	(40,000)	(40,000)

▶ Investee capitalized the compensation cost of \$40,000 (\$120,000 grant date fair value / 3-year vesting period) in 20X1 while the employees constructed the fixed asset. After completing construction, Investee expensed the share-based compensation cost in 20X2 and 20X3.

# Investor A (contributing investor)

		20X1	20X2	20X3
Debit	Equity method investment	\$ 96,000	\$ 96,000	\$ 96,000
Debit	Expense	24,000	24,000	24,000
Credit	APIC	(40,000)	(40,000)	(40,000)
Credit	Equity method income	(80,000)	(80,000)	(80,000)

- Investor A increased its equity method investment for its own share of the cost of \$16,000 (40% \* \$40,000) and expensed \$24,000 for the costs benefitting other investors (60% \* \$40,000), with an offsetting credit to APIC of \$40,000. It may be appropriate to classify the expense for the cost benefitting other investors within (reducing) equity method income.
- Investor A also increased its equity method investment for its share of Investee's net income of \$80,000 (40% \* \$200,000), increasing the equity method investment by \$96,000 (\$16,000 + \$80,000).

# Investor B (noncontributing investor)

		20X1	20X2	20X3
Debit	Equity method investment	\$ 96,000	\$ 96,000	\$ 96,000
Credit	Equity method income	(96,000)	(96,000)	(96,000)

- Investor B increased its equity method investment and recognized equity method income for its share of the increase in Investee's net book value (that is, its share of the contributed capital recognized by Investee) because of the disproportionate award funding of \$16,000 (40% \* \$40,000).
- ▶ Investor B also increased its equity method investment for its share of Investee's net income of \$80,000 (40% \* \$200,000), for a total increase in the equity method investment and total equity method income of \$96,000 (\$16,000 + \$80,000).

#### Rollforward

A rollforward of Investee's net assets and a reconciliation to Investors A and B's investments is as follows:

		20X1		20X2		20X3
Net assets of Investee		2071		2072		2073
.,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,	\$	2,000,000	Ś	2 240 000	ċ	2 490 000
Beginning net assets	Ş	, ,	Ş	2,240,000	\$	2,480,000
Contributed capital (for awards issued by Investor A)		40,000		40,000		40,000
Net income		200,000		200,000		200,000
Ending net assets	\$	2,240,000	\$	2,480,000	\$	2,720,000
Investors A and B's shares		* 40%	<u> </u>	* 40%		* 40%
Investors A and B's shares of Investee's net assets	\$	896,000	\$	992,000	\$	1,088,000
Investors A and B's ending equity method investments		896,000		992,000		1,088,000
Unamortized basis difference	\$	-	\$	-	\$	-

# 4.5.4 Investee Costs Paid by Investor



# **FASB REFERENCES**

ASC 220-10-S99-4 and ASC 323-10-S99-4

An investor may incur costs on an investee's behalf, such as by settling litigation directly with a third party.

In such cases, the investor and investee account for the transaction using the approach for share-based payments granted by the investor to the investee's employees (see Section 4.5.3) if all the following conditions are met:

- No proportionate funding by the other investors occurs
- The investor's relative ownership percentage in the investee does not increase
- ▶ The investor did not agree to incur such costs in connection with the investor's acquisition of its interest in the investee
- ► The investor is not reimbursed
- The investor's action is not because of a relationship or obligation completely unrelated to its role as an investor
- The action benefits the investee.

#### BDO INSIGHTS: PRESENTATION WHEN INVESTEE COSTS ARE PAID BY AN INVESTOR

Contributing and noncontributing investors that are SEC registrants present any income or expense from accounting for such contributions in the same income statement caption as equity method income. We believe it is appropriate for other entities that are not SEC registrants to consider using the same presentation. Contributing investors must also consider the related-party transaction disclosure requirements in ASC 850.

# 4.5.5 Investee Transactions With a Noncontrolling Interest



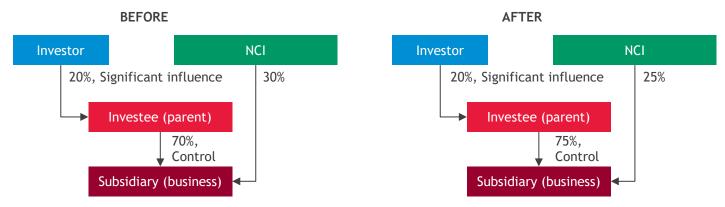
#### **FASB REFERENCES**

ASC 323-10-35-5(c), ASC 323-10-35-15, ASC 810-10-45-21A through 45-23

ASC 810-10-20: Noncontrolling interest

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

An equity method investee may itself be a parent that consolidates non-wholly-owned subsidiaries and therefore recognize NCI in its financial statements. A question arises about how an equity method investor accounts for a transaction in which the investee's (parent's) interest in its subsidiary changes because of a transaction with third parties, while the investee retains control of that subsidiary. For example, in the diagram below, the investee acquires 5% of the NCI (increasing its interest in its subsidiary from 70% to 75%, while keeping control of that subsidiary) but the investor's interest in the investee does not change.



For transactions within the scope of ASC 810, a parent accounts for changes in interest in a subsidiary while keeping control of that subsidiary as an equity transaction. The parent adjusts the NCI's carrying amount for the change in interest and recognizes any difference between that amount and the fair value of the consideration received or paid in equity (not as a gain or loss in net income). For example, if the subsidiary's net assets have a carrying amount of \$1 million but a fair value of \$1.5 million, a 5% interest may be worth \$75,000, but the change in NCI is only \$50,000. Assuming the parent (investee) pays fair value to acquire that 5% interest, it recognizes the \$25,000 difference as an adjustment to equity (for example, APIC).

In such a transaction, there is a change in the amount of the investor's claim on the investee's net assets (based on their carrying amounts), even if the investor's interest in the investee does not change. For example, in the scenario in the preceding paragraph, the difference between the consideration and the adjustment to the NCI affects the investor's (indirect) claim on assets.

#### BDO INSIGHTS: AN INVESTEE'S TRANSACTIONS WITH RESPECT TO NONCONTROLLING INTERESTS

There is diversity in practice in the investor's accounting for transactions involving an NCI. An investor should consistently apply and disclose an accounting policy from the approaches described below, which we believe are all acceptable.



Adjust investment through equity method income

The investor adjusts its equity method investment for the change in the amount of its claim on the investee's net assets through equity method income. This approach is based on the guidance for a decrease in the level of influence or ownership (see Section 5.3) and share issuances (see Section 5.4), as well as the guidance in ASC 323-10-35-5(c) to recognize an investee's capital transactions as an adjustment to equity method income.



Adjust investment through equity

The investor adjusts its equity method investment for the change in the amount of its claim on the investee's net assets through the investor's own equity. This approach is based on recognizing an investee's capital transactions as if the investee were a subsidiary, based on the principle that the equity method is a form of one-line consolidation.



No adjustment (account for as a basis difference) The investor does **not** adjust its equity method investment for the change in the amount of its claim on the investee's net assets; instead, the investor identifies and allocates the basis difference (using the method described in Section 3.3) and amortizes that basis difference to equity method income over time, as discussed in Section 4.4. This approach is based on the requirement to account for differences between the fair value of the investee's (and its subsidiary's) net assets and the carrying amount of those net assets as a basis difference.

# 4.6 SHARE OF INVESTEE'S OTHER COMPREHENSIVE INCOME



#### **FASB REFERENCES**

ASC 323-10-35-18 and ASC 323-10-45-3

As discussed in Section 4.1, an investor's equity method income is calculated as follows:

Share of investee's income (Section 4.2)

Elimination of intra-entity profit (Section 4.3)

Amortization of basis differences (Section 4.4) Share of investee's capital transactions (Section 4.5)

Share of investee's OCI (Section 4.6)

Total equity method income

An investee may recognize items in OCI, such as unrealized gains and losses on available-for-sale debt securities and effective hedges, translation of foreign currency financial statements with respect to the investee's own subsidiaries and equity method investees, and pension-related adjustments or post-employment benefits. An investor generally recognizes its share of the investee's OCI as an increase (or decrease) in its equity method investment with a corresponding adjustment to the investor's OCI.

However, an investor may need to adjust its share of the investee's OCI for basis differences. As discussed in Section 3.3.4, an investor does not recognize its share of the investor's AOCI at initial measurement of the equity method investment. Instead, the investor identifies basis differences in the memo accounts for the difference between the investee's assets' fair values and carrying amounts at that date. Therefore, when the investee reclassifies items from its AOCI that existed as of the acquisition date to income, the investor must adjust its share of the investee's OCI so that it does not recognize its share of that reclassification.

An investor may combine its share of the investee's OCI with its own OCI in the statement of comprehensive income or may separately present such amounts.

See Section 5.3 for the accounting for AOCI upon a change in ownership interest.

#### EXAMPLE 4-19: INVESTOR'S SHARE OF INVESTEE'S OTHER COMPREHENSIVE INCOME

#### **FACTS**

- On January 1, 20X1, Investor acquired 40% of Investee's voting common stock for \$1,000,000, which it accounts for using the equity method.
- Investee's net income for 20X1 is \$1,100,000 and its OCI is \$20,000 related to a gain on an effective hedge that Investee entered during 20X1 (the hedge did not exist when Investor obtained the equity method investment).
- For simplicity, assume there are no intra-entity transactions, basis differences, or income taxes,

#### CONCLUSION

Investor's equity method income is \$440,000 for 20X1 and its share of Investee's OCI is \$8,000.

#### **ANALYSIS**

- Investor's share of Investee's net income is \$440,000 (40% \* \$1,100,000).
- Investor's share of Investee's OCI is \$8,000 (40% \* \$20,000).
- Therefore, the equity method investment is \$1,448,000 as of December 31, 20X1 (\$1,000,000 investment + \$440,000 equity method income + \$8,000 share of OCI).

If Investee held the hedge at the acquisition date, Investor would need to consider the basis difference between Investor's share of the hedge's fair value and carrying amount on that date when recognizing its share of Investee's OCI (see Section 3.3.4).

# 4.7 INVESTEE LOSSES IN EXCESS OF THE INVESTMENT



#### **FASB REFERENCES**

ASC 323-10-35-19 through 35-22, ASC 810-10-45-21, and ASC 970-323-35-2 through 35-7

An investor's share of an investee's losses may exceed the investment's carrying amount. An equity method investor generally recognizes losses only up to the investment's carrying amount and any actual financial support or commitment to provide additional financial support. Financial support to the investee includes:

- Capital contributions
- Investments in common stock, preferred stock, and debt securities (including mandatorily redeemable preferred stock)
- Loans
- Advances

See Section 4.7.2 when the investor provides financial support to the investee that is recognized by the investor as a separate asset in accordance with other U.S. GAAP (that is, as an additional investment in the investee; for example, as a preferred stock investment or loan to the investee).



An investor generally **stops** (suspends) recognizing equity method losses (and amortizing basis differences) once the investment (and other recognized financial support) has been reduced to zero. However, the investor tracks the unrecognized equity method losses in its memo accounts in case the investee returns to profitability.

However, there are two exceptions to this principle. An investor continues recognizing equity method losses to reduce its investment (and any other interests in the investee) below zero as a liability if **either**:

- The investor has guaranteed the investee's obligations or has provided, or is otherwise committed to providing, more financial support to the investee: For example, this might occur when the investor is legally obligated as a guarantor or GP or the investor is implicitly committed to provide more financial support.
  - When an investor is jointly and severally liable for an obligation with an investee or issues a guarantee to a third party on an investee's behalf, the investor accounts for that obligation or guarantee in accordance with ASC 405-40, Liabilities Obligations Resulting From Joint and Several Liability Arrangements and ASC 460, respectively. That accounting is separate from the equity method investment. Therefore, the investor measures that liability separately from recognizing a liability for excess losses (as required by ASC 323).
  - An implicit commitment might arise from the investor's business reputation, intra-entity relationships, credit standing, history of providing support, or statements to other investors or third parties.
  - An investor that is explicitly or implicitly committed to provide more financial support must also consider
    whether the other investors can bear their share of the investee's losses (see Section 4.7.1) and comply with
    the disclosure requirements in ASC 440, Commitments; ASC 450; ASC 810 (if the investee is a VIE); and
    ASC 850.
- The Investee will imminently return to profitability: For example, this might occur when the investee recognizes a material, nonrecurring loss of an isolated nature, but its underlying profitability is not affected.

If the investor recognizes equity method losses in excess of any investments because either of the above situations exists, it presents that amount as a liability.



If the investee later recognizes net income, the investor **resumes** recognizing equity method income only after its share of that net income equals the share of net losses not recognized while the equity method was suspended.

#### BDO INSIGHTS: IDENTIFYING WHEN AN INVESTOR IS IMPLICITLY COMMITTED TO PROVIDE FINANCIAL SUPPORT

Determining whether an investor is explicitly or implicitly committed to provide financial support to an investee requires the application of professional judgment.

An investor must consider the facts and circumstances, including those evaluated when determining whether the investor has the ability to exercise significant influence over the investee (as discussed in Chapter 2), contractual terms, and the activities around the investee. We believe this evaluation is similar to evaluating whether the investor has an implicit variable interest in a VIE (see Section 2.6 of our Blueprint, Control and Consolidation Under ASC 810).



The questions below may be helpful in gathering information to reach a conclusion.



# Participation in designing the investee

- Are the investor and investee under common control, joint control, significant influence, or common management of another party?
- How many investors are involved with the investee, and what are their relationships with each other and roles (for example, passive investor, founder, strategic investor, financial investor)?
- What was the investor's involvement in designing (or redesigning) the investee's governance, capital structure, waterfall provisions?
- What is the investor's role in negotiating contracts, loans, or other agreements on the investee's behalf?
- Is the investor likely to provide financial support because of reputational concerns?



- Is there an industry practice the investor is expected or could be compelled to follow?
- Can banking regulators, the SEC, or other regulatory agencies directly or indirectly compel the investor to provide support?
- Does the investor have a past practice of providing financial support (or do other investors in similar arrangements provide financial support)?
- How unique are the investee's assets or operations, and how significant or important is the investee to the investor (for example, technological dependency or major supplier)?
- Under what conditions would the investor let the investee cease operations?
- Does the investee generate cash flows from operations, even though it recognizes losses under U.S. GAAP (which is common for many investees, such as those in real estate)?



# Contractual terms and arrangements

- What are the investor's explicit commitments and obligations, by contract or law (for example, as guarantor, GP, or LP)?
- Do the terms or prices in any intra-entity transactions (for example, buying and selling inventory) imply the investor would provide more financial support?
- ▶ Can the investor control, influence, or block the timing or amount of future capital calls?



Nature of interests

- ▶ How do the waterfall provisions in the allocations of profit or distributions incentivize or protect the investor?
- Do any incentives or barriers (for example, potential defaults on loan covenants) affect whether the investor provides more support?



Marketing materials and negotiations

- How do current cash flow projections compare to those received at acquisition? Did the investor know the investee would incur losses or need more funding?
- How did the investment terms evolve during negotiation? Was the investor initially asked for a greater investment or other financial support?
- Has the investor or investee communicated or implied to others that the investor will provide more financial support?



# RECOGNIZING LOSSES FOR AN EQUITY METHOD INVESTMENT DIFFERS FROM CONSOLIDATION

The recognition of equity method losses in excess of the investment's carrying amount differs from the consolidation of a non-wholly-owned subsidiary. In accordance with ASC 810, a parent generally allocates losses to NCI regardless of whether that causes the NCI to become negative. In contrast, an equity method investor stops recognizing losses once its investment is zero unless either of the two exceptions discussed above is met (the investor has guaranteed or committed to providing more financial support to the investee, or the investee will imminently return to profitability).

#### EXAMPLE 4-20: SUSPENDING EQUITY METHOD LOSSES WHEN THE INVESTMENT GOES TO ZERO

#### **FACTS**

- Investor holds 35% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ The investment's carrying amount was \$300,000 on January 1, 20X1.
- Investee's net loss for 20X1 is \$1,100,000 and its net income for 20X2 is \$400,000.
- Investor does not hold any other investments in Investee. Further, no facts or circumstances indicate that Investor is explicitly or implicitly committed to funding or providing more financial support or that Investee's return to profitability is imminent.
- For simplicity, assume there are no intra-entity transactions, basis differences, income taxes, or OCI.

#### **CONCLUSION**

Investor's equity method loss is \$300,000 for 20X1 and its equity method income is \$55,000 for 20X2.

#### **ANALYSIS**

- ▶ In 20X1, Investor's share of Investee's net loss is \$385,000 (35% of \$1,100,000), which exceeds the investment's carrying amount by \$85,000 (\$385,000 \$300,000).
- ▶ Because Investor does not hold any other investments in Investee, and no facts or circumstances indicate that it is explicitly or implicitly committed to funding or providing additional financial support to Investee, or that Investee's return to profitability is imminent, Investor stopped recognizing equity method losses once the investment has been reduced to zero. Investor tracks the excess losses of \$85,000 in its memo accounts.
- ▶ In 20X2, Investor's share of Investee's net income is \$140,000 (35% \* \$400,000). However, because Investor did not recognize \$85,000 of equity method losses in 20X1 (which it tracked in its memo accounts), Investor does not recognize the first \$85,000 of equity method income. Therefore, its equity method income for 20X2 is only \$55,000 (\$140,000 − \$85,000).
- ▶ Investor's cumulative equity method loss for 20X1 and 20X2 is \$245,000 (a loss of \$300,000 + \$55,000), which equals its share of Investee's cumulative net loss during that period of \$245,000 (35% \* (a loss of \$1,100,000 + \$400,000).

# 4.7.1 Recognizing a Liability When Other Investors Cannot Bear Their Share of Losses



## **FASB REFERENCES**

ASC 450-20-20 and ASC 970-323-35-8 through 35-10

As discussed in Section 4.2, the general principle in ASC 323 is that an investor recognizes only its share of the investee's income. That principle also generally applies when an investor recognizes losses in excess of its investment or a liability (as discussed in Section 4.7) because it has guaranteed the investee's obligations or has provided, or is otherwise committed to provide, more financial support to the investee. In other words, even when recognizing losses in excess of its investment, an investor generally recognizes only its share of losses.

However, that principle might not apply if it is probable (as defined as "the future event or events are likely to occur" in ASC 450)<sup>21</sup> that another investor cannot bear its share of the investee's losses. In making that determination, an investor considers all facts and circumstances, including:

- The fair value of the other investors' interests in the investee
- The extent to which the investee's debt (if any) is nonrecourse
- The previous loans or contributions by the other investor to support the investee's cash deficits
- ► The other investor's financial standing (credit ratings)
- ▶ The existence of any collateral or guarantees.

If an investor determines that it must recognize a liability (see Section 4.7), and another investor cannot bear its share of losses, the investor recognizes its share of the investee's losses otherwise allocable to the investor that cannot bear its share of losses. Reaching a conclusion about whether the investor is committed to provide more financial support to the investee and whether the other investors can bear their share of losses requires the application of professional judgment based on the facts and circumstances.

If the investee later has net income, the investors recognize their share of the investee's net income otherwise allocable to the investor that could not bear its share of losses until such income equals the excess losses previously recognized.

An investor that cannot bear its share of losses still recognizes its contractual share of losses unless it is relieved from the obligation by agreement or law.

#### 4.7.2 Investee Losses in Excess of the Investment When the Investor Holds Additional Investments



# **FASB REFERENCES**

ASC 323-10-35-23 through 35-28 and ASC 323-10-55-30 through 57

As discussed in Section 4.7, an investor generally recognizes losses only up to the carrying amount of its investment and any commitment to provide additional financial support. However, if the investor has other investments (such as preferred stock) in the investee, it continues recognizing losses after the common stock has been reduced to zero, up to the **adjusted basis** of those other investments, beginning with the most subordinated investments. <sup>22</sup> When applying that guidance, in-substance common stock (see Section 1.2.1) is considered with the common stock.

<sup>&</sup>lt;sup>21</sup> SOP 78-9, Accounting for Investments in Real Estate Ventures, at para. 19.

<sup>&</sup>lt;sup>22</sup> If the investor is explicitly or implicitly committed to provide more financial support, it recognizes losses in excess of the amount of the other investments, as discussed in Section 4.7.

After recognizing losses in accordance with ASC 323, the investor applies ASC 310, *Receivables*; ASC 320-10; ASC 321; or ASC 326-20, *Financial Instruments* — *Credit Losses*, as applicable, to the other investments. For example, if the other investment is preferred stock that is not accounted for using the ASC 321 measurement alternative (see Section 5.2.1), the investor remeasures the preferred stock to fair value through net income (after it recognizes the equity method losses for that reporting period). In other words, each period, the investor performs the steps below:



#### STEP 1

Determine whether the adjusted basis of any other investments is positive and, if so, recognize losses beginning with the most subordinated. investment.





#### STEP 2

Apply other U.S. GAAP (for example, ASC 310, ASC 320, or ASC 321) to the adjusted basis of the other investments.

When performing Step 1, an investor's equity method losses are not based solely on its percentage of common stock. Instead, two acceptable approaches for determining the amount are to use:

- The percentage interest in the other investment to which the equity method losses are being applied (see Example 4-22)
- ▶ The change in the investor's claim on the investee's book value, similar to HLBV as described in Section 4.2.3 (see Example 4-23).

An investor must consistently apply its accounting policy for all equity method investments.

In Step 2, the adjusted basis and the cost basis of the other investments are determined as shown below.

Cost basis The cost basis of the other investments is the original cost of those investments adjusted for:

- Write-downs (impairments)
- Unrealized holding gains and losses on debt securities classified as trading under ASC 320 or on equity securities accounted for in accordance with ASC 321 (that is, those recognized in net income)
  - However, unrealized holding gains and losses on debt securities classified as available-for-sale
    in accordance with ASC 320 are not included in the cost basis of such securities.
- Amortization of any discount or premium on loans or debt securities

Adjusted basis

The adjusted basis is the cost basis adjusted for:

- ▶ The allowance for credit losses on loans or debt securities accounted for in accordance with ASC 326
- The cumulative equity method losses applied in prior periods.



As discussed in Section 4.7, an investor generally **stops** (suspends) recognizing equity method losses (and amortizing basis differences) once the adjusted basis of each investment has been reduced to zero. However, the investor tracks the unrecognized equity method losses in its memo accounts in case the investee returns to profitability.



As discussed in Section 4.7, if the investee later recognizes net income, the investor resumes recognizing equity method income only after its share of that net income equals the share of net losses not recognized while the equity method was suspended. Thereafter, the investor recognizes any equity method income in the adjusted basis of the other investments in reverse order of the losses (that is, to the more senior investments first).

# EXAMPLE 4-21 (ADAPTED FROM ASC 323-10-55-30 THROUGH 55-37): INVESTEE LOSSES WHEN THE INVESTOR HAS OTHER INVESTMENTS IN THE INVESTEE

#### **FACTS**

- On January 1, 20X1, Investor owns:
  - 40% of the Investee's voting common stock, which it accounts for using the equity method. The common stock equity method investment was reduced to zero on January 1, 20X1, because of previous losses (that is, there were no excess losses tracked in the memo accounts during 20X0).
  - 40% of Investee's redeemable preferred stock, which is classified as an available-for-sale debt security (the investment was \$100,000).
  - 40% of Investee's loans (the loan was \$100,000).
- Investor is not explicitly or implicitly compelled to fund Investee. Investor determined that the other investors could bear their share of losses (see Section 4.7.1).
- For simplicity, assume the facts in the table below (amounts are adjusted for intra-entity interest on the loan and preferred dividends received or receivable and assume no basis differences or income taxes).

YEAR	INVESTEE NET	LOSS	CARRYING AMO LOAN UNDER A (NET OF ALLO	ASC 310	FAIR VALUE OF THE PREFERRED STOCK UNDER ASC 320		
January 1, 20X1	\$	_	\$	100,000	\$	100,000	
December 31, 20X1		(200,000)		95,000		90,000	
December 31, 20X2		(400,000)		95,000		90,000	

#### **CONCLUSION & ANALYSIS**

▶ Because Investor owns 40% of each investment (the common stock, preferred stock, and the loan), its accounting is the same regardless of whether it calculates equity method losses based on the interest it owns of the other investment, or on the change in the investor's claim on the investee's book value. If the facts differed, it would need to consistently apply an accounting policy from these alternatives.

#### 20X1

- **Step 1:** Determine whether the adjusted basis of the other investment is positive and, if so, recognize losses beginning with the most subordinated investment:
  - The adjusted basis of the other investments before any 20X1 equity method losses is \$185,000 (\$95,000 for the loan and \$90,000 for the preferred stock). Investor's equity method loss for 20X1 is \$80,000 (40% \* \$200,000). Therefore, Investor recognizes the equity method loss by reducing the preferred stock, which is the most subordinated investment:

Debit Equity method loss \$ 80,000

Credit Preferred stock \$ 80,000

- **Step 2:** Apply other U.S. GAAP to the adjusted basis of the other investments:
  - Investor recognizes an allowance for credit losses on the loan in accordance with ASC 326 for \$5,000 (\$100,000 \$95,000).

Debit Credit loss expense \$ 5,000

Credit Allowance for credit losses \$ 5,000

• Investor recognizes the change in the fair value of the available-for-sale preferred stock in accordance with ASC 320. The fair value of \$90,000 minus the preferred stock's carrying amount after the entry in Step 1 of \$20,000 (\$100,000 - \$80,000), results in a \$70,000 unrealized gain.

Debit Preferred stock \$ 70,000

Credit Unrealized gain — OCI \$ 70,000

▶ Therefore, on December 31, 20X1, the adjusted bases are \$0 for the common stock, \$95,000 for the loan, and \$20,000 for the preferred stock (which excludes the \$70,000 fair value adjustment because it an available-for-sale debt security), or \$115,000 in total.

#### 20X2

- **Step 1:** Determine whether the adjusted basis of the other investment is positive and, if so, recognize losses beginning with the most subordinated investment:
  - Because the other investments' total adjusted basis is only \$115,000 before any 20X2 equity method losses, and Investor does not have any explicit or implicit obligation to fund losses, the equity method losses are limited to that amount. Investor's equity method losses for 20X2 would be \$160,000 (40% \* \$400,000) because it owns 40% of each investment, leaving \$45,000 (\$160,000 \$115,000) of unrecognized equity method losses in the memo accounts. Investor recognizes \$20,000 of equity method losses by reducing the preferred stock, which is the most subordinated investment, until its adjusted basis is zero. Investor recognizes \$95,000 against the loan, which also has been reduced to zero:

Debit Equity method loss \$ 115,000

Credit Preferred stock \$ 20,000 Credit Loan 95,000

- **Step 2:** Apply other U.S. GAAP to the adjusted basis of the other investments:
  - Investor recognizes the change in the fair value of the available-for-sale preferred stock in accordance with ASC 320. The fair value of \$90,000 minus the preferred stock's carrying amount after the entry in Step 1 of \$70,000 (\$90,000 on December 31, 20X1 \$20,000) results in a \$20,000 unrealized gain.

Debit Preferred stock \$ 20,000

Credit Unrealized gain — OCI \$ 20,000

- ► Therefore, on December 31, 20X2, the adjusted basis is \$0 for the common stock, \$0 for the loan, and \$0 for the preferred stock (which excludes the \$90,000 cumulative fair value adjustments because it an available-for-sale debt security), with \$45,000 in unrecognized equity method losses tracked in the memo accounts.
- In accordance with ASC 310, assume there is no adjustment to the loan's carrying amount and no credit allowance in accordance with ASC 326.
- ▶ See ASC 323-10-55-38 through 55-37 for the continuation of this example, including more loan losses and recoveries, as well as additional losses on the preferred stock in accordance with ASC 320 and the subsequent sale of the preferred stock.

# EXAMPLE 4-22 (ADAPTED FROM ASC 323-10-55-49 THROUGH 55-53): DETERMINING EQUITY METHOD LOSSES BASED ON OWNERSHIP LEVEL

#### **FACTS**

- On January 1, 20X1 Investor owns:
  - 40% of Investee's voting common stock, which it accounts for using the equity method. The common stock equity method investment was reduced to exactly zero on January 1, 20X1, because of previous losses (that is, there were no excess losses tracked in the memo accounts during 20X0).
  - 50% of Investee's preferred stock, which is accounted for as an equity investment using the ASC 321 measurement alternative (assume there are no observable transactions that would cause a remeasurement) (the investment was \$100,000).
  - 60% of Investee's loans (the loan was \$100,000).
- Investor:
  - Elected a policy to determine equity method losses based on its ownership in the investment to which the losses are being applied

- Is not explicitly or implicitly obligated to fund Investee
- Determined that the other investors can bear their share of losses (see Section 4.7.1)
- Assume the facts in the table below. (Further assume for simplicity that the amounts are adjusted for intraentity interest on the loan in accordance with ASC 310, that Investor would not recognize an allowance for credit losses on this loan in accordance with ASC 326, and no preferred dividends received or receivable and assume no basis differences or income taxes).

YEAR	INVESTEE N (LOSS)	ET INCOME	LOAN CARRYIN AMOUNT UNDI (NET OF ALLO	ER ASC 310	PREFERRED S MEASUREMEN ASC 321	
January 1, 20X1	\$	_	\$	100,000	\$	100,000
December 31, 20X1		(160,000)		100,000		100,000
December 31, 20X2		(200,000)		100,000		100,000
December 31, 20X3		500,000		100,000		100,000

#### **CONCLUSION & ANALYSIS**

#### 20X1

- **Step 1:** Determine whether the adjusted basis of the other investment is positive, and if so, recognize losses beginning with the most subordinated investment:
  - The adjusted basis of the other investments before any 20X1 equity method losses is \$200,000 (\$100,000 for the loan and \$100,000 for the preferred stock). The most subordinated investment is the preferred stock; therefore, Investor's equity method loss for 20X1 is \$80,000 (50% \* \$160,000) because it owns 50% of the preferred stock. Therefore, Investor recognizes the following entry:

Debit Equity method loss \$ 80,000

Credit Preferred stock \$ 80,000

- **Step 2:** Apply other U.S. GAAP to the adjusted basis of the other investments:
  - There is no loan adjustment in accordance with ASC 310 (and no credit allowance is required in accordance with ASC 326) and no preferred stock remeasurement (because there is no observable transaction that would cause remeasurement in accordance with ASC 321).
  - Therefore, on December 31, 20X2, the adjusted basis is \$100,000 for the loan and \$20,000 for the preferred stock.

#### 20X2

- **Step 1:** Determine whether the adjusted basis of the other investment is positive and, if so, recognize losses beginning with the most subordinated investment:
  - Investor recognizes the equity method loss to the extent of the preferred stock's adjusted basis of \$20,000 (50% \* \$40,000 = \$20,000) and, because the preferred stock's adjusted basis will then be zero, recognizes the remaining equity method loss by reducing the loan (the next most subordinated investment) for \$96,000 (60% \* \$160,000 [that is, \$200,000 \$40,000 applied to the preferred stock]). Therefore, Investor records the following journal entry:

Debit Equity method loss \$ 116,000

Credit Preferred stock \$ 20,000

Credit Loan 96,000

- **Step 2:** Apply other U.S. GAAP to the adjusted basis of the other investments:
  - There is no loan adjustment in accordance with ASC 310 (and no credit allowance is required in accordance with ASC 326) and no preferred stock remeasurement (because there is no observable transaction that would cause remeasurement in accordance with ASC 321).
  - Therefore, on December 31, 20X2, the adjusted basis is \$0 for the common stock, \$4,000 for the loan, and \$0 for the preferred stock.

#### 20X3

▶ **Step 1:** Determine whether the adjusted basis of the other investment is positive and, if so, recognize income beginning with the least subordinated investment:

INVESTMENTS (IN ORDER OF PRIORITY)	ADJUSTED BEFORE 20 JOURNAL	)X3	MAXIMUM ( AMOUNT U OTHER U.S	NDER	EQUIT'	_	INCOME DCATED
							\$ 500,000
Loan (60%) (a)	\$	4,000	\$	100,000	\$	96,000	160,000
Preferred stock (50%) (b)		_		100,000		100,000	200,000
Common stock (40%) (c)		_	(n	o maximum)		56,000	140,000

- (a) The loan is the most senior instrument held by Investor. Accordingly, Investor first recognizes its share of Investee's net income by restoring the loan up to the lesser of its maximum adjusted basis (in this case, \$100,000), or by the Investor's share of Investee's net income for 20X3. Before the 20X3 journal entries, the loan's carrying amount was \$4,000 (\$100,000 carrying amount in accordance with ASC 310 minus the \$96,000 of equity method loss recognized in 20X2). Investor holds 60% of the loans, meaning that the total write-down to the loans in 20X2 (inclusive of those held by other investors) was \$160,000 (\$96,000/60%). Accordingly, of Investee's \$500,000 in net income in 20X3, the first \$160,000 was used to restore the loans to their carrying amounts.
- (b) The preferred stock is the next most senior instrument held by Investor. Accordingly, Investor next recognizes its share of Investee's net income by restoring the preferred stock up to the lesser of its maximum adjusted basis under other U.S. GAAP (in this case, \$100,000), or by the Investor's share of Investee's remaining net income for 20X3. Before the 20X3 journal entries, the loan's carrying amount was \$0 (\$100,000 carrying amount in accordance with ASC 326 minus \$80,000 of equity method loss recognized in 20X1 and the \$20,000 loss recognized in 20X2). Investor holds 50% of the preferred stock, meaning that the total write-down to the preferred stock in prior years (inclusive of those held by other investors) was \$200,000 (\$100,000 cumulative losses/50%). Accordingly, of Investee's \$500,000 in net income in 20X3, the next \$200,000 was used to restore the preferred stock to its carrying amount.
- (c) The common stock is the least senior (most subordinated) instrument held by Investor. Accordingly, Investor recognizes its share of Investee's net income that has not yet been allocated to restoring the carrying amounts of more senior instruments as an adjustment to the common stock investment. The net income of \$140,000 allocated to the common stock is calculated using Investee's total net income of \$500,000 minus net income allocated to the less subordinated (more senior) investments (that is, the \$160,000 allocated to the loan and \$200,000 allocated to the preferred stock. Therefore, the amount allocated to Investor's common stock is \$56,000 (\$140,000 \* 40%).

Therefore, Investor records the following journal entry:

Debit	Loan	\$ 96	,000	
Debit	Preferred stock	100	,000	
Debit	Common stock	56	,000	
Credit	Equity method income		\$	252,000

- **Step 2:** Apply other U.S. GAAP to the adjusted basis of the other investments:
  - There is no loan adjustment in accordance with ASC 310 (and no credit allowance is required in accordance with ASC 326) and no preferred stock remeasurement (because there is no observable transaction that would cause remeasurement in accordance with ASC 321).
  - Therefore, on December 31, 20X3, the equity method investment's carrying amount is \$56,000, and the adjusted bases for the loan and preferred stock are \$100,000.

# EXAMPLE 4-23 (ADAPTED FROM ASC 323-10-55-49 AND 55-54 THROUGH 55-57); DETERMINE EQUITY METHOD LOSSES BASED ON THE CHANGE IN INVESTOR'S CLAIM ON INVESTEE'S BOOK VALUE

#### **FACTS**

Assume the same facts as in Example 4-22, except that Investor recognizes equity method losses based on the change in its claim on Investee's book value. Further:

- ▶ There were no changes in the investments (that is, no contributions, distributions, principal payments, or dividends) from January 1, 20X1, through December 31, 20X3.
- ► Investee's balance sheet is:

	JANUA	RY 1, 20X1	DECEMBE	R 31, 20X1	DECEMBI	ER 31, 20X2	DECEMBE	ER 31, 20X3
Assets	\$	367,000	\$	207,000	\$	7,000	\$	507,000
Loan	\$	167,000	\$	167,000	\$	167,000	\$	167,000
Preferred stock		200,000		200,000		200,000		200,000
Common stock		300,000		300,000		300,000		300,000
Accumulated deficit		(300,000)		(460,000)		(660,000)		(160,000)
Total	\$	367,000	\$	207,000	\$	7,000	\$	507,000

In this example, all amounts are rounded to the nearest thousand.

#### **CONCLUSION AND ANALYSIS**

#### 20X1

- **Step 1:** Determine whether the adjusted basis of the other investment is positive and, if so, recognize losses beginning with the most subordinated investment:
  - Using HLBV, the \$207,000 available to distribute on December 31, 20X1, would be allocated as:

DECEMBER 31, 20X1	NET	ASSETS	INVESTOR	OTHERS	
Total net assets available to distribute	\$	207,000			
First, to the loans (Investor's share is 60%)		(167,000)	\$ 100,000	\$	67,000
Second, to the preferred stock (Investor's share is 50%)		(40,000)	20,000	)	20,000
Third, to the common stock (Investor's share is 40%)		_	_	-	_
Total claim on book value at year-end	\$	_	\$ 120,000	\$	87,000

• Investor would receive only \$120,000 on December 31, 20X1; its claim on Investee's book value on January 1, 20X1, was \$200,000 (\$100,000 for the loan and \$100,000 on the preferred stock). Therefore, during 20X1, Investor's claim on Investee's book value decreased by \$80,000, which is its equity method loss. Investor records the following journal entry:

Debit Equity method loss \$ 80,000

Credit Preferred stock \$ 80,000

▶ Step 2: Apply other U.S. GAAP to the adjusted basis of the other investments (See Example 4-22).

#### 20X2

- **Step 1:** Determine whether the adjusted basis of the other investment is positive, and if so, recognize losses beginning with the most subordinated investment:
  - Using HLBV, the \$7,000 available to distribute on December 31, 20X2 would be allocated as:

DECEMBER 31, 20X2	NET	ASSETS	INVESTOR		OTHERS	
Total net assets available to distribute	\$	7,000				
First, to the loans (Investor's share is 60%)		(7,000)	\$	4,000	\$	3,000
Second, to the preferred stock (Investor's share is 50%)		_		_		_
Third, to the common stock (Investor's share is 40%)		_		_		_
Total claim on book value at year-end	\$	_	\$	4,000	\$	3,000

• Investor would receive \$4,000 on December 31, 20X2; its claim on Investee's book value on December 31, 20X1, was \$120,000. Therefore, during 20X2, Investor's claim on Investee's book value decreased by \$116,000, which is Investor's equity method loss. Investor records the following journal entry:

Debit	Equity method loss	\$ 116,000	
Credit	Preferred stock		\$ 20,000
Credit	Loan		96,000

▶ Step 2: Apply other U.S. GAAP to the adjusted basis of the other investments (See Example 4-22).

#### 20X3

- ▶ **Step 1:** Determine whether the adjusted basis of the other investment is positive and, if so, recognize income beginning with the least subordinated investment:
  - Using HLBV, the \$507,000 available to distribute on December 31, 20X3 would be allocated as:

DECEMBER 31, 20X3	NET A	ASSETS	INVES	TOR	OTHERS	
Total net assets available to distribute	\$	507,000				
First, to the loans (Investor's share is 60%)		(167,000)	\$	100,000	\$	67,000
Second, to the preferred stock (Investor's share is 50%)		(200,000)		100,000		100,000
Third, to the common stock (Investor's share is 40%)		(140,000)		56,000		84,000
Total claim on book value at year-end	\$	_	\$	256,000	\$	251,000

• Investor would receive \$256,000 on December 31, 20X3; its claim on Investee's book value on December 31, 20X2, was \$4,000. Therefore, during 20X3, Investor's claim on Investee's book value increased by \$252,000, which is Investor's equity method income. Investor records the following journal entry:

Debit	Loan	\$ 96,000	
Debit	Preferred Stock	100,000	
Debit	Investment in Investee	56,000	
Credit	Equity method income		\$ 252,000

**Step 2:** Apply other U.S. GAAP to the adjusted basis of the other investments (See Example 4-22).

# 4.7.3 Investee Losses and Other Comprehensive Income



#### **FASB REFERENCES**

ASC 323-10-35-5 and ASC 323-10-35-18 through 35-22

Under the equity method, an investor recognizes its share of the investee's income and OCI. However, an investor generally recognizes its share of the investee's net losses only up to the investment's carrying amount and any actual financial support or commitment to provide additional financial support. In other words, once an investor's equity method investment has been reduced to zero, the investor stops (suspends) recognizing equity method losses. If the investee later recognizes income, the investor resumes recognizing equity method income only after its share of that income equals the share of losses not recognized while the equity method was suspended (see Section 4.7).

32,000

#### BDO INSIGHTS: RECOGNIZING EQUITY METHOD INCOME AFTER SUSPENDED LOSSES

ASC 323 does not describe how to apply the equity method once the investment has been reduced to zero through both net losses and other comprehensive losses. Therefore, we believe an investor should consistently apply an accounting policy. One policy applied in practice is to separately track the investor's share of unrecognized net losses and other comprehensive losses in separate memo accounts, which are adjusted only when the investee later recognizes net income and OCI, respectively.

# EXAMPLE 4-24: INVESTEE LOSSES WITH OCI WHEN THE INVESTMENT CARRYING VALUE IS ZERO BECAUSE OF PRIOR EQUITY METHOD LOSSES

#### **FACTS**

- On January 1, 20X1, Investor contributed \$200,000 to Investee for 40% of Investee's voting common stock, which it accounts for using the equity method. Other investors contributed \$300,000, for \$500,000 in total.
- Investor does not hold any other investments in Investee. No facts or circumstances indicate that Investor is explicitly or implicitly committed to funding or providing additional financial support or that Investee's return to profitability is imminent.
- Investor elected a policy to track its share of unrecognized net losses and other comprehensive losses in separate memo accounts, which are adjusted only when Investee later recognizes net income and OCI, respectively.
- For simplicity, assume there are no intra-entity transactions, basis differences, or income taxes.
- ▶ Investee net income (loss) and other comprehensive income (loss) for 20X1 and 20X2 are:

YEAR	NET INCOM	E (LOSS)	OTHER COMPREHENSIVE INC	COME (LOSS)
20X1	\$	(320,000)	\$	(190,000)
20X2		(60,000)		90,000

#### **CONCLUSION AND ANALYSIS**

▶ In 20X1, Investor recognizes an equity method loss of \$128,000 (\$320,000 \* 40%) and other comprehensive loss of \$72,000 (\$190,000 \* 40% is \$76,000 but it is limited to the \$72,000 equity method investment's carrying amount after the investor recognizes the equity method loss (\$200,000 − \$128,000)). Because Investor does not have a commitment to fund Investee's losses, and Investee's return to profitability is not imminent, Investor does not record its full share of Investee's other comprehensive losses. Therefore, Investor tracks the remaining \$4,000 (share of \$76,000 − \$72,000) in its memo accounts. On December 31, 20X1, Investor records the following:

Debit	Equity method loss	\$ 128,000	
Debit	Other comprehensive loss	72,000	
Credit	Fauity method investment	\$	200.000

▶ In 20X2, Investor recognizes an equity method loss of \$24,000 (\$60,000 \* 40%) and other comprehensive income of \$32,000 (\$90,000 \* 40% is \$36,000 but it is limited to \$32,000 because of the unrecognized other comprehensive losses of \$4,000 in 20X1). On December 31, 20X2, Investor records the following:

Debit	Equity method investment	\$ 8,000
Debit	Equity method loss	24,000
Credit	Other comprehensive income	\$

▶ A rollforward of Investee's net assets and a reconciliation to the equity method investment is:

	20X1		20X2	
Rollforward of Investee's net assets				
Beginning net assets	\$	500,000	\$	(10,000)
Equity method losses		(320,000)		(60,000)
Equity method other comprehensive (loss) income		(190,000)		90,000
Ending net assets	\$	(10,000)	\$	20,000
Investor's share (40%)	\$	(4,000)	\$	8,000
Reconciliation of amounts recorded by Investor				
Equity method investment (balance sheet)	\$	_	\$	8,000
Equity method investment (memo account)	(4,000)			
Ending net assets	\$	(4,000)	\$	8,000

# 4.7.4 Investments After Suspending Equity Method Losses



#### **FASB REFERENCES**

ASC 323-10-35-29 through 35-30 and ASC 810-10-35-4

As discussed in Section 4.7, once an investor's equity method investment has been reduced to zero, the investor stops (suspends) recognizing equity method losses. However, if the investor later invests in the investee but does not obtain control of the investee, it must determine whether the subsequent investment represents, in substance, the funding of prior losses and whether it is otherwise committed to provide financial support to the investee (see Section 4.7).

The later investment is funding prior losses



The investor recognizes previously suspended losses tracked in the memo accounts (up to the additional investment that is funding prior losses).

The later investment is not funding prior losses



The investor accounts for the investment as a capital contribution, as discussed in Section 4.5.2.

Reaching a conclusion about whether a subsequent investment is funding prior losses requires the application of professional judgment considering the facts and circumstances, including:

- ▶ The counterparty: If the investor bought the investment from a third party and the investee does not obtain more funds from the investor or a third party, in the absence of other factors, it is unlikely the investor is funding prior losses.
- The fair value of the consideration received compared to that of the consideration paid: If the fair value of the consideration received is less than that of the consideration paid, the investor may be funding prior losses.
- The new ownership percentage in the investee: If all investors proportionately invested (that is, the ownership interests in the investee stay the same), the investor may be funding prior losses.
- The new investment's seniority compared to existing equity: If the investment is subordinate to the investee's other equity, the investor may be funding prior losses.

# BDO INSIGHTS: RECONSIDER VIE AND PRIMARY BENEFICIARY CONCLUSIONS UPON SUBSEQUENT INVESTMENTS

As discussed in our Blueprint, <u>Control and Consolidation Under ASC 810</u>, the determination of whether an investee meets the definition of a VIE is reconsidered upon certain events, including when the investee's governing documents or contractual arrangements change in a manner that affects the characteristics or adequacy of the equity at risk, and when the investee receives more equity at risk or changes its activities in a way that decrease its expected losses. If an investee meets the definition of a VIE, its primary beneficiary is continuously evaluated.

Therefore, upon a subsequent investment in an investee, an investor must reevaluate whether the investee meets the definition of a VIE and, if so, whether the investor is the investee's primary beneficiary. If the investor is, it controls and consolidates the investee (VIE) and stops applying the equity method.

# 4.8 OTHER THAN TEMPORARY IMPAIRMENT



### **FASB REFERENCES**

ASC 323-10-35-13 through 35-14, ASC 323-10-35-31 through 35-32A, ASC 820-10-20: Level 1 inputs, and ASC 970-323-35-12 through 35-13

An investor impairs its equity method investment when it has an **other than temporary** loss in value, even if the impairment is more than what the investor would otherwise recognize by applying the equity method. If there is an OTTI, the investor remeasures the investment to fair value and recognizes an impairment for the excess of the carrying amount over fair value. Reaching a conclusion about whether an OTTI has occurred requires the application of professional judgment based on the facts and circumstances.

The OTTI model for equity method investments can be applied in the steps below:

# INTERPRETIVE GUIDANCE STEP 1 Identify Indicators of a loss in value could include: 23 indicators of The investee cannot sustain income (for example, it has a series of operating losses) impairment or continue paying dividends ▶ A decline in the investee's near-term prospects or future income potential compared to expected performance at the acquisition date, including because of changes in facts and circumstances (for example, changes in technology, discontinuing a segment, regulatory action, or loss of customers or suppliers) ▶ The investee's financial condition deteriorates, as illustrated by a decrease in capital strength, liquidity crisis, downgrade in credit rating, bankruptcy, or inability to continue as a going concern ▶ A transaction with the investee (or an impairment recognized by the investee) confirms a loss in value Other investors decrease their support or commitment to the investee ▶ The investment's fair value is less than its carrying amount or the investor cannot recover the investment, including because of changes in the economy, industry, or market in which the investee operates. This list is not exhaustive or determinative; all facts and circumstances should be considered. STEP 2 Determine The investor determines the investment's fair value in accordance with ASC 820, which the often requires the involvement of valuation expertise unless the investee issues equity investment's with a quoted market price. One acceptable technique for measuring fair value uses fair value discounted cash flows. If the investment's carrying amount exceeds its fair value, continue to Step 3. Otherwise, the investment is not impaired. STEP 3 Determine ASC 323 does not define the term "temporary" (see the BDO Insight below). whether the loss in value is other than temporary STEP 4 Recognize If the equity method investment is other than temporarily impaired, the investor impairment remeasures the investment to fair value (recognizing a loss) and adjusts the unamortized basis differences (see Section 4.8.2).

<sup>&</sup>lt;sup>23</sup> Some indicators and factors mentioned were from SEC SAB Topic 5.M and other SEC staff publications, which have been rescinded due to the issuance of ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, and the creation of a new impairment model for financial instruments other than equity method investments. However, we believe the superseded guidance continues to be helpful when applying the OTTI model for equity method investments, which was not amended by ASU 2016-01.

#### BDO INSIGHTS: MEANING OF "TEMPORARY" IN "OTHER THAN TEMPORARY"

As discussed above, ASC 323 does not define the word "temporary." We believe an investor should consider both:

- ▶ The time and extent to which the investment's fair value has been less than its carrying amount
- ▶ The investor's intent and ability to hold the investment long enough to recover the investment's fair value. 24

While there is no bright line, some believe that "temporary" is measured in months (not years). The phrase "other than temporary" does not mean that the impairment is necessarily expected to be permanent. The SEC staff speech excerpted below suggests that a decline in fair value for more than a year generally is not considered temporary.

When evaluating a recovery period, an investor may need to consider the reasonableness of any projected annual growth rate used. If the rate is constant, it takes longer to recover value than it does to decline in value. For example, if the fair value of an equity method investment declines 10% in one year, the asset will not recover in one year even if it grows at 10% annually. To illustrate, if in one year an asset declines from \$100 to \$90, a 10% growth rate the following year would result in a fair value of only \$99.

We believe an investor should consistently evaluate similar fact patterns and that the longer the period, the more evidence the investor should have to support its conclusion that the impairment is temporary.



# FREQUENT ERRORS WHEN APPLYING THE OTHER THAN TEMPORARY IMPAIRMENT MODEL

When applying the OTTI model, avoid the following errors:

- **Separately evaluating an investee's underlying asset(s) for impairment:** The unit of account for evaluating an equity method investment is the **investment as a whole**. However, as discussed in Section 4.8.2, an investor recognizes its share of the investee's impairments, adjusted for basis differences in the impaired assets.
- ▶ Using undiscounted cash flows to support not recognizing an equity method investment OTTI: ASC 323-10-35-32 states that evidence of a loss in value might include an "absence of an ability to recover the carrying amount of the investment," Some have misinterpreted that to mean that if the investor expects to recover the investment when comparing the undiscounted cash flows, there is no OTTI. However, the OTTI model considers fair value, which under ASC 820 may be determined using discounted, not undiscounted, cash flows. The SEC staff said it would object to using undiscounted cash flows as a basis for not recognizing an OTTI. 25
- **Reversing an equity method impairment:** Equity method investment impairments cannot be reversed, even if the investment does recover in value.
- ▶ Separating a decrease in value between the temporary and other than temporary portions: Even if an investor expects that an investment will recover some (but not all) of its value, it cannot consider that expectation when recognizing the impairment, except to the extent that such expectations are considered in measuring the investment's fair value in accordance with ASC 820. An other than temporarily impaired investment must be written down to its current fair value at the measurement date.
- ▶ Ignoring the tax effects of any impairment: If the investor recognizes an OTTI and the investment's tax basis is more than its new carrying amount, the investor must recognize a deferred tax asset. However, the investor must then determine whether to recognize a valuation allowance on that deferred tax asset (see ASC 740).

<sup>&</sup>lt;sup>24</sup> See Note 23.

<sup>&</sup>lt;sup>25</sup> Minutes from the discussion of EITF Issue No. 03-1 "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (Mar. 2004), at para. 25.

# BDO INSIGHTS: THE OTTI MODEL IS UNIQUE IN U.S. GAAP

The OTTI model differs from other impairment models in U.S. GAAP. For example, it differs from measuring impairments for a subsidiary, wherein the parent evaluates the underlying assets for impairment. It also differs from the model used to evaluate impairment of property, plant, equipment, and definite-lived intangible assets, which has a two-step test whose first step is evaluating the asset's recoverability based on undiscounted cash flows. Further, the OTTI model for equity method investments is the only model in U.S. GAAP that considers whether the impairment is temporary.

#### BDO INSIGHTS: APPLYING THE OTTI MODEL WHEN THE INVESTEE'S EQUITY HAS A QUOTED MARKET PRICE

When an investee's equity has a quoted market price, and the investment's carrying amount on a per-share basis is more than that amount, the investment generally is impaired. However, before recognizing an OTTI, the investor must evaluate whether:

- ▶ The impairment is other than temporary (as discussed in Step 3)
- ▶ The instrument held by the investor has the same rights and privileges (for example, voting rights and distribution privileges), as well as the same restrictions and other features as the instrument with the quoted market price.

If the investor's instrument has a quoted price (unadjusted) in an active market for the **identical** asset, which the investor can access at the measurement date, (that is, if a "Level 1" input exists as defined in ASC 820), the investor is required to use that quoted market price to measure an OTTI. In other words, an investor may not use discounted cash flows to measure an investment's fair value in this scenario.

However, if the investor's instrument has **different** characteristics from the instrument with the quoted market price, or if that quoted market price otherwise does **not** represent a Level 1 input, the investor must use professional judgment and valuation expertise and apply ASC 820 to determine which valuation techniques are permissible under the circumstances to estimate the investment's fair value.

Reaching a conclusion about whether the impairment is other than temporary, and whether the investor's instruments are the same as those with a quoted market price, requires the application of professional judgment and valuation expertise based on the facts and circumstances.



### **SEC STAFF GUIDANCE**

#### Remarks at the 2003 Thirty-First AICPA National Conference on Current SEC Developments

D. Douglas Alkema, Professional Accounting Fellow, SEC Office of the Chief Accountant

Notwithstanding rumors to the contrary, the SEC staff does not conclude on an other-than-temporary impairment issue by using a bright line or even a rule of thumb. Rather, the determination of whether a decline is other than temporary must be made using all evidence that's available to the investor, including: the severity and duration of the decline as well as the investor's ability and intent to hold an investment for a reasonable period of time sufficient for a forecasted recovery... An other-than-temporary decline could occur within a very short period or, if the facts and circumstances support it, a decline in excess of a year might still be temporary....

In these situations, an investor's ability and intent is a critical factor in determining whether an other-than-temporary impairment should be recognized. While the staff recognizes that unforeseen factors might cause an investor to subsequently deviate from its assertions regarding intent or ability, a pattern of selling investments prior to the forecasted market price recovery would call into question the investor's future assertions related to its intent and ability to hold investments until recovery....

As a practical matter there are limitations on the period of time that management can incorporate into its forecast of market price recoveries. As the forecasted market price recovery period lengthens, the uncertainties inherent in management's estimate increase, which impact the reliability of that estimate. Market price recoveries that cannot reasonably be expected to occur within an acceptable forecast period should not be included in the assessment of recoverability....

The staff appreciates that the assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment. These factors only serve to stress the importance of transparent disclosure as well as employing a systematic and rational methodology that includes documentation of all of the factors considered by management in reaching its conclusions regarding other-than-temporary impairments. [Footnotes omitted.]



# **FASB PROJECT: CODIFICATION IMPROVEMENTS**

In July 2025, the FASB decided as part of its codification improvements project to clarify that it would not be appropriate for an investor to elect the fair value option (see Section 1.6) for an equity method investment upon recording an OTTI for that investment.

The amendment will be applied either retrospectively or prospectively and will be effective for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026, for all entities. Early adoption will be allowed. See the <u>FASB website</u> for more information.

# 4.8.1 Impairment and the Effect on Basis Differences



# **FASB REFERENCES**

ASC 323-10-35-13 and ASC 323-10-35-34

As discussed in Sections 3.3 and 4.4, an investor uses memo accounts to track the basis differences between its share of the investee's net assets and the cost of the investment as if the investee were a subsidiary. When determining its equity method income, an investor adjusts for those basis differences (for example, by recognizing more depreciation, amortization, or accretion over the assets' useful lives, if applicable, leaving an unamortized basis difference.

Accordingly, an investor must consider how an OTTI affects the amounts in the memo accounts and the unamortized basis differences going forward. This is because the impairment causes an immediate change in the investment's carrying amount (which is adjusted to fair value) as compared to the investor's share of the investee's net assets.

To address that change in the investment's carrying amount, the investor must allocate an impairment to the unamortized basis differences in the memo accounts, even though the investment is evaluated for impairment as a whole (and not the individual assets). If the impairment exceeds the unamortized basis difference, or if there was no basis difference on the acquisition date, the impairment creates a negative basis difference in total, because the investment's carrying amount is less than the investor's share of the carrying amount of the investee's net assets.

#### BDO INSIGHTS: APPROACHES FOR ALLOCATING AN IMPAIRMENT TO THE UNAMORTIZED BASIS DIFFERENCES

U.S. GAAP does not specify how an investor should allocate an impairment to the unamortized basis differences in the equity method memo accounts. We believe an investor should use a consistent approach for allocating impairments in the memo accounts for equity method investments, such as by allocating the impairment using one of the following approaches:

- ▶ To any equity method goodwill, then pro rata to any basis differences related to qualifying nonfinancial assets; and third, and then to the investee's remaining assets.
- ▶ To the underlying assets based on their relative fair values on the impairment date.
- To the item that led to the impairment charge (for example, an impairment arising from infringement on an investee's patent rights would be allocated to those patents in the memo accounts).

Other approaches might be acceptable. However, we believe it would be inappropriate to allocate any impairment in a manner such that the resulting carrying amount of any asset in the investor's memo accounts is **more** than that asset's fair value, while at the same time, other assets have carrying amounts of **less** than their fair values in the memo accounts.

After recognizing an OTTI, an investor determines its equity method income using the adjusted basis differences.

#### EXAMPLE 4-25: ADJUSTING BASIS DIFFERENCES FOR OTTI OF AN INVESTMENT

#### **FACTS**

- ▶ On January 1, 20X1, Investor acquired 40% of Investee's voting common stock for \$800,000, which it accounts for using the equity method. For simplicity, assume there were no transaction costs. Investee meets the definition of a business in ASC 805.
- As of January 1, 20X1, the carrying amount of Investee's net assets was \$1,850,000 and their fair value was \$1,925,000. Investor recorded its share of Investee's net assets on the acquisition date, identified basis differences, and depreciated and amortized those basis differences in 20X1 as shown below.

	INVESTOR'S SHARE (40% OF CARRYIN AMOUNT [A	) SH G OF	VESTOR'S HARE (40%) F FAIR VALUE	INVESTOR'S BASIS DIFFERENCES [B-A]	20X1 DEPRECIATION AND AMORTIZATION	BASIS DIFFERENCE ON DECEMBER 31, 20X1
Cash	\$ 152	,000 \$	152,000	\$ -	\$ -	\$ -
Accounts receivable	120	,000	120,000	_	_	_
Buildings	500	,000	500,000	_	_	_
Customer list		_	6,000	6,000	(2,000)	4,000
IPR&D asset		_	24,000	24,000	_	24,000
Payables	(32,	000)	(32,000)	_	_	_
Equity method goodwill		_	_	30,000	_	30,000
Total net assets	\$ 740	,000 \$	770,000	\$ 60,000	\$ (2,000)	\$ 58,000

- ▶ Investee's net income for 20X1 was \$500,000; therefore, Investor's share of Investee's net income was \$200,000 (40% \* \$500,000). Also, Investor amortized the customer list basis difference over a three-year life, bringing its total equity method income to \$198,000 (\$200,000 − \$2,000).
- ▶ The investment's carrying amount on December 31, 20X1, was \$998,000 (\$740,000 + \$58,000 + \$200,000), which can also be calculated as the investment's cost of \$800,000 + \$198,000 of equity method income.
- After a new competitor entered the market, Investor concluded the investment was other than temporarily impaired. The fair value of the investment on December 31, 20X1, was \$954,000. Investor's policy when recognizing an OTTI is to first reduce the existing equity method goodwill, then reduce the basis differences related to the qualifying nonfinancial assets on a pro rata basis.
- ▶ For simplicity, assume there are no intra-entity transactions or income taxes.

#### CONCLUSION

Investor recognizes an OTTI of \$44,000, which reduces the carrying amount of its investment. Investor then adjusts the basis differences in its memo accounts to reflect the investment's lower carrying amount, as shown in the table below.

#### **ANALYSIS**

- Investor concluded the investment was other than temporarily impaired, remeasured the investment to \$954,000, and recognized an OTTI of \$44,000 in equity method income for the difference between the investment's fair value and carrying amount (\$998,000).
- ▶ Investor then allocated the impairment to the basis differences in its memo accounts as:

	IS DIFFERENCE ALLOCATED ORE IMPAIRMENT [A] IMPAIRMENT [B]		REMAINING BASIS DIFFERENCE [A+B]		
Customer list	\$ 4,000	\$	(2,000)	\$	2,000
IPR&D asset	24,000		(12,000)		12,000
Equity method goodwill	30,000		(30,000)		_
Total	\$ 58,000	\$	(44,000)	\$	14,000

- Investor first reduced the existing goodwill of \$30,000 to zero.
- ▶ Investor then allocated the remaining \$14,000 (\$44,000 − \$30,000) to the basis differences pro rata.
  - For example, Investor allocated \$2,000 of the impairment [\$14,000 \* (\$4,000 / \$28,000)] to the basis differences on the customer list, where \$28,000 is the sum of basis differences related to qualifying assets (\$4,000 for the customer list + \$24,000 for the IPR&D asset).
- ▶ There might be other acceptable approaches for allocating the \$44,000 impairment to the basis differences in the memo accounts. However, regardless of the allocation method used, the total impairment recognized would still be \$44,000.

#### 4.8.2 Impairment Recorded by Investee



#### **FASB REFERENCES**

ASC 323-10-35-32A

An investor should consider whether its equity method investment is other than temporarily impaired when the investee recognizes an impairment.

However, before recognizing an OTTI, an investor recognizes its share of an investee's income, which includes the investor's share of any impairments recognized by the investee. Additionally, the investor must adjust its share of the investee's income for its basis differences (as discussed in Section 4.4). As a result, if the impaired asset has a higher carrying amount in the investor's memo accounts due to a basis difference than it does in the investee's financial statements, the investor must adjust its equity method income to write off the excess basis difference related to that asset.

#### BDO INSIGHTS: INVESTOR'S IMPAIRMENT MAY PRECEDE INVESTEE'S IMPAIRMENT

An impairment of an equity method investment often occurs in the same reporting period as when the investee recognizes an impairment on its underlying assets. However, it is possible that an investor might recognize an OTTI before the investee; for example, this could occur when the investee has an asset that is recoverable based on undiscounted cash flows, but the asset's fair value (based on discounted cash flows) has declined. It may also happen when the investor reports the investee's results on a lag (see Section 4.8.3).

If the OTTI precedes the reporting period in which the investee recognizes an asset impairment, the investor should have already adjusted its basis differences when it recognized the OTTI (see Section 4.8.1). Accordingly, when recognizing its share of the investee's income in the later reporting period (that includes the impairment), the investor adjusts its share of the investee's impairment to reflect the asset's carrying amount in the memo accounts.

#### EXAMPLE 4-26: ADJUSTING BASIS DIFFERENCES FOR IMPAIRMENT RECORDED BY THE INVESTEE

#### **FACTS**

- ▶ On January 1, 20X1, Investor acquired 20% of Investee's voting common stock for \$200,000, which it accounts for using the equity method. There were no transaction costs.
- As of January 1, 20X1, the carrying amount of Investee's net assets was \$900,000 and their fair value was \$1,000,000. Investor determined that the basis difference was attributable to Investee's buildings, which have a 10-year useful life. Therefore, Investor recorded its share of Investee's net assets on the acquisition date in the memo accounts as:

	CARRYI VALUE			NVESTOR'S FAIR VALUE SHARE (20%)		VALUE	 STOR'S E (20%)	INVESTOR'S BASIS DIFFERENCE	
Current assets (net)	\$	250,000	\$	50,000	\$	250,000	\$ 50,000	\$	_
Buildings		650,000		130,000		750,000	150,000		20,000
Total	\$	900,000	\$	180,000	\$	1,000,000	\$ 200,000	\$	20,000

- ▶ However, on December 31, 20X1, after recognizing \$65,000 of depreciation for 20X1, assume that an event caused the fair value of the buildings to suddenly decrease to \$550,000 (that is, assume for simplicity that there was no error in the acquisition date accounting).
- ▶ For simplicity, assume there are no income taxes and that Investee's income was \$0 before the depreciation and impairment of the buildings.

#### **CONCLUSION**

Investor's equity method loss (including its share of Investee's loss and the basis difference adjustment) is \$40,000.

#### **ANALYSIS**

- ▶ Investee recognized an impairment of \$35,000 (the difference between the fair value of \$550,000 and the carrying amount of \$585,000 (\$650,000 − \$65,000)) on the buildings. As part of its equity method accounting, Investor recognizes its share of the depreciation of \$13,000 (20% \* \$65,000) and the impairment of \$7,000 (20% \* \$35,000) in its equity method income.
- Investor first recognizes the basis difference depreciation on the buildings for 20X1 of \$2,000 (\$20,000 / 10 years), which reduces the unamortized basis difference to \$18,000 at December 31, 20X1.
- Investor's basis difference on the buildings and impairment is:

	RYING DUNT	INVESTOR SHARE (20		FAIR	VALUE		ESTOR'S ARE (20%)	STOR'S BASIS ERENCE
January 1, 20X1 (acquisition)	\$ 650,000	\$ 13	30,000	\$	750,000	\$	150,000	\$ 20,000
Depreciation (10-year life)	(65,000)	(1	3,000)		(75,000)		(15,000)	(2,000)
December 31, 20X1 (impairment date)	585,000	1	17,000		675,000	•	135,000	18,000
Fair value	550,000	1	10,000		550,000		110,000	_
Impairment	\$ (35,000)	\$ (	7,000)	\$	(125,000)	\$	(25,000)	\$ (18,000)

- ▶ Because the buildings' carrying amount in the Investor's memo accounts exceeds the buildings' fair value because of the unamortized basis difference, Investor adjusts its equity method income to recognize an additional impairment on the buildings (that is, it writes off the remaining unamortized basis difference of \$18,000 related to the buildings bringing the remaining unamortized basis difference to \$0).
- ▶ Therefore, Investor's total equity method loss is \$40,000, which reflects Investor's share of Investee's depreciation of \$13,000, share of Investee's impairment of \$7,000, share of the depreciation on the basis difference of \$2,000, and its impairment of the unamortized basis difference of \$18,000, as well as its share of Investee's other income before such items (20% of \$0).
- ▶ The investment's ending carrying amount is \$160,000, which Investor can reconcile as:

Share of net assets at acquisition	\$ 180,000	Share of current assets	\$ 50,000	Cost of investment	\$ 200,000
Share of other income	_	Share of buildings	110,000	Equity method (loss)	(40,000)
Share of depreciation	(13,000)	Unamortized basis differences	_		
Share of impairment	(7,000)				
Unamortized basis differences	_				
Investment	\$ 160,000		\$ 160,000		\$ 160,000

#### 4.8.3 Impairment on a Lag



#### **FASB REFERENCES**

ASC 323-10-35-6 and ASC 810-10-45-12 through 45-13

As discussed in Section 4.2.2, an investor may report its share of an investee's income on a lag of up to about three months. When an investor is evaluating an investment reported on a lag for impairment, a question arises as to which date the investor should use to measure the investment's fair value.

#### BDO INSIGHTS: MEASURE FAIR VALUE AT THE INVESTOR'S REPORTING DATE

U.S. GAAP is silent on whether an investor that reports an equity method investment on a lag should also apply that approach in evaluating an investment for OTTI.

We believe that reporting equity method income on a lag applies only to reporting the investee's income, and not to measuring an investment's fair value. Therefore, we believe that when evaluating impairment, an investor measures the investment's fair value at the impairment date, regardless of whether the investee is accounted for on a lag. However, it is important for the investor to allocate the impairment to basis differences in the equity method memo accounts (see Section 4.8.1) and adjust its share of any impairments recognized by an investee for those basis differences (see Section 4.8.2). That can prevent the investor from double counting any impairment recognized by an investee, which could otherwise happen when the investor recognizes its share of the investee's income on a lag.

Also, an investor must disclose or recognize material intervening events between the dates of the investee and investor's financial statements, as discussed in Section 4.2.2.

#### 4.8.4 Foreign Currency Translation Adjustments in an Impairment



#### **FASB REFERENCES**

ASC 830-30-40-1 through 40-4 and ASC 830-30-45-13 through 45-14

ASC 830-30-20: Foreign Entity

An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:

- a. Prepared in a currency other than the reporting currency of the reporting entity
- b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.

An investor may recognize a cumulative translation adjustment (CTA) in connection with an equity method investment in a foreign entity (as defined in U.S. GAAP).

An investor generally excludes the CTA from the investment's carrying amount when evaluating it for impairment. However, if an investor commits to a plan of sale or substantially complete liquidation that will result in reclassifying a portion of the CTA to earnings, it must include that portion of the CTA in the investment's carrying amount in the impairment test.

#### BDO INSIGHTS: COMMITTING TO A PLAN TO SELL THE EQUITY METHOD INVESTMENT

ASC 830 does not include guidance on evaluating whether an investor has committed to a plan to sell or liquidate the equity method investment. Therefore, an investor may apply other U.S. GAAP by analogy (for example, ASC 205-20, *Presentation of Financial Statements — Discontinued Operations*, or the guidance in ASC 360 on assets held for sale). Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

#### EXAMPLE 4-27: CUMULATIVE TRANSLATION ADJUSTMENT IN AN IMPAIRMENT TEST

#### **FACTS**

- Investor has an equity method investment in a foreign entity (as defined in U.S. GAAP) that has a carrying amount of \$450,000. Investor has recognized credit of \$20,000 in equity for the CTA.
- Investor concludes that the investment is other than temporarily impaired. The investment's fair value at that date is \$420,000.
- Investor does not plan to sell the investment and is not committed to any plan of liquidation that would cause the CTA to be reclassified to earnings in accordance with ASC 830.

#### CONCLUSION

Investor recognized an impairment of \$30,000.

#### **ANALYSIS**

- In evaluating the investment for impairment, Investor considers only the investment's carrying amount and excludes the CTA because Investor is not committed to a plan that would result in reclassifying the CTA to earnings. Therefore, Investor recognizes an impairment of \$30,000 (the difference between the investment's fair value of \$420,000 and carrying amount of \$450,000).
- ► Had Investor met the criteria in ASC 830, it would have included the CTA as part of the investment's carrying amount in the impairment test and would have recognized an impairment of only \$10,000 (the difference between the investment's fair value of \$420,000 and carrying amount adjusted for the \$20,000 CTA).

#### 4.8.5 Presentation and Disclosure Upon an Other Than Temporary Impairment



#### **FASB REFERENCES**

ASC 820-10-50-2

#### BDO INSIGHTS: PRESENTING AN OTHER THAN TEMPORARY IMPAIRMENT ON AN EQUITY METHOD INVESTMENT

An investor that is an SEC registrant must report any OTTI of its equity method investment in the same line item as the investor's equity method income, in accordance with SEC staff views expressed in a March 2003 SEC Regulations Committee meeting (see Section 6.2.2). We believe other investors generally also should present any impairment in equity method income unless other U.S. GAAP applies (for example, ASC 205-20, *Discontinued Operations*). We believe an investor also should disclose the income statement caption that includes the equity method impairment.

ASC 323 does not require any explicit disclosures when an investor recognizes an OTTI related to an equity method investment. However, ASC 820-10-50-2 does require disclosure when an asset or liability is measured at fair value on a nonrecurring basis, such as when an equity method investment is impaired.

Further, the SEC staff expects an investor to disclose the information discussed below. Item 2.06 of Form 8-K also requires SEC registrants to disclose material impairments.



#### **SEC STAFF GUIDANCE**

#### Remarks at the 2003 Thirty-First AICPA National Conference on Current SEC Developments

D. Douglas Alkema, Professional Accounting Fellow, SEC Office of the Chief Accountant

As it relates to disclosures, the staff would expect to see [the following disclosures in Management's Discussion and Analysis...:

- The amount of the charge;
- A more specific discussion of the underlying reasons for the charge and its timing;
- An identification of which segment the charge relates to if it is not included in the segment's profit or loss measure under [ASC 280];
- As necessary, the risk and uncertainties regarding future declines; and
- The estimated effects that material declines would have on the registrant's liquidity. [Footnotes omitted.]

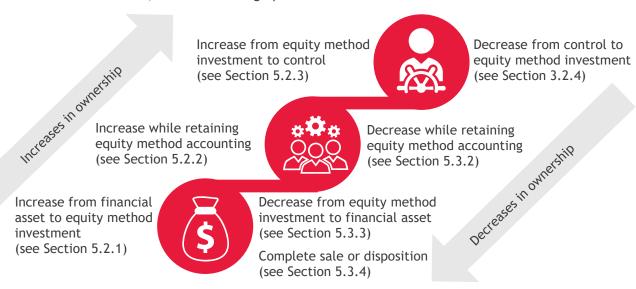
# Chapter 5: Changes in Ownership



#### 5.1 OVERVIEW: CHANGES IN OWNERSHIP OF AN EQUITY METHOD INVESTMENT

An investor's ownership interest in an investee may increase or decrease and with that the investor's level of influence over the investee may increase or decrease. Sometimes, such changes occur because of the investor's actions (such as buying or selling the investee's voting common stock). At other times, those changes occur without any action by the investor (for example, because the investee issues or repurchases shares).

This chapter addresses changes in an investor's ownership in an investee when the investor has an equity investment in the investee before the transaction, as shown in the graphic below.



Other changes in ownership interests discussed in this chapter include when an investee:

- Issues shares, including share-based payments and shares issued in common control transactions (see Section 5.4)
- Repurchases shares, including treasury shares (see Section 5.5)

#### BDO INSIGHTS: IDENTIFYING CHANGES IN THE INVESTOR'S ABILITY TO EXERCISE SIGNIFICANT INFLUENCE

An investor should develop processes and internal controls to monitor changes in facts and circumstances with respect to the investee that could affect whether the equity method applies to its investment, including changes that might occur without any action by the investor. For example, an investor's ability to exercise significant influence over an investee may be affected by the following:

- lssuances, modifications, redemptions or repurchases of the investee's equity
- Amendments to the investee's governing documents (for example, articles of incorporation, bylaws, partnership agreements, membership agreements, operating agreements, voting agreements, and standstill agreements)
- ▶ Changes in the composition of the investee's board
- Expiration of agreements with other investors or rights held by other investors in the investee
- ▶ Changes in significant service, managerial, or intra-entity agreements related to the investee
- ▶ Changes in the investee's business, such as a change in technological dependence
- Defaults by the investee on its loan covenants
- ▶ Bankruptcy (or the emergence therefrom) of the investee.

The examples listed above are illustrative, not exhaustive. Reaching a conclusion about whether an investor continues to account for its investment using the equity method after such a change requires the application of professional judgment based on the new facts and circumstances. An investor may also need to reconsider whether the investee is a VIE and, if so, whether it has become the VIE's primary beneficiary (see Sections 3.7 and 4.5 of our Blueprint, Control and Consolidation Under ASC 810).

#### BDO INSIGHTS: EVALUATING WHETHER TO ACCOUNT FOR MULTIPLE TRANSACTIONS AS A SINGLE TRANSACTION

Often, an investor's ownership interest in an investee increases or decreases in a single transaction; however, sometimes, ownership changes occur through a series of steps or transactions for tax, regulatory, or other reasons. If the investor accounts for the transactions separately, the financial statement effects might differ if the steps were accounted for as a single transaction.

In determining whether to account for multiple transactions as a single transaction, we believe an investor should consider whether:<sup>26</sup>

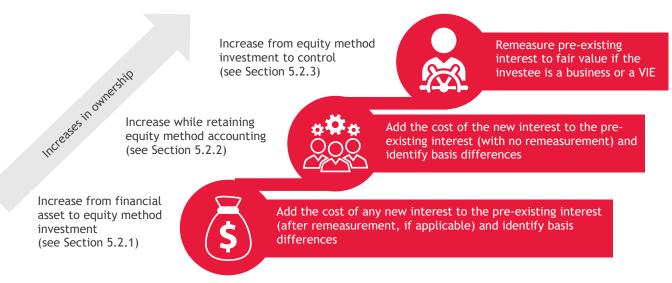
- ▶ The transactions are entered at the same time or in contemplation of one another.
- ▶ They form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement depends on at least one other arrangement.
- ▶ One arrangement considered on its own is not economically justified, but the arrangements are economically justified when considered together.

Reaching a conclusion about whether to account for multiple transactions as a single transaction requires the application of professional judgment based on the facts and circumstances. The factors listed above are not a checklist nor exhaustive.

<sup>&</sup>lt;sup>26</sup> These factors are from ASC 810-10-40-6 related to the loss of control and deconsolidation of a subsidiary.

#### 5.2 INCREASES IN OWNERSHIP OF AN EQUITY METHOD INVESTMENT

An investor's ownership interest in an investee may increase with or without an increase in its influence over the investee. This section addresses an increase in an ownership interest when the investor has a pre-existing interest in the investee, as shown in the graphic below. For guidance on initial measurement when an investor obtains an equity method investment without a pre-existing interest in the investee, see Chapter 3.



An investor's ownership interest may also increase when an investee:

- Issues shares, and the investor buys proportionately more shares than other investors (see Section 5.4).
- Repurchases shares, and the investor sells proportionately fewer shares than other investors (see Section 5.5).

Other changes in facts and circumstances also might cause a change in the level of influence (with or without an increase in ownership) and therefore might cause the investor to change to or from the equity method (see the BDO Insights "Identifying changes in the Investor's ability to exercise significant influence" in Section 5.1 for examples of such changes).

#### 5.2.1 Increase: Financial Asset to Equity Method Investment



#### **FASB REFERENCES**

ASC 321-10-20: Orderly Transaction, ASC 321-10-35-1 through 35-2, ASC 321-10-55-8 through 55-9, ASC 323-10-15-12, ASC 323-10-35-33, ASC 820-10-20: Orderly Transaction, and ASC 820-10-35-54I

ASC 321 includes three measurement models for equity securities accounted for as financial assets (other than equity method investments):

- ▶ Equity securities with readily determinable fair values are remeasured to fair value each reporting period, with unrealized holding gains and losses (changes in fair value) recognized in earnings.
- ▶ Equity securities issued by specific entities that calculate net asset value per share (or its equivalent) are remeasured to that amount each reporting period, with changes recognized in earnings.
- Equity securities without readily determinable fair values are measured at either (as an accounting policy choice for each investment):
  - Fair value, with changes in fair value recognized in earnings.
  - Cost minus impairment, if any (referred to as the "ASC 321 measurement alternative"). However, if an investor identifies an observable price change in an orderly transaction for an identical or similar investment in the same investee, the investor must remeasure the equity security to fair value as of that transaction date.

An investor may have a pre-existing investment accounted for as a financial asset in accordance with ASC 321 that becomes an equity method investment because of an increase in the investor's ownership or level of influence. For example, an investor might buy more of the investee's voting common stock from another investor and conclude it must begin to account for the combined investment using the equity method (as discussed in Chapter 2).

Upon such a transaction, the investor adds the cost of any new interest to the pre-existing interest and prospectively applies the equity method as of that date. The investor does not recast prior periods for the new ownership interest or change in accounting.

However, immediately before applying the equity method, the investor remeasures the pre-existing interest in accordance with ASC 321, if applicable. Therefore, for an investment accounted for using the ASC 321 measurement alternative, the investor must determine whether the transaction that results in applying the equity method represents an observable price change in an orderly transaction for an identical or similar investment of the same investee.

- If so, the investor remeasures its pre-existing interest to fair value immediately before applying ASC 323 and recognizes the change in earnings.
- If not, the investor does not remeasure the pre-existing interest to fair value.

When determining whether remeasurement of the pre-existing interest is required, ASC 321 states that the investor must make a reasonable (but not exhaustive) effort to identify observable price changes in **orderly transactions** for identical or **similar investments** that occurred on or before the reporting date and that are known or can be reasonably known. The table below discusses two key concepts in that evaluation.

# Was the transaction orderly?



The reference to orderly transactions in ASC 321 has the same meaning as in ASC 820, which states that circumstances that may indicate that a transaction is not orderly include the following:

- ► There was not adequate exposure to allow for marketing activities that are usual and customary for transactions involving such assets (securities) under current market conditions.
- ► There was a usual and customary marketing period, but the seller (investee) marketed the asset (securities) to a single market participant.
- ▶ The seller (investee) is in or near bankruptcy or receivership (that is, distressed).
- ▶ The seller (investee) was forced into the transaction to meet regulatory or legal requirements.
- ▶ The transaction price is an outlier when compared with other recent transactions for the same or a similar asset (securities).

An investor must evaluate the circumstances to determine whether the transaction is orderly based on the available evidence.

# Is the security identical or similar to the one held by the investor?

To identify whether a security issued by the same investee is similar to the equity security held by the investor, it must consider the different rights and obligations of the securities, such as:

- Voting rights
- Distribution rights and preferences
- Conversion features.



The investor adjusts the observable price of a similar security for any different rights and obligations when determining the adjustment to the carrying amount of the pre-existing interest (before applying the equity method).

Reaching a conclusion about whether a transaction causes the remeasurement of a pre-existing interest requires the application of professional judgment based on the facts and circumstances.

In summary, the equity method investment's initial measurement when changing from a financial asset in the scope of ASC 321 to the equity method is as follows:

Pre-existing interest (after remeasuring in accordance with ASC 321, if applicable)



Cost of new interest (see Chapter 3)



Intial carrying amount of equity method investment (identify basis differences)

# EXAMPLE 5-1: FINANCIAL ASSET ACCOUNTED FOR USING THE ASC 321 MEASUREMENT ALTERNATIVE, AND ADDITIONAL INTEREST RESULTS IN AN EQUITY METHOD INVESTMENT

#### **FACTS**

- On January 1, 20X1, Investor acquired 5% of Investee's voting common stock for \$1 million, which it accounts for as a financial asset using the ASC 321 measurement alternative.
- There are no observable price changes in orderly transactions for an identical or similar investment of Investee and no impairments in 20X1, so the investment is still measured at \$1 million on December 31, 20X1.
- ▶ On June 1, 20X2, Investor acquired from another investor 15% of Investee's voting common stock for \$3.6 million, bringing its total interest in Investee to 20%. For simplicity, this example excludes transaction costs (see Section 3.2.1).
- Investor determined that its acquisition of the 15% interest represents an observable price change in an orderly transaction for an identical investment in the same investee as its pre-existing 5% interest.

#### CONCLUSION

On remeasuring its pre-existing 5% interest in Investee, Investor recognizes a \$200,000 gain. Investor initially measures its equity method investment at \$4.8 million.

#### **ANALYSIS**

- ▶ Beginning June 1, 20X2, Investor uses the equity method to account for its interests in Investee because it holds 20% of Investee's voting common stock (assuming the presumption that Investor has the ability to exercise significant influence over Investee is not overcome (see Section 2.2)).
- ▶ Because the transaction represents an observable price change in an orderly transaction for an investment identical to its 5% interest, Investor remeasures that 5% interest to fair value. Based on the implied value from the transaction, Investor determines that the fair value of it 5% interest is \$1.2 million (\$3.6 million / 15% interest = \$24 million total equity value \* 5%). Therefore, Investor remeasures its pre-existing interest to \$1.2 million and recognizes a \$200,000 gain (\$1.2 million − \$1 million carrying amount).
- ► Therefore, the equity method investment's initial measurement is \$4.8 million (\$3.6 million new interest + \$1.2 million remeasured pre-existing interest).
- Investor identifies basis differences on June 1, 20X2, using the total initial measurement of \$4.8 million and its 20% interest (see Section 3.3).

#### 5.2.2 Increase: Equity Method Investment to Equity Method Investment



#### **FASB REFERENCES**

ASC 323-10-30-2, ASC 323-10-35-13, and ASC 323-10-35-33

An investor may have a pre-existing equity method investment, obtain a new interest in the same investee from another investor, and continue applying the equity method for the reasons discussed in Chapter 2.

Upon such a transaction, the investor:

- Adds the cost of the new interest to the pre-existing interest.
- Prospectively applies the equity method using the new ownership interest.
- Identifies basis differences for the new investment, as illustrated in Example 5-2, which may relate to new assets or changes in the fair value of the investee's identifiable assets and liabilities.

In summary, the equity method investment's total carrying amount when acquiring an additional ownership interest in the same investee from another investor while retaining an equity method investment is as follows:

Pre-existing interest (with no remeasurement)



Cost of new interest (see Chapter 3)



Total carrying amount of equity method investment (identify any incremental basis differences)

An investor does not remeasure its pre-existing interest, recast prior periods for its new ownership interest, or revise or reallocate the pre-existing basis differences related to its initial investment. However, an investor must consider whether the reasons for the transaction or the purchase price for the new interest indicates an OTTI (see Section 4.8).

See Sections 5.4 and 5.5 when an investor's interest in the investee increases because of a share issuance or share repurchase, respectively, and the investor continues to apply the equity method.

#### EXAMPLE 5-2: PURCHASE OF ADDITIONAL INTEREST IN AN EQUITY METHOD INVESTMENT

#### **FACTS**

- ▶ On January 1, 20X1, Investor acquired 40% of Investee's voting common stock for \$800,000, which it accounts for using the equity method. For simplicity, assume there were no transaction costs. Investee meets the ASC 805 definition of a business.
- ▶ On December 31, 20X1, after Investor recognized equity method income of \$198,400, the investment's carrying amount was \$998,400 (see Example 4-16). On January 1, 20X2, Investor acquired another 5% of Investee's voting common stock from another investor for \$125,000. For simplicity, assume there were no transaction costs. Investor retained the ability to exercise significant influence over Investee and does not control Investee.
- ▶ As of January 1, 20X2, the carrying amount and fair values of Investee's net assets were:

	CARRYIN	IG AMOUNT	FAIR VA	LUE
Cash	\$	942,500	\$	942,500
Accounts receivable		300,000		300,000
Buildings		1,187,500		1,168,500
Customer list		_		12,000
IPR&D		_		65,000
Payables		(80,000)		(80,000)
Total identifiable net assets	\$	2,350,000	\$	2,408,000

- As of January 1, 20X2, the fair value of Investee's identifiable assets and liabilities were as follows:
  - The buildings have a fair value of \$1,168,500 and a 19-year useful life. Investee evaluates the buildings for impairment in accordance with ASC 360; the buildings are not impaired because they are recoverable based on their undiscounted cash flows.
  - The internally developed customer list has a fair value of \$12,000 and a two-year useful life.
  - The IPR&D asset was developed internally and therefore not recognized by Investee. It is indefinite-lived and is not amortized.
  - The carrying amounts of accounts receivable and payables approximate their fair values.
- Investee's net income was \$600,000 for 20X2.

#### CONCLUSION

On January 1, 20X2, the combined investment's carrying amount was \$1,123,400. On December 31, 20X2, the combined investment's carrying amount was \$1,391,550.

#### **ANALYSIS**

- Investor continues to account for the investment using the equity method because it has neither lost the ability to exercise significant influence over Investee nor obtained control over Investee.
- ▶ **Step 1:** Investor adds the new investment's cost (\$125,000) to the original 40% investment's carrying amount on December 31, 20X1 (\$998,400), to determine the investment's new carrying amount of \$1,123,400.
- ▶ Steps 2A— 2E: The table below illustrates how Investor calculated the basis difference in the equity method memo accounts for the new 5% interest (the original basis differences and memo accounts are not adjusted).

	INVESTOR (5%) OF CA AMOUNT [	ARRYING	INVESTO (5%) OF VALUE		INVESTO DIFFERE [B-A]	DR'S BASIS ENCES
Cash	\$	47,125	\$	47,125	\$	_
Accounts receivable		15,000		15,000		_
Buildings		59,375		58,425		(950)
Customer list		_		600		600
IPR&D		_		3,250		3,250
Accounts payable		(4,000)		(4,000)		_
Equity method goodwill		_		_		4,600
Total identifiable net assets	\$	117,500	\$	120,400	\$	7,500

- ▶ The equity method goodwill of \$4,600 is calculated by comparing the investment's cost of \$125,000 to Investor's share of the fair value of Investee's net assets of \$120,400.
- Investor identified basis differences related to the buildings and customer list, which are the same assets that resulted in basis differences at the initial investment. However, that might not always be the case (an investor might identify basis differences related to different assets when acquiring an additional interest).
- Investor's equity method income from Investee for 20X2 is as follows:

	40% [A]	INTEREST	5% I [B]	NTEREST		TAL + A]
Investor's share of Investee's net income (\$600,000)	\$	240,000	\$	30,000	\$	270,000
Adjustments for basis differences:						
Buildings		400	a	50	С	450
Customer list		(2,000)	b	(300)	d	(2,300)
Investor's equity method income from Investee	\$	238,400	\$	29,750	\$	268,150

- a. The \$400 is the accretion of the negative basis difference of (\$8,000) on the building (from Example 4-16) over a 20-year useful life.
- b. The (\$2,000) is the amortization of the basis difference of \$6,000 on the customer list (from Example 4-16) over a three-year useful life.
- c. The \$50 is the accretion of the negative basis difference of (\$950) on the building over the 19-year remaining useful life.
- d. The (\$300) is the amortization of the basis difference of \$600 on the customer list over the two-year remaining useful life.
- ▶ Because Investor did not elect the private company accounting alternative, it does not amortize the equity method goodwill in the memo accounts. Investor only evaluates the equity method investment as a whole for impairment (see Section 4.8).
- ▶ The carrying amount of Investor's equity method investment is:

		20X1	20X2	
Beginning equity method investment		\$	- \$	998,400
Cost of the investments			800,000	125,000
Equity method income			198,400	268,150
Ending equity method investment		\$	998,400 \$	1,391,550
The investment's carrying amount reconciles to	the Inv	estor's share	of the investee's net asset	s as follows:
Investor's 45% share of Investee's net assets	\$	1,327,500	(net assets of \$2,350,000 or + \$600,000 in net income) *	
Unamortized basis difference on the original (40%) interest		56,800	(\$58,400 on January 1, 20X2 of amortization during 20X2	
Unamortized basis difference on the new (5%) interest		7,250	(\$7,500 on January 1, 20X2 amortization during 20X2)	+ \$50 — \$300 of
Ending equity method investment	\$	1,391,550		

#### 5.2.3 Increase: Equity Method Investment to Control

An investor (parent) consolidates an investee (subsidiary) when it obtains control of the investee (not at the beginning or end of a reporting period) and does not recast prior periods for its change in ownership or accounting. See our Blueprint, Control and Consolidation Under ASC 810, for guidance on identifying a controlling financial interest.

The table below describes the initial measurement when obtaining control of an investee.

	FACT PATTERN	GUIDANCE
Not previously under common control	The investee meets the definition of a business, and the investor and investee were not previously under common control.	Apply the acquisition method in ASC 805, which includes remeasuring to fair value any pre-existing equity interests in the acquiree (investee), which often results in recognizing a gain. See Chapter 3 and Section 5.5 of our Blueprint, <a href="Business Combinations Under ASC 805">Business Combinations Under ASC 805</a> , for guidance on the definition of a business and business combination achieved in stages, respectively.
	The investee does <b>not</b> meet the definition of business but <b>is a VIE</b> , and the investor and investee were <b>not</b> previously under common control.	Apply the acquisition method in ASC 805 but recognize a gain or loss instead of goodwill (see Chapter 2 and Section 7.2.2 of our Blueprint, Control and Consolidation Under ASC 810, for guidance on identifying a VIE and the initial measurement of a VIE that is not a business). Remeasure at fair value any pre-existing equity interests in the acquiree (investee), which often results in recognizing a gain. See Section 5.5 of our Blueprint, Business Combinations Under ASC 805, for guidance on the acquisition method.
	The investee is a voting interest entity and does not meet the definition of a business, and the investor and investee were not previously under common control.	Apply the asset acquisition guidance in ASC 805-50. See Section C.3.6.2 of our Blueprint, <u>Business Combinations Under ASC 805</u> , for guidance on the accounting policy choice for measuring a pre-existing interest in an asset acquisition of an investee that is not a VIE.

**FACT PATTERN** 

# Previously under common control

#### **GUIDANCE**

The investee is a VIE, and it and the investor (which is the primary beneficiary), were under common control before the investor's initial consolidation of the VIE.

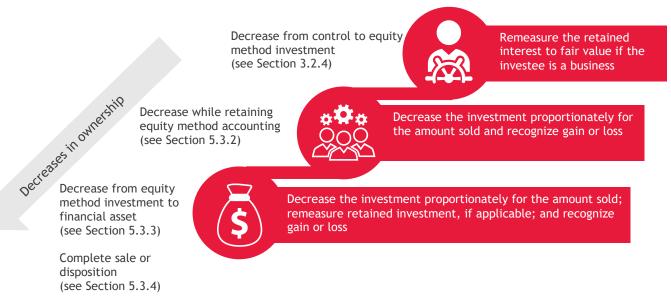
Apply the common control guidance for VIEs in ASC 810 (that is, use the ultimate parent's carrying amount) and do not recognize a gain or loss. See Sections 5.2.1 and 7.2.1 of our Blueprint, Control and Consolidation Under ASC 810, for guidance on identifying common control transactions and initial measurement, respectively.

The investee is a voting interest entity, and it and the investor (which is the new parent), were under common control before the investor's initial consolidation of the voting interest entity.

Apply the common control guidance in ASC 805-50 (see Appendix B of our Blueprint, **Business Combinations Under ASC 805**).

#### 5.3 DECREASES IN OWNERSHIP OF AN EQUITY METHOD INVESTMENT

An investor's ownership interest in an investee may decrease with or without a decrease in the level of influence over the investee. This section addresses a decrease in an ownership interest when the investor has a pre-existing interest in the investee, as shown in the graphic below.



An investor's ownership interest may also decrease when an investee:

- lssues shares, and the investor buys proportionately fewer shares than other investors (see Section 5.4).
- Repurchases shares, and the investor sells proportionately more shares than other investors (see Section 5.5).

Other changes in facts and circumstances also might cause a change in the level of influence (with or without a decrease in ownership) and therefore might cause the investor to change to or from the equity method (see the BDO Insights "Identifying changes in the Investor's ability to exercise significant influence" in Section 5.1 for examples).

This section generally applies regardless of whether the investee itself meets the definition of a business in ASC 805. In other words, the sale of an equity method investment generally is within the scope of ASC 323 (and ASC 860, as discussed in Section 5.3.1). However, if selling (a portion) of an equity method investment is part of a larger transaction, the sale of that investment might be in the scope of other U.S. GAAP. For example:

▶ The sale of a business that has an equity method investment in another entity is within the scope of ASC 810-10-40.

▶ The sale of nonfinancial assets that do not meet the definition of a business, together with an equity method investment in another entity that meets the definition of an in-substance nonfinancial asset, generally is within the scope of ASC 610-20 (see Appendix A of our Blueprint, Revenue Recognition Under ASC 606).



#### **EVALUATE THE CONDITIONS IN ASC 860 BEFORE RECOGNIZING A SALE OF AN INVESTMENT**

ASC 860 applies to the sale and derecognition of financial assets, including equity method investments, unless another scope exception applies. Therefore, an investor must evaluate whether it meets the criteria in ASC 860 (see Section 5.3.1) to derecognize an equity method investment before applying the measurement guidance in ASC 323 summarized in this section.

#### 5.3.1 Applying ASC 860 to the Sale of an Equity Method Investment



#### **FASB REFERENCES**

ASC 845 10 15 4(h), ASC 860-10-15-4(f), ASC 860-10-20: Transfer, ASC 860-10-40-4 through 40-5, ASC 860-10-55-3, ASC 860-20-25-1, and ASC 860-20-30-1

ASC 860 describes the accounting by transferors and transferees for **transfers** of financial assets. Financial assets include equity method investments (or part of an equity method investment). The transfer of a financial asset is defined in ASC 860 in part as "The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset." ASC 860 includes several scope exceptions, stating that it does not apply to "investments by owners or distributions to owners of a business entity." Therefore, when an investor's ownership interest decreases, the investor must evaluate whether the transaction is in the scope of ASC 860. If the transaction is outside the scope of ASC 860, it may be in the scope of ASC 845.

#### BDO INSIGHTS: CONSIDER THE SUBSTANCE OF AN EXCHANGE OF EQUITY METHOD INVESTMENTS

An investor might exchange an existing equity method investment for equity of another entity (that would also be accounted for under the equity method) that in substance may represent a decrease in the investor's ownership interest in the previously held investment rather than an exchange of equity method investments.

For example, consider a scenario in which Investors A, B, and C each hold one-third of Investee's common stock. The investors form a new company (NewCo) that has no other assets or activities. Investors A and B each contribute cash and their equity method investments (shares) in Investee to NewCo. Investor C contributes only its investment in Investee to NewCo (that is, no cash) and receives only 20% of Newco's voting common stock.

The investors must apply judgment when determining whether such a transaction is in the scope of ASC 860 (that is, whether it meets the definition of a transfer, and whether the scope exception for investments by owners or distributions to owners of a business entity applies). Additionally, we believe an investor should evaluate the nature of its rights, including voting, dividends, liquidation, and preemptive (veto) rights), as well as restrictions upon the sale of its retained equity investment.<sup>27</sup>

- ▶ If the investor's rights generally are the same (on a proportionate or per-share basis) before and after the exchange, we believe the investor generally should account for the exchange as a decrease in ownership in its existing equity method investment (see Section 5.3.2).
- If the investor's rights are substantively different before and after the exchange, we believe the investor generally should account for the transaction in accordance with ASC 860 (unless a scope exception applies).

Reaching a conclusion about the substance of the transaction depends on the facts and circumstances.

<sup>&</sup>lt;sup>27</sup> See Note 7 in Section 3.2.4.3.

If the transaction is a transfer in the scope of ASC 860, it must satisfy the conditions below for sale accounting in ASC 860 to qualify for derecognition.

Transferee is not consolidated



The transferor (equity method investor) does not control the transferee in accordance with ASC 810 (see our Blueprint, Control and Consolidation Under ASC 810).

No continuing involvement



A transfer of an equity method investment is accounted for as a sale **only if all** the following conditions are met:

- ▶ Isolation of transferred financial assets: The transferred financial asset (equity method investment) has been isolated from the transferor; that is, put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
- ► Transferee's rights to pledge or exchange: The transferee has the right to pledge or exchange the equity method investment received and no condition both:
  - Constrains the transferee from taking advantage of its right to pledge or exchange.
  - Provides more than a trivial benefit to the transferor.
- ▶ **Effective control:** The transferor does not maintain effective control over the transferred financial asset (equity method investment).



#### **EVALUATING THE CONDITIONS IN ASC 860 CAN BE COMPLEX**

ASC 860 applies to the sale and derecognition of financial assets, including equity method investments, unless another scope exception applies. Therefore, an investor must evaluate whether it meets the criteria in ASC 860 to derecognize an equity method investment before applying the measurement guidance in ASC 323. Reaching a conclusion about whether the criteria for sale accounting in ASC 860 have been met requires the application of professional judgment based on the facts and circumstances and may require obtaining an opinion from legal counsel in some circumstances.

The investor accounts for the transaction as follows:

- If it satisfies the conditions for sale accounting: The investor recognizes a gain or loss for the difference between the carrying amount of the equity method investment transferred (determined in accordance with ASC 323) and the fair value of the consideration received.
- ▶ If it does not satisfy both conditions for sale accounting: The investor accounts for the transaction as a secured borrowing. In other words, the "transferred" equity method investment stays on the investor's books, and no gain or loss is recognized. Instead, the investor recognizes the consideration received at fair value and an offsetting liability (as a secured borrowing).

#### 5.3.2 Decrease: Equity Method Investment to Equity Method Investment



#### **FASB REFERENCES**

ASC 323-10-35-35 and ASC 970-323-40-1

When an investor sells part of its interest in an equity method investee, it must determine the accounting model for its retained interest, as discussed in Chapters 1 and 2, and whether the sale meets the derecognition criteria in ASC 860, as discussed in Section 5.3.1.

If so, and if the retained interest continues to be accounted for using the equity method, the investor recognizes a gain or loss for the difference between the fair value of any consideration received and the carrying amount of the equity sold. Generally, an investor determines the equity's carrying amount using the proportionate interest sold. When calculating the gain or loss, the investor must also consider whether any of the following situations affect the gain or loss calculation:

- ▶ Deferred intra-entity profit in the carrying amount of other assets (see Section 4.3)
- lts share of the investee's AOCI (see Section 4.6)
- Indicators that the retained equity method investment is other than temporarily impaired, based on the reasons for the sale and the sales price (see Section 4.8).

The investor does not remeasure its retained interest or recast prior periods for its new ownership interest. However, it proportionately reduces its basis differences in the memo accounts and prospectively recognizes its equity method income using its new ownership interest and the reduced basis differences.

# EXAMPLE 5-3: DECREASE WHILE RETAINING AN EQUITY METHOD INVESTMENT WITH BASIS DIFFERENCES FACTS

Assume the same facts as in Example 4-16, except:

- On January 1, 20X2, the Investor sells 5% of Investee's voting common stock for \$130,000, when the carrying amount of its investment was \$998,400.
- Assume the derecognition requirements in ASC 860 are met and that Investor retains the ability to exercise significant influence over Investee.
- For simplicity, assume there are no amounts in AOCI, no transaction costs upon sale, and no tax effects.

#### CONCLUSION

Investor recognizes a \$5,200 gain upon selling 5% of Investee's voting common stock; the investment's carrying amount immediately after the sale is \$873,600.

#### **ANALYSIS**

- Investor continues to account for the investment using the equity method because it has neither lost the ability to exercise significant influence over Investee nor obtained control over Investee.
- $\blacktriangleright$  Investor's interest is reduced to 35% (initial interest of 40% 5% interest sold).
- ▶ The sold interest meets the derecognition requirements in ASC 860, so Investor proportionately reduces its equity method investment, including the proportionate share of its basis differences, from 40% to 35%.
- The carrying amount of the sold interest is 124,800 (998,400 \* (5% / 40%)); therefore, the gain on sale is 5,200 (sale price of 130,000 124,800), and the investment's new carrying amount is 873,600.
- Investor adjusts the memo accounts and basis differences by first determining its share of Investee's assets and liabilities and the unamortized basis differences in the memo accounts as follows:

JANUARY 1, 20X2	(40%) OF I	INVESTOR'S SHARE (40%) OF INVESTEE'S NET ASSETS		R'S SHARE MEMO TS [A]	UNAMORTIZED BASIS DIFFERENCE (40%) [B]		
Buildings (a)	\$	475,000	\$	467,400	\$	(7,600)	
Customer list (b)		_		4,000		4,000	
IPR&D		_		24,000		24,000	
Goodwill		_		38,000		38,000	
Other net assets (with no basis differences) (c)		465,000		465,000		_	
Total identifiable net assets	\$	940,000	\$	998,400	\$	58,400	

- a. The building's carrying amount of \$475,000 reflects Investor's 40% share of Investee's carrying amount of \$1,187,500 (the carrying amount on January 1, 20X1, of \$1,250,000 (see Example 4-16) minus one year of depreciation of \$62,500 over its 20-year useful life). Investor's share in the memo accounts is \$467,400 (which is 40% of \$1,168,500, which is the fair value of \$1,230,000 on January 1, 20X1 (see Example 4-16), minus one year of depreciation over a 20-year useful life of \$61,500). The unamortized basis difference of (\$7,600) is the difference between Investor's share of Investee's net assets of \$475,000 and the carrying amount in the memo accounts of \$467,400.
- b. The customer list's carrying amount of \$0 reflects Investor's 40% share of Investee's carrying amount of \$0 (see Example 4-16). Investor's share in the memo accounts is \$4,000 (which is 40% of \$10,000, which is the fair value of \$15,000 on January 1, 20X1 (see Example 4-16), minus one year of amortization over a three-year useful life of \$5,000). The unamortized basis difference of \$4,000 is the difference between Investor's share of Investee's net assets of \$0 and the carrying amount in the memo accounts of \$4,000.
- c. This amount reflects Investor's 40% share of Investee's net assets of \$740,000 at the acquisition date + \$200,000 share of Investee's 20X1 net income from Example 4-16, less the building's carrying amount of \$475,000 (see note (a)).
- Next, Investor determines the proportion sold and proportion remaining of its share of Investee's assets and liabilities and the unamortized basis differences as follows:

JANUARY 1, 20X2	MEMO A			NG SHARE MEMO	REMA SHAR UNA BASIS	STOR'S AINING RE (35%) MORTIZED S ERENCE		
	C = [A]	* 5%/40%	D = [B]	* 5%/40%	[A] - [C]		[B] -	[D]
Buildings	\$	58,425	\$	(950)	\$	408,975	\$	(6,650)
Customer list		500		500		3,500		3,500
IPR&D		3,000		3,000		21,000		21,000
Goodwill		4,750		4,750		33,250		33,250
Other net assets (with no basis differences)		58,125		_		406,875		_
Total identifiable net assets	\$	124,800	\$	7,300	\$	873,600	\$	51,100

- The investment's new carrying amount of \$873,600 equals Investor's share of Investee's net assets of \$822,500 (35% of \$2,350,000, see Example 4-16) plus the unamortized basis difference of \$51,100.
- ▶ On January 1, 20X2, Investor recorded the following journal entry to account for the sale of the 5% interest in Investee's voting common stock:

Debit	Cash	\$ 130,000	
Credit	Equity method investment		\$ 124,800
Credit	Gain on sale		5,200

Investor calculates its equity method income from Investee for 20X2 using the new reduced unamortized basis differences, as discussed in Section 4.4.

#### EXAMPLE 5-4: DECREASE WHILE RETAINING AN EQUITY METHOD INVESTMENT WITH AOCI

#### **FACTS**

- ▶ On December 31, 20X1, Investor held 40% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ The equity method investment's carrying amount was \$1,448,000 as of December 31, 20X1 (see Example 4-19). Investor also had a credit of \$8,000 in Investor's AOCI for its share of Investee's AOCI.
- For simplicity, assume there are no intra-entity transactions, basis differences, or income taxes.
- ▶ On January 1, 20X2, Investor sold 10% of Investee's voting common stock for \$410,000, retaining a 30% interest.
- Assume the derecognition requirements in ASC 860 are met and that Investor retains the ability to significantly influence Investee.

#### **CONCLUSION**

Investor recognizes a \$50,000 gain upon selling 10% of Investee's voting common stock; the investment's carrying amount immediately after the sale is \$1,086,000.

#### **ANALYSIS**

- Investor continues to account for the investment using the equity method because it has neither lost the ability to exercise significant influence over Investee nor obtained control over Investee.
- ▶ The sold interest meets the derecognition requirements in accordance with ASC 860, so Investor proportionately reduces its equity method investment, including the proportionate share of its AOCI, from 40% to 30%.
- The interest that was sold had a carrying amount of \$362,000 (\$1,448,000\*(10% / 40%)). Investor must reclassify \$2,000 of AOCI into income as part of the gain ((\$8,000\*(10% / 40%)). Therefore, the gain on sale is \$50,000 (sale price of \$410,000 + \$2,000 of AOCI reclassified into income \$362,000 reduction in the investment's carrying amount). The investment's new carrying amount is \$1,086,000 (\$1,448,000 \$362,000) and \$6,000 (\$8,000 \$2,000) left in Investor's AOCI related to this investment.
- ▶ On January 1, 20X2, Investor recorded the following journal entry to account for the sale of the 10% interest in Investee's voting common stock:

 Debit
 Cash
 \$ 410,000

 Debit
 AOCI
 2,000

CreditEquity method investment\$ 362,000CreditGain on sale50,000

#### 5.3.3 Decrease: Equity Method Investment to Financial Asset



#### **FASB REFERENCES**

ASC 321-10-30-1, ASC 323-10-35-35 through 35-39, and ASC 970-323-40-1

ASC 830-30-40-2

If a reporting entity sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that equity method investment shall be recognized in measuring the gain or loss on the sale. If the sale of part of an equity method investment that is a foreign entity results in the loss of significant influence, see paragraphs 323-10-35-37 through 35-39 for guidance on how to account for the pro rata portion of the accumulated translation adjustment component of equity attributable to the remaining investment. ...

When an investor sells part of its interest in an equity method investee, it must determine the accounting model for its retained interest, as discussed in Chapters 1 and 2, and whether the sale meets the derecognition criteria in ASC 860, as discussed in Section 5.3.1. If it does, the retained interest generally is a financial asset in the scope of ASC 321,<sup>28</sup> the investor recognizes a gain or loss for the difference between the fair value of any consideration received and the carrying amount of the equity sold. Generally, an investor determines the equity's carrying amount using the proportionate interest sold. When calculating the gain or loss, an investor must also consider any deferred intra-entity profit in the carrying amount of other assets (see Section 4.3).

Also, the investor offsets its previously recognized share of an investee's AOCI (see Section 4.6) against the investment when discontinuing the equity method. If that causes the investment to be negative, an investor **both**:

- Reduces the investment to zero
- Recognizes the balance in income

Similarly, if a reporting entity sells part of its ownership interest in an equity method investment that is a foreign entity (as defined in ASC 830), a pro rata portion of the accumulated translation adjustment in AOCI attributable to that equity method investment is recognized when measuring the gain or loss.

Prospectively, the investor stops recognizing its share of the investee's income or losses for an investment that no longer qualifies for the equity method. However, the previously recognized equity method income related to the retained interest remains within the investment's carrying amount. In other words, the investor does not recast prior periods for its new ownership interest or change in accounting.

Upon discontinuing the equity method, an investor remeasures its retained investment in accordance with ASC 321, as applicable (see Section 5.2.1 for a summary of the measurement models for financial assets in the scope of ASC 321). If using the ASC 321 measurement alternative, the retained interest is immediately remeasured to fair value unless the transaction does not represent an observable price change in an orderly transaction for an identical or a similar investment of the same investee (see Section 5.2.1).

However, if the investor discontinues the equity method without an observable transaction for an identical or similar investment (for example, because it loses a board seat), the investor does not remeasure the retained interest. Reaching a conclusion about whether to remeasure the retained interest requires the application of professional judgment based on the facts and circumstances.

# EXAMPLE 5-5: PORTION OF EQUITY METHOD INVESTMENT SOLD RESULTS IN A RETAINED FINANCIAL ASSET ACCOUNTED FOR USING THE ASC 321 MEASUREMENT ALTERNATIVE

#### **FACTS**

- ▶ On December 31, 20X1, Investor held 20% of Investee's voting common stock, which it accounts for using the equity method.
- ▶ The equity method investment's carrying amount was \$3,600,000. Investor also had a \$400,000 credit in Investor's AOCI for its share of Investee's AOCI.
- ▶ For simplicity, assume there are no intra-entity transactions or income taxes.
- ▶ On January 1, 20X2, Investor sold 15% of Investee's voting common stock for \$3,300,000, retaining a 5% interest. Assume the derecognition criteria in ASC 860 are met and that Investor loses the ability to significantly influence Investee.
- ▶ Investor will use the ASC 321 measurement alternative to account for its retained interest. The sale of the 15% interest represents an observable price change in an orderly transaction for an identical investment of the same investee as its retained 5% interest.

#### CONCLUSION

Investor derecognizes the equity method investment and AOCI and recognizes the retained interest. It recognizes a total gain of \$1,200,000, which consists of a \$900,000 gain upon selling the equity method investment and a \$300,000 gain upon remeasuring its retained interest to \$1,100,000.

<sup>&</sup>lt;sup>28</sup> For discussion on legal-form equity interests in LPs or LLCs that have debt-like characteristics, see the BDO Insight in Section 1.3.

#### **ANALYSIS**

- ▶ On January 1, 20X2, Investor discontinues the equity method because it holds only 5% of Investee's voting common stock. That treatment assumes Investor cannot overcome the presumption that it does not have the ability to exercise significant influence over Investee (see Section 2.3).
- ▶ Because Investor no longer has an equity method investment, it reduces the investment by \$400,000, from \$3.6 million to \$3.2 million, for its previously recognized share of Investee's AOCI, which effectively increases its gain upon selling the investment and remeasuring the retained interest. This represents the entire credit in AOCI with respect to this investment, because Investor is discontinuing the equity method.
- ▶ Investor then reclassifies \$800,000 (5% / 20% \* \$3.2 million) of its equity method investment for its retained interest, which it will account for as a financial asset using the ASC 321 measurement alternative and attributing \$2.4 million (15% / 20% \* \$3.2 million) to the portion of the equity method investment sold.
- ▶ However, because the transaction that caused Investor to discontinue the equity method investment represents an observable price change in an orderly transaction for an investment identical to its 5% retained interest, Investor remeasures that 5% interest to fair value. Investor determines that the retained interest's fair value is \$1.1 million based on the value implied by the transaction (\$3.3 million / 15% interest = \$22 million equity value \* 5%). Therefore, Investor remeasures its retained interest to \$1.1 million and recognizes a gain of \$300,000 (\$1.1 million − \$800,000 carrying amount).
- ▶ On selling the equity method investment, Investor recognizes a gain of \$900,000 (\$3.3 million in consideration received \$2.4 million for the derecognized equity method investment).

#### 5.3.4 Decrease: Complete Sale or Liquidation



#### **FASB REFERENCES**

ASC 323-10-35-35 through 35-39, ASC 830-30-40-1, and ASC 970-323-40-1

An investor might sell its entire equity method investment or liquidate the investee. The investor must determine whether the transaction is within the scope of ASC 323 and ASC 860 and, if so, whether the sold interest meets the criteria for derecognition in ASC 860, as discussed in Section 5.3.1. If it does, the investor recognizes a gain or loss for the difference between the fair value of any consideration received and the carrying amount of the equity sold. When calculating the gain or loss, an investor must also consider any deferred intra-entity profit in the carrying amount of other assets (see Section 4.3).

Also, the investor offsets its previously recognized share of an investee's AOCI (see Section 4.6) against the investment when discontinuing the equity method. If that causes the investment to be negative, an investor **both**:

- Reduces the investment to zero
- Recognizes the balance in income

Further, in accordance with ASC 830, upon the sale of an investment in a foreign investee, any foreign currency translation adjustment attributable to that investee in the investor's AOCI is **both**:

- Removed from AOCI
- Included in the gain or loss on sale

The investor discontinues the equity method upon sale (or liquidation) and does not recast prior periods as if it never owned the investment.

#### EXAMPLE 5-6: EQUITY METHOD INVESTMENT SOLD WITH NO RETAINED INTEREST

#### **FACTS**

- ▶ On December 31, 20X1, Investor held 20% of Investee's voting common stock, which it accounts for using the equity method. The equity method investment's carrying amount was \$3.6 million. Investor also had a \$400,000 credit in AOCI for its share of Investee's AOCI.
- On January 1, 20X2, Investor sold its entire investment in Investee for \$3.3 million. Investor concludes that the transaction is within the scope of ASC 323 and ASC 860 and that the derecognition criteria in ASC 860 are met.
- For simplicity, assume there are no intra-entity transactions or income taxes.

#### CONCLUSION

Investor recognizes a gain of \$100,000 upon selling the equity method investment and derecognizes the equity method investment and AOCI.

#### **ANALYSIS**

- ▶ On January 1, 20X2, because Investor no longer has an equity method investment, Investor reduces the investment by \$400,000, from \$3.6 million to \$3.2 million, for its previously recognized share of Investee's AOCI, which effectively increases the gain upon selling the investment.
- ▶ Investor recognizes a gain of \$100,000 (\$3.3 million in consideration received \$3.2 million for the derecognized equity method investment).

#### 5.4 INVESTEE SHARE ISSUANCES



#### **FASB REFERENCES**

ASC 323-10-30-2, ASC 323-10-35-15, and ASC 323-10-40-1

When an investor has a pre-existing equity method investment and the investee issues shares, the investor's ownership interest in the investee may increase, decrease, or stay the same, depending on whether the investor participates (purchases shares), and, if it does, whether the investor does so proportionately to others.

When the change in interest causes the investor to discontinue the equity method (either because the investor obtains control of the investee or the investment no longer qualifies for the equity method), the investor applies the relevant guidance from Section 5.2 or 5.3. In contrast, this section discusses when the investor continues to account for its interest using the equity method before and after the share issuance.

In determining the accounting, it helps to consider relevant guidance in ASC 323, which states:

- An investor initially measures an equity method investment at cost in accordance with ASC 805-50-30 (see Section 3.2).
- An investor accounts for an investee's share issuance as if the investor sold a proportionate share of its investment and recognizes any gain or loss in earnings. (However, this guidance assumes that the investor's interest decreased).
- An investor accounts for its share of an investee's capital transactions.

#### BDO INSIGHTS: ACCOUNTING FOR AN INVESTEE'S SHARE ISSUANCE

Before determining the investor's accounting for an investee's share issuance, it is important to evaluate whether to account for the investor's purchase with the effects of other investors' purchases as a single transaction or account for each transaction separately. While an investor's decision to buy investee shares may be independent from the decisions of other investors, that is not always the case. Further, from the investee's perspective, issuing shares may be rational (or legally possible) only when considering all investors' participation (see the BDO Insights in Section 5.1).

In our experience, the facts and circumstances generally are such that investee share issuances are accounted for as a single net transaction (rather than separately accounting for the shares issued to the investor and for the dilution from shares issued to other investors). The table below assumes that to be the case, and that the stock issued is economically similar to the investor's own stock.

INVESTOR'S PARTICIPATION	ACCOUNTING
None: The investor's ownership interest decreases, but the investee's net assets increase.	Similar to the accounting discussed in Section 5.3.2, the investor recognizes a dilution gain or loss as the difference between: (1) its new share of the investee's post-transaction net assets; and (2) the share of the investment sold (based on the decrease in its ownership interest). The investor also proportionately reduces basis differences in the memo accounts.
Pro rata: The investor's ownership interest stays the same, but the investor pays cash and the investee's net assets increase.	The investor increases the equity method investment for its cost (see Section 3.2). However, the investor also must evaluate whether such payments are really funding the investee's prior losses (see Section 4.7.4). If they are, the investor must recognize any suspended losses.
Net decrease (buys proportionately fewer shares than other investors): The investor pays cash and the investee's net assets increase, but the investor's ownership interest decreases.	Similar to the accounting discussed in Section 5.3.2, the investor recognizes a dilution gain or loss as the difference between: (1) its new share of the investee's post-transaction net assets; and (2) the share of the investment sold (based on the decrease in its ownership interest) after increasing the investment for the cash paid. The investor also proportionately reduces basis differences in the memo accounts.
Net increase (buys proportionately more shares than other investors): The investor pays cash, the investee's net assets increase, and the investor's ownership interest increases.	The investor increases the equity method investment for its cost and identifies basis differences for the incremental interest, similar to the accounting discussed in Section 5.2.2. However, the investor also must evaluate whether such payments are really funding the investee's prior losses (see Section 4.7.4). If they are, the investor must also recognize any suspended losses.

When an investee issues an instrument that is not in-substance common stock or equity with non-pro-rata returns (which is common for LPs and LLCs with specific capital accounts, as discussed in Section 4.2.1), determining the accounting requires the application of professional judgment based on the facts and circumstances and the principles in ASC 323.

In each of those scenarios, the investor prospectively recognizes equity method income using its new ownership interest (adjusted for any incremental or pre-existing basis differences) and does not recast prior periods for its change in interest.

Further, when recognizing the above entries, an investor also must consider:

- ▶ Deferred intra-entity profit in the carrying amount of other assets (see Section 4.3)
- ▶ The investor's share of the investee's AOCI (see Section 4.6)
- Indicators that the investment is other than temporarily impaired based on the reasons for the transaction or the share price (see Section 4.8)

#### **5.4.1 Investee Issues Share-Based Payments**



#### **FASB REFERENCES**

ASC 323-10-35-4 through 35-5, ASC 323-10-35-15, ASC 323-10-40-1

An equity method investee may issue share-based payment awards as compensation to employees or nonemployees for providing goods or services to the investee. In accordance with ASC 718, the investee recognizes those transactions as follows:

- **Step 1:** The investee recognizes compensation cost, which generally is expensed unless the cost meets the criteria to be capitalized in accordance with other U.S. GAAP.
- ▶ Step 2: At the same time, the investee recognizes an increase in equity (for example, APIC) if the award is equity-classified.
- **Step 3:** If the instrument is an option and is exercised, the investee recognizes cash and increases equity, which dilutes the ownership interests of other investors. Similarly, restricted stock units (RSUs) issued to employees and nonemployees dilute other investors upon expiration of the restrictions.

Generally, those transactions' dilutive effects are minimal and do not cause an investor to stop accounting for its interest using the equity method. Assuming so, the investor must account for its share of the investee's compensation cost (and the corresponding capital transaction), as well as the dilutive effect of the exercise of the share-based payment award (if applicable). In determining the accounting, it helps to consider the relevant guidance in ASC 323, which states:

- ▶ An investor recognizes its share of an investee's earnings or losses.
- An investor accounts for its share of an investee's capital transactions.
- An investor accounts for an investee's share issuance as if the investor sold a proportionate share of its investment and recognizes any gain or loss in earnings.

#### BDO INSIGHTS: AN INVESTOR'S ACCOUNTING FOR AN INVESTEE'S SHARE-BASED PAYMENTS

Because ASC 323 does not explicitly address an investor's accounting for an investee's share-based payment awards, there is diversity in practice. We believe the methods described in the table below are acceptable. An investor must consistently apply an accounting policy for all investees.

The table assumes that the underlying shares issued to the investee's employees or nonemployees are economically similar to the investor's equity. When an investee issues an instrument that has economic rights that differ from the investor's existing classes of equity (for example, non-pro-rata returns, which is common for LPs and LLCs with specific capital accounts, as discussed in Section 4.2.1), determining the accounting requires the application of professional judgment based on the facts and circumstances and the principles in ASC 323.

INVESTEE'S ACCOUNTING	INVESTOR'S ACCOUNTING
Step 1: Recognize compensation cost (expense) in accordance with ASC 718.	As part of its normal recurring equity method accounting, the investor recognizes its share of the investee's equity method income, as discussed in Section 4.2 (which includes the investee's compensation expense), with a corresponding entry to the equity method investment. This entry is required, regardless of which alternative below is selected.
Step 2: Recognize a corresponding increase in equity if the award is equity-classified.	<ul> <li>Select either:</li> <li>Approach 2A — No entry; instead, track the difference when reconciling the investment to the investor's claim on the investee's net assets.</li> <li>Approach 2B — Recognize an increase in the equity method investment with a corresponding increase in the investor's own equity.</li> <li>We believe it is inappropriate for an investor to recognize its share of the investee's increase in equity by debiting the investment and crediting equity method income because that contradicts the requirement to recognize the investor's share of the investee's income.</li> </ul>
Step 3: Upon exercise of an option) recognize cash received (if applicable) and increase equity.  Upon vesting of a restricted stock unit, there is no entry.	<ul> <li>Select either:</li> <li>Approach 3A — Recognize a dilution gain or loss as the difference between:         <ul> <li>(1) the investor's new share of the investee's post-transaction net assets; and (2) the share of the investor's investment sold (based on the decrease in its ownership interest), as discussed in Section 5.4 (a share issuance in which the investor does not participate). That gain or loss also can be calculated using the HLBV method discussed in Section 4.2.1.</li> </ul> </li> <li>Approach 3B — The treatment is similar to that in Approach 3A, except the investor's investment balance is calculated including the entry in the memo accounts referenced in Approach 2A.</li> </ul>

See our Blueprint, <u>Share-Based Payments Under ASC 718</u>, for the investee's accounting for share-based payment awards. See Section 4.5.3 of this Blueprint when an investor issues share-based payments on the investor's own equity as compensation to employees or others providing goods or services to the investee.

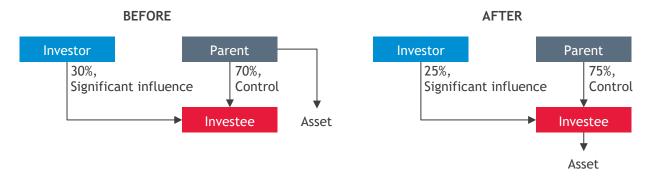
#### 5.4.2 Investee Issues Shares in a Common Control Transaction



#### **FASB REFERENCES**

ASC 323-10-35-35, ASC 810-10-45-23, and ASC 970-323-40-1

When an investor has a pre-existing equity method investment and the investee issues new shares to its parent in exchange for receiving assets, the investor's ownership interest decreases. The diagram below illustrates such a transaction.



The accounting by each party is as follows:

- Investee: The investee recognizes a common control transaction. ASC 805-50 generally requires the receiving entity in a common control transaction to recognize the transferred assets at the ultimate parent's carrying amounts and a corresponding increase in equity for the issued shares (see Appendix B.3.3.2 of our Blueprint, <a href="Business Combinations Under ASC 805">Business Combinations Under ASC 805</a>). However, if the asset received is a financial asset (such as another equity method investment), the investee applies ASC 860.
- ▶ Parent: The parent adjusts NCI for the change in ownership and the NCI's claim on the contributed assets and adjusts equity by the same amount (in its consolidated financial statements).
- Investor: A noncontrolling investor first determines whether the change in interest causes it to discontinue the equity method (and, if it does, the investor accounts for the transaction as discussed in Section 5.3.3).
  - If the investor continues to apply the equity method, it recognizes a dilution gain or loss using the method discussed in Section 5.3.2, except that it uses the fair values of the shares issued and assets received (rather than the investee's carrying amount, which, as discussed above, is the ultimate parent's carrying amount).
  - The investor also identifies any incremental basis differences between its share of the contributed asset's fair value and the investee's carrying amount, which the investor prospectively amortizes (as discussed in Sections 3.3 and 4.4).

#### 5.5 INVESTEE REPURCHASES SHARES (TREASURY SHARE REPURCHASE)



#### **FASB REFERENCES**

ASC 323-10-35-17 and ASC 323-10-35-33 through 35-35

When an investor has a pre-existing equity method investment and the investee repurchases outstanding shares, the investor's ownership interest in the investee may increase, decrease, or stay the same, depending on whether the investor participates (sells shares) and, if so, whether the investor does so proportionately to other investors.

When the change in interest causes the investor to discontinue the equity method (either because the investor obtains control of the investee or the investment no longer qualifies for the equity method), the investor applies the relevant

guidance from Section 5.2.3 or 5.3.3. In contrast, this section discusses fact patterns in which the investor continues to account for its interest using the equity method before and after the share repurchase.

In determining the accounting, it helps to consider the relevant guidance in ASC 323, which states:

- An investor recognizes an increase in its ownership interest (while retaining an equity method investment) by adding the cost of the new interest (see Section 3.2) to the pre-existing interest (see Section 5.2.2).
- ▶ When selling an interest and continuing to apply the equity method, the investor recognizes a gain or loss for the difference between the fair value of any consideration received and the carrying amount of the equity sold (see Section 5.3.2).
- Dividends received from an investee generally reduce the investment.

#### BDO INSIGHTS: AN INVESTOR'S ACCOUNTING FOR AN INVESTEE'S SHARE REPURCHASES

Before determining the investor's accounting for an investee's share repurchases, it is important to evaluate whether to account for the investor's sale and the effects of other investors' sales as a single transaction, or whether to separately account for each transaction. While an investor's decision to sell investee shares back to the investee may be independent from those of other investors, that is not always the case. Further, from the investee's perspective, the share repurchase may be rational (or legally possible) only when considering all investors' participation (see the BDO Insights "Evaluating whether to account for multiple transactions as a single transaction" in Section 5.1).

In our experience, the facts and circumstances generally are such that investee share repurchases are accounted for as a single net transaction (rather than accounting separately for a repurchase of shares from the investor and an increase in ownership resulting from repurchases from other investors). The table below assumes that to be the case, and that the shares repurchased are economically similar to shares held by the investor.

INVESTOR'S PARTICIPATION	ACCOUNTING
None: The investor's ownership interest increases, but the investee's net assets decrease.	The investor does not recognize a gain or loss or adjust the investment; however, it identifies incremental basis differences in the memo accounts related to its increased ownership in the investee (as discussed in Sections 3.3 and 5.2.2).
Pro rata: The investor's ownership interest stays the same, but the investor receives cash and the investee's net assets decrease.	We believe this transaction is economically similar to a dividend or distribution and would be accounted for accordingly (see Section 4.5.1).
Net decrease (sells proportionately more shares than other investors): The investor receives cash, the investee's net assets decrease, and the investor's ownership interest also decreases.	The investor accounts for the sale of shares to the investee (share repurchase) as if the investor sold shares to a third party, as discussed in Section 5.3.2, which results in a gain or loss if the price differs from the shares' carrying amount.
Net increase (sells proportionately fewer shares than other investors): The investor receives cash and the investee's net assets decrease, but the investor's ownership interest increases.	The investor recognizes a decrease in its equity method investment for the cash received. It also identifies incremental basis differences in the memo accounts related to its increased ownership in the investee, which are prospectively amortized (as discussed in Section 3.3).

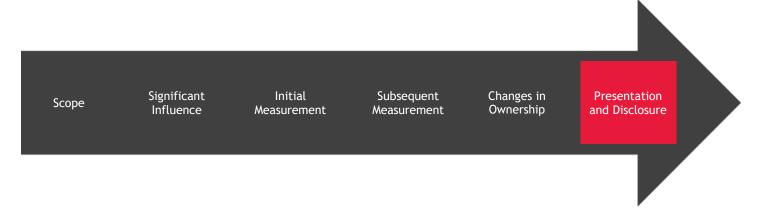
When an investee repurchases equity with non-pro-rata returns (which is common for LPs and LLCs with specific capital accounts, as discussed in Section 4.2.1), determining the accounting requires the application of professional judgment based on the facts and circumstances and the principles in ASC 323.

In each of those scenarios, the investor prospectively recognizes its equity method income using its new ownership interest (adjusted for both incremental and pre-existing basis differences) and does not recast prior periods for its change in interest.

Further, when recognizing the above entries, an investor also must consider:

- ▶ Deferred intra-entity profit in the carrying amount of other assets (see Section 4.3)
- ▶ The investor's share of the investee's AOCI (see Section 4.6)
- Indicators that the investment is other than temporarily impaired based on the reasons for the transaction or the share repurchase price (see Section 4.8)

# Chapter 6: Presentation and Disclosure



#### 6.1 OVERVIEW: PRESENTATION AND DISCLOSURE

An investor presents its equity method investments as a single amount in the balance sheet, consistent with the idea that the equity method is like a one-line consolidation (see Section 6.2.1). Likewise, ASC 323 requires an investor to present equity method income (loss) as a single line item in the income statement (see Section 6.2.2).

This chapter also discusses the presentation of an OTTI of an equity method investment; an investor's income tax related to the equity method investment; and the presentation of gains and losses related to sales, disposals, and discontinued operations. Cash flows related to equity method investments generally are investing activities, except for some dividends and distributions (see Section 6.2).

ASC 323 requires specific disclosures about equity method investments (see Section 6.3). An investor also must comply with the disclosure requirements in other U.S. GAAP, as well as with SEC guidance, if applicable.

#### 6.2 PRESENTATION OF AN EQUITY METHOD INVESTMENT



#### **FASB REFERENCES**

ASC 323-10-45-1 through 45-3, ASC 230-10-45-12 through 45-13, and ASC 230-10-45-21D

The table below summarizes presentation and disclosure requirements for an equity method investment in ASC 323.

#### PRESENTATION REQUIREMENTS

**Balance Sheet** 

An equity method investment is presented as a single line item in the investor's balance sheet (see Section 6.2.1).

#### Income Statement

- ▶ Equity method income is presented as a single line item in the investor's income statement (see Section 6.2.2).
- An investor can combine its share of an equity method investee's OCI with its own OCI components in the statement of comprehensive income or separately present such amounts (see Section 4.6).

#### PRESENTATION REQUIREMENTS

#### Cash Flow Statement

- ► Cash paid for an investment or received upon sale or disposal of an equity method investment are investing activities.
- ▶ When an investor uses the indirect method to prepare the cash flow statement, its equity method income is a reconciling item between net income and cash flows from operating activities.
- An equity method investor must elect a policy to determine whether dividends or distributions from its investee are operating or investing activities, and use either the cumulative earnings approach or the nature of distribution approach in ASC 230.

#### 6.2.1 Balance Sheet



#### **FASB REFERENCES**

ASC 323-10-45-1

An investor presents an equity method investment on the balance sheet as a single line item, which reflects its equity method income after the acquisition date (see Chapter 4) minus any dividends or distributions received from the investee (see Section 4.5.1) and any OTTIs (see Section 4.8). Proportionate consolidation is not allowed unless criteria are met, as discussed in Section 1.4.5.

An investor generally presents a negative equity method investment as a liability (for example, because of excess dividends and distributions (see Section 4.5.1) or because of equity method losses (see Section 4.7)).

Regulation S-X Rule 5-02(12) indicates that a registrant must disclose other investments in a separate line item, which may include equity method investments. However, material equity method investments may be reported in a separate line item.

#### 6.2.2 Income Statement and Statement of Comprehensive Income



#### **FASB REFERENCES**

ASC 323-10-45-1 through 45-3

An investor presents its share of the investee's income as a single line item in the income statement, except for its share of the investee's accounting changes, which are separately presented. Proportionate consolidation is not allowed unless the criteria are met, as discussed in Section 1.4.5.

An investor may combine its share of an investee's OCI with the investor's other OCI components in the statement of comprehensive income or separately present such amounts (see Section 4.6).

Regulation S-X Rule 5-03(b)(12) generally requires a registrant to present an income statement in the following order:

- Income (loss) before income tax expense (benefit) (pretax income)
- Income tax expense (benefit)
- Equity method income (loss)
- Income (loss) from continuing operations
- Discontinued operations
- Net income (loss)
- Other comprehensive income (loss)
- Comprehensive income (loss)

However, an investor may present equity method income in a different position on the income statement if justified by the facts and circumstances, as discussed further in the following SEC staff guidance and BDO Insight.



#### **SEC STAFF GUIDANCE**

Highlights of the SEC Regulations Committee Joint Meeting with SEC Staff, March 11, 2003

**Discussion:** In certain circumstances, it may be appropriate to include income from equity investments in operations. At the SEC Conference in December 2002, a member of the Staff stated, "We recognize that some companies operate their business largely through equity investees and that the operations in the equity investees are integrated into the whole. If so, Regulation S-X allows ... and it makes sense ... to include equity income of investees within operating income, but not within revenues. All amounts related to equity in earnings of investees should be included within the one-line presentation on the income statement with the components detailed in the [equity method investment] footnote. The one-line equity earnings of investees should include any excess purchase price amortization and any other than temporary impairment recognized."

If the view is that an equity investee may be significantly integral to the operations of the registrant to allow for classification within operations, what specific circumstances or in what industries should we expect to find such operationally integral equity investees?

Staff Response: The staff stated that it will take a facts-and-circumstances approach in determining whether an equity investee is operationally integral to the operations of the parent. The staff is not inclined to draw a bright line in this area (other than to prohibit proportional consolidations). It was agreed that the circumstances whereby an equity investee's operations are sufficiently integral to the operations of its parent to allow for classification within operations will be very limited. [Emphasis added]

#### BDO INSIGHTS: DETERMINING WHETHER AN INVESTEE IS "SIGNIFICANTLY INTEGRAL" TO THE INVESTOR

Reaching a conclusion about whether an investee's operations are "significantly integral" (as discussed in the SEC staff guidance) to the investor's business and therefore can be presented within income from operations requires the application of professional judgment based on the facts and circumstances.

We believe an investor should consider the following questions when evaluating the facts and circumstances:

- ▶ How significant to the investor's business are the intra-entity transactions between the investor and investee?
- ► How much does the investor rely on the investee for critical processes, such as buying materials, providing services, or producing or distributing goods?
- ▶ Does the investor manage the investee through a management or services agreement?

In practice, we have observed that many investors present equity method income as a component of other income (expense) or as separate line item before the subtotal for pretax income.

Investors other than SEC registrants are not required to apply the SEC's presentation requirements. However, we believe presenting equity method income within revenue generally is **prohibited** for all investors.

An SEC registrant must present any OTTI of its equity method investment with the investor's equity method income in accordance with the SEC staff views above (see Section 4.8).

An investor's **share** of an investee's income tax is part of the investor's equity method income, regardless of where the investor presents its equity method income. However, the investor's **own** income tax expense related to an equity method investment (determined in accordance with ASC 740) is part of the investor's income tax, not equity method income, regardless of which entity (investor or investee) remits the tax.

#### 6.2.2.1 Sales, Disposals, and Discontinued Operations



#### **FASB REFERENCES**

ASC 205-20-45-1B through 45-1C, ASC 323-10-45-1, ASC 323-10-20: Earnings or Losses of an Investee, and ASC 360-10-15-5

The disposal of a component of an entity is reported as a discontinued operation in accordance with ASC 205-20 if it represents a strategic shift that has a major impact on the entity's operations and financial results and the component is classified as held for sale, disposed of by sale, or disposed of by other means such as abandonment or spinoff. The disposal of an equity method investment is one example of a disposal that could represent a strategic shift. So, if an equity method investment is, or is part of, a discontinued operation, ASC 205-20 applies, not ASC 323.

Regardless of whether the equity method investment is, or is part of, a discontinued operation, the investment is not in the scope of the held-for-sale measurement guidance in ASC 360. Instead, an investor applies ASC 323 and evaluates whether the investment is other than temporarily impaired (see Section 4.8).

#### BDO INSIGHTS: SELLING AN EQUITY METHOD INVESTMENT THAT IS NOT A DISCONTINUED OPERATION

ASC 323 does not specify the presentation of gains and losses related to selling or disposing of equity method investments (or other similar transactions) that are not, or are not part of, a discontinued operation. Therefore, we believe that when the equity method investment is not a discontinued operation, an investor may present the gain or loss on sale (or disposal) either:

- In the same line item as equity method income
- As a separate line item.

However, we believe an investor should consistently present those kinds of transactions. For example, it would be inappropriate to present gains from selling equity method investments in one manner and losses in another (see Chapter 5).

#### BDO INSIGHTS: AN INVESTOR'S SHARE OF AN INVESTEE'S DISCONTINUED OPERATIONS

ASC 323 requires an investor to present its share of the investee's earnings or losses, except for its share of the investee's accounting changes, as a single amount in the income statement as discussed in Section 6.2.2. ASC 323 defines the term "earnings and losses" as an investee's net income as determined in accordance with U.S. GAAP - that is, net income after discontinued operations.

U.S. GAAP does not provide any exception from that requirement or other guidance on presenting an investor's share of its investee's discontinued operations. That is likely because it would be rare that an investee's disposal of a component would be a strategic shift for the investor.

Therefore, considering the absence of an exception in ASC 323, we believe an investor should present its share of its investee's discontinued operations in equity method income.

#### 6.3 DISCLOSURES ABOUT AN EQUITY METHOD INVESTMENT



#### **FASB REFERENCES**

ASC 323-10-50-2 through 50-3 and ASC 810-10-50-2

The table below summarizes the required disclosures for an equity method investment.

When evaluating the extent of disclosures about its equity method investments, an investor considers the investment's significance to its financial position and results of operations. If an investor has multiple equity method investments, it may be appropriate to combine the required disclosures.

#### TOPIC

#### **DISCLOSURE REQUIREMENTS**

# The nature and accounting for the investment

An investor must disclose parenthetically in notes to financial statements or in separate statements or schedules all the following:

- ▶ The name of each investee and ownership interest (for example, the percentage of common stock).
- ► The investor's accounting policies for investments, including the names of significant investees for which the investor's ownership percentage:
  - Is 20% or more of the voting common stock (or 3% to 5% or more for interests in LPs, LLCs, trusts, and similar entities) but the equity method is **not** applied, and the reasons why.
  - Is less than 20% of the voting common stock (or less than 3% to 5% for interest in LPs, LLCs, trusts, and similar entities), but the equity method is applied, and the reasons why.
- ▶ The difference between the investment's carrying amount and the investor's share of the investee's net assets (for example, because of basis differences, as discussed in Section 4.4, or non-pro-rata profit sharing arrangements, as discussed in Section 4.2.1) and the accounting for the difference.
- ▶ The value of each investment for which a quoted market price is available.

# The investee's financial information

- ▶ If equity method investments are material to the investor's financial position or results of operations, an investor must summarize the investee's assets, liabilities, and results of operations.
- ▶ An investor must disclose the material effects of potential conversions, exercises, or contingent issuances of an investee's convertible securities, options, or warrants that may affect equity method income.

#### **BDO INSIGHTS: OTHER DISCLOSURES ABOUT EQUITY METHOD INVESTMENTS**

Although not explicitly required by ASC 323, we believe the following disclosures also should be made when applicable:

- ▶ The investor's accounting policy for a negative basis difference, as discussed in Section 3.3.2.
- ▶ The terms and effects of any material substantive profit-sharing arrangements, as discussed in Section 4.2.1.
- Any change in the reporting lag, as discussed in Section 4.2.2.
- Any intervening events that affect an investee reported on a lag, as discussed in Section 4.2.2.
- The investor's accounting policy for presenting intra-entity profit eliminations, as discussed in Section 4.3.3.
- Distributions and dividends received and the accounting policy for any amounts received in excess of the investment's carrying amount, as discussed in Section 4.5.1.
- ▶ The equity method losses not recognized after an investment is reduced to zero, as discussed in Section 4.7.
- Information about an OTTI of an equity method investment, as discussed in Section 4.8, including disclosures about the fair value measurement.

#### BDO INSIGHTS: COMBINING DISCLOSURES ABOUT EQUITY METHOD INVESTMENTS

When determining whether to combine disclosures about different equity method investments, we believe an investor should consider the investment's:

- **Quantitative significance**, including the investment's fair value, in addition to the quantitative significance using measures reported in accordance with U.S. GAAP.
- ▶ Qualitative significance, including the significance of the investee's operations to the investor's business (see the BDO Insights in Section 6.2.2 for questions to consider), and the different risks and rewards of each investment.

An investor must balance between combining too many disclosures and providing too much detail; either can obscure important information or provide information in a way that might not be useful. SEC registrants also must consider the requirements in S-X Rule 4-08(g), which requires disclosure of summarized financial information for significant equity method investees (individually or in the aggregate) (see Section 6.3.2.2).

Reaching a conclusion requires the application of professional judgment based on the facts and circumstances.

#### **6.3.1 Other Disclosures About Equity Method Investments**



#### **FASB REFERENCES**

ASC 250-10-50, ASC 260-10-55-20 through 55-22, ASC 280-10-50-22 and 50-25, ASC 460-10-50-6, ASC 740-10-S99-1(2), ASC 740-323-50-1, ASC 810-10-50, ASC 825-10-50-28(f), ASC 830-30-50, and ASC 850-10-50-1

The table below summarizes other required disclosures related to equity method investments in U.S. GAAP.

#### **DISCLOSURE REQUIREMENTS**

#### **Accounting changes**

An investor must separately present its share of its investee's change in accounting principle (see Section 4.2). An investor also should provide the disclosures required by ASC 250.

	DISCLOSURE REQUIREMENTS
Earnings per share	ASC 260 provides guidance on calculating earnings per share when a subsidiary issues instruments, such as options, warrants, and convertible securities, that potentially are dilutive to common stock. ASC 260 also applies to equity method investees, regardless of whether the instrument is exercisable into the investor's or investee's common stock.
Segment reporting	If an equity method investment is a reportable segment, ASC 280 requires specific disclosures. An investor also must disclose its equity method income and the equity method investment if such amounts are in the measure of segment profit or segment assets, respectively, reviewed by or regularly provided to the chief operating decisionmaker.
Investments that generate income tax credits	An investor must disclose information about investments that generate income tax credits and other income tax benefits from a tax credit program for which it has elected to apply the PAM (see Section 1.5.2). That includes investments in that tax credit program that do <b>not</b> meet the conditions to be accounted for using the PAM (but which might instead be accounted for using the equity method):  The nature of its investments
	▶ The effect of the investments and the related income tax credits and other income
	tax benefits on its financial position and results of operations.  See our publication, <u>Investments in Tax Credit Structures and the Proportional Amortization Method</u> , for guidance on the PAM and required disclosures.
Guarantees to, or on behalf of, equity method investees	If an equity method investor provides a guarantee to, or on behalf of, an equity method investee, the investor must provide disclosures required by ASC 460. That includes the nature and term of the guarantee, events or circumstances requiring performance, the maximum potential exposure under the guarantee, the liability's carrying amount, any recourse provisions, and the nature of assets held as collateral by third parties.
Income tax disclosures	For SEC registrants:
	▶ If an equity method investee has an effective tax rate that differs from the applicable statutory federal income tax rate by more than 5% and the investee's tax components are known and material to the investor, additional disclosures are required.
	An investor must disclose the aggregate dollar and per-share effects of any tax holidays granted to an equity method investee, including a brief description of circumstances and the tax holiday's termination date.
VIE disclosures	If an equity method investee is a VIE, the investor must provide the disclosures required by ASC 810 (see Section 8.3 of our Blueprint, Control and Consolidation Under ASC 810). For example, when an investor holds more than 50% of an investee's voting common stock, the investor must disclose why it does not control and consolidate the investee.
Deconsolidated businesses, subsidiaries, and assets	If an investor retains an equity method investment after losing control of a business, deconsolidating a subsidiary, or derecognizing nonfinancial assets (as discussed in Section 3.2.4), disclosure may be required by ASC 810, ASC 610-20, or other U.S. GAAP.

	DISCLOSURE REQUIREMENTS
Investments for which the fair value option is elected	If an investor elects the fair value option in ASC 825 for an investment, it must disclose the information required by ASC 323 (see Section 6.3), except for the following:  The basis difference The value of each investment with a quoted market price The effects of the investee's convertible securities, options, or warrants.
Foreign currency disclosures	An investor must disclose changes in its CTA, including changes related to equity method investments, such as amounts transferred from the investor's CTA to net income because of a decrease in the investment (see Section 4.2.7).
Related-party transactions	An equity method investment and an investment accounted for using the fair value option are related parties to the investor, as defined in ASC 850. The investor must provide disclosures about related-party transactions with such entities, including:  The nature of the relationship  A description of transactions, including the amounts  Amounts due to or from the investee.

#### 6.3.2 Considerations for SEC Reporting About Equity Method Investments

#### 6.3.2.1 Historical Financial Statements

S-X Rule 3-09 requires registrants to provide historical audited annual financial statements for significant equity method investees. Significance is determined in accordance with the investment and income significant subsidiary tests in S-X Rule 1-02(w), using a 20% threshold. The financial statements must generally be provided as of and for the same periods as the registrant, but they might be unaudited for periods when the investee is not significant. Historical financial statements of significant equity method investees are not required for interim periods.

The form and content of the investee's historical financial statements must generally be the same as if the investee were a registrant. However, some disclosures are not required for nonpublic investees (for example, segment reporting and earnings per share), and the audit of the investee's financial statements generally may be conducted in accordance with AICPA standards.<sup>29</sup>

#### 6.3.2.2 Summarized Financial Information

S-X Rule 4-08(g) requires registrants to annually provide summarized financial information for significant (individually or in the aggregate) equity method investees. Significance is determined in accordance with the investment, asset, and income significant subsidiary tests in S-X Rule 1-02(w) using a 10% threshold. The summarized financial information must be as of and for the same periods as the registrant's financial statements, regardless of whether significance was met in all periods.

#### 6.3.2.3 Interim Reporting

S-X Rule 10-01(b)(1) requires registrants to provide summarized income statement information for significant equity method investees on an interim basis. Significance is determined by the investment and income significant subsidiary tests in S-X Rule 1-02(w), using a 20% threshold.

#### 6.3.2.4 Smaller Reporting Companies

For registrants that qualify as smaller reporting companies, S-X Rule 8-03(b)(3) requires summarized income statement information in the annual and interim financial statements for equity method investees that constitute at least 20% of the registrant's consolidated assets, equity, or income from continuing operations attributable to the registrant.

<sup>&</sup>lt;sup>29</sup> The audit of the investee's financial statements might have to be conducted in accordance with Public Company Accounting Oversight Board standards when the registrant's auditor refers to the investee's audit report in its opinion on the registrant's financial statements.

#### 6.3.2.5 Acquired or Disposed Equity Method Investments

S-X Rule 3-05 and Article 11 of Regulation S-X require registrants to provide historical and pro forma financial information about significant acquired or to-be-acquired businesses based on the significant subsidiary tests in S-X Rule 1-02(w). The acquisition of a business for SEC reporting purposes includes the acquisition of an equity method investment (including one accounted for under the fair value option) when the underlying investee meets the SEC's definition of a business in S-X Rule 11-01(d) (see our publication, <u>Financial Statements of Acquired Businesses:</u> A Snapshot).

Similarly, S-X Rule 3-14 and Article 11 of Regulation S-X require registrants to provide some historical and pro forma financial information about significant acquired or to-be-acquired real estate operations. A real estate operation is "a business that generates substantially all of its revenues through the leasing of real property." The acquisition of a real estate operation includes the acquisition of an equity method investment in an entity that also qualifies as a real estate operation (see our publication, Financial Statements of Acquired Real Estate Operations: A Snapshot).

A registrant that contributes a business to another entity in exchange for receiving or retaining an equity method investment in that entity (or in another entity), as discussed in Section 3.2.4, must consider the reporting requirements in Item 2.01 of Form 8-K, which require the registrant to measure the significance of the disposed business and consider pro forma requirements for significant dispositions (see our publication, <u>Financial Statements of Acquired Businesses: A Snapshot</u>).



#### DEFINITION OF A BUSINESS IN ASC 805 IS DIFFERENT THAN THE SEC DEFINITION

To determine whether a transaction is accounted for as a business combination, an asset acquisition, or a recapitalization when preparing financial statements in accordance with U.S. GAAP, the acquirer must assess (1) whether substantially all the value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets (the screen test); and (2) whether the acquired set includes the required elements of a business (see Chapter 3 of our Blueprint, <u>Business Combinations Under ASC 805</u>).

In contrast, under the SEC regulations, a legal entity, subsidiary, or a division is presumed to be a business. However, a lesser component of an entity might also constitute a business. The determination generally depends on whether the nature of the revenue-producing activity is the same before and after the acquisition (among other factors).

Therefore, an acquiree might meet the ASC 805, but not the SEC, definition of a business, or vice versa. Reaching a conclusion requires the application of professional judgment based on the facts and circumstances and the relevant guidance for that determination.

#### 6.3.2.6 Other Required Reporting About Equity Method Investments

U	REPORTING REQUIREMENTS
Rule 4-08(e)(2)	A registrant must disclose the amount in its retained earnings that represents the undistributed earnings in its equity method investments.
Rule 4-08(e)(3)	A registrant must disclose restrictions on the investee's ability to transfer funds to the investor as dividends, loans, or advances and separately disclose the investee's restricted net assets for the most recently completed fiscal year.
Rule 4-08(k)	A registrant must separately present on the balance sheet, income statement, and cash flow statement the amounts of any related-party transactions, including with equity method investees, as well as any intra-entity profits and losses.
Rule 5-03(b)(12), codified in ASC 210-10-S99-12	A registrant must disclose dividends received from an equity method investee either parenthetically or in a note.

# **Appendix A: Other BDO Blueprints**

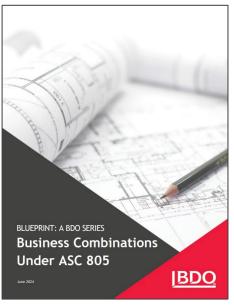
Our other Blueprints and publications are available on BDO's Accounting, Reporting and Compliance Hub (ARCH).



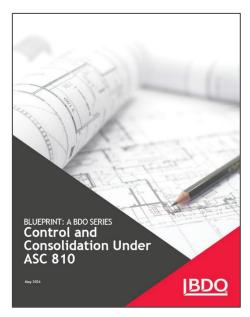
Revenue Recognition Under ASC 606



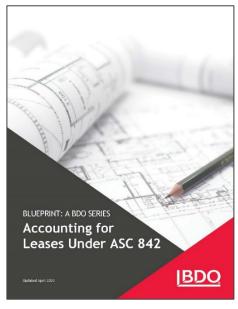
Share-based Payments Under ASC 718



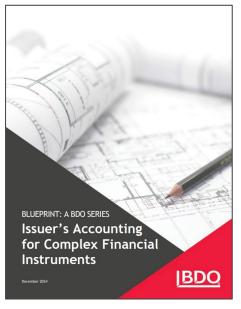
Business Combinations Under ASC 805



Control and Consolidation Under ASC 810



Accounting for Leases Under ASC 842



<u>Issuer's Accounting for Complex</u> <u>Financial Instruments</u>

### Contacts

MEREDITH TAYLOR
Professional Practice Principal - Accounting
571-461-6744 / mltaylor@bdo.com

ADAM BROWN
National Managing Principal - Accounting
214-665-0673 / <u>abrown@bdo.com</u>

ANGELA NEWELL
Professional Practice Principal - Accounting
214-689-5669 / ajnewell@bdo.com

JON LINVILLE
Professional Practice Principal - Accounting
214-243-2940 / jlinville@bdo.com

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