

Financial reporting developments  
*A comprehensive guide*

# Equity method investments and joint ventures

June 2024

# To our clients and other friends

Investors frequently enter into transactions in which they make significant but not controlling investments in an entity. When the investments are made in common stock and provide the investor significant influence with respect to the investee, the equity method of accounting may be appropriate. The equity method of accounting also would be used for investments in a joint venture.

We are providing this Financial reporting developments (FRD) publication to help you identify equity method investments and joint ventures and understand the accounting issues for these types of investments. In August 2023, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*, which requires certain joint ventures, upon formation, to apply a new basis of accounting and initially measure most of their assets and liabilities at fair value in their financial statements. See Appendix D of our FRD, *Business combinations*, for more guidance on the definition of a joint venture and the accounting by the joint venture at formation.

We have updated this edition to provide further enhancements to our interpretive guidance and to highlight recent standard-setting activity. Refer to Appendix C for further detail on the updates provided.

We hope this publication will help you identify and evaluate the issues related to the accounting for equity method investments. We are also available to answer your questions and discuss any concerns you may have.

The logo for Ernst & Young LLP, featuring the company name in a stylized, cursive script font.

June 2024

# Contents

<b>1</b>	<b>Equity investments</b>	<b>1</b>
1.1	Overview	1
1.2	Framework for determining accounting for equity investments (updated July 2023)	2
1.3	Determine whether consolidation is required	4
1.4	Determine whether the fair value option will be applied	4
1.5	Determine whether the equity method should be applied	4
1.6	Determine whether the investee is a joint venture	5
1.7	Determine whether the investment is considered an equity investment with a readily determinable fair value	5
<b>2</b>	<b>Investments in 'in-substance common stock'</b>	<b>7</b>
2.1	Overview	7
2.2	Characteristics of an investment in in-substance common stock	8
2.2.1	Subordination	10
2.2.2	Risks and rewards of ownership	11
2.2.3	Obligation to transfer value	13
2.3	Reconsideration events	14
2.3.1	Accounting following a reconsideration event	15
2.4	Put or call options	16
<b>3</b>	<b>Criteria for applying the equity method</b>	<b>17</b>
3.1	Overview (updated June 2024)	17
3.2	Evaluation of whether 'significant influence' exists	18
3.2.1	Holding less than a 20% interest	22
3.2.2	SEC staff views	23
3.3	Investments in general partnerships, limited partnerships, limited liability companies, trusts and other entities that maintain specific ownership accounts	24
3.3.1	Partnerships and other unincorporated joint ventures	25
3.3.2	Limited partnerships	25
3.3.3	Limited liability companies	26
3.3.4	Trusts and other entities that maintain specific ownership accounts	27
3.3.5	Scope exclusion for interests in entities that hold securitized assets	27
3.4	Investments in other entities	28
3.4.1	Foreign investments	28
3.4.2	Undivided interests and proportionate consolidation (updated June 2024)	28
3.4.3	Acquisition, development and construction loan arrangements	31
3.4.4	Qualified affordable housing projects (before adoption of ASU 2023-02) (updated July 2023)	32
3.4.5	Tax equity investments (after the adoption of ASU 2023-02) (added July 2023)	33
3.5	Scope exceptions	34
3.5.1	Investment companies	34
3.5.2	Investments held by real estate investment trusts	35
3.5.3	Investments held by not-for-profit entities and health care entities (updated July 2023)	36

3.6	Investments in an investee’s subsidiaries.....	36
3.7	Majority-owned entities.....	38
3.8	Reassessments regarding the ability to exercise significant influence.....	38
<b>4</b>	<b>Identifying a joint venture (updated June 2024) .....</b>	<b>39</b>
<b>5</b>	<b>Initial measurement .....</b>	<b>40</b>
5.1	Overview.....	40
5.2	Initial measurement .....	40
5.2.1	Commitments and guarantees .....	41
5.2.2	Acquisition as part of a business combination .....	42
5.2.3	Contribution of businesses or assets for an investment in an equity method investee.....	42
5.2.3.1	Determining whether the investee is a customer .....	44
5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received.....	44
5.2.3.3	Financial assets are given up and an equity method investment is received .....	45
5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received .....	45
5.2.3.5	Transactions in the scope of other guidance.....	48
5.3	Contingent consideration .....	49
5.4	Equity method basis differences .....	50
5.4.1	Equity method goodwill .....	53
5.4.2	Deferred taxes on basis differences.....	53
5.4.3	Accumulated other comprehensive income considerations.....	55
5.4.4	In-process research and development (IPR&D).....	55
5.5	Bargain purchase.....	56
5.5.1	Contingent consideration associated with a bargain purchase.....	58
5.6	Changing to the equity method of accounting.....	59
5.6.1	Change from financial asset to equity method (updated July 2023).....	59
<b>6</b>	<b>Subsequent measurement .....</b>	<b>62</b>
6.1	Overview.....	62
6.2	Earnings or losses of an investee .....	63
6.2.1	Elimination of intra-entity profits.....	65
6.2.1.1	Examples of intra-entity profit elimination.....	69
6.2.1.2	Determining whether a transaction is at arm’s length .....	73
6.2.1.3	Tax considerations for intra-entity transactions.....	74
6.2.1.4	Disclosures for intra-entity transactions .....	74
6.2.2	Effect of basis differences on equity method earnings .....	74
6.2.3	Investee’s other comprehensive income (loss) .....	76
6.2.3.1	AOCI basis differences .....	77
6.2.4	Investee’s dividends and distributions.....	77
6.2.5	Investee’s accounting basis is not US GAAP .....	78
6.2.6	Different accounting policies under US GAAP .....	78
6.2.6.1	Adoption of new accounting standards (updated June 2024) .....	79
6.2.6.2	Private company alternatives .....	79
6.2.7	Differing fiscal year ends .....	81
6.2.8	Reporting lag .....	82
6.2.8.1	Reporting lag in the period of investment.....	83

6.2.8.2	Reporting lag in the period of disposal .....	83
6.2.9	Direct earnings from an investee's subsidiaries .....	83
6.2.10	Equity method investments in entities with different functional currencies .....	84
6.2.11	Reciprocal interests.....	84
6.3	Interest costs.....	85
6.3.1	Capitalization of interest costs .....	85
6.3.2	Interest on in-substance capital contributions .....	87
6.4	Investee losses in excess of investment carrying amount plus advances.....	88
6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee (updated June 2024) .....	92
6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee (updated June 2024) .....	97
6.4.3	Effect of investee's other comprehensive income when the investment has been reduced to zero .....	102
6.4.4	Subsequent investments not resulting in a controlling interest after suspension of equity method loss recognition .....	104
6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee.....	106
6.5.1	Accounting by the investor .....	108
6.5.2	Accounting by the investee.....	108
6.5.3	Accounting by other investors .....	108
6.5.4	Example .....	108
6.6	Investee costs paid for by equity method investor.....	110
6.7	Non-pro rata profit or loss allocations (updated July 2023).....	111
6.7.1	Equity method earnings (losses) for tax equity investors (added July 2023).....	115
6.7.2	Investments in partnership or other pass-through entities that generate investment tax credits (added July 2023).....	119
6.8	Other-than-temporary impairment.....	120
6.8.1	Identifying an other-than-temporary impairment .....	121
6.8.2	Recognizing an other-than-temporary impairment .....	122
6.8.3	Measuring fair value of an equity method investment.....	122
6.8.4	Treatment of basis differences upon impairment .....	122
6.8.5	Impairment of an investment in a qualified affordable housing project (before ASU 2023-02) (updated July 2023).....	124
6.8.6	Treatment of currency translation adjustment balance in impairment review .....	124
6.8.7	Recognizing an impairment of an equity method investment when there is a lag in reporting the investee's results.....	125
6.9	Acquisition of additional ownership interests (updated July 2023) .....	126
6.9.1	Assessment of control.....	130
6.9.2	Pro rata contributions .....	130
6.10	Investee transactions.....	131
6.10.1	Impairments recorded by investee .....	131
6.10.2	Investee's sale of assets .....	132
6.10.3	Transactions in the investee's equity.....	133
6.10.3.1	Investee repurchase (treasury stock) transactions.....	134

6.10.3.2	Investee's transactions with noncontrolling interests .....	137
6.10.3.3	Investee issues stock options or restricted stock units to its employees or nonemployees .....	138
6.11	Fair value option .....	139
<b>7</b>	<b>Disposition or dissolution .....</b>	<b>141</b>
7.1	Overview .....	141
7.2	Disposition causing a loss of significant influence and/or joint control .....	141
7.2.1	Sale of an equity method investment in real estate or nonfinancial assets .....	143
7.3	Partial disposition but significant influence is maintained .....	143
7.3.1	Partial disposition of investment with losses in excess of investment carrying amount but significant influence is maintained (added July 2023) .....	145
7.4	Loss of significant influence with retained investment (updated July 2023) .....	146
7.5	Issuance of shares by an equity method investee .....	148
7.6	Nonmonetary transactions and transfers .....	150
7.7	Dissolution .....	150
<b>8</b>	<b>Presentation and disclosure .....</b>	<b>151</b>
8.1	Overview .....	151
8.2	Financial statement presentation .....	151
8.2.1	Earnings per share .....	152
8.3	Disclosures .....	153
8.3.1	SEC areas of focus .....	154
8.3.2	Reporting a change in the investee's fiscal year end, or a change in or the elimination of a lag in reporting of an equity method investee's results .....	155
8.3.3	Other required disclosures (updated July 2023) .....	156
8.4	Cash flow presentation .....	157
8.5	SEC reporting considerations (updated June 2024) .....	158
8.5.1	S-X Rule 3-05 and Article 11 – financial information for significant equity method investment acquisitions .....	159
8.5.2	Article 11 – financial information for significant equity method investment dispositions (added June 2024) .....	159
8.5.3	S-X Rule 3-09 – separate financial statements for investees .....	159
8.5.4	S-X Rule 4-08 – summarized financial information for investees .....	160
8.5.4.1	Summarized financial information – interim reporting .....	161
8.5.5	Other SEC reporting considerations (updated June 2024) .....	162
<b>A</b>	<b>Abbreviations used in this publication .....</b>	<b>A-1</b>
<b>B</b>	<b>Index of ASC references in this publication .....</b>	<b>B-1</b>
<b>C</b>	<b>Summary of important changes .....</b>	<b>C-1</b>
<b>D</b>	<b>Glossary .....</b>	<b>D-1</b>

**Notice to readers:**

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

Portions of FASB publications reprinted with permission. Copyright Financial Accounting Standards Board, 801 Main Avenue, P.O. Box 5116, Norwalk, CT 06856-5116, USA. Portions of AICPA Statements of Position, Technical Practice Aids and other AICPA publications reprinted with permission. Copyright American Institute of Certified Public Accountants, 1345 Avenue of the Americas, 27th Floor, New York, NY 10105, USA. Copies of complete documents are available from the FASB and the AICPA.

# 1 Equity investments

## 1.1 Overview

Today, companies often make investments without buying an entire company. Many times, companies purchase a significant but not controlling interest in an investee. The investee's line of business may be similar to the investor or it could differ significantly. At other times, companies may sell a controlled subsidiary, but retain a significant investment. These investments may be in the form of common stock, preferred stock or other in-substance equity interests such as unitized interests in a trust (e.g., commingled or common trust funds). These investments also could be in the form of an investment in a limited liability partnership (LLP) or limited liability corporation (LLC), such as a hedge fund, real estate fund, private equity fund, limited partnership (LP) or any other form of legal entity. Unless specified, all such investments are collectively referred to as "investments" or "equity investments" in this FRD.

An equity investment represents an ownership interest in an entity or the right (with a warrant or option, for example) to acquire an ownership interest in an entity at a fixed or determinable price. To determine the appropriate accounting, an investor holding these or similar types of equity investments should understand the legal form of the entity that issued the investment (e.g., a partnership, LLP, LLC) as well as the terms and nature of the investment.

Depending on the facts and circumstances, an equity investment may be accounted for as a controlled subsidiary, equity method investment or as a financial asset. ASC 323 provides guidance on the accounting for investments under the equity method. An investor applies the equity method of accounting if the equity investment provides the investor with significant influence over the investment (see section 3). This is presumed to be the case when an investor holds 20% of the voting common stock (or in-substance common stock, as discussed in section 2) of an investee but does not have a controlling financial interest. However, ownership levels of as little as 3% to 5% also may require application of the equity method in certain circumstances, such as investments in partnerships, unincorporated joint ventures and LLCs that maintain specific ownership accounts.

An investor also applies the equity method of accounting to an investment in a joint venture that the investor jointly controls with other investors. "Joint venture" is a term that is loosely used in practice, but is a defined term in US GAAP that has important accounting consequences. See Appendix D of our FRD, ***Business combinations***, for guidance on the definition of a joint venture and the accounting by the joint venture at formation in its standalone financial statements.

Equity method investments are recorded initially at cost (including transaction costs). A venturer in a joint venture initially recognizes an equity interest in a joint venture at fair value upon the transfer of a subsidiary or a group of assets meeting the definition of a business (with certain exceptions). Basis differences (i.e., differences between investor cost and the underlying equity in net assets of the investee at the date of investment) should be identified and accounted for as if the investee were a consolidated subsidiary. See section 5 for further details.

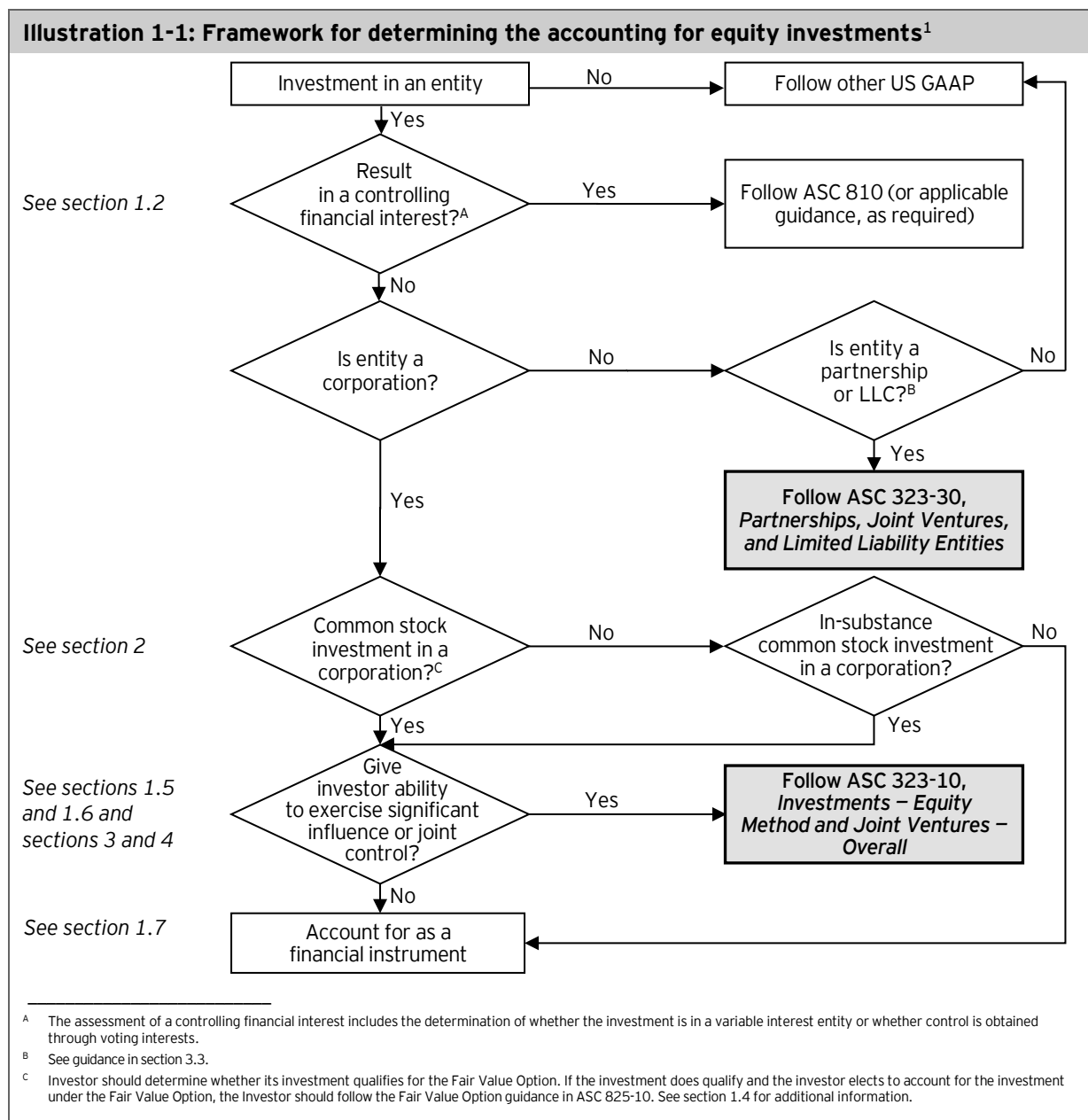
After initial measurement, an equity method investment is adjusted subsequently to recognize the investor's share of the earnings, losses and/or changes in capital of the investee after the date of acquisition (see section 6). When an investor provides other forms of financial support, such as loans, loan guarantees or preferred stock, investee losses may need to be recorded even after the common stock (or in-substance equivalent) investment has been reduced to zero. Dividends received generally reduce the carrying amount of the investment. Equity method investments are assessed for other-than-temporary impairment. The existence of basis differences will often result in differences in the investor's share of the investee's earnings or losses, including impairments.



The disposition of equity method investments is discussed in section 7. Section 8 addresses the related requirements for equity method investments, including SEC reporting considerations. A summary of the relevant accounting guidance and a framework for determining the appropriate accounting for an equity investment are provided in the remainder of section 1. The framework focuses on evaluating investments that are subject to formal arrangements and separate legal structures. Investors also should consider applicable ASC Industry Area Topics when determining the accounting treatment for equity investments.

## 1.2 Framework for determining accounting for equity investments (updated July 2023)

The following flowchart provides an overview on how to determine the accounting for equity investments.



<sup>1</sup> This decision tree does not address industry-specific guidance, such as ASC 946, which provides the accounting framework for investor entities that have certain fundamental characteristics of investment companies. Investment companies and pension plans follow fair value accounting for all investments. Other entities, such as broker dealers also have special accounting guidance for investments. Investors should consider applicable ASC Industry Area Topics when determining the accounting treatment for equity investments.

Changes in an equity method investor's ownership percentage or degree of influence should be evaluated to determine the appropriate accounting treatment.

The following table summarizes the effect of certain changes in ownership or the degree of influence.

Change in ownership	Change in degree of influence	Accounting by investor
Transaction <b>increases</b> investor's ownership percentage	Investor in a financial asset <b>obtains significant influence</b> but does not control the investee	The investor applies the equity method prospectively from the date the investment qualifies for the equity method. The investor will add the carrying value of the existing investment to the cost of the additional investment to determine the initial cost basis of the equity method investment. See section 5.6.1 for additional guidance.
	Investor <b>continues to have significant influence</b> but does not control the investee	The investor continues to apply the cost accumulation model and account for the acquisition of the additional ownership interest in a manner similar to a step acquisition. See section 6.9 for additional guidance.
	Investor <b>now controls and will consolidate</b> the investee	If the investee is a business, the acquirer remeasures its equity interest to fair value as of the acquisition date. The investor recognizes any gain or loss from the remeasurement of the previously held equity method investment in current-period earnings. See section 7.4.2.1 of our FRD, <i>Business combinations</i> , for more discussion.
Transaction <b>decreases</b> investor's ownership percentage	<b>Significant influence is maintained</b>	The investor should reduce the carrying amount of its equity method investment for the proportion sold and proportionately reduce its equity method basis differences. In addition, the investor should proportionately reduce amounts accumulated in other comprehensive income related to the equity method investment sold. The investor would also recognize a gain or loss for the difference between the proceeds and the carrying amount of the equity method investment that was sold. See section 7.3 for additional guidance.
	Investor <b>no longer has significant influence</b> over the investee	The investor should reduce the carrying amount of the investment and recognize a gain or loss on the difference between the proceeds and the carrying amount of the equity method investment that was sold, as it would when significant influence is maintained. In addition, the investor's remaining proportionate share of the investee's accumulated other comprehensive income is offset against the carrying amount of the investment at that date. If the offset would result in a carrying amount less than zero, the remaining balance is recorded as income. If the retained investment is in the scope of ASC 321, the investor remeasures the retained investment under that guidance. See section 7.4 for additional guidance.

### 1.3 Determine whether consolidation is required

An investor should consider the following guidance, as well as other applicable literature, to determine whether its interests represent a controlling financial interest that requires the investor to consolidate the entity under ASC 810:

- ▶ The investor assesses whether the entity should be consolidated under the provisions of ASC 810. This assessment would first include an evaluation to determine whether the investee is a variable interest entity (VIE), and if so, whether the investor is the VIE's primary beneficiary. Certain joint ventures may meet the business scope exception to the Variable Interest Model. Because the business scope exception to the Variable Interest Model includes a provision specifically for joint ventures, a venturer may need to determine whether an entity is a joint venture prior to assessing this scope exception.
- ▶ If the investor determines that the entity is not a VIE, it should evaluate whether it controls the entity pursuant to consolidation guidance for voting interest entities within ASC 810 (including control by contract).
- ▶ The investor should consider industry-specific guidance, such as the real estate industry accounting provisions of ASC 970-810, which address consolidation.

For more guidance on these assessments, see our FRD, *Consolidation*.

An investee can be a VIE and still not be consolidated by its variable interest holders. In these circumstances, additional disclosures may be required by ASC 810.

### 1.4 Determine whether the fair value option will be applied

Certain investments for which the equity method otherwise would be required may qualify to be measured at fair value, if elected by the investor at specified election dates (the fair value option). See section 6.11 for more information.

### 1.5 Determine whether the equity method should be applied

The guidance in ASC 323-10 applies to investments in common stock or in-substance common stock (or both), including common stock of corporate joint ventures. Investments in an entity that have substantially similar risks and rewards to investments in the common stock of that entity may be considered in-substance common stock (see section 2 for further discussion).

In addition, many of the provisions in ASC 323-10 would be appropriate for investments in partnerships and unincorporated joint ventures. Unless specified, references to common stock investments also include in-substance common stock investments throughout this publication.

The equity method is applied if an investor has the ability to exercise significant influence over the operating and financial policies of an investee. Investors should continuously monitor events or circumstances to determine if an investor has gained the ability to exercise significant influence, which would require use of the equity method, or lost the ability to exercise significant influence, which would result in discontinuation of the equity method.

*Investments equal to or greater than 20%, but less than or equal to 50% of investee's equity*

A common stock investment in a corporate entity that provides an investor ownership of 20% or more of the investee voting stock (but with less than a controlling financial interest, generally greater than 50%) leads to a presumption that the investor has the ability to exercise significant influence over the investee. In such cases, the investor applies the equity method of accounting to the investment. The 20% threshold is used throughout this section to indicate significant influence. However, the 20% presumption is not meant to be a bright line test and can be overcome based on facts and circumstances. See section 3.2 for further discussion.

### *Investments less than 20% of investee's equity*

Absent other indicators of significant influence, a common stock investment in a corporate entity that represents less than 20% of an entity's ownership is presumed to not provide significant influence and is accounted for as a financial asset, as discussed in section 1.7. However, if based on facts and circumstances, significant influence can be demonstrated with ownership interest of less than 20%, the equity method may be appropriate.

The equity method may be required for investments in certain types of entities at much lower ownership levels than 20%. For example, investments in limited partnerships, limited liability entities (e.g., LLCs or LLPs), trusts, or other structures that maintain specific ownership accounts are accounted for using the equity method when the investor has an ownership interest of 3% to 5% or greater. In some cases, we believe it would be appropriate for investors holding a smaller ownership interest (less than 3%) in these types of entities also to consider whether the investment should be accounted for using the equity method, if it better reflects the investor's economic interest in the underlying equity investment than accounting for it as a financial asset. See section 3.3 for further discussion about applying the equity method to these types of entities.

## 1.6 Determine whether the investee is a joint venture

Joint ventures are entities whose operations and activities are jointly controlled by a group of equity investors, which are referred to as "venturers." The term "joint venture" may be applied loosely in practice to arrangements that may not meet the accounting definition.

To meet the definition of a joint venture, we believe an arrangement must have all of the following characteristics:

- ▶ The arrangement must be organized within a separate legal entity.
- ▶ The entity must be under the joint control of the venturers.
- ▶ The venturers must be able to exercise joint control of the entity through their equity investments.
- ▶ The purpose of the entity must be consistent with the definition of a joint venture.

See Appendix D of our FRD, *Business combinations*, for guidance on the definition of a joint venture.

## 1.7 Determine whether the investment is considered an equity investment with a readily determinable fair value

### **Excerpt from Accounting Standards Codification**

#### **Investments – Debt and Equity Securities – Overall**

#### *Glossary*

#### **320-10-20**

#### **Security**

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.

## Investments – Equity Securities – Overall

### *Glossary*

321-10-20

### *Equity Security*

Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

- a. Written equity options (because they represent obligations of the writer, not investments)
- b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
- c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

### *Readily Determinable Fair Value*

An equity security has a readily determinable fair value if it meets any of the following conditions:

- a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.
- b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
- c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

An entity measures equity investments (other than equity method investments, controlling financial interests that result in consolidation of the investee and certain other investments) at fair value and recognizes any changes in fair value in net income. However, entities may elect a measurement alternative for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient in ASC 820 to estimate fair value using the net asset value (NAV) per share. See our FRD, *Certain investments in debt and equity securities*, for more information.

# 2 Investments in 'in-substance common stock'

## 2.1 Overview

The equity method of accounting is used when an investor has the ability to exercise significant influence over the operating and financial policies of an investee and holds an investment in voting common stock or in-substance common stock (or both) of the investee. In-substance common stock is an investment in an entity that has risk and reward characteristics that are substantially similar to the entity's common stock.<sup>2</sup> The concept of in-substance common stock is important. Without this concept, an investor might avoid using the equity method of accounting and recognizing investee losses when it has the ability to exercise significant influence over the investee.

Over time, the types and forms of investment vehicles have expanded beyond those of voting common stock to include convertible debt, preferred equity securities, options, restricted stock units, warrants and other financial instruments. These investment vehicles can convey by contract, articles of incorporation, indenture or other means a combination of rights, privileges and preferences such as (1) the right to vote with common shareholders, (2) the right to appoint board members, (3) substantive participating rights, (4) protective rights, (5) cumulative and participating dividends and (6) liquidation preferences. As a result of the rights received through these vehicles, an investor determines whether it has the ability to exercise significant influence over the investee.

The evaluation of whether an investment is in-substance common stock subject to the equity method of accounting requires significant judgment and a careful evaluation of the facts and circumstances.

### Question 2.1 Is an investment in a partnership, limited liability company or similar entity evaluated under the in-substance common stock guidance?

No. The guidance on in-substance common stock was originally issued in Emerging Issues Task Force (EITF) 02-14. Paragraph 5 of EITF 02-14 stated, "This Issue does not apply to investments accounted for under Statement 133, non-corporate entities accounted for under SOP 78-9, or to limited liability companies that maintain 'specific ownership accounts' for each investor as discussed in Issue No. 03-16, "Accounting for Investments in Limited Liability Companies." Therefore, we believe that the in-substance common stock guidance applies only to instruments issued by corporations. It does not apply to investments accounted for pursuant to ASC 815. It also does not apply to investments in partnerships, limited liability entities, trusts, or other unincorporated entities that maintain specific ownership accounts and that do not have the same capital structure as a corporation. See section 3.3 for additional guidance.

<sup>2</sup> ASC 323-10-20 defines common stock as a stock that is subordinate to all other stock of the issuer. If an investee has more than one class of common stock, the investor should compare its investment to all classes of common stock for purposes of this analysis.

## 2.2 Characteristics of an investment in in-substance common stock

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Scope and Scope Exceptions*

##### **323-10-15-13**

For purposes of this Topic, in-substance common stock is an investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock. An investor shall consider all of the following characteristics when determining whether an investment in an entity is substantially similar to an investment in that entity's common stock:

- a. **Subordination.** An investor shall determine whether the investment has subordination characteristics that are substantially similar to that entity's common stock. If an investment has a substantive liquidation preference over common stock, it is not substantially similar to the common stock. However, certain liquidation preferences are not substantive. An investor shall determine whether a liquidation preference is substantive. For example, if the investment has a stated liquidation preference that is not significant in relation to the purchase price of the investment, the liquidation preference is not substantive. Further, a stated liquidation preference is not substantive if the investee has little or no subordinated equity (for example, common stock) from a fair value perspective. A liquidation preference in an investee that has little or no subordinated equity from a fair value perspective is nonsubstantive because, in the event of liquidation, the investment will participate in substantially all of the investee's losses.
- b. **Risks and rewards of ownership.** An investor shall determine whether the investment has risks and rewards of ownership that are substantially similar to an investment in that entity's common stock. If an investment is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock, the investment is not substantially similar to common stock. If the investee pays **dividends** on its common stock and the investment participates currently in those dividends in a manner that is substantially similar to common stock, then that is an indicator that the investment is substantially similar to common stock. Likewise, if the investor has the ability to convert the investment into that entity's common stock without any significant restrictions or contingencies that prohibit the investor from participating in the capital appreciation of the investee in a manner that is substantially similar to that entity's common stock, the conversion feature is an indicator that the investment is substantially similar to the common stock. The right to convert certain investments to common stock (such as the exercise of deep-in-the-money warrants) enables the interest to participate in the investee's earnings (and losses) and capital appreciation (and depreciation) on a substantially similar basis to common stock.
- c. **Obligation to transfer value.** An investment is not substantially similar to common stock if the investee is expected to 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 provision (for example, a mandatory redemption provision or a non-fair-value put option) that is not available to common shareholders, the investment is not substantially similar to common stock. An obligation to transfer value at a specious future date, such as preferred stock with a mandatory redemption in 100 years, shall not be considered an obligation to transfer substantive value.

**323-10-15-14**

If an investment's subordination characteristics and risks and rewards of ownership are substantially similar to the common stock of the investee and the investment does not require the investee to transfer substantive value to the investor in a manner in which the common shareholders do not participate similarly, then the investment is in-substance common stock. If the investor determines that any one of the characteristics in the preceding paragraph indicates that an investment in an entity is not substantially similar to an investment in that entity's common stock, the investment is not in-substance common stock. If an investee has more than one class of common stock, the investor shall perform the analysis described in the preceding paragraph and the following paragraph (if necessary) by comparing its investment to all classes of common stock.

**323-10-15-15**

If the determination about whether the investment is substantially similar to common stock cannot be reached based solely on the evaluation under paragraph 323-10-15-13, the investor shall also analyze whether the future changes in the fair value of the investment are expected to vary directly with the changes in the fair value of the common stock. If the changes in the fair value of the investment are not expected to vary directly with the changes in the fair value of the common stock, then the investment is not in-substance common stock.

An investment must have all of the following characteristics to be substantially similar to an investment in that entity's common stock:

- ▶ Subordination (see section 2.2.1)
- ▶ Risks and rewards of ownership (see section 2.2.2)
- ▶ Obligation to transfer value (see section 2.2.3)

The initial determination of whether an investment is substantially similar to common stock should be made on the date that the investor obtains the investment if the investor has the ability to exercise significant influence over the operating and financial policies of the investee. The determination should consider the entity's entire capital structure. If an investee has more than one class of common stock, the investor considers whether its investment is substantially similar to all classes of common stock. Depending on the facts and circumstances, it may be appropriate to consider interests (such as preferred stock, options, and restricted stock units) that are not yet issued, but are authorized to be issued.

If the investor cannot determine whether the investment is substantially similar to common stock based solely on the characteristics above, the investor also analyzes whether changes in the fair value of the investment are expected to vary directly with changes in the fair value of the common stock. If not, then the investment is not in-substance common stock.

Investors do not need to reevaluate whether each investment is in-substance common stock at each periodic reporting date. See section 2.3 for further discussion.



## 2.2.1

## Subordination

**Excerpt from Accounting Standards Codification****Investments – Equity Method and Joint Ventures – Overall***Implementation Guidance and Illustrations***Case A: Subordination Substantially Similar to Common Stock****323-10-55-3**

Investor organized Investee and acquired all of the common stock of Investee on January 1, 2003. On January 1, 2004, Investee sells 100,000 shares of preferred stock to a group of investors in exchange for \$10,000,000 (\$100 par value; liquidation preference of \$100 per share). The fair value of the entity's common stock is approximately \$100,000 on January 1, 2004.

**323-10-55-4**

In this Case, the stated liquidation preference is equal to the fair value of the preferred stock. However, the fair value of the common stock (\$100,000), if compared with the fair value of the preferred stock, indicates that Investee has little or no common stock from a fair value perspective. An investor should therefore conclude that the liquidation preference is not substantive and that the subordination characteristics of its preferred stock investment are substantially similar to the subordination characteristics of Investee's common stock. The investor should also evaluate whether the preferred stock has the characteristics in paragraph 323-10-15-13(b) through 15-13(c), and paragraphs 323-10-15-14 through 15-15 (if necessary) to reach a conclusion about whether the preferred stock is in-substance common stock.

**Case B: Subordination Not Substantially Similar to Common Stock****323-10-55-5**

Assume the same facts and circumstances as in Case A, except that the fair value of Investee's common stock is approximately \$15,000,000 on January 1, 2004.

**323-10-55-6**

In this Case, the stated liquidation preference is equal to the fair value of the preferred stock. In addition, Investee has adequate subordinated equity from a fair value perspective (more than little or no subordinated equity) to indicate that the liquidation preference is substantive. An investor therefore should conclude that the subordination characteristics of its preferred stock investment are not substantially similar to the subordination characteristics of Investee's common stock. Accordingly, the preferred stock investment is not in-substance common stock. Evaluation of the characteristics in paragraph 323-10-15-13(b) through 15-13(c) and paragraphs 323-10-15-14 through 15-15 is not required.

An investor determines whether its investment has subordination characteristics that are substantially similar to the entity's common stock. If an investment has a substantive liquidation preference over common stock, it is not substantially similar to the common stock. However, if the investment is determined to have no stated or substantive liquidation preference over common stock, the investment would be viewed as substantially similar to common stock (i.e., if the other two criteria, risks and rewards of ownership and obligation to transfer value, are also met).

An investor should determine whether a liquidation preference is substantive, which requires judgment. For example, if the investment has a stated liquidation preference that is not significant in relation to the purchase price of the investment, the liquidation preference is not substantive. In addition, a stated liquidation preference is not substantive if the investee has little or no subordinated equity (for example, common stock) from a fair value perspective. A liquidation preference in an investee that has little or no

subordinated equity from a fair value perspective is nonsubstantive because, in the event of liquidation, the investment will participate in substantially all of the investee's losses. As indicated in Case A in the guidance above, the presence of common stock that is only 1% of fair value of the entity does not indicate a substantive liquidation preference. We believe when common stock exceeds 1% of the fair value of the entity, facts and circumstances would have to be evaluated to determine if the subordination characteristics are substantive.

## 2.2.2 Risks and rewards of ownership

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Implementation Guidance and Illustrations*

##### *Case C: Investment Expected to Participate in Risks and Rewards of Ownership*

##### **323-10-55-7**

Investor purchases a warrant in Investee for \$2,003,900 on July 1, 20X4. The warrant enables Investor to acquire 100,000 shares of Investee's common stock at an exercise price of \$1.00 per share (total exercise price of \$100,000) on or before June 30, 20X5; the warrant does not participate in **dividends**. The fair value of the common stock is approximately \$21.00 per share. The warrant is exercisable at any time. Investor does not expect Investee to declare dividends before exercise.

##### **323-10-55-8**

Investor should evaluate whether the warrant is expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock. To evaluate the extent to which the warrant is expected to participate with the common shareholders in Investee's earnings (and losses), Investor should evaluate whether the warrant allows Investor to currently participate in dividends on a basis substantially similar to common stock. In this Case, Investor does not participate in dividends. Investor, however, can exercise the warrant (convert into common stock) at any time, thereby enabling Investor to participate in Investee's earnings (and losses) on an equivalent basis to common stock. Because Investor does not expect Investee to declare dividends before exercise, Investor participates in Investee's earnings in a manner substantially similar to common stock. In addition, warrants that are exercisable into common stock are designed to participate equally with the common shareholders in increases in the Investee's fair value. Therefore, the warrant participates in Investee's capital appreciation.

##### **323-10-55-9**

Investor should also evaluate whether the warrant is expected to participate in Investee's capital depreciation in a manner substantially similar to common stock. An investor has alternatives for making this evaluation. In this Case, Investor could compare the current fair value of Investee's common stock with the fair value of the warrant (on an equivalent unit basis) to determine whether the warrant is exposed to capital depreciation in a manner that is substantially similar to the entity's common stock. The current fair value of the Investee's common stock of \$21.00 is substantially similar to the current fair value of each warrant of \$20.04 (on an equivalent unit basis). Therefore, the warrant's expected participation in Investee's capital depreciation is substantially similar to the common shareholders' participation. This comparison of fair values is different from the paragraph 323-10-15-15 evaluation that is performed (if necessary) to determine whether the future changes in fair value of the investment are expected to vary directly with the changes in the fair value of the entity's common stock.

**323-10-55-10**

Accordingly, Investor should conclude that, before exercise, the warrants are expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock. Investor should also evaluate whether the warrant has the characteristics in paragraph 323-10-15-13(a) and 323-10-15-13(c) and paragraphs 323-10-15-14 through 15-15 (if necessary) to reach a conclusion about whether the warrant is in-substance common stock.

***Case D: Investment Not Expected to Participate in Risks and Rewards of Ownership*****323-10-55-11**

Investor purchases a warrant in Investee for \$288,820 on July 1, 20X4. The warrant enables Investor to acquire 100,000 shares of Investee's common stock at an exercise price of \$21.00 per share (total exercise price of \$2,100,000) on or before June 30, 20X5; the warrant does not participate in dividends. The fair value of the common stock is approximately \$21.00 per share. The warrant is exercisable at any time. Investor does not expect Investee to declare dividends before exercise.

**323-10-55-12**

Investor should evaluate whether the warrant is expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock. To evaluate the extent to which the warrant is expected to participate with the common shareholders in Investee's earnings (and losses), Investor should evaluate whether the warrant allows Investor to currently participate in dividends on a basis substantially similar to common stock. In this Case, Investor does not participate in dividends. Investor, however, can exercise the warrant (convert into common stock) at any time, thereby enabling Investor to participate in Investee's earnings (and losses) on an equivalent basis to common stock. Because Investor does not expect Investee to declare dividends before exercise, Investor participates in Investee's earnings in a manner substantially similar to common stock. In addition, warrants that are exercisable into common stock are designed to participate equally with the common shareholders in increases in Investee's fair value. Therefore, the warrant participates in Investee's capital appreciation.

**323-10-55-13**

Investor should also evaluate whether the warrant is expected to participate in Investee's capital depreciation in a manner substantially similar to common stock. An investor has alternatives for making this evaluation. In this Case, Investor could compare the current fair value of Investee's common stock with the current fair value of the warrant (on an equivalent unit basis) to determine whether the warrant is exposed to capital depreciation in a manner that is substantially similar to the entity's common stock. The current fair value of the Investee's common stock of \$21.00 is substantially different from the current fair value of each warrant of \$2.88 (on an equivalent unit basis). Therefore, the warrant's expected participation in Investee's capital depreciation is substantially different from the common shareholders' participation. This comparison of fair values is different from the paragraph 323-10-15-15 evaluation that is performed (if necessary) to determine whether the future changes in fair value of the investment are expected to vary directly with the changes in the fair value of the entity's common stock.

**323-10-55-14**

Accordingly, Investor should conclude that, before exercise, the warrants are not expected to participate in Investee's earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock and, accordingly, the warrants are not in-substance common stock. Evaluation of the characteristics in paragraph 323-10-15-13(a) and 323-10-15-13(c) and paragraphs 323-10-15-14 through 15-15 is not required.

An investor determines whether the investment has risks and rewards of ownership that are substantially similar to an investment in that entity's common stock. If an investment is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock, the investment is not in-substance common stock. However, if the investment's risks and rewards of ownership were substantially similar to an investment in that entity's common stock, the investment would be viewed as substantially similar to common stock (if the other two criteria, subordination, and obligation to transfer value, are also met). One approach that could be used to evaluate whether the investment has risks and rewards of ownership that are substantially similar to an investment in that entity's common stock would be to compare the fair values of the instruments and the related exposure to capital appreciation and depreciation.

Indicators that an investment has risks and rewards of ownership that are substantially similar to an investment in that entity's common stock include (but are not limited to) the following:

- ▶ The investee pays dividends on its common stock, and the investment participates currently in those dividends in a manner that is substantially similar to common stock. The facts and circumstances (such as whether the investee is expected to pay dividends) should be evaluated when assessing whether participation in dividends is a relevant indicator.
- ▶ The investor has the ability to convert the investment into that entity's common stock without any significant restrictions or contingencies that prohibit the investor from participating in the capital appreciation of the investee in a manner that is substantially similar to that entity's common stock.
- ▶ The investor has the right to convert the investment to common stock through the exercise of deep-in-the-money warrants.

## 2.2.3

### Obligation to transfer value

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Implementation Guidance and Illustrations*

##### *Case E: Investee Not Obligated to Transfer Substantive Value*

##### **323-10-55-15**

Investor purchases redeemable convertible preferred stock in Investee for \$2,000,000. The investment can be (a) converted into common stock valued at \$2,000,000 or (b) redeemed for \$10,000 at the option of the Investor. The common shareholders do not have a similar redemption feature.

##### **323-10-55-16**

Investor should evaluate whether exercise of the \$10,000 redemption feature obligates Investee to transfer substantive value to Investor and whether the common shareholders do not participate in a similar manner. In this Case, the \$10,000 redemption feature is not substantive. Accordingly, Investor should conclude that redeemable convertible preferred stock does not require Investee to transfer substantive value to Investor and that common shareholders do not participate. Investor should also evaluate whether the redeemable convertible preferred stock has the characteristics in paragraph 323-10-15-13(a) through 15-13(b) and paragraphs 323-10-15-14 through 15-15 (if necessary) to reach a conclusion about whether the redeemable convertible preferred stock is in-substance common stock.

**Case F: Investee Obligated to Transfer Substantive Value****323-10-55-17**

Investor purchases redeemable convertible preferred stock in Investee for \$2,000,000. The investment can be (a) converted into common stock valued at \$2,000,000 or (b) redeemed for \$2,000,000 at the option of the Investor. The common shareholders do not have a similar redemption feature. Investor expects that Investee will have the ability to pay the redemption amount.

**323-10-55-18**

Investor should evaluate whether exercise of the \$2,000,000 redemption feature obligates Investee to transfer substantive value to Investor and whether the common shareholders do not participate in a similar manner. In this Case, the \$2,000,000 redemption feature is substantive because the redemption amount is substantive as compared to the fair value of the investment and, based on Investor's expectation as of the date that the investment was made, Investee has the ability to pay the redemption amount. Accordingly, Investor shall conclude that redeemable convertible preferred stock requires Investee to transfer substantive value to Investor and that common shareholders do not participate. Accordingly, the redeemable convertible preferred stock is not in-substance common stock. Evaluation of the characteristics in paragraph 323-10-15-13(a) through 15-13(b) and paragraphs 323-10-15-14 through 15-15 is not required.

An investment is not substantially similar to common stock if the investee is expected to 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 provision (such as a mandatory redemption provision or a non-fair value put option) that is not available to common shareholders, then the investment is not substantially similar to common stock. An obligation to transfer value at a date so far into the future as to be meaningless, such as preferred stock with a mandatory redemption in 100 years, should not be considered an obligation to transfer substantive value.

However, if the investee is expected to transfer substantive value to the investor, and the common shareholders do participate in a similar manner, the investment would be viewed as substantially similar to common stock (if the other two criteria, risks and rewards of ownership and subordination, are also met).

**2.3****Reconsideration events****Excerpt from Accounting Standards Codification****Investments – Equity Method and Joint Ventures – Overall****Scope and Scope Exceptions****323-10-15-16**

The initial determination of whether an investment is substantially similar to common stock shall be made on the date on which the investor obtains the investment if the investor has the ability to exercise significant influence over the operating and financial policies of the investee. That determination shall be reconsidered if any of the following occur:

- a. The contractual terms of the investment are changed resulting in a change to any of its characteristics described in paragraph 323-10-15-13 and the preceding paragraph. An expected change in the contractual terms of an investment that are provided for in the original terms of the contractual agreement shall be considered for purposes of the initial determination under paragraph 323-10-15-13 and not as a reconsideration event. However, a change in the form of the investment (for example, debt to equity or preferred stock to another series of stock) is a reconsideration event.
- b. There is a significant change in the capital structure of the investee, including the investee's receipt of additional subordinated financing.

- c. The investor obtains an additional interest in an investment in which the investor has an existing interest. As a result, the method of accounting for the cumulative interest is based on the characteristics of the investment at the date at which the investor obtains the additional interest (that is, the characteristics that the investor evaluated to make its investment decision), and will result in the investor applying one method of accounting to the cumulative interest in an investment of the same issuance.

#### **323-10-15-17**

The determination of whether an investment is similar to common stock shall not be reconsidered solely due to losses of the investee.

An investor reconsiders its initial determination of whether an investment is or is not in-substance common stock only if one or more of the events in ASC 323-10-15-16 occurs.

Reconsideration is required only if the nature of the investment and corresponding terms changes, the investee's capital structure changes or the investor makes an additional investment in the investee. When a reconsideration event occurs, the investor evaluates the investment based on the cumulative interest at that date, and does not just reconsider any newly acquired portion of the investment. The investor uses the fair value of the investment as of the date of the reconsideration event in its analysis. An investment that was previously determined not to be in-substance common stock may become in-substance common stock (or vice versa) as a result of a reconsideration event.

An investor is not required to reconsider its determination of whether an investment is similar to common stock solely due to losses of the investee. Thus, an investment that was previously determined not to be in-substance common stock does not become in-substance common stock simply because of losses of the investee, even if those losses significantly reduce or eliminate the investee's equity. See section 6.4 for further discussion.

### **Excerpt from Accounting Standards Codification**

#### **Investments – Equity Method and Joint Ventures – Overall**

##### ***Scope and Scope Exceptions***

#### **323-10-15-18**

If an investor obtains the ability to exercise significant influence over the operating and financial policies of an investee after the date the investor obtained the investment, the investor shall perform an initial determination, pursuant to paragraphs 323-10-15-13 and 323-10-15-15, using all relevant and necessary information that exists on the date that the investor obtains significant influence.

If an investor gets significant influence over an investee after it obtained its investment, the investor evaluates whether the investment is in-substance common stock based on the information that exists on the date that significant influence was obtained (and not based on the date when the investment was first obtained).

## **2.3.1**

### **Accounting following a reconsideration event**

The occurrence of a reconsideration event may affect the investor's ability to exercise significant influence over the operating and financial policies of the investee. Depending on the facts and circumstances, it may no longer be appropriate to account for the investment under the equity method. Following the reconsideration event, it may be appropriate to account for the investment as a financial asset. See section 7.4 for additional guidance.

A reconsideration event may result in the consolidation of the investee. See section 6.9 for additional guidance.

## 2.4 Put or call options

Occasionally an investor obtains an instrument to purchase additional voting common stock or sell voting common stock of the investee in the future, such as in a put or call option. Under ASC 323-10-15-4, the equity method is not applied to any instrument in the scope of ASC 815. Therefore, an investor needs to determine whether the put or call option is in the scope of ASC 815. The accounting in this area can be complex because of the different accounting principles that may apply. See our FRD, ***Derivatives and hedging***, for more information.

If the put or call options are not within the scope of ASC 815, the investor would need to assess whether the put or call options represent in-substance common stock, and if so, whether they give the investor the ability to exercise significant influence over an investee.

# 3 Criteria for applying the equity method

## 3.1 Overview (updated June 2024)

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### Scope and Scope Exceptions

##### 323-10-15-3

The guidance in the Investments–Equity Method and Joint Ventures Topic applies to investments in **common stock** or **in-substance common stock** (or both common stock and in-substance common stock), including investments in common stock of **corporate joint ventures** (see paragraphs 323-10-15-13 through 15-19 for guidance on identifying in-substance common stock). Subsequent references in this Subtopic to common stock refer to both common stock and in-substance common stock that give the **investor** the ability to exercise **significant influence** (see paragraph 323-10-15-6) over operating and financial policies of an **investee** even though the investor holds 50% or less of the common stock or in-substance common stock (or both common stock and in-substance common stock).

The guidance in ASC 323 applies to investments in common stock or in-substance common stock, including investments in common stock of corporate joint ventures. See section 2 for more discussion.

The equity method of accounting is required for investments in the common stock and/or in-substance common stock of corporations when the investor does not control an investee or is not the primary beneficiary of the investee if it is a VIE, but has the ability to exercise significant influence over the investee's operating and financial policies. The equity method of accounting also may be appropriate for entities other than corporations. See section 3.3.

#### Instruments for which the equity method is applicable

An investor generally applies the equity method of accounting only to investments in equity instruments.

Under ASC 323-10-15-3, the equity method of accounting applies only to investments in common stock or in-substance common stock. Therefore, an investor cannot apply the equity method of accounting to an investment in an instrument such as preferred stock or a warrant unless the instrument is considered in-substance common stock. See section 2 for more discussion.

The evaluation to determine whether the equity method of accounting applies to an investment differs based on the legal form of the investee (e.g., corporation, partnership). The following table summarizes the evaluation for each legal form of an investee.

Legal form of the investee	Additional guidance	Evaluation
Corporations (including corporate joint ventures)	Section 3.2	The equity method of accounting applies to investments in common stock and in-substance common stock that provides the investor an ability to exercise significant influence over the operating and financial policies of the investee. Significant influence is presumed to exist for investments of 20% or more of the voting stock of an investee.



Legal form of the investee	Additional guidance	Evaluation
Partnerships and unincorporated joint ventures	Section 3.3.2	Generally, the equity method of accounting applies to investments in partnerships unless a limited partner's interest is so minor that the limited partner may have virtually no influence over partnership operations and financial policies. Limited partner investments of greater than 3% to 5% are considered more than minor.  If a general partner does not control the limited partnership, the general partner should account for its interest under the equity method.
LLCs that <b>do not</b> maintain specific ownership accounts	Section 3.3.3	Apply model for corporations.
LLCs that maintain specific ownership accounts	Section 3.3.3	Apply model for partnerships.
Trusts and other entities that maintain specific ownership accounts	Section 3.3.4	Apply model for partnerships.

## 3.2

### Evaluation of whether 'significant influence' exists

Determining whether an investor has the "ability to exercise significant influence over operating and financial policies of the investee" requires judgment based on the facts and circumstances of each investment. "Significant influence" is presumed to exist for investments of 20% or more of the voting stock of an investee and is presumed not to exist for investments of less than 20% of the voting stock.

An evaluation of an investor's voting interest in an investee is based on outstanding securities with voting privileges. Potential voting privileges that may become available to holders of securities of an investee are disregarded. The SEC staff believes that all forms of equity investment must be evaluated in the determination of the degree of influence.<sup>3</sup> The existence of special rights through these equity investments, such as the right to veto certain acquisitions or divestitures or the right to approve operating or capital budgets may be an indicator of the investor's ability to exercise significant influence over the investee.

Presumptions of whether or not significant influence exists may be overcome by a preponderance of evidence. The guidance provides a list of indicators to consider when determining whether the investor has significant influence. This list is not meant to be all-inclusive.

<sup>3</sup> Statement made by Michael Morrissey, Professional Accounting Fellow at the SEC, 10 January 1995, at the 1995 Annual National AICPA Conference on Current SEC Developments.

## Excerpt from Accounting Standards Codification

### Investments – Equity Method and Joint Ventures – Overall

#### *Scope and Scope Exceptions*

#### **323-10-15-6**

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

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

An investor's ability to exercise significant influence may be indicated in several ways. The ability of an investor to exercise significant influence over an investee is not necessarily precluded by the existence of a substantial or majority ownership of the voting stock by another investor.

## Excerpt from Accounting Standards Codification

### Investments – Equity Method and Joint Ventures – Overall

#### *Scope and Scope Exceptions*

#### **323-10-15-7**

Determining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of each investment.

#### **323-10-15-8**

An investment (direct or indirect) of 20 percent or more of the voting stock of an investee shall lead to a presumption that in the absence of predominant evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. The equity method shall not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in paragraph 323-10-25-2 would apply to investments other than those in **subsidiaries**.

#### **323-10-15-9**

An investor's voting stock interest in an investee shall be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges that may become available to holders of securities of an investee shall be disregarded.

#### **323-10-15-10**

Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial

policies stands until overcome by predominant evidence to the contrary. Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

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

### **323-10-15-11**

The list in the preceding paragraph is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

When an investor holds 20% or more of the voting stock of an investee, an investor is presumed to have significant influence. ASC 323 does not require the investor to *actively exercise* its influence over the investee for significant influence to exist. The investor must simply have the *ability* to significantly influence the investee, regardless of the investor's intent to exercise such influence. An investor owning 20% or more of the voting stock of an investee should evaluate all facts and circumstances to determine whether predominant evidence exists that the investor is unable to exercise significant influence over the investee's operating and financial policies.

The list of indicators in ASC 323-10-15-10, which are evaluated to determine if the significant influence presumption is overcome when an investor holds 20% or more of the voting stock, is not meant to be all-inclusive. None of the individual circumstances can necessarily show conclusively that an investor is unable to exercise significant influence over the investee. All facts and circumstances relating to an investment are evaluated to determine whether the presumption established by an ownership percentage of 20% or more has been overcome. It may be necessary to evaluate the facts and circumstances for a period before reaching a judgment.

**Illustration 3-1: Ability to exercise significant influence**

Assume that all of the investees are voting interest entities (not VIEs) in all of the following examples.

**Example 1 – Investor actively participates and has material intra-entity transactions**

Investor A holds a 40% interest in the voting shares of Investee Z, and the other two investors each hold 30% interests. Investor A has three of the eight board seats of Investee Z and actively participates in the operating and financial policies of Investee Z. Investor A also has material intra-entity sales to Investee Z. Investor A has the ability to exercise significant influence over Investee Z (the presumption that significant influence exists is not overcome).

**Example 2 – Investor does not actively participate in the operating and financial policies of investee**

Investor A holds a 20% interest in the voting shares of Investee Z, and the other three investors, Investors B, C, and D hold 35%, 30%, and 15% voting interests, respectively. No party has a controlling interest. Investor A is not represented on the board of Investee Z and has not tried to obtain representation. In addition, there are no indications that there are barriers to obtaining representation. Investor A does not actively participate in the operating and financial policies of Investee Z. Investor A has the ability to exercise significant influence over Investee Z, regardless of whether Investor A has representation on the board, or whether Investor A actively exercises that influence (because the presumption that significant influence exists is not overcome).

**Example 3 – Investor does not actively participate in the operating and financial policies of investee and another party controls the investee**

Investor A holds a 20% interest in the voting shares of Investee Z. Investors B and C hold 70% and 10%, respectively, of the voting interests. Investor B controls and consolidates Investee Z. Investor A has two of the eight board seats of Investee Z. Investor A does not actively participate in the operating and financial policies of Investee Z. Even though Investor B has control and consolidates Investee Z, Investor A has the ability to exercise significant influence over Investee Z, regardless of whether Investor A actively exercises that influence (the presumption that significant influence exists is not overcome).

**Example 4 – Investor holds a 20% interest and cannot exercise significant influence**

Investor A holds a 20% interest in the voting shares of Investee Z; Investors B and C hold 55% and 25%, respectively, of the voting interests. Investor A does not have board representation. All board members are appointed by Investors B and C, which actively run Investee Z regardless of Investor A's views. In past years, Investor A has tried and failed to obtain board representation. Investor A also is unable to obtain quarterly financial information that Investors B and C receive regularly. Predominant evidence exists that Investor A does not have the ability to exercise significant influence over Investee Z, despite holding a 20% interest in Investee Z (i.e., the presumption that significant influence exists is overcome).

### 3.2.1 Holding less than a 20% interest

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### Scope and Scope Exceptions

##### 323-10-15-8

An investment (direct or indirect) of 20 percent or more of the voting stock of an investee shall lead to a presumption that in the absence of predominant evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. The equity method shall not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in paragraph 323-10-25-2 would apply to investments other than those in **subsidiaries**.

A presumption exists that when an investor owns *less than 20%* of the voting stock of an investee, the investor does *not* have significant influence over the investee. In this situation, the investor considers whether the facts and circumstances *demonstrate* that it has significant influence over the operating and financial policies of an investee. This is a higher hurdle than is required when an investor owns more than a 20% interest (in which the investor must only have the *ability* to exercise significant influence over the investee).

An investor may demonstrate that it has significant influence over the operating and financial policies of an investee through representation on the board of directors, participation in policymaking, material intra-entity transactions, interchange of managerial personnel, technological dependency and/or other factors to overcome the presumption that the investor does not have significant influence over the investee. An investor will need to apply judgment to determine whether it has demonstrated that it has significant influence over the operating and financial policies of an investee.

#### Illustration 3-2: Demonstrating significant influence when holding less than a 20% interest

Investor A holds a 15% interest in the voting shares of Investee Z; Investors B and C hold 55% and 30% respectively, of the voting interests. Investee Z is not a VIE. Most of Investee Z's revenue is generated through sales to Investor A. In addition, Investor A has two of the eight board seats of Investee Z. Despite the higher ownership percentages held by Investors B and C (and Investor B's controlling ownership interest), Investor A likely has demonstrated the ability to exercise significant influence over Investee Z based upon representation on the board and the significance of transactions between Investor A and Investee Z (the presumption that significant influence does not exist is overcome).

#### Question 3.1

**When evaluating whether board representation demonstrates that an investor has the ability to exercise significant influence over an investee, does an investor need to have 20% or greater of the board seats?**

Not necessarily. Given that ASC 323-10-15-8 presumes that an investor that holds 20% of the voting common stock of the investee has the ability to exercise significant influence, some have questioned whether an investor is required to have 20% of the board seats to indicate that significant influence may exist. As discussed in ASC 323-10-15-6, representation on the board of directors is one factor that may demonstrate the ability to exercise significant influence over operating and financial policies of an investee.

ASC 323-10-15-6 does not establish a threshold with respect to the percentage of board seats necessary to indicate significant influence. We believe that participation on the board of directors may demonstrate the ability to exercise significant influence even in circumstances where the representation is less than 20% of the board. Judgment will be necessary based upon the facts and circumstances. For example, holding one seat on an extremely large board (e.g., one of 20 people) and/or a seat that was voted by general shareholder election may be less demonstrative of the ability to exercise significant influence than holding one seat on a smaller board (e.g., one of six people) and/or a seat that was specified in a contractual arrangement. All facts and circumstances, including representation on the board and the other indicators referenced in ASC 323-10-15-6, should be considered when determining whether an investor has significant influence.

### Question 3.2

**When evaluating all facts and circumstances to determine whether an investor has the ability to exercise significant influence over an investee, how should the ability to appoint an observer seat on the board be considered?**

As discussed in ASC 323-10-15-6, representation on the board of directors may indicate that an investor has the ability to exercise significant influence over an investee's operating and financial policies. In some cases, an investor may negotiate for an "observer" seat on the board of directors that allows the investor to observe board meetings but does not give the investor the ability to vote. Judgment will be necessary based upon the facts and circumstances in determining whether the investor has significant influence when it has a board observer seat. Factors to be considered in making this judgment include:

- ▶ Background information about how the investor obtained an "observer" seat rather than a voting seat
- ▶ Role of the observer seat, including whether the board observer has an ability to actively participate in discussions
- ▶ Observer rights on board committees
- ▶ Size of the board (see Question 3.1 for more guidance) and size of the investor's holding relative to other investors
- ▶ Any unique expertise or role that the investor holds relative to other board members, which may indicate a higher degree of influence

All facts and circumstances, including other indicators referenced in ASC 323-10-15-6, should be considered when determining whether an investor has significant influence.

### 3.2.2

#### SEC staff views

The SEC staff has indicated publicly<sup>4</sup> that, while the starting point in any evaluation of significant influence is the investor's common stock ownership in the investee, the staff does not apply a bright line test in the application of ASC 323. When considering whether the equity method of accounting is required for an investment in common stock:

- ▶ The staff evaluates the nature and significance of the investments, in any form, in the investee. The staff does not consider the difference between a 20% common stock investment and a 19.9% investment to be substantive. 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.

<sup>4</sup> Statement made by Paul R. Kepple, Professional Accounting Fellow at the SEC, 7 December 1999, at the 1999 Annual National AICPA Conference on Current SEC Developments.

- ▶ The staff analyzes the capitalization 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 (e.g., is the investor the sole funding source).
- ▶ The staff looks at the 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.
- ▶ The staff considers the investor's 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 two of five board seats, coupled with a 15% common stock investment, will likely be viewed to have significant influence over the investee.
- ▶ The staff evaluates other factors, such as those in ASC 323-10-15-10.

### 3.3

## Investments in general partnerships, limited partnerships, limited liability companies, trusts and other entities that maintain specific ownership accounts

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Scope and Scope Exceptions*

##### **323-10-15-5**

The guidance in the Overall Subtopic does not apply to any of the following:

- a. An investment in a partnership or unincorporated joint venture (also called an undivided interest in ventures), see Subtopic 323-30
- b. An investment in a limited liability company that maintains specific ownership accounts for each investor as discussed in Subtopic 272-10.

#### Investments – Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities

##### *Recognition*

##### **323-30-25-1**

Investors in unincorporated entities such as partnerships and other unincorporated joint ventures generally shall account for their investments using the equity method of accounting by analogy to Subtopic 323-10 if the **investor** has the ability to exercise **significant influence** over the **investee**.

Investments in partnerships, unincorporated joint ventures and LLCs that maintain specific ownership accounts for each investor are excluded from the scope of ASC 323-10. However, ASC 323-30 provides guidance on applying the criteria for equity method accounting to investments in partnerships, unincorporated joint ventures and LLCs. When an investor in a partnership, unincorporated joint venture or LLC has the ability to exercise significant influence over that investment, it should apply the equity method (ASC 323-10) by analogy. In addition, ASC 970-323 addresses ownership in real estate development projects through various forms (such as partnerships, corporate joint ventures or undivided interests). In practice, that accounting guidance has been applied by analogy to investments that are not real estate ventures.

### 3.3.1 Partnerships and other unincorporated joint ventures

#### Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities

##### *Recognition*

##### **323-30-25-1**

Investors in unincorporated entities such as partnerships and other unincorporated joint ventures generally shall account for their investments using the equity method of accounting by analogy to Subtopic 323-10 if the **investor** has the ability to exercise **significant influence** over the **investee**.

If an investor determines that it does not have a controlling financial interest in a partnership or unincorporated joint venture, the investor should determine whether it has the ability to exercise significant influence over the investment. If a noncontrolling investor in an unincorporated entity, such as a partnership or other unincorporated joint venture, has the ability to exercise significant influence over the investee, the investor should account for its investment using the equity method of accounting. ASC 970-323 includes similar guidance for the real estate industry.

### 3.3.2 Limited partnerships

#### Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities

##### *SEC Materials – General – SEC Staff Guidance*

##### **323-30-S99-1**

The following is the text of SEC Staff Announcement: Accounting for Limited Partnership Investments.

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.

##### *Real estate – Consolidation*

##### *Limited Partnerships*

##### **970-810-25-3**

If a **limited partnership** does not meet the conditions in paragraph 810-10-15-14 and, therefore, is not a variable interest entity, limited partners shall evaluate whether they have a controlling financial interest according to paragraph 810-10-15-8A. The guidance in Subtopic 810-10 on consolidation shall be used to determine whether any limited partners control the limited partnership:

- a. If no single partner controls the limited partnership, the general and limited partners shall apply the equity method of accounting to their interests, except for instances when a limited partner's interest is so minor that the limited partner may have virtually no influence over partnership operations and financial policies (see paragraph 323-30-S99-1).
- b. Subparagraph superseded by Accounting Standards Update No. 2015-02.
- c. If a single limited partner controls the limited partnership, that limited partner shall consolidate the limited partnership and apply the principles of accounting applicable for investments in subsidiaries in Topic 810.



It is generally appropriate for public companies to apply the equity method of accounting as described in ASC 323 to interests in limited partnerships when the investor does not control the partnership. However, a limited partner's interest may be "so minor that the limited partner may have virtually no influence over partnership operating and financial policies ... and, accordingly, accounting for the investment using the cost method may be appropriate."<sup>5</sup> The SEC staff's position is that investments of greater than 3% to 5% are considered more than minor and, therefore, should be accounted for using the equity method. The presumption that investment interests greater than 3% to 5% are accounted for by the equity method may be overcome in limited circumstances if it is readily apparent based on the facts and circumstances that the investor has virtually no influence over the partnership's financial and operating policies.<sup>6</sup> This guidance also is generally applied in practice to investments in limited partnerships held by nonpublic entities.

In some cases, we believe it would be appropriate for investors holding a smaller ownership interest (less than 3% to 5%) also to consider whether the investment should be accounted for using the equity method, because it may better reflect the investor's economic interest in the underlying equity investment than accounting for it as a financial asset. For example, this may be the case when an investor invests in a fund of funds, and the investee uses the fair value accounting model. It should be noted that the carrying amount resulting from the application of the equity method of accounting is not equivalent to the fair value of the investment. The fair value of an investment would consider the existence of longer-term lock-up provisions, redemption fees or other provisions. Nonetheless, the carrying amount resulting from the application of the equity method of accounting may better reflect the investor's economic interest in the underlying equity investment than accounting for it as a financial asset.

Ownership interests in limited partnerships of less than 3% to 5% should be accounted for consistently as an accounting policy election. That is, an investor should account for all similar investments in which it holds the same approximate ownership level in the same manner.

The rights and obligations of the general partner in a limited partnership are different from those of the limited partners. If a general partner does not control the limited partnership, the general partner should account for its interest under the equity method of accounting. See our FRD, *Consolidation*, for guidance on assessing whether a general partner controls a limited partnership.

### 3.3.3

### Limited liability companies

#### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities

#### *Subsequent Measurement*

#### *Investment in a Limited Liability Company*

#### **323-30-35-3**

An investment in a limited liability company that maintains a specific ownership account for each investor—similar to a partnership capital account structure—shall be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company shall be accounted for in accordance with the guidance in Topic 321 or the equity method.

<sup>5</sup> These equity investments are accounted for in accordance with ASC 321. The cost method of accounting is no longer appropriate. See our FRD, *Certain investments in debt and equity securities*, for more information.

<sup>6</sup> This position was reiterated by Erin Bennett, Professional Accounting Fellow, Office of the Chief Accountant, at the 2019 AICPA Conference on Current SEC and PCAOB Developments, 9 December 2019.

If an investment is in an LLC that maintains a specific ownership account for each investor, similar to a partnership capital account structure, the investment is viewed in a manner similar to an investment in a limited partnership for determining whether an investment in an LLC is accounted for using the equity method. If the LLC maintains specific ownership accounts, then investors holding more than a 3% to 5% ownership interest would be required to account for their investments under the equity method of accounting. The presumption that LLC interests of greater than 3% to 5% are accounted for under the equity method of accounting may be overcome in limited circumstances if it is readily apparent based on the facts and circumstances that the investor has virtually no influence on the financial and operating policies over the LLC.<sup>7</sup> See section 3.3.2.

In some cases, we believe investors that hold an even smaller ownership interest may also consider using the equity method of accounting, because the equity method may more closely approximate the investor's economic interests in the underlying entity. For further discussion, see section 3.3.2.

For guidance on investments in LLCs that can be contractually prepaid or otherwise settled in such a way that the investor would not recover substantially all of its recorded investment, see section 3.3.5.

If an LLC does not maintain specific ownership accounts, then it should be evaluated like a corporation to determine whether the investor has the ability to exercise significant influence over that LLC. A specific ownership account is one in which each owner (e.g., partner, member) has an account to which the owner's share of profits and losses, contributions and distributions are allocated directly.

### 3.3.4 Trusts and other entities that maintain specific ownership accounts

If an equity investment is not in an LLP or LLC that would follow the provisions of ASC 323-30, but is in a different ownership structure that also maintains specific ownership accounts similar to a partnership capital account structure (such as an investment in a common trust fund), we believe it is appropriate to analogize to the guidance in ASC 323-30-35-3 in determining what level of ownership requires the use of the equity method of accounting. However, when evaluating whether to apply the equity method of accounting, the facts and circumstances of the arrangements should be carefully examined to determine if the investor has the ability to exercise significant influence.

### 3.3.5 Scope exclusion for interests in entities that hold securitized assets

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities

##### *Scope and Scope Exclusions*

##### **323-30-15-4**

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

LLCs, partnerships, trusts and similar type entities are sometimes formed in securitization transactions. Investments that can be contractually prepaid or otherwise settled in such a way that the investor would not recover substantially all of its recorded investment are accounted for as debt securities under ASC 320 and classified as available-for-sale or trading. Therefore, these types of securities are excluded from the scope of ASC 323-30 and related guidance.

<sup>7</sup> Erin Bennett, Professional Accounting Fellow, Office of the Chief Accountant, at the 2019 AICPA Conference on Current SEC and PCAOB Developments on 9 December 2019 reiterated the SEC staff's longstanding position that the views on applying the equity method to investments in limited partnerships also apply to investments in LLCs that maintain specific ownership accounts.

## 3.4 Investments in other entities

### 3.4.1 Foreign investments

The equity method of accounting would generally apply to all foreign investments in common stock (or in-substance common stock) in which the investor does not control but has the ability to exercise significant influence over the investee. The equity method of accounting also would apply to investments in foreign partnerships that the investor does not control, unless the interest in the foreign partnership is so minor that the limited partner has virtually no influence over the partnership's operating and financial policies. Judgment should be used, based on the facts and circumstances, to determine whether a foreign entity is more akin to a US corporation or partnership when determining whether it is appropriate to apply the equity method.

In certain cases, it may not be appropriate for an investor to account for a foreign investment using the equity method of accounting. For example, if an investee operates under foreign exchange restrictions, controls or other governmentally imposed uncertainties that are so significant that significant doubt is cast on the investor's ability to exercise significant influence over the investee, the presumption of significant influence may be overcome.

### 3.4.2 Undivided interests and proportionate consolidation (updated June 2024)

#### Excerpt from Accounting Standards Codification

##### Consolidation – Overall

##### *Other Presentation Matters*

##### **810-10-45-14**

If the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 323-10-45-1 may not apply in some industries. For example, in certain industries the investor-venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses of the venture. Specifically, a proportionate gross financial statement presentation is not appropriate for an investment in an unincorporated legal entity accounted for by the equity method of accounting unless the investee is in either the construction industry (see paragraph 910-810-45-1) or an extractive industry (see paragraphs 930-810-45-1 and 932-810-45-1). An entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas exploration and production) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources.

##### Real Estate – General – Investments – Equity Method and Joint Ventures

##### *Recognition*

##### **970-323-25-12**

If real property owned by undivided interests is subject to **joint control** by the owners, the investor-venturers shall not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, such investments shall be presented in the same manner as investments in noncontrolled partnerships.

##### Real Estate – General – Consolidation

##### *Other Presentation Matters*

##### **970-810-45-1**

An investment in real property may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture if all of the following conditions are met:

- a. The real property is owned by **undivided interests**.

- b. The approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned.
- c. Each investor is entitled to only its pro rata share of income.
- d. Each investor is responsible to pay only its pro rata share of expenses.
- e. Each investor is severally liable only for indebtedness it incurs in connection with its interest in the property.

### Master Glossary

#### Joint control

Occurs if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners.

#### 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.

Proportionate consolidation is permitted only for the following:

- ▶ Investments in unincorporated legal entities (e.g., partnerships) in either the extractive<sup>8</sup> or construction<sup>9</sup> industries that otherwise would be accounted for under the equity method of accounting (i.e., a controlling financial interest does not exist). To determine whether a legal entity (e.g., an LLC) represents an unincorporated legal entity for purposes of determining whether proportionate consolidation is permitted, the investor should consider whether the governance provisions are more akin to a partnership or corporation (see section 7.3.1.6 of our FRD, ***Consolidation***). Based on discussions with the SEC staff, we understand that the SEC staff shares this view.
- ▶ Ownership of an undivided interest in each asset when each owner is entitled only to its pro rata share of income and expenses and is proportionately liable for its share of each liability. However, for real estate entities subject to ASC 970-323, if the undivided interest is in real property subject to joint control (as defined in US GAAP), the equity method of accounting must be used.

<sup>8</sup> ASC 810-10-45-14 states, "An entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas exploration and production) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources."

<sup>9</sup> To determine which entities are in the construction industry, ASC 910-10-15-3 through 15-4 (as amended for the adoption of ASC 606) describes certain characteristics that are common to entities in the industry. "The most basic characteristic is that work is performed under contractual arrangements with customers. A contractor, regardless of the type of construction activity or the type of contractor, typically enters into an agreement with a customer to build or to make improvements on a tangible property to the customer's specification. The contract with the customer specifies the work to be performed, specifies the basis of determining the amount and terms of payment of the contract price and generally requires total performance before the contractor's obligation is discharged. Unlike the work of many manufacturers, the construction activities of a contractor are usually performed at job sites owned by customers rather than at a central place of business, and each contract usually involves the production of a unique property rather than repetitive production of identical products. Other characteristics common to contractors and significant to accountants and users of financial statements include the following:

- (a) A contractor normally obtains the contracts that generate revenue or sales by bidding or negotiating for specific projects.
- (b) A contractor bids for or negotiates the initial contract price based on an estimate of the cost to complete the project and the desired profit margin, although the initial price may be changed or renegotiated.
- (c) A contractor may be exposed to significant risks in the performance of a contract, particularly a fixed-price contract.
- (d) Customers (usually referred to as owners) frequently require a contractor to post a performance and a payment bond as protection against the contractor's failure to meet performance and payment requirements.
- (e) The costs and revenues of a contractor are typically accumulated and accounted for by individual contracts or contract commitments extending beyond one accounting period, which complicates the management, accounting, and auditing processes.
- (f) The nature of a contractor's risk exposure varies with the type of contract. The several types of contracts used in the construction industry are described in paragraphs 605-35-15-2 through 15-5. The four basic types of contracts used based on their pricing arrangements are fixed-price or lump-sum contracts, unit-price contracts, cost-type contracts, and time-and-materials contracts."

Under proportionate consolidation, the investor presents its proportionate share of the investee's revenues and expenses in each major revenue and expense caption of the investor's income statement. Also, the investor may present its proportionate share of the investee's assets and liabilities separately in each major asset and liability caption of the investor's balance sheet.<sup>10</sup> In the construction industry, a combination of a one-line presentation and proportionate consolidation also may be used. That is, some entities in the construction industry may present their investment on the balance sheet using a one-line presentation and present their proportionate share of the investee's revenues and expenses using proportionate consolidation. An investor is not precluded from proportionately consolidating an investment that would otherwise qualify for such treatment simply because another party controls and consolidates the investment in accordance with ASC 810.

An investor applying proportionate consolidation needs to apply typical consolidation procedures and eliminate intercompany balances and transactions in the same manner that it would for consolidated entities. See section 17 of our FRD, *Consolidation*, for guidance.

When an investee does not qualify to be proportionately consolidated, we have observed that the SEC staff has objected to presenting pro forma financial statements prepared using proportionate consolidation as a non-GAAP disclosure.

### Question 3.3

**If an investor that is a public business entity (PBE) is proportionately consolidating its undivided interest or equity method investee, must the proportionately consolidated information comply with the accounting requirements for PBEs?**

Yes. We believe for a PBE investor that is proportionately consolidating its undivided interest or equity method investee, the proportionately consolidated information must comply with the accounting requirements for PBEs, including those related to the timing of adoption of ASC 606 and ASC 842. ASC 932-10-S99-3 requires a registrant that proportionately consolidates its equity investees to present them all on the same basis of accounting (i.e., all using PBE standards). We believe this guidance should be applied by investors in other industries to the adoption of new accounting standards when proportionate consolidation is used. We understand that the SEC staff shares this view.

#### Excerpt from Accounting Standards Codification

##### Extractive Activities – Oil and Gas – Overall

##### SEC Materials – General

##### 932-10-S99-3

The following is the text of SAB Topic 12.C, Methods of Accounting by Oil and Gas Producers ...

##### 2. Consistent Use of Accounting Methods Within a Consolidated Entity ...

**Question 2:** Must the method of accounting (full cost or successful efforts) followed by a registrant for its oil and gas producing activities also be followed by any fifty percent or less owned companies in which the registrant carries its investment on the equity method (equity investees)?

**Interpretive response:** No. Conformity of accounting methods between a registrant and its equity investees, although desirable, may not be practicable and thus is not required. However, if a registrant proportionately consolidates its equity investees, it will be necessary to present them all on the same basis of accounting.

<sup>10</sup> Paragraph 2 of EITF 00-1 states, "However, there is a longstanding practice in the construction industry and in the extractive industries of investors displaying investments in separate legal entities (that is, they do not own an undivided interest as described in paragraph 1) accounted for using the equity method of accounting on a proportionate gross basis. Under that practice, the investor presents its proportionate share of the investee's revenues and expenses in each major revenue and expense caption of the investor's income statement and **may** also present its proportionate share of the investee's assets and liabilities separately in each major asset and liability caption of the investor's balance sheet." [Emphasis added]. Although this paragraph was not codified, we believe it remains relevant for entities operating in these industries.

### 3.4.3 Acquisition, development and construction loan arrangements

#### Excerpt from Accounting Standards Codification

##### Receivables – Overall

##### *Recognition – Acquisition, Development, and Construction Arrangements*

##### *Characteristics Implying Investment in Real Estate or Joint Ventures*

##### **310-10-25-19**

In an acquisition, development, and construction arrangement in which the lender participates in expected residual profit, in addition to the lender's participation in expected residual profit, the following characteristics suggest that the risks and rewards of the arrangement are similar to those associated with an investment in real estate or joint venture:

- a. The lender agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- b. The lender funds the commitment or origination fees or both by including them in the amount of the loan.
- c. The lender funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- d. The lender's only security is the acquisition, development, and construction project. The lender has no **recourse** to other assets of the borrower, and the borrower does not guarantee the debt.
- e. In order for the lender to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

##### **310-10-25-27**

An acquisition, development, and construction arrangement shall be accounted for as follows:

- a. If the lender is expected to receive over 50 percent of the expected residual profit from the project, the lender shall account for income or loss from the arrangement as a real estate investment as specified by Topic 970.
- b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement shall be accounted for either as a loan or as a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 310-10-25-20(b) through (e) or a qualifying personal guarantee shall be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.

#### Master Glossary

##### **Expected Residual Profit**

The amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by a lender.

In the real estate industry, lenders commonly enter arrangements to finance the acquisition, development or construction of real estate. A lender typically participates in the expected residual profit from the sale or refinancing of the property. In some cases, the characteristics of the arrangement may indicate that, in substance, the risks and rewards of the arrangement are similar to an investment in real estate or a real estate joint venture. In other cases, the risks and rewards of the arrangement are such that it should be accounted for as a loan.

When an acquisition, development and construction arrangement has the characteristics described in ASC 310-10-25-19, and the lender is expected to receive more than 50% of the expected residual profit from the project, the arrangement would be accounted for as a real estate investment. If the lender is expected to receive 50% or less of the expected residual profit, the entire arrangement is accounted for either as a real estate joint venture, or as a loan, depending on the circumstances. If the arrangement is accounted for as a real estate joint venture, the equity method is applied.

### 3.4.4 Qualified affordable housing projects (before adoption of ASU 2023-02) (updated July 2023)

#### Excerpt from Accounting Standards Codification

Investments – Equity Method and Joint Ventures – Income Taxes

*SEC Materials – General – SEC Staff Guidance*

**323-740-S99-2**

The following is the text of SEC Observer Comment: Accounting for Tax Benefits Resulting from Investments in Qualified Affordable Housing Projects. [The SEC Staff conformed this Comment to the guidance issued in Accounting Standards Update No. 2014-01, Investments–Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects.]

It has been observed that the decision to apply the proportional amortization method of accounting is an accounting policy decision to be applied consistently to all investments in qualified affordable housing projects that meet the conditions in paragraph 323-740-25-1 rather than a decision to be applied to individual investments that qualify for use of the proportional amortization method. The SEC staff believes that it would be inappropriate to extend the proportional amortization method of accounting to situations analogous to those described in paragraph 323-740-05-3.

ASC 323-740 provides accounting guidance for investments in qualified affordable housing projects.

ASC 323-740 allows an investor that invests in qualified affordable housing projects through limited liability entities to amortize the cost of its investment in proportion to the tax credits and other tax benefits it receives (i.e., the proportional amortization method) and to present the amortization as a component of income tax expense.<sup>11</sup>

An entity that invests in qualified affordable housing projects through limited liability entities may elect the proportional amortization method if all of the following conditions are met:

- ▶ It is probable that the tax credits allocable to the investor will be available.
- ▶ The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.

<sup>11</sup> Investments in qualified affordable housing projects that existed prior to the adoption of ASU 2014-01 may continue to be accounted for under the effective yield method. For PBEs, ASU 2014-01 became effective for annual periods, and interim periods within those annual periods, beginning after 15 December 2014. For all other entities, the guidance became effective for annual periods beginning after 15 December 2014 and interim periods within annual periods beginning after 15 December 2015. ASU 2014-01 applies retrospectively to all periods presented. However, entities that qualified for and used the effective yield method to account for investments in qualified affordable housing projects before adoption may continue to do so for those investments made prior to the effective date of ASU 2014-01.

- ▶ Substantially all of the projected benefits are from tax credits and other tax benefits (e.g., operating losses).
- ▶ The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.
- ▶ The investor is a limited liability investor in the limited liability entity for both legal and tax purposes and the investor's liability is limited to its capital investment.

We believe that an investor that (1) does not qualify for the proportional amortization method or elects not to apply it and (2) does not apply the equity method can elect, as an accounting policy choice, to account for its investment in a qualified affordable housing project under the cost method (as described in ASC 323-740) or in accordance with ASC 321. The method elected must be applied consistently.

Prior to the adoption of ASU 2023-02,<sup>12</sup> the proportional amortization method only is applicable to investments in qualified affordable housing projects. As discussed in ASC 323-740-S99-2, the SEC staff believes it would be inappropriate to extend the proportional amortization method by analogy to other investments.

See section 4.2.7.5 of our FRD, *Income taxes*, for additional guidance on the proportional amortization method prior to the adoption of ASU 2023-02.

### 3.4.5 Tax equity investments (after the adoption of ASU 2023-02) (added July 2023)

ASC 323-740 provides guidance for the proportional amortization method, which entities can elect to apply to equity investments in tax credit programs that meet certain conditions. The proportional amortization method allows entities to amortize the cost of the equity investment in proportion to the income tax credits and other income tax benefits received and to present the amortization expense and the income tax benefits on a net basis in income tax expense/benefit in the income statement.

ASU 2023-02 expanded the use of the proportional amortization method to equity investments in tax credit programs that meet certain conditions, which generally includes the New Markets Tax Credit program, the Historic Rehabilitation Tax Credit program and the renewable energy tax credit programs. Previously, entities were permitted to apply the proportional amortization method only to investments in qualified affordable housing projects that generated LIHTCs and met certain conditions.

ASU 2023-02 also eliminated certain guidance on the accounting for investments in LIHTC programs when the proportional amortization method is not applied to align it with the accounting for investments in other types of tax credit equity investment structures. Entities applying the legacy equity method guidance to their investments in LIHTC programs will need to consider the amendments that:

- ▶ Eliminate an alternative method to measure impairments for investments accounted for using the equity method in ASC 323-740-55-8 through 55-9 and require entities to apply the impairment guidance in ASC 323 to their income tax credit investments accounted for under the equity method. If the alternative impairment method was used, entities will need to consider the effective date and transition guidance in ASU 2023-02.

<sup>12</sup> In March 2023, the FASB issued Accounting Standards Update (ASU) 2023-02, *Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, rather than just investments in qualified affordable housing projects that generate low-income housing tax credits (LIHTCs). Under the amended guidance, entities can elect the proportional amortization method on a tax-credit-program by tax-credit-program basis. If elected, the method should be applied consistently to all investments in the tax credit program. The guidance is effective for public business entities for fiscal years beginning after 15 December 2023 and interim periods within those fiscal years, and for all other entities for fiscal years beginning after 15 December 2024 and interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. Refer to section 4.2.7.5A in our FRD, *Income taxes*, for guidance on applying the proportional amortization method after the adoption of ASU 2023-02, including eligibility considerations.



- ▶ No longer permit entities with investments in LIHTC structures that did not use the proportional amortization method (e.g., those that applied the equity method or cost method) to use the delayed equity contribution guidance in ASC 323-740-25-3. If the delayed equity contribution method was used, entities will need to consider the effective date and transition guidance in ASU 2023-02.

See section 4.2.7.5A of our FRD, *Income taxes*, for additional guidance on the adoption of ASU 2023-02, including transition considerations.

## 3.5

### Scope exceptions

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Scope and Scope Exceptions*

##### *Instruments*

##### **323-10-15-4**

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

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

The equity method of accounting generally does not apply to investments in entities held by certain types of investors, such as investment companies, estates, trusts and individuals. Judgment is often needed to determine whether a trust is considered a business or a non-business entity.

### 3.5.1

### Investment companies

#### Excerpt from Accounting Standards Codification

##### Financial Services – Investment Companies

##### *Other presentation matters*

##### *General*

##### *Application of the Equity Method*

##### **946-323-45-1**

Except as discussed in the following paragraph, use of the equity method of accounting by an investment company is not appropriate. Rather, those noncontrolling ownership interests held by an investment company shall be measured in accordance with guidance in Subtopic 946-320, which requires investments in debt and equity securities to be subsequently measured at **fair value**.

##### **946-323-45-2**

An exception to the general principle in the preceding paragraph occurs if the investment company has an investment in an operating entity that provides services to the investment company, for example, an investment adviser or transfer agent (see paragraph 946-10-55-5). In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. If an investment company holds a noncontrolling ownership interest in such an operating entity that otherwise qualifies for use of the equity method of accounting, the investment company should use the equity method of accounting for that investment, rather than measuring the investment at fair value.

Investment companies are not permitted to use the equity method of accounting as described in ASC 323 for their investments in *non-investment companies*. Investments made by an investment company in a non-investment company are accounted for at fair value in accordance with ASC 946. However, an investment company would apply the equity method of accounting if it has a noncontrolling investment in an entity that provides services to the investment company (e.g., an investment adviser, a transfer agent) and has the ability to exercise significant influence over that entity. See section G.1.1 of our FRD, [Consolidation](#), for guidance on attributes of an investment company.

The ASC 323 scope exception applies only to investments held by an investment company. That is, entities investing in, or providing services to, investment companies (e.g., asset managers) are subject to the equity method of accounting.

An investment company must measure noncontrolling ownership interests in other investment companies at fair value, rather than using the equity method of accounting.

## 3.5.2

### Investments held by real estate investment trusts

#### Excerpt from Accounting Standards Codification

##### Real Estate – Real Estate Investment Trusts

##### *Recognition – General – Service Corporations*

##### **974-323-25-1**

The existence of some or all of the following factors indicates that the **real estate investment trust** has the ability to exercise at least significant influence over the **service corporation** and that, accordingly, the real estate investment trust should either account for its investment under the equity method or should consolidate the investee.

- a. The service corporation performs activities primarily for the real estate investment trust.
- b. Substantially all of the economic benefits in the service corporation flow to the real estate investment trust.
- c. The real estate investment trust has the ability to designate a seat on the board of directors of the service corporation.
- d. The real estate investment trust and the service corporation have common board members.
- e. The real estate investment trust and the service corporation have common officers, employees, or both.
- f. The owners of the majority voting stock of the service corporation have not contributed substantial equity to the service corporation.
- g. The views of the real estate investment's management influence the operations of the service corporation.
- h. The real estate investment trust is able to obtain financial information from the service corporation that is needed to apply the equity method of accounting to its investment in the service corporation.

The determination of whether the real estate investment trust should use the equity method of accounting for its investment in the service corporation or consolidate the service corporation in its financial statements should be based on facts and circumstances.

Investments in common stock held by a nonbusiness entity, such as a trust, are excluded from the scope of ASC 323. Real estate investment trusts (REITs) typically make real estate loans and investments, and are capitalized using a combination of equity and debt financing. As a result, because REITs have business activities (and therefore are considered business entities, rather than nonbusiness entities), investments held by REITs generally are within the scope of ASC 323.

A REIT should evaluate whether it has the ability to exercise significant influence over the operating and financial policies of the service corporation, as discussed in section 3.2. In addition, the REIT also should consider the guidance in ASC 974-323-25-1.

### 3.5.3 Investments held by not-for-profit entities and health care entities (updated July 2023)

Under ASC 958-810-15-4, when a not-for-profit (NFP) entity has a 50% or less investment in the voting stock of a for-profit entity and has the ability to exercise significant influence, the NFP applies the guidance in ASC 323-10 to account for the investment under the equity method, unless the entity has elected to account for the investment at fair value. Similarly, when an NFP has more than a minor noncontrolling interest in a general partnership, limited partnership, limited liability company, trust or entity that maintains a specific ownership account, it generally should apply the guidance in ASC 323-30, unless the entity has elected to account for the investment at fair value.

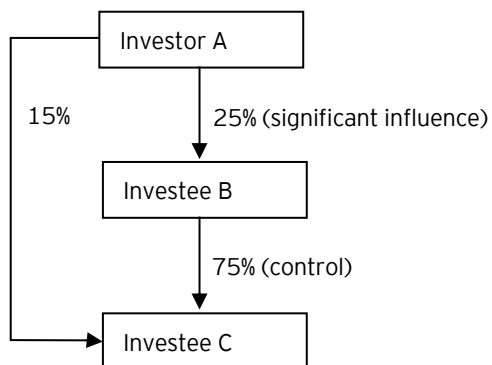
Similar guidance also applies to investments held by not-for-profit business-oriented health care entities, in accordance with ASC 954-810-15-3, although the fair value election for certain investments is not available to these entities.

### 3.6 Investments in an investee's subsidiaries

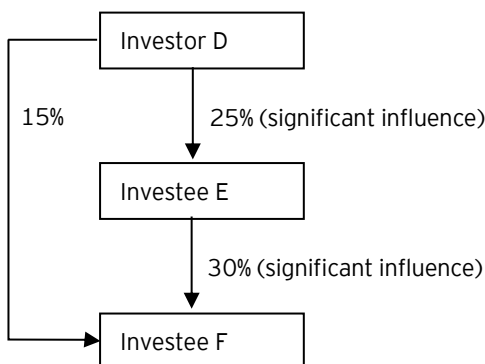
Both direct and indirect investments in the voting stock of an investee are considered when determining whether an investor has the ability to exercise significant influence over an investee. Therefore, if an investor purchases common voting shares of a consolidated subsidiary of an investee accounted for under the equity method of accounting, the investor also should account for its investment in the subsidiary under the equity method.

#### Illustration 3-3: Significant Influence over the subsidiary of an equity method investee

##### Example 1



Investor A owns a 25% interest in the voting shares of Investee B. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and accounts for its investment under the equity method. Investee B owns 75% of the voting shares of Investee C and controls and consolidates the subsidiary. Investor A then purchases a 15% interest in the voting shares of Investee C, a subsidiary of Investee B. Since Investee B controls Investee C, and Investor A has the ability to exercise significant influence over Investee B, Investor A also has the ability to exercise significant influence over Investee C and accounts for its investment under equity method accounting.

**Example 2**

Investor D owns a 25% interest in the voting shares of Investee E. Investor D has the ability to exercise significant influence over Investee E (the presumption that significant influence exists is not overcome) and applies the equity method. Investor D then purchases a 15% interest in the voting shares of Investee F, an investee of Investee E. Investee E owns 30% of the voting shares of Investee F and does not control Investee F. Investor D's 15% interest in Investee F does not give Investor D the ability to exercise significant influence over Investee F (the presumption that significant influence does not exist is not overcome). Further, we do not believe Investor D should determine its ownership percentage in Investee F based on direct and indirect holdings. In this circumstance, it will be necessary to evaluate the facts and circumstances before determining if Investee D has the ability to exercise significant influence over Investee F.

When an investor is applying the equity method of accounting to both a direct and an indirect interest in an investee, it should not double-count the earnings and losses of the investee's subsidiary. The investor would record its portion of the earnings and losses of the investee's subsidiary as well as its portion of the investee's earnings and losses, which would include the investee's consolidated subsidiaries.

**Illustration 3-4: Accounting for equity method earnings of an equity method investee's subsidiary**

Assume the fact pattern as described in Illustration 3-3, Example 1.

Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

For the year ending 20X1, Investee B's consolidated financial information is as follows:

Income from Investee B's other operations, net of tax	\$ 800
Income from Investee C, net of tax	400
Net income	<u>1,200</u>
Less: net income attributable to noncontrolling interest in Investee C (25% of \$400)	<u>(100)</u>
Net income attributable to controlling interest	<u>\$ 1,100</u>

Investor A would record earnings of \$335 to account for its investment in Investee B and Investee C, calculated as follows:

Equity method earnings from interest in Investee B (25% of \$1,100)	\$ 275
Equity method earnings from incremental direct interest in Investee C (15% of \$400)	60
Investor A's total equity method earnings	<u>\$ 335</u>

Intra-entity transactions between Investor A and Investee C would need to be considered to ensure that earnings are properly eliminated and not double counted. See section 6.2.1.

### 3.7 Majority-owned entities

In certain situations, accounting for a majority-owned voting interest entity using the equity method of accounting may be appropriate. For example, ASC 810 discusses situations in which the majority owner does not have a controlling financial interest due to the presence of “participating” rights held by the minority owner. If consolidation by the majority owner were not appropriate, for example, due to the existence of “participating” minority rights, the investment would be accounted for using the equity method.

If an entity is a VIE but the majority owner is not the primary beneficiary, the majority owner would account for its investment in the common stock of the VIE under the equity method if the majority owner has the ability to exercise significant influence over the VIE.

See our FRD, [Consolidation](#), for additional guidance.

### 3.8 Reassessments regarding the ability to exercise significant influence

The evaluation of whether the equity method of accounting is required is a continuous assessment. That is, the investor should reevaluate whether it has the ability to exercise significant influence over the investee when any relevant facts and circumstances change.

Certain situations may call into question whether an investor continues to have significant influence, including, for example, when the investee:

- ▶ Begins a legal reorganization or files for bankruptcy; the facts and circumstances of the bankruptcy proceeding may call into question the investor’s ability to exercise significant influence
- ▶ Comes under foreign exchange restrictions, controls or other governmentally imposed uncertainties so severe that significant doubt is cast on the investor’s ability to exercise significant influence
- ▶ Changes its equity structure (e.g., issues shares or purchases treasury shares) or governance (e.g., its articles of incorporation)

This list is not all-inclusive. Upon a change in facts and circumstances, an investor should determine whether it continues to have the ability to exercise significant influence. See sections 5.6.1 and 7.4 for the accounting when changing to or from the equity method.

## 4 Identifying a joint venture (updated June 2024)

Determining whether an entity meets the definition of a joint venture is important. It could affect the accounting applied by the investors as well as the accounting applied by the entity. However, the term “joint venture” is applied loosely in practice and may appear in legal documents and public statements, which may result in an entity as being improperly identified as a joint venture. See Appendix D of our FRD, *Business combinations*, for more guidance on the definition of a joint venture and the accounting by the joint venture at formation.

# 5 Initial measurement

## 5.1 Overview

An investor can obtain an equity method investment through the following transactions:

- ▶ Purchase of an investment that provides the investor with the ability to exercise significant influence over the operating and financial policies of the investee (see section 5.2)
- ▶ Acquisition of an additional equity interest that gives the investor the ability to exercise significant influence (e.g., a step acquisition) when the investor previously accounted for its investment as a financial asset (see section 5.6.1)
- ▶ Loss of control, but the ability to exercise significant influence over an investment is retained, sometimes referred to as a “partial sale” (see section 5.2.3)

An investor using the equity method to account for its interest in an investee or joint venture initially records its investment at cost, including transaction costs. Under the equity method, an investment in common stock and in-substance common stock is presented on the balance sheet of an investor as a single amount. However, any difference between the cost of the investment and the underlying equity in net assets of an investee – commonly referred to as a basis difference – should be accounted for as if the investee were a consolidated subsidiary. See section 5.4 for further discussion.

Unless specified, references to equity method investments and investors also include joint ventures and venturers, respectively, throughout this section.

## 5.2 Initial measurement

### **Excerpt from Accounting Standards Codification**

#### **Investments – Equity Method and Joint Ventures – Overall**

##### *Initial Measurement*

##### *The Equity Method – Overall Guidance*

##### **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.

An investor is required to measure an equity method investment initially at cost using the guidance for asset acquisitions in accordance with ASC 805-50-30.<sup>13,14</sup> Consequently, equity method investments generally are recognized using a cost accumulation model in which the investment is recognized based on the cost to the investor, which generally is based on the fair value of the consideration paid, and which includes transaction costs. Transaction costs are included in the carrying amount of the equity method investment, which differs from the accounting for transaction costs in the acquisition of a business.

Costs incurred by an investor that are included in the cost of an equity method investment should be limited to direct costs of acquiring the equity method investment. These direct costs include “out-of-pocket” costs or incremental costs directly related to the equity method investment. Examples of such costs include a finder’s fee, fees paid to outside consultants for accounting and legal services, and appraisals. Any internal costs related to the equity method investment are expensed as incurred, even if the costs are incremental, nonrecurring and directly related to the equity method investment. Costs incurred by an investor to issue debt or equity securities to acquire an equity method investment are not considered costs of the equity method investment and are accounted for as debt or equity issue costs, respectively, in accordance with other applicable accounting guidance.

An investor should evaluate whether the incremental costs incurred are costs of obtaining the equity method investment or costs incurred on behalf of the investee. An investor may incur costs on behalf of an investee, for example, if the investee is only a “shell” company that will subsequently acquire a business or assets. See section 6.6 for guidance on the accounting in such situations.

**Illustration 5-1: Initial measurement of an equity method investment**

An investor purchases a 25% interest in the voting common stock of an investee for \$500,000 in cash and incurs \$50,000 in legal fees associated with the transaction. The fees are incremental direct costs of the acquisition. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and therefore accounts for the investment using the equity method.

The investor would record its initial investment at \$550,000.

## 5.2.1 Commitments and guarantees

When an investor has a commitment to make future contributions to its equity method investment, the commitment generally would not be included in the initial measurement of the equity method investment unless other authoritative guidance requires it. For example, investors that have commitments to fund an equity method investment should consider the accounting and disclosure guidance in ASC 440.

Investors that issue guarantees to third parties (e.g., banks) or to the investees should record the guarantee in accordance with ASC 460. While ASC 460 does not prescribe a specific account for the guarantor’s offsetting entry when it recognizes that liability, ASC 460-10-55-23 provides examples that are meant to illustrate how the initial offsetting entry may vary depending on the circumstances under which the guarantee was issued. ASC 460-10-55-23(c) states, “If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.” Therefore, if the investor does not receive other consideration for issuing the guarantee, any liability recognized upon issuance of the guarantee would be included in the measurement of the

<sup>13</sup> If an investor retained a noncontrolling interest in an investee in a deconsolidation transaction in the scope of ASC 810-10-40, it should measure that interest at fair value in accordance with ASC 810-10-40-3A through 40-5.

<sup>14</sup> An investor measures an equity method investment recognized upon the derecognition of a nonfinancial asset or in substance nonfinancial asset at fair value in accordance with ASC 610-20. See section 5.2.3 for further guidance.



equity method investment (i.e., the offsetting entry would be a debit to the investment account). Thereafter, the accounting for the guarantee issued to a third party is separate from the accounting for the equity method investment, and is governed by ASC 460.

**Illustration 5-2: Initial measurement of an equity method investment when the investor issues a guarantee in conjunction with the acquisition**

An investor purchases a 25% interest in the voting common stock of an investee for \$500,000 upon the investee's formation. The investor also issues a financial guarantee to a bank for the repayment of a loan the investee has outstanding. In accordance with ASC 460, the investor determines that the guarantee should be recognized at inception at its fair value, which is \$50,000. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and therefore accounts for the investment using the equity method.

The investor would record its equity method investment initially at \$550,000, which includes the cash paid by the investor and the fair value of the guarantee at inception.

Subsequently, the investor accounts for its equity method investment in accordance with ASC 323 and separately accounts for its liability for the financial guarantee.

## 5.2.2 Acquisition as part of a business combination

An investor may obtain an equity method investment as part of a business combination, as defined in ASC 805. In accordance with ASC 805, the acquirer (investor) initially recognizes the equity method investment at its fair value on the date of acquisition, pursuant to the guidance in ASC 820. The acquirer would determine its basis differences at the date of acquisition, based on the difference between the fair value of the acquired investment and the carrying amounts of the underlying net assets in the investee's US GAAP financial statements. See section 5.4.

For guidance on applying the requirements of ASC 805, see our FRD, *Business combinations*. For further discussion on determining fair value and the required disclosures, see our FRD, *Fair value measurement*.

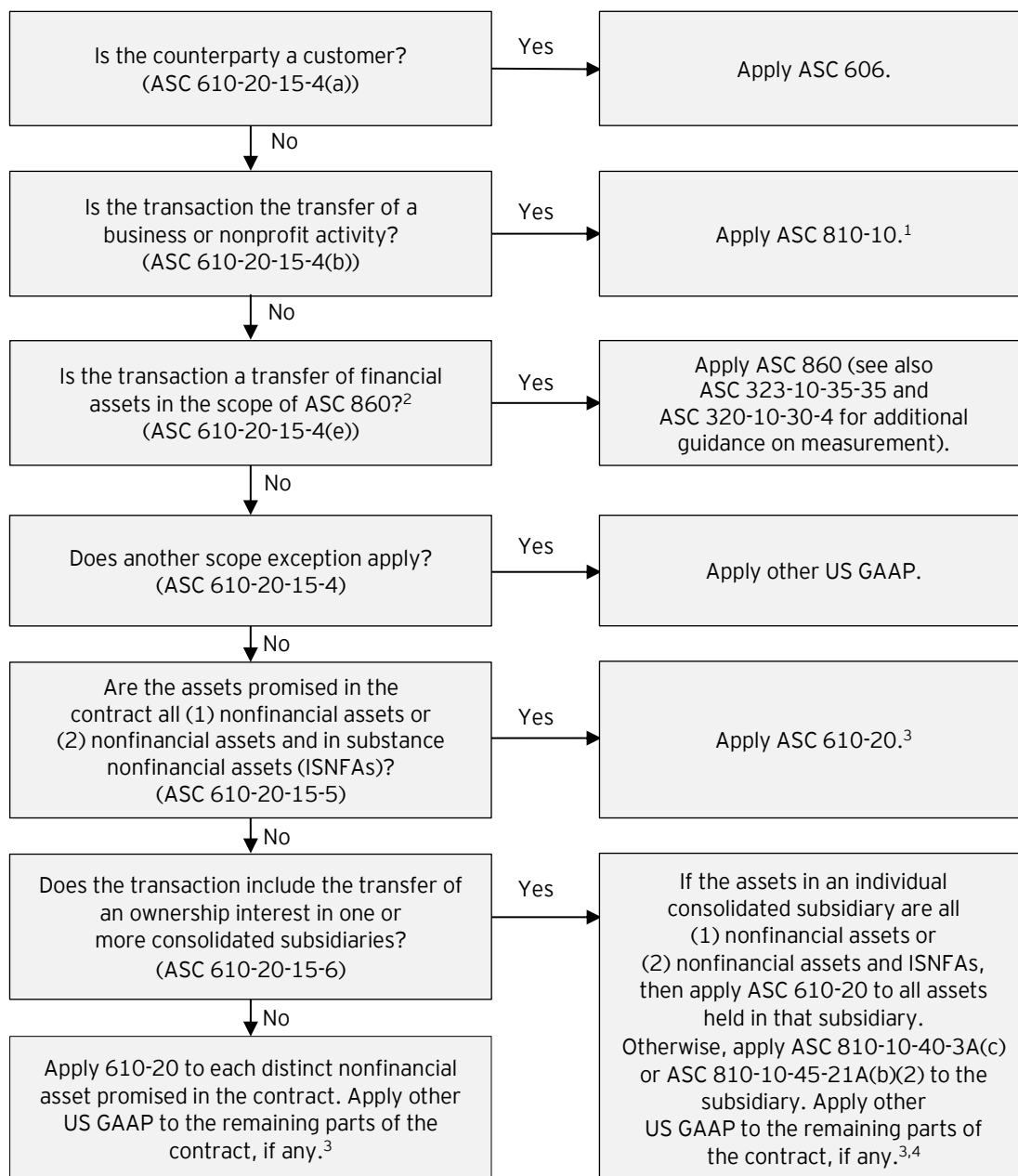
## 5.2.3 Contribution of businesses or assets for an investment in an equity method investee

When businesses or assets are given up in exchange for an equity method investment or an interest in a joint venture (or an equity investment is retained), the initial measurement will generally depend on whether the investee (i.e., the counterparty) is considered to be a customer in the transaction, the nature of any assets contributed, and in some cases, the legal form of the transaction.

The decision tree in Illustration 5-3, which is adapted from ASC 610-20-15-10, summarizes how an investor would determine the appropriate accounting.

If nonmonetary consideration is given up in exchange for an equity method investment and the transaction is not in the scope of other guidance (e.g., ASC 606, ASC 610-20), an investor would generally measure the cost of the investment based on the fair value of the consideration given, unless the fair value of the equity method investment acquired is more reliably measurable under ASC 805-50, as discussed in Appendix A.2.1 of our FRD, *Business Combinations*.

When the transaction is between an investor and investee, intra-entity profits may be eliminated. See section 6.2.1 for additional guidance on the elimination of intra-entity profits.

**Illustration 5-3: Decision tree – Accounting at formation of an equity method investment****Notes**

- <sup>1</sup> Certain types of transactions (e.g., spin-offs, split-offs, conveyances of oil and gas mineral rights accounted for under ASC 932-360-40) are excluded from the scope of ASC 810, as stated in ASC 810-10-40-3A and 40-5, because they are addressed by other guidance.
- <sup>2</sup> Sales of equity method investments, even if the investees hold only nonfinancial assets, such as real estate, are accounted for under ASC 860, unless a scope exception applies.
- <sup>3</sup> ASC 610-20 is applied to each distinct asset promised in the contract as discussed in section 3.2.2 of our FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*. If the contract includes terms or other contractual obligations that are not assets of the seller (e.g., guarantees), these aspects of the contract are separated and accounted for under other US GAAP.
- <sup>4</sup> An entity first evaluates all of the assets transferred, collectively, in the contract. If substantially all of the fair value of all of the assets is not concentrated in nonfinancial assets, the entity evaluates each individual consolidated subsidiary (i.e., the entity determines whether substantially all of the fair value of the assets in each subsidiary is concentrated in nonfinancial assets).

### 5.2.3.1 Determining whether the investee is a customer

A sale or transfer of a nonfinancial asset in a contract with a customer is in the scope of ASC 606. If an investor receives an equity method investment as a form of consideration in connection with the sale or transfer of goods or services to a customer in the scope of ASC 606, the investor initially measures the equity method investment at fair value at contract inception. See our FRD, [Revenue from contracts with customers \(ASC 606\)](#), for more guidance.

Determining whether a counterparty is a customer is important because, among other things, it will determine whether intra-entity profits are eliminated. That is, if an arm's-length transaction is with a customer (i.e., in the scope of ASC 606), the selling entity is required to eliminate profit from the intra-entity transaction until that profit is realized in a transaction with a third party. See section 6.2.1 for further details.

### 5.2.3.2 Control of a business or a nonprofit activity is given up and an equity method investment is retained or received

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Initial Measurement*

##### *The Equity Method – Overall Guidance*

##### **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.

The derecognition of a group of assets (or deconsolidation of a subsidiary) that constitutes a business or a nonprofit activity (as defined by ASC 810-10-20) is generally within the scope of ASC 810.<sup>15</sup> An investor initially measures, at fair value, a retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with ASC 810-10-40-3A through 40-5. See section 19 of our FRD, [Consolidation](#), for guidance on applying ASC 810. See section 2 of our FRD, [Business combinations](#), for more guidance on the definition of a business.

See sections 12.2.4, 14.3.3.1 and 14.3.3.1A of our FRD, [Income taxes](#), for discussion of income tax considerations related to the accounting for a loss of control over a subsidiary.

<sup>15</sup> The derecognition of a group of assets (or deconsolidation of a subsidiary) that constitutes a business or a nonprofit activity (as defined by ASC 810-10-20) is within the scope of ASC 810 except for either a transfer of a good or service in a contract with a customer within the scope of ASC 606 or a conveyance of oil and gas mineral rights. If a company is conveying a mineral interest, the transaction would be accounted for under ASC 932. Spin-offs and split-offs also are excluded from the scope of ASC 810, because they are addressed by other guidance (ASC 845 and ASC 505-60).

### 5.2.3.3 Financial assets are given up and an equity method investment is received

- ▶ A transfer of a financial asset in exchange for an equity method investment is generally within the scope of ASC 860, unless the financial asset given up is an in substance nonfinancial asset (ISNFA).<sup>16</sup> If the transfer of the financial asset given up is within the scope of ASC 860, see our FRD, *Transfers and servicing of financial assets*, for guidance on when to recognize the gain or loss, and see also section 7 for guidance on measuring the gain or loss if it is an equity method investment.
- ▶ If the exchange is not within the scope of ASC 860 or ASC 610-20, it may be considered a nonmonetary exchange in the scope of ASC 845. The general provisions of ASC 845 apply (i.e., measure the equity method investment at fair value unless it qualifies for one of the three exceptions to fair value accounting) unless another scope exception from ASC 845, exception from fair value accounting or other specific literature applies.

### 5.2.3.4 Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received

#### Excerpt from Accounting Standards Codification

##### Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets – Overall

##### Measurement

##### 610-20-32-2

When an entity meets the criteria to derecognize a distinct nonfinancial asset or a distinct **in substance nonfinancial asset**, it shall recognize a gain or loss for the difference between the amount of consideration measured and allocated to that distinct asset in accordance with paragraphs 610-20-32-3 through 32-6 and the carrying amount of the distinct asset. The amount of consideration promised in a **contract** that is included in the calculation of a gain or loss includes both the **transaction price** and the carrying amount of liabilities assumed or relieved by a counterparty.

##### 610-20-32-4

If an entity transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset in exchange for a **noncontrolling interest**, the entity shall consider the noncontrolling interest received from the counterparty as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24. Similarly, if a **parent** transfers control of a distinct nonfinancial asset or in substance nonfinancial asset by transferring ownership interests in a consolidated **subsidiary** but retains a noncontrolling interest in its former subsidiary, the entity shall consider the noncontrolling interest retained as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24. (See Case A of Example 2 in paragraphs 610-20-55-11 through 55-14.)

<sup>16</sup> A financial asset, including an equity method investment, is an ISNFA in the scope of ASC 610-20 if it is transferred in a contract with a noncustomer as part of a group of assets that is not a business and substantially all of the fair value of the group of assets is concentrated in nonfinancial assets. See section 2 of our FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*, for further guidance.

## Real Estate – General – Investments – Equity Method and Joint Ventures

### *Initial Measurement*

#### *Contribution of Real Estate*

##### **970-323-30-3**

An investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at fair value when the real estate is derecognized, regardless of whether the other investors contribute cash, property, or services. The transaction shall be accounted for in accordance with the guidance in paragraphs 360-10-40-3A through 40-3C. Some transactions are sales of an ownership interest that result in an entity being an investor in a real estate venture. An example of such a transaction includes one in which investor A contributes real estate with a fair value of \$2,000 to a venture and investor B contributes cash in the amount of \$1,000. The real estate is not considered a business or nonprofit activity and, therefore, is within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets. Investor A immediately withdraws the cash contributed by investor B and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor A does not have a controlling financial interest in the venture, investor A applies the guidance in paragraphs 610-20-25-5 and 610-20-25-7. When investor A meets the criteria to derecognize the property, investor A measures its retained ownership interest at fair value consistent with the guidance in paragraph 610-20-32-4 and includes that amount in the consideration used in calculating the gain or loss on derecognition of the property.

As shown in Illustration 5-3, when a transfer is not with a customer, not a transfer of a business, not a transfer of a financial asset (i.e., not in the scope of ASC 606, ASC 810 or ASC 860, as discussed above) and no other scope exceptions in ASC 610-20 apply,<sup>17</sup> an entity evaluates whether all of the assets promised in the contract are in the scope of ASC 610-20 because they are either all (1) nonfinancial assets or (2) nonfinancial assets and ISNFAs.<sup>18</sup> That is, regardless of whether an entity transfers assets directly<sup>19</sup> or through one or more consolidated subsidiaries, it must first evaluate whether substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the entire contract, collectively, is concentrated in nonfinancial assets. Examples of nonfinancial assets include real estate (e.g., buildings, land, windmills, solar farms) and intellectual property.

When a contract involves the transfer of an ownership interest in one or more subsidiaries that is not with a customer and not a business, and substantially all of the fair value of the assets, collectively, in the contract is *not* concentrated in nonfinancial assets, each subsidiary must be evaluated *individually* to determine whether substantially all of the fair value of the assets held in an individual consolidated subsidiary is concentrated in nonfinancial assets. If this is the case, the financial assets in that subsidiary are ISNFAs and all the assets in that subsidiary are in the scope of ASC 610-20. See section 2.6 of our FRD, **Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)**, for additional guidance.

Partial sales of nonfinancial assets are common in certain industries (e.g., real estate). ASC 610-20 includes guidance for a partial sale of nonfinancial assets and ISNFAs held in a legal entity. In this context, the term “partial sale” generally refers to a transaction in which an entity sells a controlling financial interest in a subsidiary that holds nonfinancial assets (or nonfinancial assets and ISNFAs) but retains a noncontrolling interest in the former subsidiary (e.g., an equity method investment). The term partial sale also may refer to a seller’s transfer of a nonfinancial asset or a nonfinancial asset and an

<sup>17</sup> See section 2.5 of our FRD, **Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)**, for further guidance.

<sup>18</sup> As discussed in ASC 610-20-15-5 through 15-8, a financial asset is an ISNFA in the scope of ASC 610-20 if it is transferred in a contract with a noncustomer as part of a group of assets that is not a business and substantially all of the fair value of the assets (recognized and unrecognized) is concentrated in nonfinancial assets.

<sup>19</sup> By “transfers assets directly,” we mean that the assets are not held in a legal entity.

ISNFA to an entity that is owned or newly formed by a third party in exchange for a noncontrolling interest in that entity.<sup>20</sup> Those transactions generally will be accounted for under ASC 610-20 if all of the assets promised in the contract are in the scope of ASC 610-20, because they are either all (1) nonfinancial assets or (2) nonfinancial assets and ISNFAs.

ASC 610-20 requires the seller to recognize the difference between the consideration received using the measurement principles of ASC 606 and the carrying amount of the asset sold when its derecognition criteria are met. An equity method investment received or retained by the seller (e.g., in a partial sale) is noncash consideration and is measured at fair value. As a result, the accounting for a partial sale will result in the recognition of a full gain or loss.

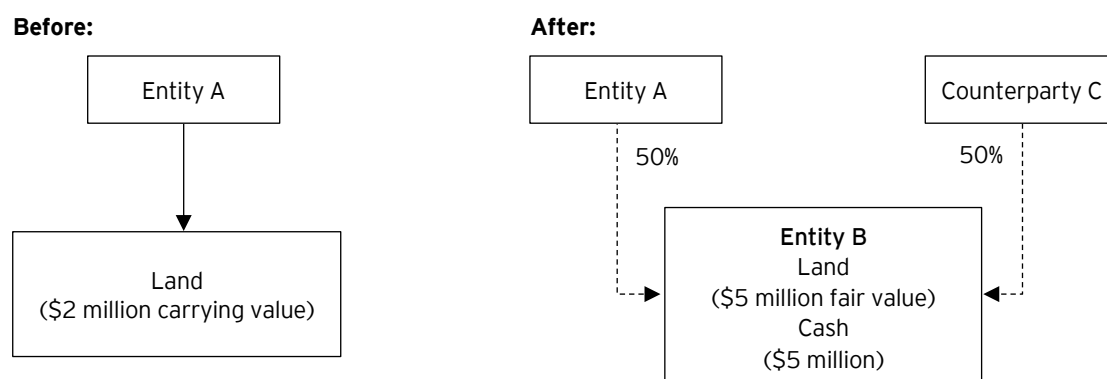
ASC 610-20 does not provide guidance on how the receiving entity accounts for the transaction. An investee that receives an asset in exchange for issuing equity to one of its investors would apply other US GAAP (e.g., ASC 805-50).

See our FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*, for more guidance and examples on the requirements of ASC 610-20, including when to recognize the gain or loss and how and when to measure the fair value of noncash consideration received (e.g., an equity method investment in a partial sale).

The following example illustrates the application of ASC 610-20 and ASC 970-323 for a transaction in which a selling entity transfers real estate to a newly formed legal entity and receives a noncontrolling interest in the new entity that it accounts for under the equity method:

**Illustration 5-4: Transfer of a nonfinancial asset to a newly formed legal entity in exchange for a noncontrolling interest**

Entity A and Counterparty C create a newly formed legal entity, Entity B. Entity A contributes land with a fair value of \$5 million and a carrying value of \$2 million. Counterparty C contributes \$5 million cash to Entity B, and each party receives a 50% noncontrolling interest in Entity B, which Entity A accounts for under the equity method. The land transferred to Entity B is not a business, and Counterparty C and Entity B are not Entity A's customers in this transaction.



<sup>20</sup> A sale of a partial interest in a nonfinancial asset (e.g., an undivided interest (see ASC 970-323); ownership of a portion of the ownership rights to an asset, such as a mineral right) is not addressed in ASC 610-20.

**Analysis**

Entity A measures the transaction price considering the fair value of the noncash consideration received (i.e., Entity A's equity method investment in Entity B). Assume Entity A determines that the fair value of its equity method investment in Entity B is \$5 million. This amount becomes the initial measurement for that investment. Under ASC 610-20, the gain on the sale is calculated as follows:

Fair value of retained interest (equity method investment)	\$ 5m
Less: carrying amount of land contributed	<u>2m</u>
Gain on sale	<u>\$ 3m</u>

**5.2.3.5****Transactions in the scope of other guidance****Excerpt from Accounting Standards Codification****Consolidation – Overall*****Derecognition******Deconsolidation of a Subsidiary or Derecognition of a Group of Assets*****810-10-40-3A**

The deconsolidation and derecognition guidance in this Section applies to the following ...

- c. A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
  1. Topic 606 on **revenue** from contracts with customers
  2. Topic 845 on exchanges of nonmonetary assets
  3. Topic 860 on transferring and servicing financial assets
  4. Topic 932 on conveyances of mineral rights and related transactions
  5. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

The loss of control of a subsidiary that is not a nonprofit activity or a business is in the scope of ASC 810 unless the substance of the transaction is addressed by other guidance (e.g., ASC 606, ASC 610-20, ASC 845, ASC 860, ASC 932). The FASB decided<sup>21</sup> that an entity should not separate the assets transferred in an individual subsidiary and apply different recognition models to the underlying assets.

Therefore, if an investor loses control of a subsidiary in a transaction in the scope of ASC 810 and receives an equity method investment in exchange, the investor would recognize the equity method investment received at fair value and record a gain or loss on the transaction, pursuant to ASC 810. See section 19 of our FRD, **Consolidation**, for guidance on ASC 810.

See sections 12.2.4, 14.3.3.1 and 14.3.3.1A of our FRD, **Income taxes**, for discussion of income tax considerations related to the accounting for a loss of control over a subsidiary.

<sup>21</sup> Paragraph BC26 of ASU 2017-05.

## 5.3 Contingent consideration

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Initial Measurement*

##### **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.

Because the equity method of accounting is a cost accumulation model, the amount recognized for the contingent consideration is a component of its cost basis in the investment acquired. Contingent consideration is only included in the initial measurement of an equity method investment if it is required to be recognized by authoritative guidance other than ASC 805 (e.g., ASC 815, ASC 610-20).

For example, if a contingent consideration arrangement is accounted for as a derivative under ASC 815, the arrangement would be initially recognized at fair value and recorded as part of the cost basis in the investment acquired. Subsequent changes in the fair value of the derivative are recorded in the income statement. Payments made after the inception of the arrangement with respect to the derivative would not be included in the cost of the investment, but rather represent settlements of the derivative asset or liability. See our FRD, *Derivatives and hedging*, for more information on the accounting for derivatives.

If the contingent consideration is not required to be recognized by authoritative guidance other than ASC 805 or as discussed in section 5.5.1, the contingent consideration arrangement is recognized only when the contingency is resolved and the consideration is paid or becomes payable. The consideration paid would then be included in the cost of the equity method investment.

#### **Illustration 5-5: Contingent consideration arrangement in an equity method investment**

##### **Example 1 – Contingent consideration accounted for as a derivative**

An investor acquires a 20% interest in the voting stock of an investee for \$80 in cash and a contingent consideration arrangement meeting the definition of a derivative (for which no scope exceptions apply) with a fair value of \$2. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and therefore accounts for the investment using the equity method. At the date of acquisition, the investor would record a total initial cost of the investment of \$82.

Subsequently, the derivative would be accounted for according to ASC 815, and changes in the fair value of the derivative are not included in the cost of the equity method investment.

##### **Example 2 – Contingent consideration not accounted for as a derivative**

An investor acquires a 20% interest in the voting stock of an investee for \$80. Contingent consideration of \$10 may become payable depending on whether the investee obtains a future earnings target. The contingent consideration is not accounted for as a derivative under ASC 815 (it meets the revenue scope exception in ASC 815-10-15-59(d)<sup>22</sup>) and is not required to be recognized by authoritative guidance other than ASC 805. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and therefore applies the equity method.

<sup>22</sup> ASC 815-10-15-59(d) states that contracts that are not exchange-traded are not subject to the requirements of ASC 815 if the underlying on which the settlement is based is a specified volume of sales or service revenues of one of the parties to the contract. See section 2.5.5.3 of our FRD, *Derivatives and hedging*, for further information about this scope exception as we believe the scope exception has broader application than just the specific volumes of sales or service revenues of one of the parties to the contract.



At the date of acquisition, the investor would record a total initial cost of the investment of \$80.

Subsequently, the contingency is resolved, and \$10 becomes payable. The investor would record an increase in the cost basis of its equity method investment for the additional consideration of \$10.

## 5.4

### Equity method basis differences

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **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.

When an entity makes an investment that qualifies for the equity method of accounting, there may be a difference in the cost basis of the investment and the proportional interest in the underlying equity in the net assets of the investee – often referred to as a basis difference. An investor accounts for basis differences as if the investee were a consolidated subsidiary. However, the equity method investment would be presented as a single line item in the investor’s balance sheet.

The investor should determine the acquisition date fair value of the identifiable assets and assumed liabilities in the same manner as for a business combination in accordance with ASC 805. For example, this would include identifying any previously unrecognized identifiable intangible assets that were acquired, as well as fair value adjustments to the measurement of inventory, debt and other assets and liabilities. The resulting fair values are compared with the assets and liabilities recorded in the investee’s financial statements; the resulting differences are considered basis differences. While most assets and liabilities would be measured at fair value, certain exceptions related to recognition and measurement of assets and liabilities are described within ASC 805. See section 4 of our FRD, *Business combinations*, for guidance on the recognition and measurement exceptions in a business combination.

Any excess cost of the investment over the proportional fair value of the assets acquired and liabilities assumed of the investee is recognized as goodwill, commonly referred to as “equity method goodwill.”<sup>23</sup> However, an investor cannot arbitrarily assign the basis difference to goodwill. The investor first appropriately identifies all identifiable assets and assumed liabilities, and determines the fair value of all the underlying assets and liabilities of the investee.

<sup>23</sup> See section 5.4.1 for additional discussion. Equity method goodwill should only be recognized if the investee is a business, as defined in ASC 805.

Basis differences should be tracked because they will affect the measurement of the investor's share of investee income in subsequent periods. The tracking of identified basis differences is often referred to as the "memo" accounts. Since the investment is reflected in a one-line presentation in the balance sheet, "memo" accounts serve as a subsidiary ledger to the equity method investments. While these basis differences are tracked in the "memo" accounts, the unit of account for the equity method investment remains the investment as a whole.

Basis differences are important, because when an investor records its equity method earnings, the entity reflects not only its portion of earnings of the investee, but also any effects of the basis differences related to identified assets or assumed liabilities (e.g., depreciation, amortization, revenue). See section 6.2.2 for additional guidance.

The acquisition date fair values of the assets acquired and liabilities assumed in an equity method investment and any resulting "memo" accounting are determined for any additional increases in the proportional interest in the investment in the investee, while the investor retains the ability to exercise significant influence over, but not control, the investee. This type of transaction is sometimes referred to as a "step acquisition."

See section 6.2.6.2 for guidance on applying accounting alternatives available to private companies. See section 6.2.5 for additional guidance when that fact pattern occurs.

#### **Illustration 5-6: Equity method investment basis differences**

##### Assumptions:

- ▶ Investor A purchases 40% of the common stock of Investee B on 1 January 20X1 for \$1,000,000 in cash. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and therefore applies the equity method. Investee B meets the definition of a business.
- ▶ The net assets recorded in the financial statements of Investee B on 1 January 20X1 are as follows:
 

Cash	\$ 100,000
Other current assets	250,000
Plant and equipment	1,000,000
Accounts payable	(100,000)
Other current liabilities	<u>(200,000)</u>
Net assets	<u>\$ 1,050,000</u>
Investor A's 40% share	<u>\$ 420,000</u>
- ▶ Investor A determines that the fair value of the plant and equipment on 1 January 20X1 is \$1,800,000. The plant and equipment have a remaining life of 10 years.
- ▶ Investor A determines that Investee B has internally developed trade names. These trade names are considered definite-lived intangible assets with a fair value of \$500,000 and a useful life of 20 years. As the trade names have been internally developed, the intangible assets have not been recorded on the financial statements of Investee B.
- ▶ The book value of the other current assets, accounts payable and other current liabilities approximates fair value.
- ▶ Intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

The following worksheet illustrates how the \$580,000 difference between Investor A's cost basis of \$1,000,000 and its basis in the underlying equity in net assets of Investee B of \$420,000 would be assigned on the date of investment.

	<b>Investee B book value</b>	<b>Investor A's 40% share of Investee B's book value</b>	<b>Fair value of Investee B's net assets on 1 January 20X1</b>	<b>Equity method basis difference (difference between book value and fair value)</b>	<b>Investor A's 40% of equity method basis difference</b>
Cash	\$ 100,000	\$ 40,000	\$ 100,000	\$ -	\$ -
Other current assets	250,000	100,000	250,000	-	-
Plant and equipment	1,000,000	400,000	1,800,000	800,000	320,000
Intangible assets	-	-	500,000	500,000	200,000
Goodwill	-	-	N/A	-	60,000
Accounts payable	(100,000)	(40,000)	(100,000)	-	-
Other current liabilities	<u>(200,000)</u>	<u>(80,000)</u>	<u>(200,000)</u>	<u>-</u>	<u>-</u>
	<u>\$ 1,050,000</u>	<u>\$ 420,000</u>	<u>\$ 2,350,000</u>	<u>\$ -</u>	<u>\$ 580,000</u>

Investor A records the 40% investment in Investee B of \$1,000,000 (\$420,000 + \$580,000) on its books. The basis differences are accounted for as part of the "memo" accounting entries by Investor A. See section 6.2.2 for a discussion of the depreciation and amortization that would be recorded related to the basis differences.

### Question 5.1

**Is an investor's equity method accounting affected when an investee is subsequently acquired by a third party in a business combination and the investee (acquiree) applies pushdown accounting in connection with the change in control event, assuming there is no change in the investor's ownership interest in the investee?**

No. An investor's equity method accounting is not affected when its ownership interest in the investee remains unchanged. However, since the financial statements of the investee reflect a new basis as a result of applying pushdown accounting, the investor will need to consider further adjustments when recording its share of equity method earnings or losses of the investee. For example, an increase in the value of fixed assets (and corresponding depreciation expense) as a result of pushdown accounting should not result in the investor recognizing a greater amount of depreciation expense than it would have otherwise, had pushdown accounting not been applied. Accordingly, the application of pushdown accounting should not affect the amount of earnings or losses recognized by the investor.

However, if an investor's ownership interest in an investee increased in conjunction with such a transaction, an investor would identify new basis differences for its additional investment as discussed in section 6.9.

## 5.4.1 Equity method goodwill

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **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.

#### Intangibles – Goodwill and Other – Goodwill

##### *Subsequent Measurement*

##### **350-20-35-58**

The portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee that is recognized as goodwill in accordance with paragraph 323-10-35-13 (equity method goodwill) shall not be amortized.

When an investee meets the definition of a business, any excess of the cost of the investment over the proportional fair value of the assets and liabilities of the investee is reflected in the "memo" accounts as goodwill, commonly referred to as "equity method goodwill." The SEC staff has encouraged registrants to ensure that the purchase price allocation appropriately reflects stepped-up values for tangible assets, identifiable intangible assets and not only allocated to goodwill.<sup>24</sup> Basis differences are only assigned to equity method goodwill if the investee is a business, as defined in ASC 805.

The purchase price assigned to the investor's share of the underlying net assets and liabilities of the investee, including any equity method goodwill, is included within the equity method investment as a single amount in the investor's balance sheet. In accordance with ASC 350-20-35-39, equity method goodwill is not amortized and is not tested for impairment under ASC 350. Instead, equity method investments are reviewed for impairment and a loss in value of an equity method investment that is other-than-temporary should be recognized. See section 6.8 for more discussion on the assessment that should be applied to the equity method investment as whole.

See section 2 of our FRD, *Business combinations*, for more guidance on the definition of a business. See section 6.2.6.2 for guidance on applying accounting alternatives available for private companies.

## 5.4.2 Deferred taxes on basis differences

### *Outside basis differences*

A basis difference between the carrying amount of an equity method investment in the financial statements and the tax basis of that investment creates a temporary difference for which deferred taxes are recorded (this is often referred to as an "outside basis difference"). This can occur at acquisition date and during step acquisitions. See section 14 of our FRD, *Income taxes*, for further discussion.

<sup>24</sup> Statement made by D. Douglas Alkema, Professional Accounting Fellow at the SEC, 11 December 2003, at the 2003 Thirty-first AICPA National Conference on Current SEC Developments.

### Inside basis differences

The financial statements of an investee should already reflect any deferred tax assets and liabilities for temporary differences between the investee's carrying amounts of its pretax assets and liabilities and their tax bases (inside basis differences of the investee).

The investor also identifies differences between the cost of an equity method investment and its proportionate interest in the assets and liabilities of the investee (referred to as "equity method basis differences"). See section 5.4 for further discussion. The investor should identify deferred tax consequences of the equity method basis differences as well. The investor should not consider whether deferred tax assets associated with the equity method basis differences are more likely than not to be realized, because the deferred tax assets are not separately recognized in the investor's financial statements.

#### Illustration 5-7: Equity method investment deferred taxes on basis differences

Assume the same fact pattern as Illustration 5-6

The effective tax rate for both the investor and the investee is 21%. The investee is a C-corporation.

- ▶ The tax basis of the assets and liabilities equals the book value in Investee B's financial statements, so Investee B does not record any deferred tax assets or liabilities in its own financial statements.
- ▶ Assume that there is no outside basis difference related to Investor A's interest in Investee B. That is, the carrying amount of Investor A's equity method investment in Investee B is the same for financial statement and tax purposes.

The following worksheet illustrates how the \$580,000 difference between Investor A's cost of \$1,000,000 and its share in the underlying equity in net assets of Investee B of \$420,000 would be assigned on the date of investment.

	Investee B book value	Investor A's 40% share of Investee B's book value	Fair value of Investee B's net assets on 1 January 20X1	Equity method basis difference (difference between book value and fair value)	Investor A's 40% of equity method basis difference
Cash	\$ 100,000	\$ 40,000	\$ 100,000	\$ -	\$ -
Other current assets	250,000	100,000	250,000	-	-
Plant and equipment	1,000,000	400,000	1,800,000	800,000	320,000
Intangible assets	-	-	500,000	500,000	200,000
Goodwill	-	-	N/A	-	169,200
Accounts payable	(100,000)	(40,000)	(100,000)	-	-
Other current liabilities	(200,000)	(80,000)	(200,000)	-	-
Deferred tax liability <sup>(a)</sup>	-	-	-	(273,000)	(109,200)
	<u>\$ 1,050,000</u>	<u>\$ 420,000</u>	<u>\$ 2,350,000</u>	<u>\$ 1,027,000</u>	<u>\$ 580,000</u>

<sup>(a)</sup> As a result of the basis differences identified, Investor A recognizes as part of its "memo" accounting a deferred tax liability of \$109,200. This amount is calculated as the sum of each of Investor A's 40% share of the pretax equity method basis differences multiplied by the effective tax rate of 21%. This entity has treated the equity method goodwill as if it were goodwill acquired in a business combination and therefore has not established a deferred tax liability for this basis difference.

	Investor A's 40% of equity method basis difference (from above)	Effective tax rate	Deferred tax liability
Plant and equipment deferred tax liability	\$ 320,000	21%	\$ 67,200
Intangible assets deferred tax liability	<u>200,000</u>	21%	<u>42,000</u>
Total deferred tax liability	<u>\$ 520,000</u>		<u>\$ 109,200</u>

Investor A records the 40% investment in Investee B of \$1,000,000 (\$420,000 + \$580,000) on its books. Because there is no outside basis difference, there is no separate entry to record deferred taxes in the financial statements of Investor A.

### 5.4.3 Accumulated other comprehensive income considerations

An investee may have assets (or liabilities) that are accounted for with changes recorded in accumulated other comprehensive income (AOCI). For example, the investee may have investments in available-for-sale debt securities, derivative instruments designated in hedging relationships or pension and/or other post-employment benefits that are recorded through the investee's other comprehensive income (loss).

When an investor makes an investment in an entity that qualifies for equity method accounting, the investor determines the acquisition date fair value of the identifiable assets and assumed liabilities (subject to the same recognition and measurement differences in ASC 805). Therefore, in the investor's memo accounts, the investor would not recognize any amounts in AOCI, even if such amounts are recorded in the investee's financial statements. This may create additional basis differences in the assets acquired and liabilities assumed. As a result, subsequent changes in the investee's AOCI will need to be tracked to account for these basis differences.

Even though the identification of basis differences for an equity method investment generally follows the same process as described in ASC 805, we believe that an investor would not re-assess prior classifications or designations of derivative instruments in hedging relationships in connection with acquiring an equity method investment. This is because, unlike in a business combination in which an acquirer has control over the acquiree and therefore the ability to make such designations, an investor with significant influence or joint control will likely not have the ability to designate derivative instruments in effective hedging relationships.

### 5.4.4 In-process research and development (IPR&D)

Upon acquisition, an investor may identify a basis difference related to IPR&D, for example, related to formulae and designs of an IPR&D project of the investee. The accounting depends on whether the investee meets the definition of a business.

If the investee meets the definition of a business, the investor would identify and measure the basis difference in the IPR&D intangible asset, consistent with the guidance in ASC 805 which requires IPR&D intangible assets to be recognized and measured at fair value when acquired in a business combination.

However, if the investee does not meet the definition of a business, the investor applies the guidance in ASC 730, which requires that both tangible and intangible identifiable research and development assets with no alternative future use be allocated a portion of the investment. We believe this amount would be charged to expense at the investment date. That is, we believe the investor would immediately expense the basis difference related to IPR&D upon acquisition. Conversely, we believe tangible and intangible identifiable IPR&D assets with an alternative future use would initially be allocated a portion of the cost basis of the investment in the equity method memo accounts as a basis difference. See section 6.2.2 for more guidance on the subsequent accounting effects of basis differences on equity method earnings.

See the Master Glossary in ASC 730 and sections 4.2.6.1.3 and A.3.1.1.2 of our FRD, *Business combinations*, for more guidance on the definition of and accounting for IPR&D in a business combination and in an asset acquisition, respectively. See section 2 of our FRD, *Business combinations*, for more guidance on the definition of a business.

#### **Illustration 5-8: Investee with IPR&D that does not meet the definition of a business**

An investor acquires a 20% interest in the voting common stock of an investee for \$20. The investor accounts for the investment under the equity method and determines the investee does **not** meet the definition of a business.

Excluding IPR&D, the investee has no other net assets or liabilities. The investor estimates the fair value of the IPR&D to be \$100 at the date of the investment, and concludes that the IPR&D has no alternative future use.

Within the memo accounts, the investor allocates the \$20 cost basis of its investment entirely to IPR&D (20% x \$100 fair value of the IPR&D). However, since the investee is not a business and the IPR&D does not have an alternative future use, we believe the investor should recognize an expense for the \$20 basis difference attributable to IPR&D.

## 5.5 Bargain purchase

In rare circumstances, an investor's investment in an equity method investee (i.e., the fair value of consideration transferred) may be less than the fair value of the identifiable net assets acquired. Such a transaction results in an economic gain to the investor and is referred to as a bargain purchase.

ASC 323 does not specifically address a bargain purchase associated with an equity method investment.<sup>25</sup> Two approaches that are seen in practice are the bargain purchase gain approach and the negative basis difference approach. An investor should apply a selected accounting policy consistently.

Under both approaches, the investor needs to account for the subsequent effects of basis differences, whether positive or negative, on equity method earnings, as described in section 6.2.2.

### *Bargain purchase gain approach*

One approach is to recognize a bargain purchase gain if the equity method investee is a business (as defined in ASC 805). See section 2 in our FRD, *Business combinations*, for more guidance on the definition of a business.

We believe gain treatment is acceptable because ASC 323-10-35-13 requires the difference between the cost of an investment and the underlying equity in net assets of an investee to be accounted for as if the investee were a consolidated subsidiary. Under this approach, any excess fair value of the identifiable net assets over the cost of the equity method investment would be recognized as a bargain purchase gain in earnings on the investment date, consistent with the accounting for bargain purchases in business combinations as discussed in ASC 805-30-25-2.

However, bargain purchases should be rare. Therefore, before recognizing a gain on a bargain purchase, the investor should carefully reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed as part of the equity method investment, to validate that all identifiable assets or liabilities are properly recognized. In addition, the investor should reconsider and challenge all valuations to verify that the consideration paid and identifiable net assets are properly measured. See section 7.2 in our FRD, *Business combinations*, for additional guidance on factors to consider in the reassessment, which we believe would also apply to the acquisition of an equity method investment.

Because bargain purchases are rare, we believe that an important aspect of the reassessment is for the investor to understand why there is a bargain purchase – why the seller would be willing to sell an interest in the investee at an amount less than what a market participant would be willing to pay. Usually, a seller acts in an economically rational manner given the fiduciary responsibility that it has to its shareholders. Examples of factors that may justify a bargain purchase gain, individually or in aggregate, include the following:

- ▶ The transaction was a “forced” or “distressed” sale. Bargain purchases are most common when there is a “forced” or “distressed” sale.
- ▶ The seller was required to sell the noncontrolling interest in a less than an optimal period of time.

<sup>25</sup> This topic also was discussed as part of EITF Issue 08-6, but the EITF did not reach a consensus.

- ▶ The transaction was not subject to a competitive bidding process. Transactions subject to a competitive bidding process generally are less likely to result in a bargain purchase gain because the noncontrolling interest typically would be sold at fair value.

Investors should consider these factors when disclosing the reasons for the bargain purchase in the notes to their financial statements. See section 8.3 for further discussion.

If, after completing that reassessment, a gain is recognized from a bargain purchase, no goodwill is recognized in the “memo” accounts on that purchase. The assets acquired and liabilities assumed are recognized in the “memo” accounts at fair value. There is no residual to measure because the consideration transferred is less than the fair value of the identifiable net assets of the investee. See Illustration 5-9 for an example of this approach.

#### **Negative basis difference approach**

Another acceptable approach is to allocate the negative basis difference in the memo accounts on a relative fair value basis to all qualifying assets of the investee, including identifiable intangible assets and other long-lived assets. Proponents of this approach observe that it is consistent with a cost accumulation model; it is inconsistent to recognize the investment at an amount other than cost (and the resulting gain). This approach results in the investor recognizing such assets at less than their fair value in its memo accounts. That is, the investor first recognizes an investee's non-qualifying assets<sup>26</sup> at fair value (unless other GAAP prescribes another measurement basis) in its memo accounts, then it allocates the excess cost of the investment to reduce the investee's qualifying assets based on their fair value relative to the total fair value of all qualifying assets. This approach is consistent with that used in an asset acquisition. See section A.4.2 in our FRD, *Business combinations*, for additional guidance.

#### **Illustration 5-9: Bargain purchase gain in equity method investment**

Assume the same facts as in Illustration 5-7, except that Investor A purchases 40% of the common stock of Investee B on 1 January 20X1 for \$750,000 cash. The following worksheet illustrates how Investor A would determine the basis differences.

	<b>Investee B book value</b>	<b>Investor A's 40% share of Investee B's book value</b>	<b>Fair value of Investee B's net assets on 1 January 20X1</b>	<b>Equity method basis difference (difference between book value and fair value)</b>	<b>Investor A's 40% of equity method basis difference</b>
Cash	\$ 100,000	\$ 40,000	\$ 100,000	\$ -	\$ -
Other current assets	250,000	100,000	250,000	-	-
Plant and equipment	1,000,000	400,000	1,800,000	800,000	320,000
Intangible assets	-	-	500,000	500,000	200,000
Accounts payable	(100,000)	(40,000)	(100,000)	-	-
Other current liabilities	(200,000)	(80,000)	(200,000)	-	-
Deferred tax liability <sup>(a)</sup>	-	-	-	(273,000)	(109,200)
	<u>\$ 1,050,000</u>	<u>\$ 420,000</u>	<u>\$ 2,350,000</u>	<u>\$ 1,027,000</u>	<u>\$ 410,800</u>

<sup>(a)</sup> As a result of the basis differences identified, Investor A recognizes as part of its “memo” accounting a deferred tax liability of \$109,200. This amount is calculated as the sum of each of Investor A's 40% share of the pretax equity method basis differences multiplied by the effective tax rate of 21%.

<sup>26</sup> Section A.4.1 of our FRD, *Business combinations*, provides guidance on non-qualifying assets.



Investor A's 40% share of the identifiable net assets of Investee B of \$830,800 (\$420,000 + \$410,800) exceeds the consideration paid of \$750,000. Therefore, Investor A reassesses whether it has correctly identified all of the assets acquired and all of the liabilities assumed as part of its equity method investment in Investee B. In addition, Investor A reconsiders and challenges all valuations to verify that the consideration paid, assets acquired, and liabilities assumed are properly measured.

Investor A completes the reassessment and does not identify any changes. Investor A records the 40% investment in Investee B at \$830,800. The basis differences are accounted for as part of the "memo" accounting entries by Investor A. In addition, Investor A would record a gain on bargain purchase for the equity method investment of \$80,800 (\$830,800 – \$750,000). That is, the investor would recognize the following entry:

Investment	\$ 830,800	
Cash		\$ 750,000
Gain on bargain purchase of equity method investment		80,800

### 5.5.1

## Contingent consideration associated with a bargain purchase

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Recognition*

##### **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.

##### *Initial Measurement*

##### **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:

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

##### *Subsequent Measurement*

##### **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.

When the initial cost of an equity method investment is less than the fair value of the net assets of the investee and the acquisition includes contingent consideration, a liability is recognized for the contingent consideration. The liability is measured at the lesser of the maximum amount of contingent consideration not initially recognized or the excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

When the contingency is resolved and the consideration is issued or becomes issuable, any difference between the fair value of the contingent consideration issued or issuable and the liability is recognized as an adjustment to the cost of the investment. See section 5.3 where we discuss how this accounting differs from the subsequent measurement of contingent consideration issued in a business combination.

**Illustration 5-10: Contingent consideration arrangement in an equity method investment with a bargain purchase**

At the date of an equity method investment, the fair value of the investor's share of the investee's net assets is \$80, the cash consideration paid is \$70. Additional contingent consideration of \$15 is payable if future earnings targets are reached. At the date the equity method investment is acquired, the contingent consideration is not resolved or considered payable. Therefore, before applying the guidance with respect to contingent consideration, the \$15 would not be recognized.

At the date the equity method investment is acquired, the fair value of the investor's share of the investee's net assets of \$80 exceeds the initial cost of \$70 by \$10. Therefore, the investor also would record a liability for the contingent consideration. The liability recorded is \$10, which is the lesser of (1) the maximum amount of contingent consideration not initially recognized of \$15 and (2) the excess of the fair value of the investor's share of the investee's net assets of \$80 over the initial cost of \$70. Therefore, the initial cost of the equity method investment is \$80 (\$70 + \$10).

When the contingency is resolved, any difference (increase or decrease) between the liability recorded and the fair value of the contingent consideration issued or issuable should be recorded as an adjustment to the investment (e.g., an increase of up to \$5 or a decrease of up to \$10).

## 5.6 Changing to the equity method of accounting

An investor may obtain the ability to exercise significant influence over an investment that was previously accounted for as a financial asset (see section 5.6.1). Alternatively, it may lose control over an entity that was previously consolidated but retains an equity method investment (see section 5.2.3).

### 5.6.1 Change from financial asset to equity method (updated July 2023)

**Excerpt from Accounting Standards Codification**

**Investments – Equity Method and Joint Ventures – Overall**

*Subsequent Measurement*

**323-10-35-33**

Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. The current basis of the investor's previously held interest in the investee shall be remeasured in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable, immediately before adopting the equity method of accounting. For purposes of applying paragraph 321-10-35-2 to the investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or a similar investment of the same issuer that results in it applying Topic 323, the entity shall remeasure its previously held interest at fair value immediately before applying Topic 323.

The assessment of whether the equity method of accounting is required is made throughout the life of the investment. An investor may have an investment that was accounted for as a financial asset and subsequent transactions may occur that result in the investment being accounted for as an equity method investment. For example, the investor may acquire additional voting stock of the investee, the investee may buy back shares held by other investors, or other transactions may occur. The assessment of whether an investor applies the equity method is based not only on changes in the investor's ownership percentage, but also on changes that provide the investor with the ability to exercise significant influence over the operational and financial policies of the investee or joint control over the investee.

When an investment initially qualifies for equity method accounting, ASC 323-10-35-33 requires the investor to apply the equity method prospectively from the date the investment qualifies for the equity method. The investor will add the carrying value of the existing investment to the cost of the additional investment to determine the initial cost basis of the equity method investment.

Entities generally measure equity investments within the scope of ASC 321 at fair value and recognize any changes in fair value in net income. However, entities may elect a measurement alternative for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient in ASC 820 to estimate fair value using the NAV per share. Under the alternative, they measure these investments at cost less any impairment. If there are observable price changes in orderly transactions for an identical or similar investment of the same issuer (i.e., an observable transaction), an entity must remeasure its equity investment at fair value in accordance with ASC 820.

ASC 323-10-35-33 states that an entity that applies the measurement alternative in ASC 321 should consider all observable transactions, including those that require it to apply or discontinue the equity method. If a transaction occurs that results in the investment being accounted for as an equity method investment, the entity determines whether the transaction represents an observable transaction. If it is, the entity must remeasure the previously held investment to fair value in accordance with ASC 820 and add the remeasured amount to the cost of the additional investment to determine the initial cost basis of the equity method investment. See section 3.6.2 of our FRD, [Certain investments in debt and equity securities](#), for more information.

The carrying amount of an equity method investment may differ from the proportional interest in the assets and liabilities of the investee when the investment qualifies for the equity method. An investor is required to identify and allocate basis differences on the date the investment initially qualifies for equity method accounting based on the overall interest in the investee (i.e., interest previously held and new interest acquired, if any). See section 5.4 for further discussion.

#### **Illustration 5-11: Changing to the equity method of accounting**

##### **Example 1 – Change from financial asset that has a readily determinable fair value to equity method**

Investor A acquires 15% of the common stock of Investee B on 1 January 20X1 for \$1,250. The common stock of Investee B has a readily determinable fair value, so Investor A measures it at fair value with unrealized gains and losses recognized in earnings. The fair value of Investor A's investment in the common stock of Investee B was \$1,800 on 31 December 20X1. As a result, Investor A recognized \$550 of unrealized gains in earnings for the year ended 31 December 20X1.

Investor A acquires an additional 5% of Investee B's common stock on 1 February 20X2 for \$750, resulting in a total 20% interest. Investor A determines that it has the ability to exercise significant influence over Investee B. The fair value of Investor A's existing 15% investment on 1 February 20X2 is \$2,250.

Investor A (1) remeasures its investment to its fair value and (2) derecognizes the investment and recognizes an equity method investment for the total of the new carrying value of the investment (the fair value as measured in step 1), plus the cash paid. Investor A records the following journal entries on 1 February 20X2:

Investment in B	\$ 450	
Earnings		\$ 450
(Fair value of 15% investment is \$2,250, less previous carrying amount of \$1,800)		
Equity method investment in B	\$ 3,000	
Investment in B		\$ 2,250
Cash		750

**Example 2 – Change from financial asset that does not have a readily determinable fair value to equity method**

Assume the same facts as in Example 1, except that the common stock of Investee B does not have a readily determinable fair value. Accordingly, for the year ended 31 December 20X1, Investor A applied the measurement alternative when accounting for its investment in the common stock of Investee B.

When Investor A acquires an additional 5% of Investee B's common stock on 1 February 20X2 and determines that it has the ability to exercise significant influence over Investee B, Investor A would need to determine, based on the facts and circumstances, whether that transaction represents an observable price change in an orderly transaction for an identical or similar investment in Investee B (i.e., an observable transaction).

If it determines that the transaction is an observable transaction, Investor A would remeasure its existing 15% investment to fair value in accordance with ASC 820 and add the cost of the new investment (\$750) to the remeasured amount of its investment in Investee B.

If Investor A determines that the transaction is not an observable transaction, Investor A would add the cost of the new investment (\$750) to the carrying amount of its investment in Investee B.

In both cases, the total amount would become the new initial measurement of the equity method investment in Investee B (assuming there is no impairment).

# 6 Subsequent measurement

## 6.1 Overview

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Other Presentation Matters*

##### **323-10-45-1**

Under the equity method, an investment in **common stock** shall be shown in the balance sheet of an **investor** as a single amount. Likewise, an investor's share of earnings or losses from its investment shall be shown in its income statement as a single amount.

##### **323-10-45-2**

The investor's share of accounting changes reported in the financial statements of the **investee** shall be classified separately.

After initial measurement, the carrying amount of an equity method investment is increased to reflect the investor's share of income of the investee and is reduced to reflect the investor's share of losses of the investee, dividends received and other-than-temporary impairments (see section 6.8). The investor's share of earnings or losses should be based on the shares of *common stock* and in-substance common stock held by the investor and should be adjusted for the effects of basis differences. If the investee has outstanding cumulative preferred stock, the investor should compute its share of earnings or losses after deducting the investee's preferred dividends, regardless of whether such dividends are declared, as discussed in section 6.2.

The investor's share of income is also adjusted for the effects of intra-entity profit and losses (see section 6.2.1) and capital transactions (see section 6.10.3). Subsequent changes to basis differences will result in adjustments to the investor's share of income or losses of the investee, as discussed in section 6.2.2.

When the investor provides other financial support, such as loans, loan guarantees or preferred stock, investee losses may need to be recorded even after the common stock (or in-substance equivalent) investment has been reduced to zero. Equity method investments are assessed for other-than-temporary impairment, as discussed in section 6.4.

An investor's share of earnings or losses from its investment is ordinarily presented in its income statement as a single amount. In addition, the investor records its proportionate share of other comprehensive income as increases or decreases to the investment account. An exception to this treatment relates to the reporting of an investor's share of accounting changes reported in the financial statements of the investee, which are recorded by an investor and presented separately, if material.

An investor might hold an investment in an investee that has a contractual arrangement for which the allocation ratio differs from the investor's ownership interest. If substantive, the contractual arrangement is used for recognizing the investor's share of earnings or losses of the investee. See section 6.7 for additional guidance.

This section discusses these topics, as well as other considerations related to the subsequent measurement of an equity method investment. Unless specified, references to equity method investments and investors also include joint ventures and venturers, respectively, throughout this section.

## 6.2 Earnings or losses of an investee

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-4**

Under the equity method, an investor shall recognize its share of the **earnings or losses of an investee** in the periods for which they are reported by the investee in its financial statements rather than in the period in which an investee declares a dividend. An investor shall adjust the carrying amount of an investment for its share of the earnings or losses of the investee after the date of investment and shall report the recognized earnings or losses in income. An investor's share of the earnings or losses of an investee shall be based on the shares of common stock and in-substance common stock held by that investor. (See paragraphs 323-10-15-13 through 15-19 for guidance on identifying in-substance common stock. Subsequent references in this Section to common stock refer to both common stock and in-substance common stock.)

##### **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:

- a. Intra-entity profits and losses. Adjustments to eliminate intra-entity profits and losses.
- b. Basis differences. Adjustments to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment.
- c. Investee capital transactions. Adjustments to reflect the investor's share of changes in the investee's capital.
- d. Other comprehensive income.

##### **323-10-35-16**

If an investee has outstanding cumulative preferred stock, an investor shall compute its share of earnings (losses) after deducting the investee's preferred **dividends**, whether or not such dividends are declared.

#### Real Estate – Investments – Equity Method and Joint Ventures

##### *Subsequent Measurement*

##### **970-323-35-2**

Investors shall record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles (GAAP), without regard to unrealized increases in the estimated fair value of the venture's assets.

Once an investor has determined it will apply the equity method of accounting to its investment, the investor will recognize its share of the investee's earnings or losses in subsequent periods. Typically, the investor will begin the calculation by multiplying the proportion of the investee's common stock and in-substance common stock it holds, usually stated as a percentage, by the net income or loss of the investee for each interim and annual reporting period. The investor then adjusts its share of the investee's earnings for intra-entity transactions, basis differences, investee capital transactions and other comprehensive income.

An investor should not include the effects of any outstanding warrants, options, conversion rights or other instruments (unless the instruments represent in-substance common stock, as discussed in section 2) when calculating its proportion of common stock held. These instruments are only included in calculating the proportion of common stock held once exercised or converted. An investor should disclose the existence of such instruments and consider the impact when calculating its earnings per share. See section 6 of our FRD, *Earnings per share*, for additional guidance.

In addition, if the investee has outstanding cumulative preferred stock, the investor computes its share of earnings or losses after deducting the investee's preferred dividends (whether or not such dividends are declared). Similarly, we believe an investor also would adjust the net income or loss of an investee to include accretion of preferred stock that is classified in temporary equity in the investee's financial statements when calculating its share of the investee's earnings or losses.

#### **Illustration 6-1: Calculating an investor's earnings of an equity method investee**

##### **Example 1 – Investee has one class of stock**

Investor A acquired a 25% interest (250 shares out of 1,000 shares) in the voting common shares of Investee B for \$1,000. Based on this investment, Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method.

Assume there are no intra-entity transactions, basis differences, effect of income taxes or other comprehensive income transactions. The net income of Investee B is \$400.

Investor A would calculate its share of the earnings of Investee B based on its investment in the voting common stock of Investee B. Investor A's earnings with respect to Investee B are \$100 (25% of \$400). The carrying amount of the investment would be \$1,100 (\$1,000 original investment + \$100, which represents Investor A's share of earnings in Investee B).

##### **Example 2 – Investee has common and preferred stock**

Investor A acquired a 25% interest (250 shares out of 1,000 shares) in the voting common shares of Investee B for \$1,000. Investee B has also issued non-voting cumulative preferred stock to other investors that entitles those investors to receive dividends at a rate of 10% annually. Based on Investor A's investment in the voting common stock of Investee B, Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method.

Assume there are no intra-entity transactions, basis differences, effect of income taxes or other comprehensive income transactions. The net income of Investee B is \$900. Preferred dividends for the year would be \$100.

Investor A would calculate its share of the earnings of Investee B based on its investment in the voting common stock of Investee B, after deducting the cumulative preferred dividends that would be due to other investors. Investor A's earnings with respect to Investee B would be \$200 (25% of (\$900-\$100)). The carrying amount of the investment would be \$1,200 (\$1,000 original investment + \$200, which represents Investor A's share of earnings in Investee B).

## 6.2.1 Elimination of intra-entity profits

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **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.

##### **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.

##### **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.

##### **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.



**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).

**Real Estate – Investments – Equity Method and Joint Ventures*****Initial Measurement*****970-323-30-7**

An investor shall not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit shall be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction shall be recorded as a reduction in the carrying amount of the capitalized cost.

***Subsequent Measurement*****970-323-35-14**

Intra-entity profit shall be eliminated by the investor in relation to the investor's **noncontrolling interest** in the investee, unless one of the exceptions in paragraph 323-10-35-7 applies. An investor that controls the investee and enters into a transaction with the investee shall eliminate all of the interentity profit on assets remaining within the group. (See Subsection 323-30-35 for accounting guidance concerning partnership ownership interest.)

**970-323-35-15**

A sale of property in which the seller holds or acquires a noncontrolling interest in the buyer shall be evaluated in accordance with the guidance in paragraphs 360-10-40-3A through 40-3B. No profit shall be recognized if the seller controls the buyer.

ASC 323 provides guidance about the elimination of intra-entity profits and losses on transactions between an investor and investee. The accounting depends on several factors, including the nature of the transaction, the derecognition guidance that is applied, whether it's an upstream or downstream transaction and whether the intra-entity profits and losses have been realized by the investor or investee in transactions with third parties (e.g., the inventory or equipment involved in the transaction remains on the books of either party). The accounting also depends on whether the transaction is at arm's length.

Any elimination of intra-entity profit may be reflected in the investor's balance sheet in various ways. The income statement and balance sheet presentation will depend on what is most meaningful based on the circumstances. Those circumstances may include whether the activity is upstream or downstream. We believe investors should disclose where any elimination of intra-entity profits and losses is presented (e.g., as a reduction of the equity method investment, as equity method earnings or in other line items in the financial statements).

***Determining the derecognition guidance to apply and how much profit to eliminate***

The decision tree in Illustration 5-3 in section 5.2.3 summarizes the appropriate derecognition guidance to apply. See section 2.1 of our FRD, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*** for additional guidance. See our FRD, ***Consolidation***, and our FRD, ***Transfers and servicing of financial assets***, for additional guidance on ASC 810 and ASC 860, respectively.

After the investor determines which derecognition guidance to apply, it evaluates whether one of the following three exceptions to profit elimination applies.<sup>27</sup> Profit is not eliminated if the transaction with an investee is at arm's length and includes any of the following:

- ▶ A deconsolidation of a business, a subsidiary or a group of assets in the scope of ASC 810-10-40-3A through 40-5 in a downstream transaction (see section 19 of our FRD, ***Consolidation***, for additional guidance)
- ▶ A downstream transaction in the scope of ASC 810-10-45-21A through 45-24<sup>28</sup> in which the investor's ownership interest in a subsidiary changes but it retains control of the subsidiary (see section 18 of our FRD, ***Consolidation***, for additional guidance)
- ▶ A derecognition of a nonfinancial asset in the scope of ASC 610-20 in a downstream sale

Intra-entity profit is not eliminated for an arm's-length transaction between an investor and an investee that does not result in an asset that remains on the books of either party.

Determining whether a counterparty is a customer is important because, among other things, it is one of the factors when determining whether intra-entity profits are eliminated. That is, if the asset being sold is an output of an entity's ordinary activities and the transaction is in the scope of ASC 606, an investor will eliminate its proportionate share of the profit from intra-entity transactions until that profit is realized in a transaction with third parties. For example, if an investor owns 30% of an investee's common stock, the investor would eliminate 30% of the intercompany profit. See ASC 323-10-55-27 to 29 and Illustration 6-2 in section 6.2.1.1 for illustrations of this accounting. This differs from the accounting for the sale of a nonfinancial asset in the scope of ASC 610-20 in a downstream sale, for which no profit is eliminated under the exception described above, as shown in Illustration 6-3.

The FASB acknowledged<sup>29</sup> that the elimination of intra-entity profits under ASC 610-20 is inconsistent with the accounting for revenue transactions with equity method investees that are in the scope of ASC 606. However, the accounting for transfers to an equity method investee in the scope ASC 610-20 is aligned with transfers in the scope of ASC 810 (i.e., transfers of a business). The FASB chose to eliminate differences between the derecognition of assets and the derecognition of businesses rather than align ASC 606 and ASC 610-20.

Investors also will eliminate the profit recognized by an investee from upstream transactions in the scope of ASC 610-20 (i.e., when the investee sells a nonfinancial asset or ISNFAs to the investor) until that profit is realized, as shown in Illustration 6-4. For productive assets (e.g., equipment, intangible assets) that are not sold to a third party, the investor would amortize any profit that was deferred over the life of the asset. Similarly, as discussed in ASC 970-323-30-7, when an investee sells real estate to an investor, the investor eliminates its share of the investee's profit as a reduction in the carrying amount of the real estate and recognizes that income on a pro rata basis as the real estate is depreciated or when it is sold to a third party.

Intra-entity profit also is not eliminated for an arm's-length service transaction between an investor and an investee that does not result in an asset that remains on the books of either party, as shown in Example 1 in Illustration 6-5. However, if the recipient capitalizes the cost of services performed, the investor eliminates its share of the profit as a reduction in the carrying amount of the capitalized cost, as shown in Example 2 in Illustration 6-5.

<sup>27</sup> We believe the exceptions only apply to downstream transactions (i.e., from an investor to an investee). For transactions in the scope of ASC 810-10-40-3A through 40-5 and transactions in the scope of ASC 810-10-45-21A through 45-24, this view is based on paragraph 17 of the Basis for Conclusions of ASU 2010-02. With respect to ASC 610-20 transactions, our view is based on paragraphs 66-67 of the Basis for Conclusions of ASU 2017-05 and discussions with the FASB staff.

<sup>28</sup> ASC 810 requires a change in ownership transaction in which a parent does not lose control to be recognized within equity (i.e., there is no profit or loss that would be subject to elimination).

<sup>29</sup> Paragraph BC67 of ASU 2017-05.

While ASC 323 specifically addresses circumstances when intra-entity assets remain on the books, it does not address the accounting for intra-entity liabilities. We believe that an investor also should consider eliminating intra-entity liabilities (e.g., deferred revenue, gains) that remain on the books. Once an investor determines that an intra-entity liability remains, it determines whether a portion of the intra-entity income or loss should be eliminated.

The table below summarizes how the intra-entity profit elimination guidance is applied to common fact patterns in an arm's-length transaction when the asset remains on the books of the recipient.

Guidance	Example transaction	Downstream	Upstream
ASC 606	Sale of inventory that is an output of an entity's ordinary activities	Eliminate proportionate share of profit if the asset remains on the books of the recipient at the end of the reporting period. See ASC 323-10-55-27 to 29 and Illustration 6-2 in section 6.2.1.1.	
	Service transaction that is an output of an entity's ordinary activities	No profit elimination unless the cost of the service is capitalized (i.e., an asset remains on the books of the recipient at the end of the reporting period). See Illustration 6-5.	
ASC 610-20	Sale of equipment that is not an output of an entity's ordinary activities	No profit elimination (ASC 323-10-35-7(c)). See Illustration 6-3.	Eliminate proportionate share of profit if the asset remains on the books of the recipient at the end of the reporting period. See Illustration 6-4.
ASC 810-10-40-3A through 40-5	Sale of a business	No profit elimination (ASC 323-10-35-7(a)), similar to the approach shown in Illustration 6-3.	Eliminate proportionate share of profit if the business remains on the books of the recipient at the end of the reporting period, similar to the approach shown in Illustration 6-4.
ASC 815	Intra-entity derivative transaction	This type of transaction is not a sale between entities. Therefore, there is no intra-entity profit to be eliminated. As a result, the derivative is accounted for under ASC 815, with no elimination of intra-entity gains or losses.	
ASC 835	Intra-entity loan	The elimination of interest depends on the activities of the investee. See section 6.3.	Eliminate proportionate share of profit if the interest is capitalized at the end of the reporting period, similar to the approach shown in Illustration 6-4.
ASC 860	Sale of another equity method investment or other financial asset	Eliminate proportionate share of profit if the asset remains on the books of the recipient at the end of the reporting period, similar to the approach shown in ASC 323-10-55-27 to 29 in section 6.2.1.1.	

### 6.2.1.1 Examples of intra-entity profit elimination

ASC 323-10-55-27 includes two partial elimination examples (upstream and downstream, which are included below) when the transaction is within the scope of ASC 606 for the seller and at arm's length. In these examples, no profit had been realized with third parties (i.e., all of the assets sold remained on the recipient's books at the end of the reporting period). If the profit had been realized with third parties, no profit would have been eliminated.

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Implementation Guidance and Illustrations*

##### **323-10-55-27**

The following Cases illustrate how eliminations of intra-entity profits might be made in accordance with paragraph 323-10-35-7. Both Cases assume that an investor owns 30 percent of the common stock of an investee, the investment is accounted for under the equity method, and the income tax rate to both the investor and the investee is 40 percent, the inventory is a good that is an output of the entity's ordinary activities, and the contract is with a customer that is within the scope of Topic 606 on revenue from contracts with customers:

- a. Investor sells inventory downstream to investee (Case A)
- b. Investee sells inventory upstream to investor (Case B).

##### **Case A: Investor Sells Inventory Downstream to Investee**

##### **323-10-55-28**

Assume an investor sells inventory items to the investee (downstream). At the investee's balance sheet date, the investee holds inventory for which the investor has recorded a gross profit of \$100,000. The investor's net income would be reduced \$18,000 to reflect a \$30,000 reduction in gross profit and a \$12,000 reduction in income tax expense. 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.

##### **Case B: Investee Sells Inventory Upstream to Investor**

##### **323-10-55-29**

Assume an investee sells inventory items to the investor (upstream). At the investor's balance sheet date, the investor holds inventory for which the investee has recorded a gross profit of \$100,000. In computing the investor's equity pickup, \$60,000 (\$100,000 less 40 percent of income tax) would be deducted from the investee's net income and \$18,000 (the investor's share of the intra-entity gross profit after income tax) would thereby be eliminated from the investor's equity income. Usually, the investor's investment account would also reflect the \$18,000 intra-entity profit elimination, but the elimination might also be reflected in various other ways; for example, the investor's inventory might be reduced \$18,000.

The following illustration shows examples of an upstream and a downstream sale of inventory within the scope of ASC 606.

### **Illustration 6-2: Downstream and upstream sales of inventory within the scope of ASC 606**

#### **Example 1 – Upstream transaction**

On 1 January 20X1, Investor A acquired a 30% interest in the voting common stock of Investee B. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and will apply the equity method. Basis differences and the effect of income taxes have been ignored to simplify this example.

Investor A and Investee B also sign an agreement on 1 January 20X1 that Investee B will produce and deliver 1,000 computers (an output of Investee B's ordinary activities) to Investor A by 30 June 20X1. Investee B will sell each computer to Investor A for \$400, recognizing a \$100 profit on each computer sold. Investee B delivers all 1,000 computers to Investor A by 30 June 20X1. On 31 December 20X1, Investor A has sold 950 computers and has 50 remaining in its inventory.

Investor A determines that based on the facts and circumstances, including the terms of the agreement, the transaction was an arm's-length transaction. Therefore, Investor A eliminates its proportionate share of Investee B's profit relating to the 50 computers remaining in Investor A's inventory at 31 December 20X1.

Investor A eliminates its intra-entity portion of \$1,500 ( $(\$100 \text{ profit} \times 50 \text{ computers}) \times 30\% \text{ interest in the voting common stock of Investee B}$ ). Investor A will reduce its equity method earnings by \$1,500. Depending on what is most meaningful in these circumstances, Investor A would either reduce its equity method investment or inventory by \$1,500 and disclose its accounting policy for such eliminations.

#### **Example 2 – Downstream transaction**

On 1 January 20X1, Investor C acquired a 40% interest in the voting common stock of Investee D. Investor C has the ability to exercise significant influence over Investee D (the presumption that significant influence exists is not overcome) and will apply the equity method. Basis differences and the effect of income taxes have been ignored to simplify this example.

Investor C and Investee D also sign an agreement on 1 January 20X1 that Investor C will produce and deliver 500 printers (an output of Investor C's ordinary activities) to Investee D by 30 June 20X1. Investor C will sell each printer to Investee D for \$850, recognizing a \$250 profit on each printer sold. Investor C delivers all 500 printers to Investee D by 30 June 20X1. On 31 December 20X1, Investee D has sold 450 printers and has 50 remaining in its inventory.

Investor C determines that based on the facts and circumstances including the terms of the agreement, the transaction was an arm's-length transaction. Therefore, Investor C eliminates the portion of its profit relating to the 50 printers remaining in Investee D's inventory at 31 December 20X1.

Investor C eliminates \$5,000 in profit ( $(\$250 \text{ profit} \times 50 \text{ printers}) \times 40\% \text{ interest in the voting common stock of Investee D}$ ). It will reduce revenue by \$17,000, cost of sales by \$12,000 and its equity method investment by \$5,000. As an alternative, the Investor could have reduced its equity method earnings. The presentation will depend on what is most meaningful for the users of the financial statements. Investor C would disclose its accounting policy for such eliminations.

Alternatively, if the transaction was not at arm's length, Investor C would eliminate all of the profit that has not yet been realized through transactions with third parties. Therefore, Investor C would eliminate profit of \$12,500 ( $\$250 \text{ profit} \times 50 \text{ printers remaining in Investee D's inventory at 31 December 20X1}$ ).

The following illustration shows an example of a downstream sale of an intangible asset within the scope of ASC 610-20 at arm's length.

**Illustration 6-3: Downstream sale of asset within the scope of ASC 610-20**

Investor A has a 30% equity method investment in Investee B. Investor A has the ability to exercise significant influence over Investee B and applies the equity method. Basis differences and the effect of income taxes have been ignored to simplify this example.

Investor A sells intellectual property to Investee B in an arm's-length transaction for \$400 on 1 January 20X1 instead of licensing it. At the sale date, the intellectual property had a cost basis of \$300. Investee B uses the intellectual property, which has a useful life of 10 years.

Investee B is not a customer as defined in ASC 606 because selling the intellectual property is not an output of Investor A's ordinary activities, and the intellectual property is not a business. As a result, Investor A concludes that the transaction is the sale of a nonfinancial asset in the scope of ASC 610-20. On the transaction closing date, Investor A determines that it does not have a controlling financial interest in Investee B. Further, Investor A determines that Investee B has control of the nonfinancial asset under ASC 606. Therefore, Investor A derecognizes the intellectual property under ASC 610-20.

Since the transaction is in the scope of ASC 610-20, Investor A would recognize a gain of \$100 (\$400 – \$300) on 1 January 20X1. Although the asset remains on the books of the investee, no profit is eliminated because the transaction is a downstream transaction in the scope of ASC 610-20 and is at arm's length. Investor A would record the following journal entry:

Cash	\$ 400	
Intellectual property		\$ 300
Gain on sale		100

Subsequently, Investor A would recognize its proportionate share of Investee B's amortization over the 10-year useful life of the intellectual property. That is, Investor A would not defer any profit or adjust its equity method earnings for this intra-entity sale.

The following illustration shows an example of an upstream sale of nonfinancial asset within the scope of ASC 610-20 at arm's length that remains on the books of the investor. If the profit was realized in a transaction with third parties (i.e., the asset was sold by the investor to a third party), no profit would be eliminated.

**Illustration 6-4: Upstream sale of asset within the scope of ASC 610-20**

Investor E holds a 40% interest in the voting common stock of Investee F. Investor E has the ability to exercise significant influence over Investee F (the presumption that significant influence exists is not overcome) and will apply the equity method. Basis differences and the effect of income taxes have been ignored to simplify this example.

On 1 January 20X1, Investee F sells real estate to Investor E for \$400, which had a cost basis to Investee F of \$300 (i.e., Investee F recognized a profit of \$100). Investor E retains the real estate, which has a useful life of 40 years. Investor E determines that, based on the facts and circumstances, including the terms of the agreement, the transaction was an arm's-length transaction. Regardless of whether the transaction is in the scope of ASC 610-20 from Investee F's perspective, because the transaction is upstream and the real estate remains on Investor E's books, Investor E eliminates the portion of its profit recognized by Investee F.

Investor E eliminates its share of Investee F's intra-entity portion of \$40 (\$100 profit x 40% interest in the voting common stock of Investee F) with a corresponding reduction in the carrying amount of the real estate, resulting in a net carrying amount of \$360 (\$400 - \$40). Investor E would record the following journal entry (this journal entry presumes that Investor E previously recorded its share of Investee F's income, inclusive of the \$40 profit on the transaction recognized by Investee F):

Real estate	\$ 360	
Equity method income/loss	40	
Cash		\$ 400

Subsequently, Investor E recognizes the \$40 of eliminated profit over the 40-year useful life of the real estate (or \$1 annually), which may be recorded by adjusting its depreciation expense. This concept is further illustrated below:

	<b>Investor E's books before elimination</b>	<b>Intra-entity profit elimination (40% of \$100)</b>	<b>Investor E's books after elimination</b>
1 January 20X1	\$ 400	\$ (40)	\$ 360
Depreciation (20X1)	(10)	1	(9)
31 December 20X1	\$ 390	\$ (39)	\$ 351

If the profit was realized in a transaction with third parties (i.e., the real estate was sold by Investor E to a third party) in the same period that it was received by Investor E, no profit would have been eliminated.

The following illustration shows an example of a service transaction within the scope of ASC 606 at arm's length. In Example 1, the service is not capitalized by the investee. In Example 2, the service is capitalized by the investee.

#### **Illustration 6-5: Accounting for intra-entity service transactions**

Investor G has a 40% interest in the voting common stock of Investee H on 1 January 20X1. Investor G has the ability to exercise significant influence over Investee H (the presumption that significant influence exists is not overcome) and applies the equity method to account for its investment in Investee H. Basis differences and the effect of income taxes have been ignored to simplify this example.

During the year, Investor G provides IT services to Investee H for \$100,000 (at a cost of \$80,000, which generates a profit of \$20,000). Investor G determines that the transaction was entered into at arm's length.

##### **Example 1 – Investee consumes (does not capitalize) the service transaction**

For the year ended 31 December 20X1, Investee H reports \$1.3 million of net income, inclusive of the \$100,000 in IT service expense. When the service transaction between Investor G and Investee H is consumed (realized) and is not capitalized at the end of the reporting period, Investor G does not eliminate any profit associated with the transaction, regardless of whether a receivable or payable remains at the end of the reporting period. Consequently, Investor G records revenue of \$100,000 and cost of sales of \$80,000 related to the transaction. Investor G also recognizes equity method earnings of \$520,000 (Investee H's net income of \$1.3 million x 40% interest in Investee H).

**Example 2 – Investee capitalizes the service transaction**

The \$100,000 in IT services meets the criteria to be capitalized and is being amortized over the useful life of the capitalized software of four years.

When the service transaction between Investor G and Investee H is capitalized, Investor G eliminates its portion of the profit. Similar to Example 1, Investor G *initially* records revenue of \$100,000 and cost of sales of \$80,000 related to the transaction. However, Investor G eliminates its intra-entity portion of \$8,000 (\$20,000 profit x 40% interest in the voting common stock of Investee H).

Investor G then releases the \$8,000 in deferred profit over the four-year useful life of the capitalized software for \$2,000 each year (\$8,000 / 4 years). This concept is further illustrated below:

	<b>Investee H's book value</b>	<b>Investor G's share (40%)</b>	<b>Intra-entity profit elimination</b>	<b>Investor G's basis</b>
1 January 20X1	\$ 100	\$ 40	\$ (8)	\$ 32
Amortization (20X1)	(25)	(10)	2	(8)
31 December 20X1	\$ 75	\$ 30	\$ (6)	\$ 24

Another way of calculating Investor G's basis is to perform the calculation using Investor G's cost (\$80,000) as Investee H's book value.

	<b>Investee H's book value (at investor G's cost)</b>	<b>Investor G's share (40%)</b>
1 January 20X1	\$ 80	\$ 32
Amortization (20X1)	(20)	(8)
31 December 20X1	\$ 60	\$ 24

The elimination of intra-entity profit and subsequent release of that profit might be reflected in Investor H's financial statements in various ways. The presentation will depend on what is the most meaningful in the circumstances.

**6.2.1.2****Determining whether a transaction is at arm's length****Excerpt from Accounting Standards Codification****Investments – Equity Method and Joint Ventures – Overall*****Subsequent Measurement******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.



When an intra-entity transaction is not at arm's length, all of the intra-entity profit or loss is eliminated until realized through transactions with third parties.

When assessing whether a transaction is at arm's length, the following factors, among others, should be considered:

- ▶ Whether the sales price approximates the fair value of the assets transferred (i.e., whether it is reasonable and objectively supportable).
- ▶ Whether the transaction has economic substance.
- ▶ Whether the sales price will be collected. The lack of a significant cash payment may raise questions about collectibility and whether the transaction represents an in-substance contribution.
- ▶ Whether the seller is obliged to support the asset sold.

The intra-entity profit or loss would be eliminated even if the amount exceeds the carrying amount of the equity method investment (that is, even if eliminating it would result in a negative equity method investment balance).

### **6.2.1.3 Tax considerations for intra-entity transactions**

An investor recognizes the tax effects of the transaction, including any deferred taxes, regardless of whether profit or loss is eliminated (see section 5.4.2 and section 14.4.2.2 of our FRD, *Income taxes*).

### **6.2.1.4 Disclosures for intra-entity transactions**

When an investor has significant intra-entity transactions with an investee, the investor should disclose the nature of the transactions and the investor's accounting policy for these transactions, as described in section 6.2.1 and the amount of any revenue recognized. An investor also should consider disclosing whether receivables from the investee represent advances to the investee that form part of the cost of its investment, as described in section 6.3.2.

An investor and its equity method investee are considered related parties under ASC 850 and should disclose material intra-entity transactions as related-party transactions. See section 8.3.3 and ASC 850 for additional information.

## **6.2.2 Effect of basis differences on equity method earnings**

In determining its equity method earnings or losses in an investee, the investor includes adjustments (e.g., depreciation, depletion, amortization, accretion) related to basis differences that were identified as part of the initial accounting for the investment.

For guidance on the investor's equity method accounting when an investee is acquired in a business combination and elects to apply pushdown accounting see Question 5.1 in section 5.4.

**Illustration 6-6: Effect of basis differences on equity method earnings**

Assume the same facts as in Illustration 5-6:

- ▶ Investor A purchases 40% of the common stock of Investee B on 1 January 20X1 for \$1,000,000 cash.
- ▶ The net assets recorded in the financial statements of Investee B on 1 January 20X1 are as follows:

Cash	\$ 100,000
Other current assets	250,000
Plant and equipment	1,000,000
Accounts payable	(100,000)
Other current liabilities	(200,000)
Net assets	<u>\$ 1,050,000</u>
Investor A's 40% share	<u>\$ 420,000</u>

- ▶ Investor A determines that the fair value of the plant and equipment on 1 January 20X1 is \$1,800,000. The plant and equipment have a remaining life of 10 years.
- ▶ Investor A determines that Investee B has internally developed trade names. These trade names are considered definite-lived intangible assets with a fair value of \$500,000 and a useful life of 20 years. As the trade names have been internally developed, the intangible assets have not been recorded on the financial statements of Investee B.
- ▶ The book value of the other current assets, accounts payable and other current liabilities approximates fair value.
- ▶ Intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

The following worksheet illustrates how the \$580,000 difference between Investor A's cost basis of \$1,000,000 and its basis in the underlying equity in net assets of Investee B of \$420,000 would be assigned on the date of investment.

	Investee B book value	Investor A's 40% share of Investee B's book value	Fair value of Investee B's net assets on 1 January 20X1	Equity method basis difference (difference between book value and fair value)	Investor A's 40% of equity method basis difference
Cash	\$ 100,000	\$ 40,000	\$ 100,000	\$ -	\$ -
Other current assets	250,000	100,000	250,000	-	-
Plant and equipment	1,000,000	400,000	1,800,000	800,000	320,000
Accounts payable	(100,000)	(40,000)	(100,000)	-	-
Other current liabilities	(200,000)	(80,000)	(200,000)	-	-
Intangible assets	-	-	500,000	500,000	200,000
Goodwill	-	-	N/A	-	60,000
	<u>\$ 1,050,000</u>	<u>\$ 420,000</u>	<u>\$ 2,350,000</u>	<u>\$ 1,300,000</u>	<u>\$ 580,000</u>

Investor A records the 40% investment in Investee B of \$1,000,000 on its books. The basis differences are accounted for as part of the "memo" accounting entries by the investor.

In 20X1, Investee B has net income of \$400,000. Investor A's equity method earnings from Investee B would be calculated as follows:

Investor A's share of Investee B's net income	\$ 160,000	40% x \$400,000
Adjustment for plant and equipment basis difference	(32,000)	\$320,000 / 10 years
Adjustment for intangible asset basis difference	(10,000)	\$200,000 / 20 years
Investor A's equity method earnings from Investee B	<u>\$ 118,000</u>	

As a result of the basis differences identified, Investor A's equity method earnings reflect not only the allocable portion of net income of Investee B (\$160,000) but also the depreciation of \$32,000 related to the plant and equipment basis difference and amortization of \$10,000 related to the intangible asset basis difference.

The equity method goodwill reflected in Investor A's "memo" accounts for Investee B is not amortized or separately tested for impairment under ASC 350. Instead, equity method goodwill is evaluated for impairment as part of the equity method investment, in accordance with ASC 323-10-35-32. See section 6.8 for further discussion.

### 6.2.3

## Investee's other comprehensive income (loss)

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-18**

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

An investor records its proportionate share of an investee's other comprehensive income (OCI) with a corresponding adjustment to its equity method investment. An investor may combine its proportionate share of other comprehensive income from its equity method investees with its own other comprehensive income components and present the aggregate in the statement in which comprehensive income is presented. Alternatively, an investor is permitted to present components of other comprehensive income related to an equity method investee separately from the investor's other comprehensive income components.

### **Illustration 6-7: Calculating an investor's share of equity method investee's OCI**

On 1 January 20X1 Investor A acquired a 30% interest in the voting common stock of Investee B for \$1,000. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method. Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

The net income of Investee B was \$1,000 for the year ended 31 December 20X1. During 20X1, Investee B also recorded OCI of \$50 related to unrealized gains on available-for-sale debt securities.

Investor A recorded its equity method earnings from Investee B as \$300 (30% of \$1,000). In addition, Investor A calculated its share of Investee B's OCI activity of \$15 (30% of \$50). Investor A would record the following journal entry:

Equity method investment	\$ 315	
Equity method earnings		\$ 300
Other comprehensive income – equity method investee		15

The carrying amount of the equity method investment would be \$1,315 (\$1,000 original investment + \$300 share of earnings in Investee B + \$15 share of OCI activity for Investee B).

### 6.2.3.1 AOCI basis differences

As discussed in section 5.4.3, an investor may have basis differences resulting from the fair value measurement of the investee's assets (or liabilities) that are accounted for with changes recorded in AOCI. As a result, subsequent changes in the investee's AOCI will need to be tracked to account for these basis differences.

For example, consider a situation in which an investee has unrealized gains recorded in AOCI related to the change in fair value of an available-for-sale debt security, but the investor does not have unrealized gains because the available-for-sale debt security was measured at its fair value at the date of the investment by the investor. If the investee subsequently realizes the unrealized gains recorded in AOCI upon sale of the available-for-sale debt security, the investor would not have any gain to recognize. Accordingly, the investor would not record its proportionate share of the changes in the investee's AOCI, or the related realized gain, with respect to that security.

### 6.2.4 Investee's dividends and distributions

#### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

#### *Subsequent Measurement*

#### *323-10-35-17*

Dividends received from an investee shall reduce the carrying amount of the investment.

Dividends received by an investor are recognized as a reduction in the carrying amount of the investment and are not recognized as dividend income.

If the investee has outstanding cumulative preferred stock, the investor computes its share of earnings or losses after deducting the investee's preferred dividends (whether or not such dividends are declared).

See section 8.4 for discussion of the presentation of dividends in the investor's cash flow statement.

When dividends from an investee exceed the carrying amount of an equity method investment (and recognition of the dividend received would reduce the carrying amount below zero), the facts and circumstances are evaluated to determine the appropriate accounting for the excess distribution. Factors to consider include the following:

- ▶ Possibility that the excess distributions may be refundable by agreement or by law (e.g., partnership agreement)
- ▶ Implicit or explicit commitments to fund the investee (see section 6.4 for additional discussion)
- ▶ Source of the proceeds – distributions made possible through refinancing may have resulted from new agreements or commitments to fund the investee by the investor. Refinancing of existing debt or financing of new debt is generally a reconsideration event under the Variable Interest Model. See our FRD, *Consolidation*, for additional discussion.

Careful consideration should be given to the appropriate accounting, depending on the facts and circumstances and the investor's accounting policy in such situations. The SEC staff has stated that it would not object to gain recognition for the excess distribution, if the investor is not liable for the obligations of the investee nor otherwise committed to provide financial support.<sup>30</sup>

<sup>30</sup> Remarks by Robert Malhotra, Professional Accounting Fellow, Office of the Chief Accountant at the 2008 AICPA National Conference on Current SEC and PCAOB Developments, 8 December 2008.

We believe that if an investor records an excess distribution as a gain, the investor generally should not record any subsequent equity method earnings until subsequent earnings equal the gain recorded. This would be similar to the approach used when recovering unrecorded losses, as described in section 6.4. However, if the investor defers the gain and records a negative equity method investment (liability), the investor would record subsequent equity method earnings.

## 6.2.5 Investee's accounting basis is not US GAAP

### Excerpt from Accounting Standards Codification

#### Real Estate – Investments – Equity Method and Joint Ventures

##### *Subsequent Measurement*

##### **970-323-35-20**

In the real estate industry, the accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from GAAP. If the financial statements of the investor are to be prepared in conformity with GAAP, such variances that are material shall be eliminated in applying the equity method.

The earnings or losses of an investee are defined as the net income or net loss of an investee determined in accordance with US GAAP. If an equity method investee follows accounting principles that differ from US GAAP (e.g., IFRS, other accounting basis), the investee's financial statements should be adjusted to US GAAP when applying equity method accounting.

An investor also should consider the potential effect of the investee's application of a different basis of accounting upon acquisition of the equity method investment. During the initial accounting for the investee, an investor would need to consider adjustments to US GAAP, in addition to considering whether any basis differences exist. See section 5.4 for additional guidance.

## 6.2.6 Different accounting policies under US GAAP

### Excerpt from Accounting Standards Codification

#### Real Estate – Investments – Equity Method and Joint Ventures

##### *Recognition*

##### **323-10-25-7**

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

An investor and its equity method investee may not have the same accounting policies, especially when the equity method investee was recently acquired, the equity method investee is a public company or the equity method investee follows specialized industry accounting principles.

US GAAP does not require that the investor and the equity method investee follow the same accounting policies. ASC 323-10-20 defines earnings or losses of an investee as "net income (or net loss) of an investee determined in accordance with U.S. generally accepted accounting principles." Therefore, as long as the equity method investee's financial statements were prepared in accordance with US GAAP, the financial statements of an equity method investee generally are *not* adjusted to conform the accounting policies to the investor. When applying the equity method of accounting, an investor retains any industry-specific guidance applied by that investee.

For example, if an investee applies the first-in, first-out (FIFO) method for inventory accounting, but the investor applies the last-in, first-out (LIFO) method, adjustments to conform the inventory policies are not permitted. However, the investor and investee should consider these different inventory policies when determining their equity method earnings, as discussed in section 6.2.1. Similarly, an investor cannot designate a derivative held by investee as an effective hedging instrument, for determining its equity method earnings and losses, if the investee has not elected to do so in its own financial statements (or vice versa).

### 6.2.6.1 Adoption of new accounting standards (updated June 2024)

If an investor is a PBE and is required to furnish financial statements or financial information on an equity method investee to the SEC (e.g., under Rule 3-05, Rule 3-09 or Rule 4-08(g) of Regulation S-X), this information must comply with the accounting requirements for a PBE. That is, for the purposes of such financial statements or financial information, the investee is considered a PBE because it would meet criterion (a) of the FASB's definition of a PBE. When equity method investees meet the definition of a PBE, the SEC staff stated that the investor's equity method accounting should be based on the investees' PBE-basis financial statements, which would have to be prepared using the PBE effective dates of new standards.<sup>31</sup>

However, the SEC staff indicated that an equity method investee that doesn't otherwise meet the definition of a PBE (e.g., when a PBE-investor uses an investee's financial information as a basis for recording equity method earnings or losses but does not furnish or file or otherwise include the investee's financial information in its financial statements) is not required to use the effective dates for PBEs for purposes of the registrant's recognition of its share of earnings or losses of the investee. The SEC staff said that "amounts recognized by a registrant in applying the equity method of accounting would not be considered financial information included in a filing with the SEC under the FASB's definition of public business entity."<sup>31</sup> Therefore, such equity method investees would not be required to use the effective dates for PBEs for new standards solely for purposes of the investor's equity method accounting.

### 6.2.6.2 Private company alternatives

The FASB has issued several ASUs that are designed to give private companies accounting alternatives, which if elected would simplify their accounting. Certain of these alternatives, such as the goodwill amortization alternative and the intangible asset alternative described below, could affect equity method accounting.

If an investor is a PBE because it meets criterion (a) of the FASB's definition of a PBE and is required to furnish to or file financial statements (or financial information) with the SEC on its equity method investee under Regulation S-X Rule 3-05, S-X Rule 3-09 or S-X Rule 4-08(g), the investee also is a PBE for its financial statements or financial information that is furnished to or filed with the SEC, and therefore it must comply with the accounting requirements for a PBE (see section 6.2.6.1 for further guidance). Therefore, using private company alternatives generally would not be permitted for such financial statements (or financial information) or when recognizing the investor's share of the investee's earnings or losses. However, the private company or NFP may still avail itself of an alternative in its financial statements that are not furnished or filed with the SEC.

If the investor and investee are not PBEs, either entity may apply a private company alternative under US GAAP. Although accounting policies generally are not permitted to be conformed, we believe that an exception may be acceptable in certain circumstances, for example, if the investor plans to go public in the future and would become a PBE at such date. In this case, conforming accounting policies would avoid having to retroactively revise the financial statements when the investor becomes a PBE. In these cases, we believe that a non-PBE investor that does not apply a private company alternative may conform the private company accounting policy of its investee to its own policy when recording its share of net income. However, we believe that conforming the accounting policy of an investee that does not apply a private company alternative to the policy of an investor that does apply a private company alternative would not be acceptable. We understand that the FASB staff shares our views.

<sup>31</sup> Remarks by Jonathan Wiggins, SEC Associate Chief Accountant, Office of the Chief Accountant, at the 2016 National Conference on Current SEC and PCAOB Developments, 5 December 2016.

The following illustration provides an overview on how to determine whether the private company alternatives are available (as an accounting policy choice) in cases whereby the investor is a PBE and the investee is not a PBE (that is, a private company or not-for-profit entity), or vice versa.

		Investor	
		PBE	Not a PBE
Investee	PBE	Neither the investor nor the investee can apply the accounting alternatives.	An investor can apply the accounting alternatives. An investee cannot apply the accounting alternatives in its own financial statements. An investor cannot conform the investee's accounting policy to its accounting policy.
	Not a PBE	The investor cannot apply the accounting alternative. <sup>1</sup> The investee can apply the accounting alternatives in its own financial statements. <sup>1</sup>	Both the investor and the investee can apply the accounting alternatives. An investor can conform its accounting policy to unwind a private company alternative elected by the investee, but it cannot conform the investee's accounting policy to apply a private company alternative for an investee that did not elect it.

<sup>1</sup> If an investor is a PBE because it meets criteria (b) through (e) of the FASB's definition of a PBE (but not criterion (a)), the investor is not required to reverse the effect of private company alternatives applied by a non-PBE investee when it recognizes its share of the investee's earnings or losses. The investor can elect to conform the accounting policies of the investee when recording equity method earnings or losses, if conforming reverses a non-PBE accounting alternative elected by the investee. This view is consistent with the American Institute of Certified Public Accountants (AICPA) guidance in AICPA *Technical Questions and Answers*, section 7100.08, *Definition of a Public Business Entity, 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)*. While guidance issued by the AICPA is not authoritative, we believe that this view would be acceptable if applied in practice.

Equity method investors that are private companies or NFPs may elect to amortize goodwill and equity method goodwill. See section A.2.3.2 of our FRD, *Intangibles – Goodwill and other*, for more guidance. It should be noted that because equity method goodwill is a residual of the investor's equity method investment "upon its initial measurement, any goodwill recorded by the investee in its standalone financials prior to or on the investment date would be disregarded, including its subsequent amortization", regardless of the policies or status of the investor and investee. Because the goodwill amortization alternative specifically references equity method goodwill, the investor's goodwill amortization accounting policies generally apply.

However, if the investee recognizes goodwill due to a business combination after the investor made its investment, the investee's goodwill amortization policies generally apply. That said, an investor that is a PBE because it meets criterion (a) under the FASB's definition of a PBE would adjust its share of the non-PBE investee's earnings for amortization of goodwill recognized by the investee, consistent with the table above. Private companies or NFPs may elect to assess whether triggering events for goodwill impairment have occurred only as of the end of their annual reporting period or interim reporting period if they report more frequently. See section A.3 of our FRD, *Intangibles – Goodwill and other*, for more guidance on this election. Equity method goodwill is not separately tested for impairment, as discussed in section 5.4.1. Therefore, even if the investor elects this private company alternative with respect to its own goodwill, it would not apply this alternative to equity method goodwill recognized in the memo accounts on the date of the equity method investment.<sup>32</sup>

<sup>32</sup> If the investee recognizes goodwill due to a business combination after the investor made its investment, the investee's goodwill impairment testing policies generally apply to that goodwill. However, a PBE investor under criterion (a) would need to adjust its share of the investee's earnings to reflect any interim impairment the investee would have recognized, had the investee not elected the goodwill triggering event private company accounting alternative.

Under the intangible asset alternative, a private company or NFP is allowed to limit the customer-related intangibles it recognizes to those that are capable of being sold or licensed independently from the other assets of the business. Once elected, the intangible assets alternative applies to (1) all future equity method investments when identifying basis differences (as discussed in section 5.4), (2) all future business combinations and (3) any transactions in which fresh-start accounting is applied. That is, the intangible assets alternative is an accounting policy choice that must be applied consistently to all future intangible assets. See section E.4 of our FRD, *Business combinations*, for further guidance.

## 6.2.7

### Differing fiscal year ends

#### Excerpt from Accounting Standards Codification

##### Consolidation – Overall

##### *Other Presentation Matters*

##### *Differing Fiscal Year-Ends Between Parent and Subsidiary*

##### **810-10-45-12**

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

##### *A Change in the Fiscal Year-End Lag Between Subsidiary and Parent*

##### **810-10-45-13**

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

In certain cases, there may be a difference between the date of the investee's financial statements and the date of the investor's financial statements. For example, an investor might have a year end of 31 December; however, the investee's year end might be 30 September.

ASC 323 does not specifically address how the investor should apply the equity method in these situations. However, ASC 810-10-45-12 states that it is usually acceptable to use a subsidiary's financial statements for consolidation if the difference in their reporting periods is not more than three months. We believe this guidance also should be used for equity method investments. This difference in fiscal year should be disclosed along with the fiscal year end of the investee entity and a brief explanation of the necessity for using different year ends. Intervening events that materially affect the financial position or results of operations should be disclosed or recorded.



If the investee changes its year end, ASC 323 does not specifically address how the investor should apply the equity method in these situations. ASC 810-10-45-13 states that the investor is required to report a change in accounting principle in accordance with ASC 250. ASC 250 generally requires retrospective application to prior-period financial statements of voluntary changes in accounting principle, unless it is impracticable to apply the effects of the change retroactively. An entity may change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. See section 8.3.2 and ASC 250 for further discussion.

## 6.2.8 Reporting lag

### Excerpt from Accounting Standards Codification

#### Consolidation – Overall

#### *Other Presentation Matters*

#### *Differing Fiscal Year-Ends Between Parent and Subsidiary*

#### **810-10-45-12**

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

#### Investments – Equity Method and Joint Ventures – Overall

#### *Subsequent Measurement*

#### **323-10-35-6**

If financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

When an investor applies the equity method of accounting, the investor should record its share of the investee's earnings or losses based on the most recently available financial statements from the investee, which might be on a lag. For example, both an investor and an investee may have a year end of 31 December; however, the investor might not receive the investee's 31 December financial statements until mid-March. As a result, it might not be practical for the investor to use the investee's 31 December financial statements when recording its equity method earnings in its own 31 December financial statements. In such cases, the investor might record its equity method earnings, as well as any basis difference adjustments (e.g., depreciation, amortization), on a quarter lag.

The decision to apply the equity method of accounting on a lag is a policy election that is applied to each equity method investment. An investor could have one equity method investment on a lag, and another that is not. However, the investor would apply the policy elected for each equity method investment consistently from period to period. ASC 323 does not provide specific guidance on the maximum permissible lag. However, we believe that investors should apply the same maximum difference allowed under ASC 810-10-45-12 (i.e., three months) with respect to consolidated subsidiaries to equity method investments. Similar to situations when a lag is applied because of a difference in fiscal year end, intervening events that materially affect the financial position or results of operations should be disclosed or recorded.

The investor's decision to change or eliminate an existing lag between the investor and the investee is considered a change in accounting principle, in accordance with ASC 250. The investor is required to assess whether the change is preferable and, if so, report the change in accordance with ASC 250. ASC 250 requires retrospective application to prior-period financial statements of voluntary changes in accounting principle, unless it is impracticable to apply the effects of the change retroactively. See section 8.3.2 and ASC 250 for further discussion.

### **6.2.8.1 Reporting lag in the period of investment**

An investor is required to apply its lag policy to each equity method investment consistently from period to period. When accounting for an equity method investment on a lag basis, an investor must ensure that its equity in earnings during the initial period of its investment does not include earnings from the investee prior to the date the investment was acquired (i.e., prior to when the investor was entitled to its proportionate share of earnings). Accordingly, during the initial period in which the investor obtains its equity method investment accounted for on a lag basis, the investor will not recognize equity method earnings for the entire period that the investment was owned. If it reported equity method earnings for the entire period that the investment was owned, the lag period used to recognize equity method earnings would be as of a date prior to when the investor obtained its investment and such earnings would have already been reflected in the fair value of the investment at initial measurement.

For example, assume that an investor acquires an equity method investment on 1 January 20X1, and it elects to account for the investment on a one-quarter lag. That means the investor would first recognize equity method earnings in its financial statements for the quarter ended 30 June 20X1, for its share of the investee's earnings for its quarter ended 31 March 20X1. The investor would not recognize any equity method earnings for the investment in the quarter ended 31 March 20X1 (related to the investee's earnings for the quarter ended 31 December 20X0). The investee's earnings for that period are reflected in the cost of the investment and the initial measurement on 1 January 20X1.

### **6.2.8.2 Reporting lag in the period of disposal**

When an investor disposes of an equity method investment that is accounted for on a lag, the investor recognizes equity method earnings only up to the date of the investee's most recently available financial statements. An investor recognizes a gain or loss on disposal when the investment is sold, not on a lag.

For example, assume that a calendar year-end investor disposes of an equity method investment that is on a quarterly lag on 31 December 20X1. The last equity method earnings that the investor would recognize would be in that quarter for its share of the investee's earnings or losses for the quarter ended 30 September 20X1. The investor would not recognize any equity method earnings for that investment in the quarter ended 31 March 20X2 (related to the investee's financial statements for the quarter ended 31 December 20X1). The investee's earnings for the quarter ended 31 December 20X1 is already reflected in the selling price of the investment and the gain or loss on disposal.

## **6.2.9 Direct earnings from an investee's subsidiaries**

As discussed in section 3.6 if an investor holds a direct interest in the common voting shares of a consolidated subsidiary of an investee accounted for under the equity method of accounting, in addition to an interest in the investee, the investor accounts for its investment in the subsidiary under the equity method.

When an investor is applying the equity method of accounting to both a direct and an indirect interest in an investee, it should not double-count the earnings and losses of the investee's subsidiary. The investor would record its portion of the earnings and losses of the investee's subsidiary as well as its portion of the investee's earnings and losses, which would include the investee's consolidated subsidiaries.

See Illustration 3-4 for an example.

## 6.2.10 Equity method investments in entities with different functional currencies

### Excerpt from Accounting Standards Codification

#### Other Considerations

#### *Financial Statements of an Equity Method Investee*

#### **830-10-15-5**

The **functional currency** approach applies equally to **translation** of financial statements of foreign investees whether accounted for by the equity method or consolidated. Therefore, the foreign currency statements and the foreign currency transactions of an investee that are accounted for by the equity method shall be translated in conformity with the requirements of this Topic in applying the equity method.

When the equity method investee's functional currency differs from the reporting currency of the investor, the financial statements of the investee should be translated into the reporting currency of the equity method investor in the same manner as it would for the financial statements of a consolidated subsidiary. See section 1.3.1 of our FRD, *Foreign currency matters*, for additional guidance.

## 6.2.11 Reciprocal interests

A reciprocal interest arises when an investee holds an equity method investment in the equity method investor (reporting entity).

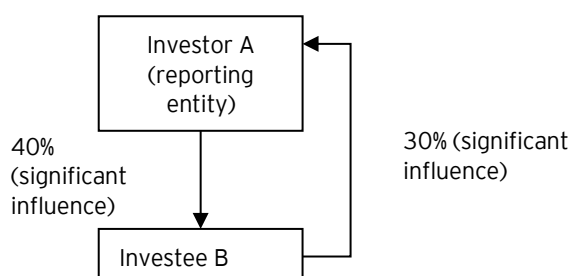
When a reciprocal interest exists, applying the equity method to the investee's total net income would result in the investor double counting income (from the 'investee's equity method earnings from its investment in the investor) if no elimination entries were recorded. As discussed in section 6.2.1, ASC 323-10-35-7 requires the elimination of intra-entity equity method profits until realized by the investor or investee as if the investee were a consolidated subsidiary.

An approach that is commonly used in practice is the treasury stock method. Under the treasury stock method, the investor records its share of the investee's net income, excluding any equity method earnings from the reciprocal holding. Investors also should consider the effect on earnings per share.

However, an equity method investor should not present the shares held by the equity method investee as treasury stock in its balance sheet, since the investor does not control the investee, and the investee is not a consolidated subsidiary.

### Illustration 6-9: Reciprocal holdings

In 1 January 20X1, Investor A acquired a 40% interest in the voting common stock of Investee B. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method. Investee B holds a 30% interest in the voting common stock of Investor A.



Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this example. Relevant data for each entity is shown in the following table:

	Entity A	Entity B
Cost of equity method investment	\$160,000	\$180,000
Net income (before equity method earnings from reciprocal holding) for 20X1	\$60,000	\$110,000
Shares outstanding	100,000	40,000

Entity A's net income for 20X1, after equity method earnings from Entity B would be \$104,000 ( $\$60,000 + 40\% \times \$110,000$ ). Entity B's net income equity method earnings from Entity A would be \$128,000 ( $\$110,000 + 30\% \times \$60,000$ ).

As a result, Entity A's total equity method investment in Entity B would be \$264,000 ( $\$160,000 + \$104,000$ ). That is, Entity A would not reduce its equity method investment or record treasury stock for the reciprocal interest held by Entity B. Similarly, Entity B's equity method investment in Entity A would be \$208,000 ( $\$180,000 + \$128,000$ ).

## 6.3 Interest costs

Investees may incur interest expense as a result of loans from equity method investors or other third parties. The accounting for interest by the investor and the investee depends on the identity of the lender(s) and the activities of the investee.

### 6.3.1 Capitalization of interest costs

#### Excerpt from Accounting Standards Codification

##### Interest-Capitalization of Interest

##### *Scope and Scope Exceptions*

##### *Assets for Which Interest Shall Be Capitalized*

##### **835-20-15-5**

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

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

##### *Assets for Which Interest Shall Not Be Capitalized*

##### **835-20-15-6**

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

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

##### *Initial Measurement*

##### **835-20-30-6**

The total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the entity in that period. In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost incurred by the parent entity and consolidated subsidiaries on a consolidated basis. In any separately issued financial

statements of a parent entity or a consolidated subsidiary and in the financial statements (whether separately issued or not) of unconsolidated subsidiaries and other investees accounted for by the equity method, the limitation shall be applied by reference to the total amount of interest cost (including interest on intra-entity borrowings) incurred by the separate entity.

### ***Subsequent measurement***

#### ***Amortization of Capitalized Interest on an Equity Method Investment***

##### **835-20-35-2**

This Subtopic requires capitalization of **interest cost** on an investment accounted for by the equity method that has not begun its planned principal operations while the investee has **activities** in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. Under those circumstances, capitalized interest cost may be associated with the estimated useful lives of the investee's assets and amortized over the same period as those assets. Interest capitalized on the investments accounted for by the equity method is amortized consistent with paragraph 323-10-35-13.

In certain situations, an investor is required to capitalize interest costs it incurs related to an equity method investment. ASC 835 includes investments (e.g., equity, loans, advances) accounted for using the equity method as qualifying assets of the investor during the period beginning upon the commencement of spending by the investee and ending when the investee begins its principal operations. Such investments are qualifying assets of the investor as long as both of the following conditions exist:

- ▶ The investee has activities in progress necessary to commence its planned principal operations.
- ▶ The investee is using its funds to acquire qualifying assets for its operations.

Once the investee begins its planned principal operations, the investor ceases capitalization of interest. If the investee is already operating, the investment does not qualify for interest capitalization, even if a construction project is in process. That is, the investor is not permitted to look through its investment to determine whether a portion of the investment is undergoing construction. For example, if an investee is constructing a hotel but already has another operating property, the investment does not qualify for any interest capitalization by the investor. If the investee has multiple construction projects underway, when the first project commences operations, the entire equity method investment no longer qualifies for interest capitalization by the investor.

In its own financial statements, the investee would still qualify for capitalization of interest on construction if it meets the criteria identified in ASC 835-20. However, ASC 835-20-30-6 limits the total interest cost eligible for capitalization by a consolidated group to the interest incurred by a parent and its subsidiaries. Because of that limitation, interest incurred by an investee is not eligible for capitalization by the consolidated group. Likewise, interest incurred by the investor is not eligible for capitalization by the investee. Applying this limitation may result in reporting different amounts of net income and stockholders' equity than the amounts that would have resulted had the investee been a consolidated subsidiary.

The effects of interest capitalized by the investee would be carried through to the investor under the normal application of the equity method of accounting, unless the interest relates to borrowings from the equity method investor. In that case, the interest is deducted from the equity method investment.

When recording its equity method earnings, an investor should consider the effects of any basis differences (and resulting depreciation or amortization) resulting from any capitalized interest on loans from the investor (see section 5.4 for more guidance). These basis differences should be adjusted over the same period as the underlying assets of the investee (see section 6.2.2 for more guidance).

**Illustration 6-10: Capitalized interest costs**

On 1 January 20X1, Investor A acquired a 20% interest in the voting common stock of Investee Z. Investor A has the ability to exercise significant influence over Investee Z (the presumption that significant influence exists is not overcome) and applies the equity method of accounting. Basis differences, other intra-entity transactions and the effect of income taxes have been ignored to simplify this illustration. At the date of acquisition, Investor A determined that Investee Z had already commenced principal operations.

Investor A also loaned \$2 million to Investee Z on 1 January 20X1 for Investee Z to build a new manufacturing plant. The loan is for 10 years and has a 10% annual interest rate. Construction began on the project immediately and is expected to continue for three years, with the manufacturing plant not commencing production until the end of the third year. Because Investee Z's manufacturing plant is under construction through 31 December 20X1, the project qualifies for capitalized interest in accordance with ASC 835-20 for the year ended 31 December 20X1. Therefore, Investee Z is capitalizing the interest related to the loan of \$200,000 ( $\$2,000,000 \times 10\%$ ) in 20X1. For the year ended 31 December 20X1, Investee Z reports \$500,000 of net income (since Investee Z is capitalizing its interest on the loan from Investor A, this amount does not reflect any interest expense).

Investor A first records its 20% share of the \$500,000 of earnings of Investee Z:

Equity method investment	\$ 100,000	
Equity method earnings		\$ 100,000

Investor A also records interest income related to the loan to Investee Z:

Cash	\$ 200,000	
Interest income		\$ 200,000

Because Investee Z capitalized the interest, Investor A adjusts its equity method earnings so that it does not record its share of the capitalized interest. Investor A's 20% portion of the capitalized interest is \$40,000 ( $\$200,000 \times 20\%$ ). Therefore, Investor A adjusts its equity method earnings as follows:

Equity method earnings	\$ 40,000	
Equity method investment		\$ 40,000

Therefore, Investor A's equity method earnings for the year are \$60,000 ( $\$100,000 - \$40,000$ ), before considering the effects of any basis differences (and resulting depreciation) on the manufacturing plant resulting from the capitalized interest.

The elimination of the intra-entity profit might be reflected in the investor's balance sheet and income statement in various ways. The income statement and balance sheet presentation for this elimination entry will depend on what is the most meaningful in the circumstances. See section 6.2.1 for additional guidance.

Because Investor A has determined that Investee Z has already commenced principal operations, no additional interest is capitalized by Investor A on its investment in Investee Z.

**6.3.2****Interest on in-substance capital contributions****Excerpt from Accounting Standards Codification****Real estate – Investments – Equity Method and Joint Ventures*****Subsequent Measurement*****970-323-35-22**

Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) shall be accounted for as distributions rather than as interest income by the investors.

When assessing how to account for interest on loans and advances to an investee, an investor should evaluate whether the loans or advances are in-substance capital contributions. For example, this might be the case if all investors are required to make loans and advances proportionate to their equity interests. When an investor determines that the loans or advances represent in-substance capital contributions, the investor should account for the interest as a distribution (that is, decreasing its equity method investment balance), rather than as interest income.

In addition, in accordance with ASC 970-835-35-1, we believe an investor should consider whether the principal and/or interest are collectible, before recording interest income on a loan or an advance to an investee. A loan or advance might not be collectible if it does not contain adequate collateral or other terms normally required by an independent lender that would exist in an arm's-length transaction. The investor also should evaluate whether other investors can bear their share of losses when evaluating whether to record interest income on any loans from the investor to the investee (see section 6.4).

While this guidance was written for the real estate industry in ASC 970, we believe it should be considered for all equity method investments.

## 6.4 Investee losses in excess of investment carrying amount plus advances

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-19**

An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. An equity method investor shall continue to report losses up to the investor's investment carrying amount, including any additional financial support made or committed to by the investor. Additional financial support made or committed to by the investor may take the form of any of the following:

- a. Capital contributions to the investee
- b. Investments in additional common stock of the investee
- c. Investments in preferred stock of the investee
- d. Loans to the investee
- e. Investments in debt securities (including mandatorily redeemable preferred stock) of the investee
- f. Advances to the investee.

See paragraphs 323-10-35-24 and 323-10-35-28 for additional guidance if the investor has other investments in the investee.

##### **323-10-35-20**

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

##### **323-10-35-21**

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

**323-10-35-22**

If the investee subsequently reports net income, the investor shall resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

**Real Estate – General*****Subsequent Measurement*****970-323-35-2**

Investors shall record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles (GAAP), without regard to unrealized increases in the estimated fair value of the venture's assets.

**970-323-35-3**

An investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture shall record its equity in **real estate venture** losses in excess of its investment, including loans and advances.

**970-323-35-4**

The following are examples of such circumstances:

- a. The investor has a legal obligation as a guarantor or general partner.
- b. The investor has indicated a commitment, based on considerations such as business reputation, intra-entity relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

**970-323-35-5**

An investor, though not liable or otherwise committed to provide additional financial support, shall provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero though the underlying profitable pattern of an investee is unimpaired.

**970-323-35-8**

If it is probable that one or more investors cannot bear their share of losses, the remaining investors shall record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses. This does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of investors' creditors are limited to investors' respective interests in such property.

**970-323-35-9**

When the venture subsequently reports income, those remaining investors shall record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess losses they previously recorded. An investor who is deemed by other investors to be unable to bear its share of losses shall continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.



**970-323-35-10**

The accounting by an investor for losses otherwise allocable to other investors shall be governed by the provisions of Subtopic 450-20 relating to loss contingencies. Accordingly, the investor shall record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, each investor shall look primarily to the fair value of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses. An investor may not be able to apply the general rule to an investment in an **undivided interest** because the extent to which the interests of other investors are encumbered by liens may not be known. However, there may be satisfactory alternative evidence of an ability and willingness of other investors to bear their allocable share of losses. Such evidence might be, for example, that those investors previously made loans or contributions to support cash deficits, possess satisfactory financial standing (as may be evidenced by satisfactory credit ratings), or have provided adequately collateralized guarantees.

In applying the equity method, an investor's share of losses may equal or exceed the carrying amount of the investment plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment and any net advances are reduced to zero. The investor should not record additional losses unless (1) the investor guaranteed obligations of the investee, (2) the investor is otherwise committed to provide further financial support for the investee or (3) it is anticipated that the investee's return to profitability is imminent. If the investee subsequently reports net income, the investor should resume application of the equity method only after its share of unrecognized net income equals the share of net losses not recognized during the period the equity method was suspended. Accordingly, it is important to track any unrecorded losses.

If the investor provided a commitment to fund losses, the investor would continue to record losses resulting in a negative equity method investment, which should be presented as a liability. Commitments may be explicit, and may include formal guarantees to the investee, legal obligations, arrangements by contract or legal obligations that result from the legal form of the investment (e.g., general partner). Implicit commitments may arise from reputational expectations, intercompany relationships, statements by the investor of the investor's intention to provide support, a history of providing financial support or other facts and circumstances.

When an investor issues a guarantee directly to a third party (e.g., a bank) in conjunction with an equity method investment, ASC 460 and ASC 450-20 provide guidance on the accounting for the guarantee. The accounting for the guarantee is separate from the accounting for the equity method investment (including any commitment that the investor may have given to the investee itself), which is accounted for under ASC 323. That is, there are two separate units of account. However, the issuance of a guarantee directly to a third party may indicate that the investor has a commitment to fund the investee and should be carefully considered when making that assessment.

In addition, an investor should record its share of losses when an investee's imminent return to profitable operations appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the investee is expected to operate profitably in the near term. Startup losses may also reduce the carrying amount of an investment below zero.

When determining the share of losses to be recorded, an investor also should consider the ability and the intention of other investors to fund their proportionate share of losses. In some cases when an investor has explicitly or implicitly committed to fund losses of an investee, the investor might need to record losses in excess of its proportionate share if the other investors are unwilling or unable to fund their proportionate share and the company is required or otherwise expected to fund the additional amounts. For example, this may be the case if an investor has fully guaranteed an obligation of the investee, rather than just its proportionate share.

When an investee is generating losses, the investor should consider whether an other-than-temporary impairment has occurred, as discussed in section 6.8.

The equity method of accounting for an investee's losses may differ from consolidation procedures for a subsidiary's losses. ASC 810 requires that losses be attributed to the noncontrolling interest, even when the noncontrolling interest's basis in a partially owned subsidiary has been reduced to zero. This will often result in asymmetry with an investor's equity method accounting, because the equity method investment is generally not reduced below zero for losses, except when the investor is committed to provide other financial support or is otherwise obligated to fund the investee.

**Illustration 6-11: Recording additional losses when imminent return to profitable operations of investee is assured**

**Example 1**

On 1 January 20X1, Investor A acquired a 25% interest in the voting common stock of Investee B for \$1,000. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method. Investee B has been in business for 15 years and has had net income for the past 10 years. Basis differences, intra-entity transactions, and the effect of income taxes have been ignored to simplify this illustration.

Investee B has \$400 in net income for the year ended 31 December 20X1. Investor A records \$100 as equity method earnings (25% of \$400) with a corresponding increase to its investment account.

During 20X2, one of Investee B's business operations is destroyed by a natural disaster, which results in a nonrecurring loss recorded in that year. Investee B's net loss for the year ended 31 December 20X2 was \$5,000. Investee B expects to return to profitable operating results in 20X3. Investor A determines that the loss is due to an event that is isolated in nature. Because Investee B is expecting to return to operating profitability in the next year, Investor A records its share of Investee B's loss from 20X2 of \$1,250 (25% of \$5,000). This will reduce its investment to a negative carrying amount of \$(150) (which is calculated as \$1,000 + 20X1 income of \$100 – 20X2 loss of \$1,250). This amount is presented as a liability in Investor A's balance sheet.

**Example 2**

Assume the same facts as in Example 1, except that Investee B's imminent return to profitability is not reasonably assured. In this situation, even though Investor A's proportionate share of Investee B's losses for 20X2 was \$1,250, Investor A would only record equity method losses of \$1,100. This is because Investor A would not reduce its investment balance below zero since it did not have a commitment to fund losses of Investee B and Investee B's imminent return to profitable operations was not reasonably assured.

As a result, Investor A would not record \$150 of its proportionate share of losses in 20X2 in its income statement. Instead, Investor A would track the unrecorded loss of \$150 in its "memo" accounts.

If Investee B has net income for the year ended 31 December 20X3 of \$2,000, Investor A's proportionate share of Investee B's net income would be \$500 (25% of \$2,000). Investor A would record its first \$150 of income in the "memo" accounts, against the \$150 of losses previously accumulated in the "memo" accounts, resulting in a \$0 balance in the "memo" accounts. Investor A would then record its remaining proportionate share of income for 20X3 of \$350 (total of \$500 less \$150 recorded in the "memo" accounts) in its equity method earnings in net income.

## 6.4.1 Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee (updated June 2024)

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-23**

The guidance in the following paragraph applies to situations in which both of the following conditions exist:

- a. An investor is not required to advance additional funds to an investee.
- b. Previous losses have reduced the common stock investment account to zero.

##### **323-10-35-24**

In the circumstances described in paragraph 323-10-35-23, the investor shall continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments shall follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments shall be adjusted for the equity method losses, then the investor shall apply Subtopic 310-10, 320-10, or 321-10 to the other investments, as applicable.

##### **323-10-35-25**

The cost basis of the other investments is the original cost of those investments adjusted for the effects of other-than-temporary write-downs, unrealized holding gains and losses on debt securities classified as trading in accordance with Subtopic 320-10 or equity securities accounted for in accordance with Subtopic 321-10 and amortization of any discount or premium on debt securities or loans. The adjusted basis is the cost basis adjusted for the valuation allowance account recognized in accordance with Subtopic 310-10 for an investee loan and the cumulative equity method losses applied to the other investments. Equity method income subsequently recorded shall be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (that is, equity method income is applied to the more senior investments first).

##### **323-10-35-26**

If the investor has other investments in the investee (including, but not limited to, preferred stock, debt securities, and loans to the investee) that are within the scope of Subtopic 310-10, 320-10, or 321-10, the investor should perform all of the following steps to determine the amount of equity method loss to report at the end of a period:

- a. Apply this Subtopic to determine the maximum amount of equity method losses.
- b. Determine whether the adjusted basis of the other investment(s) in the investee is positive, and do the following:
  1. If the adjusted basis is positive, the adjusted basis of the other investments shall be adjusted for the amount of the equity method loss based on the investments' seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the debt security's basis from which subsequent changes in fair value are measured. Paragraph 321-10-35-5 explains that for investments accounted for in accordance with Subtopic 321-10, this adjusted basis becomes the equity security's basis from which subsequent changes in fair value are measured.

2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported. Example 4 (see paragraph 323-10-55-30) illustrates the application of (b)(2).
- c. After applying this Subtopic, apply Subtopics 310-10, 320-10, and 321-10 to the adjusted basis of the other investments in the investee, as applicable.
- d. Apply appropriate generally accepted accounting principles (GAAP) to other investments that are not within the scope of Subtopics 310-10, 320-10, or 321-10.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.

### **Pending Content:**

**Transition date:** (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

#### **323-10-35-24**

In the circumstances described in paragraph 323-10-35-23, the investor shall continue to report its share of equity method losses in its statement of operations to the extent of and as an adjustment to the adjusted basis of the other investments in the investee. The order in which those equity method losses should be applied to the other investments shall follow the seniority of the other investments (that is, priority in liquidation). For each period, the adjusted basis of the other investments shall be adjusted for the equity method losses, then the investor shall apply Subtopic 310-10, 320-10, 321-10, 326-20, or 326-30 to the other investments, as applicable.

**Transition date:** (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-1

#### **323-10-35-25**

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

**Transition date:** (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-2

#### **323-10-35-26**

If the investor has other investments in the investee (including, but not limited to, preferred stock, debt securities, and loans to the investee) that are within the scope of Subtopic 310-10, 320-10, or 321-10, the investor should perform all of the following steps to determine the amount of equity method loss to report at the end of a period:

- a. Apply this Subtopic to determine the maximum amount of equity method losses.

- b. Determine whether the adjusted basis of the other investment(s) in the investee is positive, and do the following:
1. If the adjusted basis is positive, the adjusted basis of the other investments shall be adjusted for the amount of the equity method loss based on the investments' seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the debt security's basis from which subsequent changes in fair value are measured. Paragraph 321-10-35-5 explains that for investments accounted for in accordance with Subtopic 321-10, this adjusted basis becomes the equity security's basis from which subsequent changes in fair value are measured.
  2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported. Example 4 (see paragraph 323-10-55-30) illustrates the application of (b)(2).
- c. After applying this Subtopic, apply Subtopics 310-10, 320-10, 321-10, 326-20, and 326-30 to the adjusted basis of the other investments in the investee, as applicable.
- d. Apply appropriate generally accepted accounting principles (GAAP) to other investments that are not within the scope of Subtopic 310-10, 320-10, 321-10, 326-20, or 326-30.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.

## **Investments – Debt and Equity Securities – Overall**

### ***Subsequent Measurement***

#### **320-10-35-3**

Paragraphs 323-10-35-23 through 35-26 identify circumstances in which an entity must adjust the basis of its investment in debt securities of an equity method investee for the amount of an equity method loss based on the investment's seniority. For investments accounted for in accordance with this Subtopic, the adjusted basis resulting from the application of paragraphs 323-10-35-23 through 35-26 becomes the debt security's basis from which subsequent changes in fair value are measured.

When an investor is not required to advance additional funds to an investee and previous losses have reduced the investor's common stock investment account to zero, the investor should continue to record its share of equity method losses to the extent it has a positive adjusted basis in any investments in the investee. Other investments may include, but are not limited to, preferred stock, debt securities and loans. The order in which those equity method losses are applied to the other investments is based on the seniority of the other investments, with the investment that is lowest in priority in liquidation reduced first.

The application of equity method losses to debt securities within the scope of ASC 320 and equity securities within the scope of ASC 321 results in an adjusted basis for those securities, which becomes the security's basis for measuring subsequent changes in fair value.

**Illustration 6-12: Equity method losses applied to other investments of an investee held by investor**

An investor has an equity method investment in an investee that is comprised of 2,000 shares of common stock (20% interest), 100 shares of preferred A stock (10% interest) and 100 shares of preferred B stock (10% interest). In addition, the investor loaned \$1,000,000 to the investee, which remains outstanding. The investor is not required to advance additional funds to the investee, and because of prior year losses, the common stock investment account of the investor in the investee has been reduced to zero.

Based on the liquidation rights, the loan is the most senior of the investor's investments. The preferred B shares are senior to the preferred A shares and the preferred A shares are senior to the common stock. The common stockholders are entitled to the residual.

The investor would continue to report its share of equity method losses by applying them to the other investments according to their seniority. Since the common stock investment is at zero, any additional equity method losses would be applied to the remaining investments in reverse order of priority. That is, the equity method losses would first be recorded against the adjusted basis of the preferred A stock, followed by the preferred B stock and, lastly, to the loan.

As discussed in ASC 323-10-35-25, to determine the adjusted basis of an investor's other investments in an investee, the investor first calculates its cost basis in the other investments.

The cost basis of an investment is the original purchase price of the investment adjusted for:

- ▶ Write-offs
- ▶ Unrealized gains and/or losses recorded on debt securities classified as trading in accordance with ASC 320-10 and equity securities in accordance with ASC 321-10
- ▶ Amortization of any discount or premium on debt securities or loans

The cost basis, as described above, is modified further by the following to arrive at the *adjusted cost basis*:

- ▶ An allowance for credit losses on financing receivables and debt securities in accordance with ASC 326
- ▶ Cumulative equity method losses previously applied to the investment

If an investor holds other investments that have a positive adjusted basis, these other investments are eligible to absorb any remaining equity method losses once the balance of the common stock equity method investment is reduced to zero. Once an adjusted basis reaches zero, equity method losses should stop being recorded. However, the investor should continue to track the unreported equity method losses. Tracking losses is important for determining equity method earnings in subsequent periods when an investee returns to profitability.

Equity method earnings subsequently recorded should be applied to the adjusted basis of the other investments in reverse order of the application of the equity method losses (i.e., applied to the more senior securities first). In addition, when the adjusted basis reaches zero for debt securities classified as trading in accordance with ASC 320 or equity securities accounted for in accordance with ASC 321, we believe that subsequent increases in fair value (unrealized gains) should only be recognized for amounts in excess of cumulative unrecognized equity method losses.

After recording its share of equity method losses, the investor would then apply other US GAAP with respect to receivables or other investments in debt and equity securities (e.g., ASC 310, ASC 320, ASC 321, ASC 326).

Generally, entities are required to measure equity investments (other than equity method investments, controlling financial interests that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value in net income. However, entities may elect a measurement alternative for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient in ASC 820 to estimate fair value using the NAV per share.

See our FRD, *Certain investments in debt and equity securities*, and our FRD, *Credit impairment under ASC 326*, for more information.

### Question 6.1

Assume an investor owns common stock in an investee that is accounted for under the equity method and preferred stock in the same investee that is accounted for as an equity security under ASC 321.

If the investor has reduced both its equity method investment and preferred stock investment to zero and has cumulative unrecognized equity method losses, should the investor recognize a subsequent increase in the fair value of the preferred stock investment (or, if the measurement alternative is selected, an increase based on an observable price change) as an unrealized gain (loss) through net income?

It will depend on the facts and circumstances. Recognizing an increase in the preferred stock investment would require the investor to apply any previously unrecognized cumulative equity method losses to the new positive adjusted basis immediately. Therefore, since the investor has cumulative unrecognized equity method losses, we believe that the investor would not recognize an unrealized gain on the subsequent increase in fair value (or, if the measurement alternative is selected, an increase based on an observable price change) of the preferred stock, unless the amount of the subsequent increase in fair value of the preferred stock investment (or an increase based on an observable price change) exceeds the cumulative unrecognized equity method losses. In that circumstance, only the excess portion of the unrealized gain would be recognized.



#### FASB agenda decision

In May 2019, the FASB added a project to the EITF agenda on *Financial Instruments: Clarifying the Interactions between Topic 321 and Topic 323* (EITF 19-A) in response to stakeholder questions. One of the questions related to sequencing of the allocation of equity method losses under ASC 323 to other investments in the same investee that are measured under the measurement alternative in ASC 321 when there are cumulative unrecognized equity method losses. The EITF did not reach a consensus at its June 2019 meeting on this issue. Therefore, there may be diversity in practice, and more than one approach might be acceptable. Other issues that were raised in this project were addressed by the issuance of ASU 2020-01.

## 6.4.2 Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee (updated June 2024)

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### *Percentage Used to Determine the Amount of Equity Method Losses*

##### **323-10-35-27**

The guidance in the following paragraph applies if all of the following conditions exist:

- a. An investor owns common stock (or in-substance common stock) and other investments in an investee.
- b. The investor has the ability to exercise significant influence over the operating and financial policies of the investee.
- c. The investor is not required to advance additional funds to the investee.
- d. Previous losses have reduced the common stock investment account to zero.

##### **323-10-35-28**

In the circumstances described in the preceding paragraph, the investor shall not recognize equity method losses based solely on the percentage of investee common stock held by the investor. Example 5 (see paragraph 323-10-55-48) illustrates two possible approaches for recognizing equity method losses in such circumstances.

##### *Implementation Guidance and Illustrations*

##### **323-10-55-48**

The following Cases illustrate possible approaches to recognizing equity method losses in accordance with paragraph 323-10-35-28:

- a. Ownership level of particular investment (Case A)
- b. Change in investor claim on investee book value (Case B).

##### **323-10-55-49**

Cases A and B share all of the following assumptions:

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



- e. Investor A is not obligated to provide any additional funding to Investee. As of the beginning of 20X1, the adjusted basis of Investor's total combined investment in Investee is \$200, as follows.

Common stock	\$	–
Preferred stock	\$	100
Loan	\$	100

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

20X1	\$	(160)
20X2	\$	(200)
20X3	\$	500

- g. Investee's balance sheet is as follows.

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

### Case A: Ownership Level of Particular Investment

#### 323-10-55-50

Under this approach, Investor A would recognize equity method losses based on the ownership level of the particular investee security, loan, or advance held by the investor to which equity method losses are being applied.

#### 323-10-55-51

In 20X1, in accordance with this Subtopic, Investor A would record the equity method loss to the adjusted basis of the preferred stock (the next most senior level of capital) after the common stock investment becomes zero ( $50\% \times \$160 = \$80$ ). Investor A would record the following journal entry.

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

#### 323-10-55-52

In 20X2, in accordance with this Subtopic, Investor A would record the equity method loss to the extent of the adjusted basis of the preferred stock of \$20 ( $50\% \times \$40 = \$20$ ) and, because the adjusted basis of the preferred stock will then be reduced to zero, record the remaining equity method loss to the adjusted basis of the loan (the next most senior level of capital) ( $60\% \times \$160$  [that is,  $\$200 - \$40$  applied to the preferred stock] = \$96). Investor A would record the following journal entry.

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

#### 323-10-55-53

In 20X3, in accordance with this Subtopic, Investor A would record the equity method income first to the loan until its adjusted basis is restored ( $60\% \times \$160 = \$96$ ), then to the preferred stock until its adjusted basis is restored ( $50\% \times \$200 = \$100$ ), and finally to the common stock ( $40\% \times \$140 = \$56$ ). Investor A would record the following journal entry.

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

**Case B: Change in Investor Claim on Investee Book Value****323-10-55-54**

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

**323-10-55-55**

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

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

**323-10-55-56**

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

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

**323-10-55-57**

With respect to 20X3, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X3, it would have \$507 available to distribute. Investor A would receive \$256 (Investor A's 60% share of a priority claim from the loan [\$100], Investor A's 50% share of a priority distribution from its preferred stock investment [\$100], and 40% of the remaining cash available to distribute [\$140 × 40% = \$56]). Investor A's claim on Investee's book value at December 31, 20X2, was \$4 (see above). Therefore, during 20X3, Investor A's claim on Investee's book value increased by \$252 and that is the amount Investor A would recognize in 20X3 as its share of Investee's earnings. Investor A would record the following journal entry.

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

Once an investor that owns other investments in an investee reduces its common stock investment to zero and is not required to advance additional funds to the investee, it should not recognize subsequent equity method losses based solely on the percentage of common stock it holds. Instead, the investor has two possible approaches for measuring equity method losses. As illustrated in ASC 323-10-55-48 through 55-57, measurement can be based on either (a) its ownership of the particular investee security, loan, or advance to which equity method losses are being applied, or (b) the change in the investor's claim on the investee's book value.

Investors should disclose their accounting policy for determining equity method losses when previous losses have reduced the common stock investment account to zero. Once an investor adopts a policy for one of its equity method investments, it should apply the policy consistently for all of its equity method investments. See section 8.3 for more discussion.

Following is an example of the application of the equity method when an investor's common stock investment has been reduced to zero, the investor has a preferred stock investment in the investee and the investor uses its ownership level with respect to a particular investment to recognize equity method losses. The comprehensive example in ASC 323-10-55-30 through 55-47 covers several years and illustrates the application of the equity method when an investor holds (1) common stock, (2) preferred stock that meets the definition of a debt security classified as available-for-sale and (3) a loan, and there is a change in the loan's credit loss allowance.

**Illustration 6-13: Application of the equity method when investor's common stock investment has been reduced to zero and investor has preferred stock investment in investee**

Investor A owns 30% of the outstanding common stock of Investee B. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method. The common stock equity method investment has been reduced to zero as of the beginning of 20X1 because of previous losses. Investor A also has invested \$100 in preferred stock that meets the definition of a debt security and is classified as an available-for-sale security, which represents 40% of the outstanding preferred stock of Investee B. Investor A is not required to provide any additional funding to Investee B.

Basis differences, intra-entity transactions, dividends and the effect of income taxes have been ignored to simplify this illustration. In addition, this example assumes that there is no, write-off or credit loss allowance, or unamortized discount or premium related to the preferred stock.

As of the beginning of 20X1, the cost basis of Investor A's combined investment in Investee B is \$100: zero for the equity method investment in the common stock and \$100 for the preferred stock.

Investor A calculates its percentage of equity method losses to be recognized against the preferred stock in accordance with the ownership level of the preferred stock, as described in ASC 323-10-55-48(a).

Assume the following facts for years 20X1 and 20X2:

Year	Investee B's net income/(loss)	Fair value of the preferred stock
20X1	\$ (200)	\$ 90
20X2	(300)	60

The preferred stock was sold on 1 January 20X3 for \$60.

20X1:

(1) Investor A will record an equity method loss ( $40\% \times \$200 = \$80$ ) to the preferred stock (the next level of capital). This reduces its carrying amount to \$20 (\$100 less \$80).

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

- (2) Investor A will record the mark-to-market (fair value) adjustment for the available-for-sale preferred stock investment (fair value of \$90 less the adjusted carrying amount of \$20 after entry (1) above, resulting in an unrealized gain of \$70).

Preferred stock investment	\$ 70	
Unrealized gain-other comprehensive income (loss)		\$ 70

This increases its carrying amount to \$90 (\$20 + \$70).

A rollforward of the 20X1 activity in the preferred stock investment is as follows:

Beginning balance	\$ 100
Other items included in cost basis	N/A
Ending cost basis, 20X1	<u>100</u>
Equity method losses	<u>(80)</u>
Ending adjusted basis, 20X1	20
Unrealized gains/losses recorded in other comprehensive income	<u>70</u>
Ending carrying amount, 20X1	<u>\$ 90</u>

In 20X1, Investor A records the equity method loss of \$80. Other comprehensive income (OCI) would reflect a \$70 unrealized gain for the preferred stock investment. The carrying amount of the investment is reduced to \$90, and the balance in accumulated OCI is a credit of \$70. The adjusted basis of the preferred stock in Investee B is reduced to \$20. Since there are no write-offs or credit loss allowances, or unamortized discounts or premiums, the cost basis of the preferred stock remains \$100.

Note that unrealized gains and losses are not included in the cost basis of available-for-sale securities, but are included in the cost basis of trading securities.

20X2:

- (1) Investor A records the equity method loss of \$20. Investor A's proportionate share of loss is \$120 (40% of \$300). However, the loss is limited to \$20, because the adjusted basis (which at the end of 20X1 is \$20, prior to this entry) cannot be reduced below zero when the investor is not required to provide additional funding. The remaining \$100 in losses will be tracked in a "memo" account, and would only be realized if Investee B has net income in future years or upon sale of the equity method investment. This reduces its carrying amount to \$70 (\$90 less \$20).

Equity method loss	\$ 20	
Preferred stock investment		\$ 20

- (2) Investor A records a \$10 mark-to-market (fair value) adjustment for the available-for-sale preferred stock investment (fair value of \$60 less the carrying amount of \$70 after 20X2 entry (1), decreasing the carrying amount to \$60 (\$70 less \$10).

Unrealized loss – other comprehensive income (loss)	\$ 10	
Preferred stock investment		\$ 10

A rollforward of the cumulative activity in the preferred stock investment is as follows:

Beginning balance	\$ 100
Other items included in cost basis	N/A
Ending cost basis, 20X2	<u>100</u>
Cumulative equity method losses	<u>(100)</u>
Ending adjusted basis, 20X2	-
Cumulative unrealized gains/losses recorded in other comprehensive income	<u>60</u>
Ending carrying amount, 20X2	<u>\$ 60</u>

In 20X2, Investor A records equity method losses of \$20 and \$100 of losses are tracked in the “memo” accounts. Other comprehensive loss would reflect a \$10 unrealized loss for the preferred stock investment. The carrying amount of the preferred stock investment is reduced to \$60, and the balance in accumulated OCI is a credit of \$60. The adjusted basis of the preferred stock in Investee B is reduced to zero. Since there are no, write-offs or credit loss allowances, unrealized gains or losses on trading securities, or amortization of debt discounts or premiums, the cost basis of the preferred stock remains \$100.

20X3:

(1) Record the sale of the preferred stock, which was sold for \$60.

Cash	\$	60	
Other comprehensive income (loss)		60	
Preferred stock investment			\$ 60
Gain on sale of security			60

Immediately before the sale, the carrying value of the preferred stock of \$60 exceeded its adjusted basis of \$0. Therefore, as a result of the sale of the preferred stock, \$100 of the previously recorded equity method losses (representing the difference between the cost basis of the preferred stock of \$100 and its adjusted basis of \$0) have effectively been reversed in 20X3 entry (1). For example, if the equity method losses had not been applied to the preferred stock, Investor A would have had a realized loss on the sale of the preferred stock of \$40 (\$100 cost less \$60 proceeds). Instead, Investor A has a realized gain of \$60. The difference represents the previously recognized equity method losses of \$100.

Since Investor A has no other investments, the \$100 of previously recognized equity method losses that have been effectively reversed on the sale of the preferred stock will be tracked in its “memo” accounts against which subsequent equity method income would be recorded prior to recording any actual equity method earnings or losses.

### 6.4.3 Effect of investee’s other comprehensive income when the investment has been reduced to zero

As discussed in section 6.2.3 an investor records its proportionate share of an investee’s other comprehensive income (OCI) with a corresponding adjustment to its equity method investment. In addition, an investor ordinarily should stop applying the equity method when the investment and any net advances are reduced to zero.

Therefore, an investment could be reduced to zero through equity method losses recorded through a combination of earnings and OCI. If the investee subsequently reports net income or other comprehensive income, the investor should resume applying the equity method only after its share of unrecognized net income and other comprehensive income, respectively, equals the share of losses not recognized during the period the equity method was suspended.

ASC 323 does not specify how an investor should resume applying the equity method. An investor should develop a consistent and rational method when resuming its equity method accounting. We believe that the nature of the income components (i.e., net income and other comprehensive income) should be tracked separately in the memo accounts with their characterization preserved during suspension and upon resuming equity method accounting. In addition, an investor should not recognize equity method income until its share of unrecognized net income and other comprehensive income equals its share of net losses that it would have recognized if the equity method of accounting had not been temporarily suspended. The investor should be able to reconcile its equity method investment balance to its proportionate share of the investee’s net assets.

The following example illustrates a method that gives precedence to net income and losses over other comprehensive income and losses.

**Illustration 6-14: Application of the equity method when equity method investment has been reduced to zero and investee subsequently records other comprehensive income**

Investor A owns 20% of the outstanding common stock of Investee B. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and applies the equity method.

On 1 January 20X1, Investor A makes an initial cash investment in Investee B of \$100.

Equity method investment	\$ 100	
Cash		\$ 100

Assume the following facts for years 20X1 and 20X2:

Year	Investee B's net income/(loss)	Investee B's other comprehensive income (loss)
20X1	\$ (300)	\$ (350)
20X2	(75)	275

Assume that Investor A did not have a commitment to fund losses of Investee B, Investee B's imminent return to profitable operations is not reasonably assured, and there are no additional investments in Investee B by Investor A. Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this illustration.

Investor A records an equity method loss of \$60 (20% \* \$300).

Equity method loss	\$ 60	
Equity method investment		\$ 60

Investor A records an equity method other comprehensive loss of \$40 to its equity method investment. Investor A's proportionate share of Investee B's other comprehensive loss is \$(70) (20% \* \$350). However, Investor A's equity method losses are limited to \$40, which is the remaining adjusted cost basis in the equity method investment after recording the journal entry above (\$100 less \$60). Investor A would not record the full amount of its proportionate share of equity method other comprehensive losses, because it does not have a commitment to fund losses of Investee B and Investee B's imminent return to profitability is not reasonably assured. Investor A would track the remaining \$30 (proportionate share of \$70 less \$40 recorded) in its "memo" accounts.

Other comprehensive income loss (equity method investment)	\$ 40	
Equity method investment		\$ 40

**Rollforward of Investor A's proportionate share of net assets of Investee B:**

Beginning proportionate share of net assets of Investee B, 20X1	\$ 100
Equity method losses	(60)
Equity method other comprehensive losses	(70)
Ending proportionate share of net assets of Investee B, 20X1	<u>\$ (30)</u>

**Reconciliation to amounts recorded by Investor A:**

Equity method investment (balance sheet)	\$ -
Equity method investment ("memo" account)	(30)
Ending proportionate share of net assets of Investee B, 20X1	<u>\$ (30)</u>

**20X2:**

Investor A records an equity method other comprehensive gain of \$25 to its equity method investment. Investor A's proportionate share of Investee B's other comprehensive gain is \$55 (20% of \$275). However, Investor A had previous unrecorded other comprehensive losses of \$30 from 20X1. Therefore, Investor A's other comprehensive gain for 20X2 is reduced by the amount of previously unrecorded other comprehensive losses, resulting in an unrealized gain of \$25 (\$55 less \$30).

Equity method investment	\$ 25	
Other comprehensive income gain (equity method investment)		\$ 25

Investor A records equity method losses of \$15 (20% of \$75).

Equity method loss	\$ 15	
Equity method investment		\$ 15

**Rollforward of Investor A's proportionate share of net assets of Investee B:**

Beginning proportionate share of net assets of Investee B, 20X2	\$ (30)
Equity method losses	(15)
Equity method other comprehensive gain	55
Ending proportionate share of net assets of Investee B, 20X2	<u>\$ 10</u>

## Reconciliation to amounts recorded by Investor A:

Equity method investment (balance sheet)	\$ 10
Equity method investment ("memo" accounts)	-
Ending proportionate share of net assets of Investee B, 20X2	<u>\$ 10</u>

For both periods, the equity method investment balance (including the "memo" account) reconciles to Investor A's proportionate share of net assets in Investee B. In addition, the cumulative equity method other comprehensive loss of \$15 recognized [ $$(40) + \$25$ ] equals Investor B's cumulative proportionate share of other comprehensive loss [ $$(70) + \$55$ ].

## 6.4.4

### Subsequent investments not resulting in a controlling interest after suspension of equity method loss recognition

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### Subsequent Measurement

##### 323-10-35-29

If a subsequent investment in an investee does not result in the ownership interest increasing from one of significant influence to one of control and, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (see (b)). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances. Judgment is required in determining whether prior losses are being funded and all available information should be considered in performing the related analysis. All of the following factors shall be considered; however, no one factor shall be considered presumptive or determinative:

- Whether the additional investment is acquired from a third party or directly from the investee. If the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.

- b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.
- c. Whether the additional investment results in an increase in ownership percentage of the investee. If the investment is made directly with the investee, the investor shall consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.
- d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

### **323-10-35-30**

Upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

If an investor makes an additional investment in an investee and retains an equity method investment, and the investment represents the funding of prior losses, the investor recognizes previously suspended losses that it tracked. However, losses recognized should not exceed the additional investment that represents the funding of prior losses.

However, whether the investment represents the funding of prior losses will depend on the facts and circumstances. Judgment is required when determining whether prior losses are being funded and all available information should be considered in the analysis, including all the factors discussed in ASC 323-10-35-29. While no one factor should be considered determinative, we would generally presume that non-pro rata contributions directly to the investee would represent the funding of prior losses.

After making the additional investment in an investee, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

### **Illustration 6-15: Subsequent investment not resulting in a controlling interest after suspension of equity method loss recognition**

**The following background applies to both examples:**

Investor A owns 30% of the outstanding common stock of Investee Z. Investor A has the ability to exercise significant influence over Investee Z (the presumption that significant influence exists is not overcome) and applies the equity method. The common stock equity method investment has been reduced to zero at the beginning of 20X1 because of previous losses. Investor A is not required to provide any additional funding to Investee Z. Due to the equity method investment being reduced to zero, Investor A has suspended equity method accounting. Basis differences, intra-entity transactions, dividends and the effect of income taxes have been ignored to simplify this illustration.

#### **Example 1**

In 20X3, Investor A makes an additional \$2 million advance to Investee Z. Investor A does not receive any additional ownership for making this advance; therefore, its ownership of Investee Z remains at 30%. Based on these facts and circumstances, and considering the factors in ASC 323-10-35-29, Investor A determines that the \$2 million advance represents the funding of prior losses, and therefore it should recognize any previously suspended losses up to the amount of the additional investment. Because it provided the advance to Investee Z, Investor A also should evaluate whether it has become otherwise committed to provide financial support to Investee Z.



**Example 2**

In 20X3, Investor A acquired an additional 15% of the outstanding common stock of Investee Z from a third party in exchange for \$2 million (i.e., Investee Z did not receive the proceeds of this additional investment by Investor A). Investor A's ownership in Investee Z increases to 45% from 30% because of the additional investment.

Since the additional investment was purchased from a third party and Investee Z does not obtain additional funds from Investor A or the third party, Investor A determines that it has not funded prior losses, since the additional investment increased Investor A's ownership of Investee Z, and no other investors are making simultaneous investments. In this situation, Investor A would apply the equity method of accounting to its additional investment, including recording its share of losses incurred after the additional investment. However, Investor A would not recognize any previously suspended losses on its initial investment.

**Example 3**

In 20X3, Investor A acquired newly issued shares of common stock of Investee Z in exchange for \$2 million (i.e., Investee Z received the proceeds of this additional investment from Investor A). Investor A's ownership in Investee Z did not change, because each of the other investors in Investee Z also acquired a pro rata share of the newly issued common stock.

Since the proceeds from the additional investment are received by Investee Z and Investor A does not obtain any new rights or privileges, Investor A determines that prior losses are being funded. Therefore, Investor A recognizes any previously suspended losses up to the amount of the additional investment. As a result of having made the additional investment in Investee Z, Investor A also should evaluate whether it has become otherwise committed to provide financial support to Investee Z.

**6.5****Share-based payments granted by investors to employees and nonemployees of an equity method investee****Excerpt from Accounting Standards Codification****Investments – Equity Method and Joint Ventures – Overall****Recognition****323-10-25-3**

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

**323-10-25-4**

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

**323-10-25-5**

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

***Initial Measurement*****323-10-30-3**

Share-based compensation cost recognized in accordance with paragraph 323-10-25-4 shall be measured initially at fair value in accordance with Topic 718. Example 2 (see paragraph 323-10-55-19) illustrates the application of this guidance.

***SEC Materials*****323-10-S99-4**

The following is the text of SEC Observer Comment: Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee.

Paragraph 323-10-25-3 provides guidance on the accounting by an investor for stock-based compensation based on the investor's stock granted to employees of an equity method investee. Investors that are SEC registrants should classify any income or expense resulting from application of this guidance in the same income statement caption as the equity in earnings (or losses) of the investee.

**Compensation – Stock Compensation – Overall*****Recognition*****505-10-25-3**

Paragraphs 323-10-25-3 through 25-5 provide guidance on accounting for share-based compensation granted by an investor to employees or nonemployees of an equity method investee that provide goods or services to the investee that are used or consumed in the investee's operations. An investee shall recognize the costs of the share-based payment incurred by the investor on its behalf, and a corresponding capital contribution, as the costs are incurred on its behalf (that is, in the same period(s) as if the investor had paid cash to employees and nonemployees of the investee following the guidance in Topic 718 on stock compensation.

An investor may grant share-based payments on its own shares to employees or nonemployees of an equity method investee in exchange for goods or services the employees or nonemployees provide to the investee. Issues arise in both the accounting by the investor and the investee.

The guidance in ASC 323-10 applies to share-based payments granted by an investor to employees or nonemployees of an investee that are based on that investor's shares (i.e., stock of the investor or other equity instruments indexed to, and potentially settled in, the shares of the investor).

An illustration of the accounting for share-based payments granted to employees of an equity method investee is included in section 6.5.4 and in ASC 323-10-55-20 through 55-26. See also section 2.4 of our FRD, ***Share-based payment***, for further discussion.

## 6.5.1 Accounting by the investor

ASC 323 requires an investor to recognize its share of the earnings or losses of an investee in the periods the amounts are reported by the investee in its financial statements. However, an investor recognizes the full cost of share-based payment awards it grants to employees or nonemployees of an equity method investee to the extent that the investor's claim on the investee's book value does not increase in the same period and same manner as if the investee had paid cash for the goods or services.

The investor's claim on the investee's book value would not increase if proportionate funding is not provided by the other investors and the investor does not receive any increase in its relative ownership percentage of the investee. For example, if an investor's ownership percentage does not increase, an investor would recognize 100% of the compensation cost, even if the investor holds a 40% investment in the investee. However, an investor's claim on the book value could increase, for example, if an investor obtains more shares in the investee or if the investee capitalizes some of the compensation cost. ASC 323 assumes that the compensation cost incurred on behalf of the investee was not agreed to when the investor acquired its interest in the investee. The cost of the shares in that transaction is measured under ASC 718 and is accounted for as an additional investment.

For investors that are SEC registrants, income or expense resulting from the application of this guidance should be classified in the same income statement line item as the equity method earnings or losses.

## 6.5.2 Accounting by the investee

An investee recognizes the cost of share-based payments granted by an investor and a corresponding capital contribution because the costs are incurred on its behalf. The cost of share-based payments granted to employees and nonemployees is measured under ASC 718. The contribution and expense should be recognized in the same period(s) and same manner as if the investee had paid cash for the goods or services).

## 6.5.3 Accounting by other investors

An investor that doesn't contribute to the investee also needs to account for the effects of such an award. That is, a noncontributing investor recognizes income equal to the amount by which its interest in the net book value of the investee increases (i.e., its share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the compensation costs. Noncontributing investors also recognize their share of earnings or losses in the investee, including any expense recognized by the investee for the share-based payments funded on the investee's behalf. For investors that did not contribute to the investee and are SEC registrants, income or expense resulting from the application of this guidance should be classified in the same income statement caption as the equity method earnings or losses in accordance with ASC 323-10-S99-4.

## 6.5.4 Example

### **Illustration 6-16: Share-based payments granted by investors to employees of an equity method investee**

Investor A owns 40% of the voting common stock of Investee Z. Investor B holds 30% of the voting common stock of Investee Z. Both Investor A and Investor B have the ability to exercise significant influence over Investee Z (the presumption that significant influence exists is not overcome) and apply the equity method. All other investors hold individually immaterial investments in Investee Z. Investee Z's net assets were \$1,000 on 1 January 20X1.

On 2 January 20X1, Investor A grants 100 options (in the shares of Investor A) to Investee Z's employees. The options cliff vest in two years. None of the other investors in Investee Z shared in funding the options granted to the employees of Investee Z. That is, the funding of options by investors is disproportionate between investors. Investor A was not obligated to grant the options under any preexisting agreement with either Investee Z or other investors and its equity interest will not increase as a result. Assume that the recognition of compensation cost for the stock options is the only transaction that occurs during 20X1 and 20X2, and there were no forfeitures (assumed or actual). Basis differences and the effect of income taxes have been ignored to simplify this illustration. The options had a fair value at 2 January 20X1 (the grant date) of \$1,000. The journal entries for Investee Z, Investor A and Investor B would be the following:

Year	Investee Z	Investor A (Grantor)	Investor B (Other investor)
12/31/20X1	Expense	500	Equity method loss
	APIC	500	Investment
	<i>(to record employees' compensation in shares of the investor)</i>		<i>(to record proportionate share of Investee Z's net loss, or 40% * \$500)</i>
			<i>(to record proportionate share of Investee Z's net loss, or 30% * \$500)</i>
12/31/20X2	Expense	500	Equity method loss
	APIC	500	Investment
	<i>(to record employees' compensation in shares of the investor)</i>		<i>(to record 40% of Investee Z's net loss)</i>
			<i>(to record 30% of Investee Z's net loss)</i>

Investee Z recognizes the compensation cost of \$500 in 20X1 and 20X2 (\$1,000/2 years) with a corresponding increase to APIC.

Investor A records its share of Investee Z's loss (i.e., 40% of \$500 or \$200) in 20X1 and 20X2, with a corresponding decrease to the investment account. Investor A also increases its investment account for its portion of the options granted, recognizes a loss for the portion of the options granted to Investee Z that benefits the other investors (i.e., 60% of the total cost, or \$300 in 20X1 and 20X2) and records an increase to APIC for the total fair value of the shares. If Investor A were an SEC registrant, it would be required to present the portion of the compensation cost recorded as a result of applying this guidance in the same income statement line item as its equity method earnings or losses.

Investor B will record its share of Investee Z's earnings (which, in this example, consists solely of compensation cost) for \$150 (30% of \$500) in 20X1 and 20X2. However, since Investor B's interest in Investee Z's net book value has increased because of the disproportionate funding, Investor B will record the related benefit for the same amounts, resulting in a net effect of zero.

If Investee Z had other transactions recorded in net income or net loss, the first entries recorded by Investor A and Investor B would differ in amount from the journal entries above.

Although the above example illustrates the issuance of an employee award, the same concepts apply to a nonemployee award granted by an investor in exchange for goods or services provided to the investee.

## 6.6 Investee costs paid for by equity method investor

### Excerpt from Accounting Standards Codification

#### Income Statement – Reporting Comprehensive Income – Overall

#### SEC Materials – General

#### 220-10-S99-4

The following is the text of SAB Topic 5.T, Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)...

The staff believes that the problem of separating the benefit to the principal stockholder from the benefit to the company cited in FASB ASC Topic 718 is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other<sup>36</sup> transactions where a principal stockholder pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company...

<sup>36</sup> For example, SAB Topic 1.B indicates that the separate financial statements of a subsidiary should reflect any costs of its operations which are incurred by the parent on its behalf. Additionally, the staff notes that AICPA Technical Practice Aids § 4160 also indicates that the payment by principal stockholders of a company's debt should be accounted for as a capital contribution.

An investor may incur costs on behalf of an equity method investee that are not reimbursed by an investee, have no proportionate funding by the other investors and the investor does not receive any increase in the investor's relative ownership percentage of the investee. No specific guidance exists for costs incurred by an investor on behalf of an investee in this situation, except for share-based payments granted to the employees or nonemployees of an investee by an investor.

However, the SEC staff believes the guidance on share-based payments granted by an investor to the employees or nonemployees of an investee should be applied by analogy to other expenses that an investor incurs on behalf of an equity method investee. Therefore, similar to the concepts described in section 6.5, an investee should recognize a capital contribution for any costs incurred by the investor on its behalf, and should capitalize or expense the costs based on their nature and the applicable accounting guidance for such costs. A contributing investor should expense the cost incurred on behalf of the equity method investee as incurred if the investor's claim on the investee's book value has not changed. However, the investor should take care not to double-count the effects these transactions, as discussed in section 6.2.1. We believe that SEC registrants should present any income or expense resulting from the application of this guidance in the same income statement caption as the equity method earnings or losses, consistent with the approach required for share-based payment expenses.

Other (noncontributing) investors should recognize income equal to the amount by which their interest in the net book value of the investee has increased (i.e., their share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the costs. Also, other investors should recognize their share of earnings or losses in the investee, including any expense recognized by the investee for the costs funded on the investee's behalf.

## 6.7 Non-pro rata profit or loss allocations (updated July 2023)

### Excerpt from Accounting Standards Codification

#### Real estate – Overall

#### *Allocation Ratios*

#### **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.

#### **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.

Certain investees may have contractual arrangements that use allocation ratios that differ from the investor's ownership interest for a variety of items including profits and losses, specified costs and expenses, distributions of cash from operations or distributions of cash proceeds from liquidation. ASC 970-323 provides guidance for these arrangements in the context of real estate joint ventures. We believe that, if substantive, a contractual arrangement that specifies allocation ratios among investors for any of the items in ASC 970-323-35-16 also should be used for recognizing an investor's share of the earnings or losses for equity method investments in other industries.

Examples of profit-sharing arrangements could include (this list is not exhaustive):

- ▶ One investor is allocated all income generated from tax credits, while other investors receive all other operating income and losses.
- ▶ One investor receives a preferential return (e.g., the first \$X of income, or based on a specified internal rate of return).
- ▶ One investor is allocated all of the investee's interest expense; thereafter, distributions are allocated on a pro rata basis.

To be substantive, an arrangement should retain its economic outcome over time and subsequent events should not have the potential to retroactively affect or unwind prior allocations. For example, if an arrangement used one allocation while it continued as a going concern but used a different method for allocations upon liquidation, that may suggest that the prior allocations were not substantive. However, a change in the earnings (a loss) of an investee from one period to the next (i.e., the investee reports income in one period and a loss in the next period), would not be considered a subsequent event that would unwind prior allocations.

Determining whether a profit-sharing arrangement is substantive is a matter of individual facts and circumstances requiring the use of professional judgment. Additionally, we believe it would be appropriate to disclose the terms and effects of any material substantive profit-sharing arrangement, as discussed in section 8.3.

For example, if an agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but the arrangement also requires that distributions to the investors be made simultaneously and be divided equally between them, the purported allocation of depreciation expense has no substance.

To determine an investor's equity method earnings (losses) to be recorded when a substantive profit sharing arrangement exists, the investor would analyze the agreements and arrangements to determine how a change in net assets of the investee (determined in conformity with US GAAP) would affect cash payments to the investor over the life of the investee and upon its liquidation. However, little implementation guidance exists on how to make this determination.

One approach applied in practice to account for substantive profit-sharing arrangements is the hypothetical-liquidation-at-book-value (HLBV) method. As described in more detail below, the use of such an approach is appropriate when the terms of the substantive profit-sharing arrangement are consistent with the calculation of HLBV. Under the HLBV approach, the investor's share of the investee's earnings or loss is calculated by:

- ▶ The investor's capital account at the end of the period assuming that the investee was liquidated or sold at book value, plus
- ▶ Cash distributions received by the investor during the period, minus
- ▶ The investor's new investments in the investee during the period, minus
- ▶ The investor's capital account at the beginning of the period assuming that the investee was liquidated or sold at book value

The HLBV method would be applied using the investee's book values in accordance with US GAAP. However, in determining its equity method earnings or losses in an investee, the investor would also include any adjustments related to basis differences that were identified as part of the initial accounting for the investment. See section 6.2.2 and Question 6.2.

The HLBV method was discussed in detail in a proposed Statement of Position (SOP), *Accounting for Investors' Interests in Unconsolidated Real Estate Investments*. However, the proposed SOP was never adopted. As a result, there is no authoritative guidance requiring the use of HLBV. The HLBV method therefore should be considered only as an approach for how an investor might calculate equity method earnings or losses when a substantive profit-sharing arrangement exists and the application of HLBV is consistent with such terms. Said differently, the investor should ensure that the application of the HLBV method is consistent with the economic substance of an arrangement and does not conflict with authoritative guidance. Therefore, using the HLBV method (or any other methodology) to make such attributions is appropriate only if doing so reflects the terms of an existing substantive profit-sharing arrangement.

Determining whether the terms of an arrangement are substantive and whether the HLBV method (or any other allocation methodology) reflects that substance requires a careful evaluation of the individual facts and circumstances and requires the use of professional judgment. In evaluating the substance of the terms, the investor should consider whether the terms retain their economic outcome over time and whether subsequent events have the potential to retroactively affect or unwind prior allocations.

**Illustration 6-17: Application of a substantive profit sharing arrangement**

Investee was formed as a partnership on 1 January 20X1 by two investors. Investor A contributed \$200 in exchange for units of the Investee. Investor B made a nominal contribution; however, the investee is not a VIE. Investor B provides the technical knowledge and background for the Investee to operate. For purposes of this example, assume that no asset is recognized by Investee related to the technical knowledge and background provided by Investor B. Both Investor A and Investor B have the ability to exercise significant influence over the Investee and apply the equity method.

There have not been any changes in ownership interests and there were no additional contributions from or distributions to the investors from 1 January 20X1 through 31 December 20X3. Investee does not distribute any dividends in any period. Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this illustration.

Investee's book value is as follows:

	<u>1/1/X1</u>	<u>12/31/X1</u>	<u>12/31/X2</u>	<u>12/31/X3</u>
Net assets	\$ 200	\$ 150	\$ 320	\$ 560
Net income (losses)		\$ (50)	\$ 170	\$ 240

Under the terms of the substantive profit-sharing arrangement, Investor A would receive back its initial investment of \$200, plus an additional return of \$200. After Investor A has received these amounts, all remaining profits and losses are allocated evenly (50/50) between Investor A and B. The investors determined that applying HLBV is an appropriate method for recognizing the substance of the profit-sharing arrangement.

Based on the above net assets and the terms of the substantive profit-sharing arrangement, the claim to net assets at book value would be as follows:

	<u>1/1/X1</u>	<u>12/31/X1</u>	<u>12/31/X2</u>	<u>12/31/X3</u>
Book value of net assets	\$ 200	\$ 150	\$ 320	\$ 560
Return of capital to Investor A (up to original investment of \$200)	(200)	(150)	(200)	(200)
Remaining assets to allocate	-	-	120	360
Return to Investor A (up to a maximum of \$200)	-	-	(120)	(200)
Remaining profits to allocate	-	-	-	160
50% pro rata to Investor A	-	-	-	(80)
50% pro rata to Investor B	-	-	-	(80)
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
HLBV capital of Investor A	\$ 200	\$ 150	\$ 320	\$ 480
HLBV capital of Investor B	-	-	-	80

20X1:

If Investee hypothetically liquidated its assets and liabilities at book value at 31 December 20X1, it would have \$150 available to distribute. Investor A would receive \$150 as its return of capital according to the substantive profit-sharing arrangement. Therefore, during 20X1, Investor A's claim on Investee's book value decreased by \$50 (\$150 capital less initial capital of \$200), which Investor A would recognize in 20X1 as its share of Investee's losses. Investor A would record the following journal entry:

Equity method loss	\$ 50	
Equity method investment		\$ 50

Since the entire loss under HLBV has been allocated to Investor A, Investor B would not record any equity method earnings or losses during 20X1.



20X2:

If Investee hypothetically liquidated its assets and liabilities at book value at 31 December 20X2, it would have \$320 available to distribute. Investor A would receive \$200 as its return of capital, plus \$120 as part of its return, according to the substantive profit-sharing arrangement. Therefore, during 20X2, Investor A's capital increased to \$320. Investor A's income for the year would be \$170 (\$320 in capital at 31 December 20X2 less \$150 in hypothetically liquidated capital at 31 December 20X1). Investor A would record the following journal entry:

Equity method investment	\$ 170	
Equity method earnings		\$ 170

Since all profits were allocated to Investor A, Investor B would not record any equity method earnings or losses during 20X2.

20X3:

If Investee hypothetically liquidated its assets and liabilities at book value at 31 December 20X3, it would have \$560 available to distribute. Investor A would receive \$200 as its return of capital, plus \$200 as its return, according to the substantive profit-sharing arrangement. Therefore, during 20X3, Investor A's HLBV capital increased to \$480 (Investor A's \$200 return of capital, \$200 in return for the year plus 50% share of the remaining net assets available to distribute [ $\$160 \times 50\% = 80$ ]). Investor A's income for the year would be \$160 (\$480 in capital at 31 December 20X3 less \$320 in hypothetically liquidated capital at 31 December 20X2). Investor A would record the following journal entry:

Equity method investment	\$ 160	
Equity method earnings		\$ 160

Investor B would record the following journal entry (50% share of the remaining net assets available to distribute [ $\$160 \times 50\% = 80$ ]):

Equity method investment	\$ 80	
Equity method earnings		\$ 80

## Question 6.2

**How should the investor account for basis differences when applying the HLBV method when there are differences between the fair value and carrying value of the equity method investee's net assets upon initial investment?**

As discussed in section 5.4, when an entity makes an investment that qualifies for the equity method of accounting, there may be a difference between the cost basis of the investment and the proportional interest in the underlying equity in the net assets of the investee (i.e., basis difference). An investor accounts for basis differences as if the investee were a consolidated subsidiary.

The HLBV method determines the investor's proportionate claim to the net assets of the investee as if the investee were liquidated at book value. Investors often use a "recast method" to subsequently account for basis differences identified at inception of the investment when applying the HLBV method. This method recasts (or steps up) the assets to their fair value at the time of initial investment and then reflects an increase in depreciation over the useful life of the asset to account for the stepped-up basis in the asset. These recast amounts are then used by the investor for purposes of applying the HLBV method consistently with the terms of the underlying agreement.

This method is consistent with an approach outlined in the proposed SOP referenced above. Although the recast method is commonly used in practice, other methods may also be acceptable.

Identifying and subsequently accounting for basis differences when applying the HLBV method can be complex and entities should carefully evaluate their facts and circumstances to ensure that the approach is consistent with the guidance in ASC 323-10-35-13.

### 6.7.1 Equity method earnings (losses) for tax equity investors (added July 2023)

Entities may invest in partnerships or other pass-through entities, which we refer to as project entities, that acquire or construct assets that generate investment tax credits that are passed on to investors. For example, project entities may invest in solar or wind energy projects or qualified affordable housing projects. An investor in these projects generally receives a return on its investment from the allocation of investment tax credits (ITCs), an allocation of tax losses (that are available to offset the investor's taxable income from other sources) and/or cash distributions.

These structures are typically designed to provide disproportionate allocations of income (loss), ITCs and/or cash distributions until a targeted rate of return has been achieved. After that date, which is commonly referred to as the "flip date," the allocation changes. In these circumstances, it's important to consider the substantive terms of the underlying partnership agreement in determining the appropriate attribution method when accounting for an equity method investment following a substantive profit-sharing arrangement. In practice, entities often account for such investments using the HLBV method following the substantive terms of the underlying arrangement.

The following illustration provides an example of an investor's equity method earnings or losses for these structures. However, entities should carefully evaluate the terms of the underlying agreements, which can be complex and can vary significantly from one investee to another. In addition, entities should consider consulting with their tax specialists and other advisers, given the complexities often encountered in evaluating the partnership and liquidation provisions of the underlying agreements.

#### **Illustration 6-18: Application of a substantive profit sharing arrangement (tax equity flip)**

Investee was formed as a partnership on 1 January 20X1 by two investors to develop and construct a solar power plant facility. Investee will own the facility and sell electricity to a local utility under a power purchase agreement. Investee is a pass-through entity for tax purposes and the related tax attributes from the solar facility (e.g., ITCs, accelerated tax depreciation) are allocated to the two investors in accordance with Investee's operating agreement between the partners.

The tax equity investor (Investor A) and the sponsor (Investor B) will contribute \$90,000 and \$160,000 to Investee, respectively. Investor A applies the equity method of accounting for its investment in Investee. Investor B consolidates Investee. Certain calculations have been provided for Investor B below but the analysis focused on the accounting for Investor A, which will apply the equity method of accounting for its investment in Investee.

Investee has a complex capital structure that requires a different allocation of income, gain, loss, tax deductions and tax credits to the investors before and after a "flip date." This allocation is disproportionate to the investors' ownership interests. That is, Investor A will receive the majority of the benefits before the flip date and the minority of the benefits after the flip date. The flip date is the date at which Investor A reaches a targeted internal rate of return (IRR) on its initial investment. This IRR is achieved through the allocation of ITCs and other tax benefits (e.g., accelerated tax depreciation) in addition to cash distributions.

Under the terms of the agreement between the investors, the taxable income (loss) is allocated between Investor A and Investor B as follows:

	<u>Pre-flip</u>	<u>Post-flip</u>
Investor A	99%	5%
Investor B	1%	95%

Cash distributions, which do not approximate US GAAP earnings, are allocated between Investor A and Investor B as follows:

	<u>Pre-flip</u>	<u>Post-flip</u>
Investor A	25%	5%
Investor B	75%	95%

For the purposes of this illustration, we have assumed generic liquidation provisions in computing HLBV equity method income (loss). We have also assumed the asset has a five-year useful life for tax purposes and that 100% of the cost is ITC-eligible equipment at a 30% tax credit rate.

Given Investee's complex structure, Investor A uses the HLBV method to account for the substantive profit-sharing arrangement. To determine the amounts allocated to each investor in liquidation, Investor A must perform an analysis of the investors' IRC Section 704(b) capital accounts, as adjusted to reflect the terms of the partnership agreement. Below are the steps the investors would follow to ensure consistency with the liquidation provisions of the underlying partnership agreement:

- ▶ Determine the US GAAP capital accounts (step 1)
- ▶ Determine the 704(b) capital accounts (step 2)
- ▶ Determine the taxable gain on liquidation (step 3)
- ▶ Allocate hypothetical proceeds in liquidation, including allocation of tax gain (loss) on liquidation in accordance with the terms of the arrangement (step 4):
  - ▶ Eliminate capital account deficits (step 4A)
  - ▶ Provide Investor A with a priority return so that it achieves the target IRR (step 4B)
  - ▶ Split remaining liquidation gain according to post-flip allocation percentages (step 4C)
- ▶ Determine change in claim (step 5)

The attribution of Investee's HLBV equity income (loss) is calculated for Investor A and Investor B in years 1 through 3 below. For simplicity, we have assumed there are no intra-entity transactions or basis differences (other than the realization of the ITC).

*Step 1: US GAAP capital accounts of Investee (partnership)*

	20X1	20X2	20X3
US GAAP net income	\$ 67	\$ 318	\$ 576
Beginning balance	-	240,000	230,000
<i>Plus:</i> Capital contributions	250,000	-	-
<i>Plus:</i> Net income (loss)	67	318	576
<i>Less:</i> Cash distributions	(10,067)	(10,318)	(10,576)
Ending balance	<u>\$ 240,000</u>	<u>\$ 230,000</u>	<u>\$ 220,000</u>

*Step 2: 704(b) capital accounts of Investee*

	20X1	20X2	20X3
Taxable income (loss) of Investee	\$ (24,933)	\$ (45,682)	\$ (23,024)
Beginning balance	-	177,500	121,500
<i>Plus:</i> Capital contributions	250,000	-	-
<i>Plus:</i> Taxable income (loss)	(24,933)	(45,682)	(23,024)
<i>Less:</i> Cash distributions	(10,067)	(10,318)	(10,576)
<i>Less:</i> ITC basis reduction*	(37,500)	-	-
Ending balance	<u>\$ 177,500</u>	<u>\$ 121,500</u>	<u>\$ 87,900</u>

\* The total investment tax credit was \$75,000 (\$250,000 cost of ITC-eligible equipment x 30%). In accordance with Section 50(c)(3)(A) of the Internal Revenue Code, the basis of the property shall be reduced by 50% of the investment tax credit.

*Step 2A: determine 704(b) capital accounts of Investor A*

	%	20X1	20X2	20X3
Beginning balance		\$ -	\$ 25,674	\$ (22,130)
<i>Plus:</i> Capital contributions		90,000	-	-
<i>Plus:</i> Taxable income (loss)	99%	(24,684)	(45,225)	(22,794)
<i>Less:</i> Cash distributions	25%	(2,517)	(2,579)	(2,644)
<i>Less:</i> ITC basis reduction	99%	(37,125)	-	-
Ending balance		<u>\$ 25,674</u>	<u>\$ (22,130)</u>	<u>\$ (47,568)</u>

*Step 2B: determine 704(b) capital accounts of Investor B*

	%	20X1	20X2	20X3
Beginning balance		\$ -	\$ 151,826	\$ 143,630
<i>Plus:</i> Capital contributions		160,000	-	-
<i>Plus:</i> Taxable income (loss)	1%	(249)	(457)	(230)
<i>Less:</i> Cash distributions	75%	(7,550)	(7,739)	(7,932)
<i>Less:</i> ITC basis reduction	1%	(375)	-	-
Ending balance		<u>\$ 151,826</u>	<u>\$ 143,630</u>	<u>\$ 135,468</u>

*Step 3: calculate the tax gain on liquidation*

	20X1	20X2	20X3
HLBV proceeds (US GAAP account) - Step 1	\$ 240,000	\$ 230,000	\$ 220,000
Partnership tax basis - Step 2	177,500	121,500	87,900
Gain (loss) on liquidation	<u>\$ 62,500</u>	<u>\$ 108,500</u>	<u>\$ 132,100</u>

*Step 4: allocate hypothetical proceeds in liquidation, including allocation of tax gain (loss) on liquidation in accordance with the terms of the arrangement\*\**

	20X1	20X2	20X3
Investor A hypothetical proceeds in liquidation**	\$ 28,799	\$ 12,082	\$ 9,131
Investor B hypothetical proceeds in liquidation**	\$ 211,201	\$ 217,918	\$ 210,869

\*\* This calculation involves multiple steps as noted above and may be complex. For purposes of this illustration, the steps to determine the investor account balances have been combined and reflect all allocations, including the target IRR.

*Step 5: determine change in claim (adjusted for contributions and distributions)*

	20X1	20X2	20X3
Investor A account - ending	\$ 28,799	\$ 12,082	\$ 9,131
<i>Plus:</i> Investor A distributions	2,517	2,579	2,644
<i>Less:</i> Investor A contributions	(90,000)	-	-
<i>Less:</i> Investor A beginning balance	-	(28,799)	(12,082)
Change in claim (allocated income (loss))	<u>\$ (58,684)</u>	<u>\$ (14,138)</u>	<u>\$ (307)</u>
Investor B account - ending	\$ 211,201	\$ 217,918	\$ 210,869
<i>Plus:</i> Investor B distributions	7,550	7,739	7,932
<i>Less:</i> Investor B contributions	(160,000)	-	-
<i>Less:</i> Investor B beginning balance	-	(211,201)	(217,918)
Change in claim (allocated income (loss))	<u>\$ 58,751</u>	<u>\$ 14,456</u>	<u>\$ 883</u>

Below are the journal entries recorded by Investor A to reflect its contributions, equity method earnings (losses) and cash distributions related to its equity method investment in Investee based on the amounts above.

## 20X1:

If Investee hypothetically liquidated its net assets at book value at 31 December 20X1, it would have \$240,000 available to distribute. Investor A would receive \$28,799 in liquidation following the terms of the partnership agreement. Therefore, during 20X1, Investor A's claim on Investee's book value decreased by \$58,684 (initial capital of \$90,000 less distributions of \$2,517, less ending capital of \$28,799), which Investor A would recognize in 20X1 as its equity method loss. Investor A would record the following journal entries in 20X1:

Equity method investment	\$ 90,000	
Cash		\$ 90,000
Cash	\$ 2,517	
Equity method investment		\$ 2,517
Equity method loss	\$ 58,684	
Equity method investment		\$ 58,684

## 20X2:

If Investee hypothetically liquidated its net assets at book value at 31 December 20X2, it would have \$230,000 available to distribute. Investor A would receive \$12,082 in liquidation following the terms of the partnership agreement. Therefore, during 20X2, Investor A's claim on Investee's book value decreased by \$14,138 (beginning capital of \$28,799 less distributions of \$2,579, less ending capital of \$12,082), which Investor A would recognize in 20X2 as its equity method loss. Investor A would record the following journal entries in 20X2:

Cash	\$ 2,579	
Equity method investment		\$ 2,579
Equity method loss	\$ 14,138	
Equity method investment		\$ 14,138

20X3:

If Investee hypothetically liquidated its net assets at book value at 31 December 20X3, it would have \$220,000 available to distribute. Investor A would receive \$9,131 in liquidation following the terms of the partnership agreement. Therefore, during 20X3, Investor A's claim on Investee's book value decreased by \$307 (beginning capital of \$12,082 less distributions of \$2,644, less ending capital of \$9,131), which Investor A would recognize in 20X3 as its equity method loss. Investor A would record the following journal entries in 20X3:

Cash	\$	2,644		
Equity method investment			\$	2,644
Equity method loss	\$	307		
Equity method investment			\$	307

## 6.7.2 Investments in partnership or other pass-through entities that generate investment tax credits (added July 2023)

As discussed above, an investor in certain project entities may receive a return on its investment in the form of ITCs. ASC 740 provides guidance on accounting for ITCs resulting from the acquisition of depreciable property. However, ASC 740 does not directly address the accounting for tax benefits from tax credits that are generated by a project entity and passed through to its investors.

We believe that an investor in a project entity that accounts for its investment using the equity method could apply the ITC guidance in ASC 740 to account for the tax benefits from ITCs. That is, the investor could apply a method similar to the deferral or flow-through methods described in ASC 740 to account for the tax credits in its financial statements. However, there may be other acceptable methods an investor can apply to account for the tax credits that are passed through from the project entity. An investor should carefully analyze its arrangement to determine when the tax credits are generated and whether there are any recapture provisions attached to the credits.

See section 4.2.7.2 of our FRD, *Income taxes*, for further discussion on application of the deferral and flow-through methods.

### Question 6.3

**Assume an investor receives an ITC from its equity method investment in a solar project, which is organized as a partnership. How does the tax equity investor that applies the HLBV method for purposes of determining its equity method earnings (loss) account for the reduction in its claim on the investee's net assets as a result of receiving its allocated portion of ITCs?**

As demonstrated in Illustration 6-18, when the ITC is generated and passed along to the tax equity investor, there is a reduction in its claim on the investee's net assets since a portion of the tax equity investor's investment has effectively been monetized through receipt of the ITC. There is diversity in practice on how investors recognize the effects of this reduction in claim when determining the amount of equity method earnings (loss).

If the tax equity investor separately applies the flow-through method for the ITC, as referenced in section 4.2.7.2 of our FRD, *Income taxes*, we believe the equity method loss resulting from the reduction in its claim on net assets should be recognized in earnings in the period the ITC is earned. If the tax equity investor applies the deferral method for the ITC, there is diversity in how investors recognize the reduction in their claim on net assets as a result of the ITC. Some investors recognize it in earnings in the period the ITC is earned (consistent with Illustration 6-18), while others account for it as a basis difference that

is amortized in accordance with the guidance in ASC 323-10-35-13 (i.e., it is amortized as an adjustment to equity method earnings (loss) over the life of the underlying project asset that gave rise to the ITC). See section 5.4 for guidance on accounting for basis differences.

We believe both approaches are acceptable but should be consistently applied.

## 6.8 Other-than-temporary impairment

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-31**

A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that shall be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.

##### **323-10-35-32**

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

##### **323-10-35-32A**

An equity method investor shall not separately test an investee's underlying asset(s) for impairment. However, an equity investor shall recognize its share of any impairment charge recorded by an investee in accordance with the guidance in paragraphs 323-10-35-13 and 323-10-45-1 and consider the effect, if any, of the impairment on the investor's basis difference in the assets giving rise to the investee's impairment charge.

#### Real Estate – Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **970-323-35-12**

A loss in value of an investment other than a temporary decline shall be recognized. Such a loss in value may be indicated, for example, by a decision by other investors to cease providing support or reduce their financial commitment to the venture.

The investor's unit of account for evaluating impairment associated with an equity method investment is the investment as a whole. The investment is assessed for other-than-temporary impairment in accordance with ASC 323-10-35-31 through 35-32A. Any equity method goodwill is not separately tested for impairment under the provisions of ASC 350. In addition, an equity method investor does not separately test an investee's underlying asset(s) for impairment.

An equity method investment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment might not be recoverable. These circumstances can include, but are not limited to the following:

- ▶ Evidence that the investor does not have the ability to recover the carrying amount of the investment
- ▶ The inability of the investee to sustain earnings

- ▶ A current fair value of the investment that is less than the carrying amount
- ▶ Other investors ceasing to provide support or reduce their financial commitment to the investee

When an investor has the intent and/or ability to recover the carrying amount of the investment over a long period, for example, from cash flows from the investee, the investor still evaluates whether that recovery will occur in the near term. If the fair value of the investment is less than its carrying amount, and the investment will not recover in the near term, then an other-than-temporary impairment may exist.

An investor should consider whether its equity method investment might be impaired when an investee recognizes an impairment loss (which would, in turn, be reflected by the investor through its application of the equity method). See section 6.10.1 for further discussion.

### 6.8.1 Identifying an other-than-temporary impairment

While ASC 323 does not specifically address how to identify an other-than-temporary impairment (OTTI), entities have historically applied the OTTI model in ASC 320 by analogy. We believe that the OTTI concepts that were in ASC 320 are still relevant for evaluating OTTI of an equity method investment, even though the OTTI model in ASC 320 was superseded by ASU 2016-01 (for equity securities) and ASU 2016-13 (for debt securities).

Using this approach, there are no bright lines or safe harbors to identify securities that may have an OTTI. Rather, an entity should consider all relevant evidence when determining whether an investment has been other than temporarily impaired using a three-step approach:

- ▶ Determine when an investment is considered impaired (Step 1)
- ▶ Evaluate whether an impairment is other-than-temporary (Step 2)
- ▶ Measure and recognize an OTTI (Step 3)

The following are examples of the factors that should be considered when determining if a decline in the value of an equity method investment is other-than-temporary:

- ▶ The length of the time and the extent to which the market value has been less than cost
- ▶ The financial condition and near-term prospects of the issuer, including any specific events that may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential
- ▶ The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value<sup>33</sup>

This list is not all-inclusive, and the relative significance of factors will vary. See section 5 of our FRD, **Certain investments in debt and equity securities**, for further discussion.

When the carrying amount of an equity method investment with a readily determinable fair value exceeds market value for a prolonged period, the SEC staff has asked registrants to demonstrate that an OTTI of the investee has not occurred. Although registrants have asserted numerous positions supporting a recoverability-based approach (such as an intent and ability to hold the investment over the long term and a discounted cash flow analysis supporting the long-term recoverability of the investment), the SEC staff has seldom wavered in its view that readily determinable market values should be used in OTTI analyses.

<sup>33</sup> These factors are from ASC 320-10-S99-1, which codified SAB Topic 5-M, *Other Than Temporary Impairment of Certain Investments in Equity Securities*. The SEC staff rescinded SAB Topic 5-M as a result of the issuance of ASC 321.



## 6.8.2 Recognizing an other-than-temporary impairment

Once an investor determines that an equity method investment is other than temporarily impaired, it is recorded at its fair value (that is, the impairment is measured as the difference between its carrying amount and fair value). Generally, we believe that the investor should record the impairment loss in the same line item on the income statement that it reports the equity method earnings (loss). However, we acknowledge diversity in practice in where investors present the impairment in the income statement. An investor should clearly disclose the line item in which it presents an impairment loss.

SEC registrants are required to disclose material impairments, including those of equity method investments, as discussed in section 8.5.4.

## 6.8.3 Measuring fair value of an equity method investment

ASC 820 provides the authoritative guidance for measuring fair value. This guidance should be applied to measure the fair value of an equity method investment, when determining an impairment charge.

For equity investments in public companies that are actively traded, fair value would generally be determined based on the security's trading price multiplied by the number of shares held.

Determining fair value for investments in privately held entities can be more challenging. The valuation of an investment in a privately held entity requires using a valuation model or models consistent with the principles in ASC 820. Different valuation approaches may produce enterprise values (i.e., total debt plus total equity) or total equity values. If the valuation method produces an enterprise value, the valuation of the total debt must be determined and subtracted from enterprise value to estimate total equity value. Further, the priority of equity instruments affects their valuation.

Valuation methods may produce the fair value of a controlling interest or the fair value of a noncontrolling interest. An investor should identify any valuation adjustments that may be necessary to value a noncontrolling position. In addition, the investor also should consider whether the shares held have other rights or privileges that are a feature or attribute of the security. Sometimes these attributes provide the investor with the ability to exercise significant influence or joint control over the investee (e.g., a guaranteed seat on the investee's board of directors). If such attributes are features of the security, they would be included in the determination of fair value. Given the complexities in the valuation of an investment in a privately held entity, we encourage the use of valuation experts.

See our FRD, *Fair value measurement*, for additional discussion on determining fair value and the required disclosures.

## 6.8.4 Treatment of basis differences upon impairment

The other-than-temporary impairment assessment is applied to the equity method investment as a whole. That is, none of the individual assets underlying the equity method investment, including basis differences, are assessed for impairment by the investor.

Because ASC 323 does not address how an impairment charge affects an investor's basis differences, there may be diversity in practice. An investor should determine an appropriate accounting policy for assigning impairment charges recorded for an equity method investment to the basis differences related to that equity method investment. We believe that one acceptable accounting policy is for an investor to adjust its basis differences by assigning the impairment to the individual net assets underlying the equity method investment based on their fair values at the date of the impairment. Other approaches may also be appropriate.

**Illustration 6-19: Impairment of an equity method investment**

On 1 January 20X1, an investor acquires a 30% equity interest in an investee. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and applies the equity method. The consideration paid is \$500, including transaction costs. At the acquisition date, the book value of the net assets of the investee is \$1,000. The investor's share of the book value of the net assets would be \$300 (30% of \$1,000), resulting in a \$200 basis difference. The investee meets the definition of a business.

On the acquisition date, the investor determines the fair value of the identifiable assets and assumed liabilities. The investor concludes that \$150 of the basis difference relates to plant and equipment; therefore, the remaining \$50 is equity method goodwill. The following worksheet illustrates how the \$200 difference between the investor's cost basis of \$500 and its basis in the underlying equity in net assets of the investee's of \$300 would be assigned on the date of investment.

	Investee B book value	Investor's 30% share of Investee's book value	Fair value of Investee's net assets on 1 January 20X1	Equity method basis difference (difference between book value and fair value)	Investor's 30% of equity method basis difference	Investor's basis
Plant and equipment	\$ 1,000	\$ 300	\$ 1,500	\$ 500	\$ 150	\$ 450
Goodwill	—	—	N/A	—	50	50
	<u>\$ 1,000</u>	<u>\$ 300</u>	<u>\$ 1,500</u>	<u>\$ 500</u>	<u>\$ 200</u>	<u>\$ 500</u>

To simplify this illustration, assume that during 20X1 there has been no change in the investor's share of the book value of the net assets or the related basis differences. At 31 December 20X1, the fair value of the investment is \$375, which indicates to the investor that the investment is now less than its carrying amount, and that there has been a loss in value of the investment. The reduction in fair value is determined to be other-than-temporary.

Because the reduction in fair value is other-than-temporary, the investor recognizes an impairment charge of \$125 on its equity method investment (\$500 carrying amount – \$375 fair value). To assign the impairment in the investor's "memo" accounts, the investor determines the fair value of the identifiable assets and assumed liabilities as of the impairment date. The fair value of the plant and equipment is \$1,200. The following worksheet illustrates how the impairment is allocated in the memo accounts.

	Investee B book value	Investor's 30% share of Investee's book value	Fair value of Investee's net assets on 31 December 20X1	Equity method basis difference (difference between book value and fair value)	Investor's 30% of equity method basis difference	Investor's basis
Plant and equipment <sup>(a)</sup>	\$ 1,000	\$ 300	\$ 1,200	\$ 200	\$ 60	\$ 360
Goodwill <sup>(b)</sup>	—	—	N/A	—	15	15
	<u>\$ 1,000</u>	<u>\$ 300</u>	<u>\$ 1,200</u>	<u>\$ 200</u>	<u>\$ 75</u>	<u>\$ 375</u>

<sup>(a)</sup> The investor determines that its basis in the plant and equipment is \$360 (30% of \$1,200). Therefore, its basis difference in the plant and equipment is now \$60 (\$360 – \$300). This represents a reduction in the "memo accounts" of \$90 (\$150 – \$60).

<sup>(b)</sup> Since the total fair value of the equity method investment is \$375, of which the plant and equipment represents \$360, the equity method goodwill is \$15 (\$375 – \$360). This represents a reduction in the "memo accounts" of \$15 (\$50 – \$35).

In summary, when the investor records its impairment charge of \$125, \$90 (\$150 less \$60) is allocated to the basis difference in the investee's underlying plant and equipment and the remainder of \$35 (\$50 less \$15) is allocated to the equity method goodwill. The investor will need to consider the reduction of its basis in the investee's plant and equipment when recording its equity method earnings or losses in future periods, as discussed in section 6.2.2.

## 6.8.5 Impairment of an investment in a qualified affordable housing project (before ASU 2023-02) (updated July 2023)

As discussed in section 3.4.4, ASC 323-740 permits investments in a qualified affordable housing project to be accounted for using the proportional amortization method in certain circumstances.

See section 4.2.7.5 of our FRD, *Income taxes*, for guidance on applying the proportional amortization method.

We believe that an investor that (1) does not qualify for the proportional amortization method or elects not to apply it and (2) does not apply the equity method can elect, as an accounting policy choice, to account for its investment in a qualified affordable housing project under the cost method (as described in ASC 323-740) or in accordance with ASC 321. The method elected must be applied consistently.

Prior to ASU 2023-02, ASC 323-740-55-8 illustrated an impairment model for an investment in a qualified affordable housing project that is accounted for using the equity method in which the impairment is measured based on undiscounted cash flows. As stated in ASC 323-740-55-9, this model is acceptable for investments within the scope of ASC 323-740 but is not necessarily a preferred method. We do not believe this impairment model should be used by analogy for investments accounted for under the equity method that are not within the scope of ASC 323-740. This alternative was eliminated with ASU 2023-02.<sup>34</sup>

See section 4.2.7.5.2 of our FRD, *Income taxes*, for an illustration of this method.

## 6.8.6 Treatment of currency translation adjustment balance in impairment review

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Translation of Financial Statements

#### Other Presentation Matters

#### 830-30-45-13

An entity that has committed to a plan that will cause the cumulative translation adjustment for an equity method investment or a consolidated investment in a foreign entity to be reclassified to earnings shall include the cumulative translation adjustment as part of the carrying amount of the investment when evaluating that investment for impairment. The scope of this guidance includes an investment in a foreign entity that is either consolidated by the reporting entity or accounted for by the reporting entity using the equity method. This guidance does not address either of the following:

- a. Whether the cumulative translation adjustment shall be included in the carrying amount of the investment when assessing impairment for an investment in a foreign entity when the reporting entity does not plan to dispose of the investment (that is, the investment or related consolidated assets are held for use)
- b. Planned transactions involving foreign investments that, when consummated, will not cause a reclassification of some amount of the cumulative translation adjustment.

<sup>34</sup> In March 2023, the FASB issued ASU 2023-02, *Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*, allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, rather than just investments in qualified affordable housing projects that generate LIHTCs. The guidance is effective for public business entities for fiscal years beginning after 15 December 2023 and interim periods within those fiscal years, and for all other entities for fiscal years beginning after 15 December 2024 and interim periods within those fiscal years. Early adoption is permitted for all entities in any interim period. Refer to section 3.4.4 for additional information and section 4.2.7.5A in our FRD, *Income taxes*, for guidance on applying the proportional amortization method after the adoption of ASU 2023-02, including eligibility considerations.

**830-30-45-14**

In both cases, paragraph 830-30-40-1 is clear that no basis exists to include the cumulative translation adjustment in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the cumulative translation adjustment. (If the reclassification will be a partial amount of the cumulative translation adjustment, this guidance contemplates only the cumulative translation adjustment amount subject to reclassification pursuant to paragraphs 830-30-40-2 through 40-4.)

**830-30-45-15**

An entity shall include the portion of the cumulative translation adjustment that represents a gain or loss from an effective hedge of the net investment in a foreign operation as part of the carrying amount of the investment when evaluating that investment for impairment.

In some situations, an investor will have an equity method investment in or within a foreign entity, which therefore has a related cumulative translation adjustment (CTA). If the investor has committed to a plan that will cause the CTA related to the equity method investment to be reclassified into earnings, ASC 830-30-45-13 requires the investor to include that CTA amount in the carrying amount of the equity method investment when testing the investment for other-than-temporary impairment. Otherwise, the carrying amount of the equity method investment should exclude the related CTA amount accumulated within equity. For additional guidance on when CTA related to an equity method investment would be reclassified into earnings, see section 4.4.3 of our FRD, *Foreign currency matters*.

**Illustration 6-20: Treatment of CTA in equity method impairment test**

Investor A is performing an other-than-temporary impairment test for an equity method investment that is a foreign entity (as defined in ASC 830), which has the following balances (after currency translation):

Equity method investment	\$	30
Cumulative translation adjustment accumulated within equity		5

Investor A has not committed to a plan that will cause the CTA balance to be reclassified to earnings.

**Analysis**

Because Investor A has not committed to a plan that will cause the CTA balance to be reclassified to earnings, the CTA balance should not be included in the carrying amount of the equity method investment when testing for other-than-temporary impairment. Therefore, the carrying amount of the equity method investment should be based on current exchange rates, or \$30.

## 6.8.7 Recognizing an impairment of an equity method investment when there is a lag in reporting the investee's results

Once an investor determines that there is an other-than-temporary impairment of an equity method investment that is reported on a lag, a common question is when to measure the fair value of the investment (i.e., the measurement date) for calculating the impairment. We are aware of two acceptable approaches in practice. An investor should apply a consistent accounting policy for measuring fair value for all investees that are reported on a lag.

One approach is to measure the fair value of the investment and calculate the impairment as of the date the investor determines the investment to be other than temporarily impaired. This would generally be the investor's balance sheet date. The rationale for doing this is that the investor's unit of account for evaluating and recognizing an impairment of an equity method investment is the investment as a whole.

Alternatively, the fair value of the investment could be measured as of the end of the period through which the investee's earnings are included in the investor's operating results. This approach aligns the measurement date with the date of the investee's financial information that the investor uses to record its share of investee's losses, including any impairment loss recognized by the investee. Under this approach, an investor should disclose relevant information about any additional impairment the investor expects to recognize in a future period.

Under either approach, fair value information obtained after the date of the investee's financial statements (and before the investor issues its financial statements) would be considered in evaluating whether any impairment is other-than-temporary. When an impairment is recognized, investors should consider the effect on basis differences, as discussed in section 6.8.4. In addition, intervening events between the dates of the investee's financial statements and those of the investors' financial statements that materially affect the investor's financial position or results of operations should be disclosed, as discussed in section 6.2.8.

**Illustration 6-21: Recognizing an impairment of an equity method investment when there is a lag in reporting**

An investor has an equity method investment. When the investor prepares its financial statements for the year ended 31 December, it recognizes its share of the earnings of the investee on a three-month lag (i.e., through 30 September). Assume that the investor concludes that its investment has suffered an OTTI at 31 December.

Under the first approach, the investor would write down the carrying amount of the investment to its fair value as of 31 December. Under the second approach, it would write down the carrying amount of the investment to its fair value as of 30 September. The investor would disclose relevant information about any additional impairment it expects to recognize in its quarter ending 31 March, as a result of any further decline in the fair value of the investment between 30 September and 31 December.

Under either approach, the investor also would consider the effect on basis differences, as discussed in section 6.8.4.

## 6.9 Acquisition of additional ownership interests (updated July 2023)

**Excerpt from Accounting Standards Codification**

**Investments – Equity Method and Joint Ventures – Overall**

***Subsequent Measurement***

**323-10-35-33**

Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. The current basis of the investor's previously held interest in the investee shall be remeasured in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable, immediately before adopting the equity method of accounting. For purposes of applying paragraph 321-10-35-2 to the investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or a similar investment of the same issuer that results in it applying Topic 323, the entity shall remeasure its previously held interest at fair value immediately before applying Topic 323.

See section 5.6.1 for guidance on the accounting when an investor obtains significant influence or joint control over the investee after previously holding an investment in the investee that was accounted for as a financial asset.

An investor may increase its investment in an investee accounted for under the equity method (e.g., from 40% to 45%). If an investor determines that its additional investment does not provide it with a controlling financial interest, the subsequent investment will result in a change in the investor's ownership interest.

If the investor determines that the equity method of accounting continues to be appropriate after acquiring the additional interest, the investor will continue to apply the cost accumulation model and account for the acquisition of the additional ownership interest in a manner similar to a step acquisition. The investor would identify any differences between the cost of the additional investment and its incremental underlying equity in net assets of the investee as of the date of the step-acquisition, as described in section 5.4. However, the existing interest in the equity method investee is not remeasured.

Prospectively, the investor records its share of earnings and losses of the investee, adjusted for the effect of any basis differences, both from the original investment and the step-acquisition. The equity method earnings are not adjusted retroactively to reflect the acquisition of the additional interest.

#### Illustration 6-22: Acquisition of additional ownership interests

##### Background

- Investor A purchases 40% of the common stock of Investee B, which is a business, on 1 January 20X1 for \$1,000,000 in cash. Investor A has the ability to exercise significant influence over Investee B (the presumption that significant influence exists is not overcome) and therefore applies the equity method.

##### Initial Investment

- The net assets recorded in the financial statements of Investee B on 1 January 20X1 are as follows:

Cash	\$ 100,000
Other current assets	250,000
Plant and equipment	1,000,000
Accounts payable	(100,000)
Other current liabilities	(200,000)
Net assets	<u>\$ 1,050,000</u>
Investor A's 40% share	<u>\$ 420,000</u>

- Investor A determines that the fair value of the plant and equipment on 1 January 20X1 is \$1,800,000. The plant and equipment have a remaining life of 10 years.
- Investor A determines that Investee B has internally developed trade names. These trade names are considered definite-lived intangible assets with a fair value of \$500,000 and a useful life of 20 years. As the trade names have been internally developed, the intangible assets have not been recorded on the financial statements of Investee B.
- The book value of the other current assets, accounts payable and other current liabilities approximates fair value.
- Intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

The following worksheet illustrates how the \$580,000 difference between Investor A's cost basis of \$1,000,000 and its basis in the underlying equity in net assets of Investee B of \$420,000 was assigned on the date of investment.

	Investee B book value	Investor A's 40% share of Investee B's book value	Fair value of Investee B's net assets on 1 January 20X1	Equity method basis difference (difference between book value and fair value)	Investor A's 40% of equity method basis difference
Cash	\$ 100,000	\$ 40,000	\$ 100,000	\$ -	\$ -
Other current assets	250,000	100,000	250,000	-	-
Plant and equipment	1,000,000	400,000	1,800,000	800,000	320,000
Intangible assets	-	-	500,000	500,000	200,000
Goodwill	-	-	N/A	-	60,000
Accounts payable	(100,000)	(40,000)	(100,000)	-	-
Other current liabilities	(200,000)	(80,000)	(200,000)	-	-
	<u>\$ 1,050,000</u>	<u>\$ 420,000</u>	<u>\$ 2,350,000</u>	<u>\$ 1,300,000</u>	<u>\$ 580,000</u>

Investor A records the 40% investment in Investee B of \$1,000,000 (\$420,000 + \$580,000) on its books. The basis differences are accounted for as part of the "memo" accounting entries by Investor A.

In 20X1, Investee B has net income of \$400,000. Investor A's equity method earnings from Investee B would be calculated as follows:

Investor A's share of Investee B's net income	\$ 160,000	40% x \$400,000
Adjustment for plant and equipment basis difference	(32,000)	\$320,000 / 10 years
Adjustment for intangible asset basis difference	(10,000)	\$200,000 / 20 years
Investor A's equity method earnings from Investee B	<u>\$ 118,000</u>	

As a result of the basis differences identified, Investor A's equity method earnings reflect not only the allocable portion of net income of Investee B (\$160,000) but also the depreciation of \$32,000 related to the plant and equipment basis difference and amortization of \$10,000 related to the intangible asset basis difference.

#### Additional Investment

- ▶ On 1 January, 20X2, Investor A purchases an additional 5% of the common stock of Investee B for \$150,000 cash, including transaction costs. Investor A retains the ability to exercise significant influence over Investee B and does not control Investee B.

- ▶ The net assets recorded in the financial statements of Investee B on 1 January 20X2 are as follows:

Cash	\$ 600,000
Other current assets	250,000
Plant and equipment	900,000
Accounts payable	(100,000)
Other current liabilities	(200,000)
Net assets	<u>\$ 1,450,000</u>
Investor A's additional 5% share	<u>\$ 72,500</u>

- ▶ Investor A determines that the fair value of the plant and equipment on 1 January 20X2 is \$1,700,000. The plant and equipment still have a remaining life of 10 years.
- ▶ Investor A determines that Investee B has internally developed trade names. These trade names are considered definite-lived intangible assets with a fair value of \$550,000 with a useful life of 20 years. As the trade names have been internally developed, the intangible assets have not been recorded on the financial statements of Investee B.
- ▶ The book values of the other current assets, accounts payable and other current liabilities approximate fair value.

The following worksheet illustrates how the \$77,500 difference between Investor A's cost basis of \$150,000 and its basis in the underlying equity in net assets of Investee B of \$72,500 would be assigned on the date of investment in the incremental 5% ownership interest.

	<b>Investee B book value</b>	<b>Investor A's 5% share of Investee B's book value</b>	<b>Fair value of Investee B's net assets on 1 January 20X2</b>	<b>Equity method basis difference (difference between book value and fair value)</b>	<b>Investor A's 5% of equity method basis difference</b>
Cash	\$ 600,000	\$ 30,000	\$ 600,000	\$ -	\$ -
Other current assets	250,000	12,500	250,000	-	-
Plant and equipment	900,000	45,000	1,700,000	800,000	40,000
Accounts payable	(100,000)	(5,000)	(100,000)	-	-
Other current liabilities	(200,000)	(10,000)	(200,000)	-	-
Intangible assets	-	-	550,000	550,000	27,500
Goodwill	-	-	N/A	-	10,000
	<u>\$ 1,450,000</u>	<u>\$ 72,500</u>	<u>\$ 2,800,000</u>	<u>\$ 1,350,000</u>	<u>\$ 77,500</u>

Investor A increases its investment in Investee B for the 5% equity method investment of \$150,000 (\$72,500 + \$77,500). The basis differences are accounted for as part of the "memo" accounting entries by Investor A. Investor A does not adjust the "memo" accounts related to its original 40% equity method investment to reflect the changes in fair value.

In 20X2, Investee B has net income of \$500,000. Investor A's equity method earnings would be calculated as follows:

	<b>40% Interest</b>	<b>5% Interest</b>	<b>Total</b>
Investor A's share of Investee B's net income	\$ 200,000	\$ 25,000	\$ 225,000
Adjustments for basis differences:			
Property, plant and equipment (a)	(32,000) <sup>(a)</sup>	(4,000) <sup>(b)</sup>	(36,000)
Intangible assets (b)	(10,000) <sup>(c)</sup>	(1,375) <sup>(d)</sup>	(11,375)
Investor A's equity method income	<u>\$ 158,000</u>	<u>\$ 19,625</u>	<u>\$ 177,625</u>

<sup>(a)</sup> For the original 40% interest, \$32,000 is the \$320,000 basis difference / 10-year useful life.

<sup>(b)</sup> For the additional 5% interest, \$4,000 is the \$40,000 basis difference / 10-year useful life.

<sup>(c)</sup> For the original 40% interest, \$10,000 is the \$200,000 basis difference / 20-year useful life.

<sup>(d)</sup> For the 5% interest, \$1,375 is the \$27,500 basis difference / 20-year useful life.

(Note: to simplify this illustration, we assumed no change in useful lives).

As a result of the basis differences identified, Investor A's equity method earnings reflect its share of the net income of Investee B as well as the effect of the basis differences. Investor A does not retroactively record equity method earnings related to the 5% investment prior to the date it acquired the 5% investment.

Investor A's equity method investment balance at 31 December 20X2 is as follows:

Cost basis in original 40% investment on 1 January 20X1	\$ 1,000,000
Investor A's equity method earnings from Investee B during 20X1	118,000
Cost basis in incremental 5% investment on 1 January 20X2	150,000
Investor A's equity method earnings from Investee B during 20X2	177,625
Investor A's equity method investment for Investee B at 31 December 20X2	<u>\$ 1,445,625</u>



## 6.9.1 Assessment of control

When an investor's ownership interest in an investee increases, the investor should consider whether it obtained a controlling financial interest in the investee. See section 1.3 for additional guidance.

If the investor obtains a controlling financial interest, the investor should stop using the equity method of accounting and begin consolidating the investment as of the date control is obtained. The investor presents the investee in accordance with the equity method for the periods prior to gaining control. The investor does not retrospectively adjust the financial statements to consolidate the investee during the period in which it only had an equity method investment and did not control the investee.

When the investee is a business, the acquirer remeasures its equity interest to fair value as of the acquisition date. The acquirer recognizes any gain or loss from the remeasurement of the previously held equity method investment in current-period earnings. Any amounts accumulated in other comprehensive income related to the investee should be reclassified and included in the calculation of the gain or loss. See section 7.4.2.1 of our FRD, *Business combinations*, for more discussion.

When the investee is not a business or a VIE, the acquirer generally accounts for the transaction in which it obtains control as an asset acquisition, which is a cost accumulation model. Therefore, we believe the investor should include both the carrying value of its pre-existing ownership interest and the cost of the additional ownership interest acquired in the total cost of the asset acquisition. We are aware of an alternative view in practice that would result in the remeasurement of the previously held interest at its fair value as of the date of the transaction. See Appendix A of our FRD, *Business combinations*, for more guidance.

If the investee is not a business but is a VIE, the recognition and measurement guidance in ASC 810-10-30-3 and 30-4 should be applied. Refer to Appendix A of our FRD, *Business combinations*, and section 13.4 of our FRD, *Consolidation*, for more discussion.

If the former equity method investee (now subsidiary) is an investment in a foreign entity or is within a foreign entity (as defined by ASC 830), special considerations apply. A foreign entity may include a subsidiary, division, branch, or joint venture that contains an equity method investment or is an equity method investment by itself. That is, a foreign entity as defined by ASC 830 may differ from a legal entity. See section 1.2.2 of our FRD, *Foreign currency matters*, for additional discussion on the definition of a foreign entity under ASC 830, and section 4.4.3 of that FRD for guidance on how to treat any cumulative translation adjustment in these scenarios.

See sections 11, 13, 14.3.3.1 and 14.3.3.1A of our FRD, *Income taxes*, for discussion of income tax considerations related to business combinations and asset acquisitions.

## 6.9.2 Pro rata contributions

Investors may decide to contribute additional cash or other assets to an equity method investee after its initial formation. Cash contributions in proportion to existing ownership increase the cost basis of the investment. The accounting for proportionate nonmonetary contributions varies depending on the recognition and measurement of the items contributed and on the relationship between the investor and investee, and should follow the framework discussed in section 5.2.3 as applicable.

Disproportionate contributions (regardless of type) result in the dilution of one or more parties. See sections 6.9 and 7.5 for guidance on increases and decreases in ownership, respectively.

## 6.10 Investee transactions

### 6.10.1 Impairments recorded by investee

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-32A**

An equity method investor shall not separately test an investee's underlying asset(s) for impairment. However, an equity investor shall recognize its share of any impairment charge recorded by an investee in accordance with the guidance in paragraphs 323-10-35-13 and 323-10-45-1 and consider the effect, if any, of the impairment on the investor's basis difference in the assets giving rise to the investee's impairment charge.

If an investee has recorded an impairment in accordance with ASC 350 or ASC 360, the equity method investor would recognize its share of the impairment loss, adjusting for any basis differences.<sup>35</sup> This treatment is consistent with the manner in which an equity method investor recognizes its share of the earnings or losses of an investee. Based on our discussions with the FASB staff, we understand that this may result in an investor recognizing more or less than its share of the impairment recorded by the investee.

However, an equity method investor would disregard any goodwill impairment recognized by the investee in its financial statements related to goodwill that existed prior to or on the investment date. This is because the equity method investor would have disregarded such goodwill when identifying and allocating basis differences upon its initial measurement because equity method goodwill is a residual of the investor's equity method investment, as discussed in section 5.4.1.

#### **Illustration 6-23: Investee impairment**

An investor acquires a 25% equity interest in an investee. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and applies the equity method. The cost of the investment was \$95, including transaction costs.

To simplify this illustration, assume that the only assets held by the investee are fixed assets and there is no equity method goodwill. At the acquisition date, the fair value of the fixed assets is \$380; therefore, the investor's basis in the fixed assets of the investee is \$95 (25% of \$380). On that date the book value of the fixed assets of the investee is \$300; therefore, the investor's share of the book value of the fixed assets is \$75 (25% of \$300). The \$20 difference between the investor's cost basis of \$95 and its basis in the underlying equity in net assets of Investee B of \$75 would be assigned entirely to fixed assets.

Depreciation, intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

	Investee's book value	Investor's 25% share of investee's book value	Fair value of investee's net assets	Equity method basis difference (difference between book value and fair value)	Investor's 25% of equity method basis difference
Fixed assets	\$ 300	\$ 75	\$ 380	\$ 80	\$ 20

<sup>35</sup> When an investee recognizes an impairment loss, an investor should consider whether its equity method investment might be impaired. See section 6.8 for further discussion.

Subsequently, the investee determines that the fixed assets are impaired and the fair value of the fixed assets at the date of impairment is \$280. Therefore, the investee subsequently recognizes an impairment charge of \$20 to reduce the book value of the fixed assets to their fair value. The investor's share of the revised book value (which also would be its share of fair value) of the fixed assets would be \$70 (25% of \$280).

In the ordinary course of recording equity method earnings, the investor will record its share of the impairment charge \$5 (25% of \$20). That is, the impairment charge recorded by the investee is included in its net income/loss, which is the basis for the investor to determine its share of the investee's earnings.

In addition, the investor would need to assess the effect of the impairment on its basis in the fixed assets recorded in its "memo" accounts. Because the investor's basis in the fixed assets of \$90 (\$95 less the impairment charge of \$5) exceeds its share of the fair value of the fixed assets (\$70), the investor recognizes an additional impairment charge of \$20. Therefore, the total impairment charge recognized by the investor is \$25 (\$5 that was included in the investor's share of the investee's net income/loss + \$20 additional loss related to the basis differences). While the investor does not assess individual underlying assets for impairment, when the investee recognizes an impairment, the investor adjusts the impairment charge to reflect its basis in the underlying assets. After recording the impairment charge, adjusted for basis differences, the investor's basis in the fixed assets of the investee is as follows:

	Investee's book value (after impairment)	Investor's 25% share of investee's book value	Fair value of investee's net assets on impairment date	Equity method basis difference (difference between book value and fair value)	Investor's 25% of equity method basis difference
Fixed assets (after impairment)	\$ 280	\$ 70	\$ 280	\$ -	\$ -
Cost basis in original 25% equity method investment				\$ 95	
Investor's equity method loss from investee (25% * \$20)				(5)	
Additional equity method loss for impairment [(95 - 5) - (25% of \$280)]				(20)	
Investor's equity method investment carrying amount				<u>\$ 70</u>	

## 6.10.2

### Investee's sale of assets

ASC 323 does not address how the investor should account for its share of the gain or loss that arises from the investee's sale of assets to a third party. We believe that the accounting should be consistent with the manner in which the investor recognizes its share of the earnings or losses of an investee based on its investment, adjusting for basis differences, as appropriate. The investor should record its share of a gain or loss recognized by the investee, adjusted for basis differences, in the assets sold.

See section 6.2.1 for guidance when the investee sells assets to the investor in an intra-entity transaction.

#### Illustration 6-24: Treatment of basis differences upon investee sale of assets

An investor acquires a 25% equity interest in an investee. The investor has the ability to exercise significant influence over the investee (the presumption that significant influence exists is not overcome) and applies the equity method. The investor paid \$120 in cash, including transaction costs.

The investor determined that the investee is composed almost entirely of fixed assets. At the acquisition date, the fair value of the fixed assets is \$480; therefore, the investor's basis in the fixed assets of the investee is \$120 (25% of \$480). The book value of the fixed assets of the investee is \$300; therefore, the investor's share of the book value of the fixed assets would be \$75 (25% of \$300). Depreciation, intra-entity transactions and the effect of income taxes have been ignored for illustration purposes. The following worksheet illustrates that the \$45 difference between the investor's cost basis of \$120 and its basis in the underlying share of net assets of the investee of \$75 relates to fixed assets.

	Investee's book value	Investor's 25% share of investee's book value	Fair value of investee's net assets	Equity method basis difference (difference between book value and fair value)	Investor's 25% of equity method basis difference
Fixed assets (at acquisition date)	\$ 300	\$ 75	\$ 480	\$ 180	\$ 45

The investee subsequently sells a portion of its fixed assets for \$400. The fixed assets sold had a book value of \$240 (the proportion of assets sold was 80%, or \$240/\$300). Assume for illustration purposes that the investee had no other transactions during the year. The investee's net income would be \$160 (\$400 less \$240). The investor records its pro rata share of the investee's net income, or \$40 (25% of \$160) as equity method earnings.

However, because the investor's basis in the assets that were sold exceeded their carrying amount in the investee's books, the investor must adjust its equity method earnings to reflect its basis in the assets disposed.

Assume the previously identified \$45 basis difference was proportionate to the book value of the fixed assets.

	Investee's book value	Investor's 25% share of book value	Equity method basis difference	Investor's 25% equity method basis difference
Sold assets (80%)	\$ 240	\$ 60	\$ 144	\$ 36
Retained assets	60	15	36	9

The investor would reduce its equity method earnings of \$40 for the proportion of the basis difference related to the assets sold, or \$36 (80% of \$45). Therefore, the equity method earnings of the investor for the period would be \$4 (\$40 less \$36).

After the transaction, the remaining basis difference in the fixed assets is \$9 (original difference of \$45, less the \$36 recognized upon the investee's sale of the fixed assets), which will be depreciated over its remaining useful life.

### 6.10.3

### Transactions in the investee's equity

An investee may record equity transactions (e.g., share repurchases, transactions with its noncontrolling interests, stock option issuances). An investor needs to determine the appropriate accounting for the effect on its claim to the investee's net assets. We would expect an investor to select a consistent accounting policy for all such transactions (i.e., the policy selected for an investee's treasury stock transactions should be consistent with the policy selected for the investee's issuance of stock options).

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **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.

### 6.10.3.1 Investee repurchase (treasury stock) transactions

An investee may acquire its own common stock and retain the shares as treasury stock. The equity method investor's accounting depends on whether the investor participates in the share repurchase, and if so, whether that participation is proportionate to the share repurchase from the other investors. In all cases, the investor also will need to adjust its share of earnings and losses of the investee to reflect the increase in ownership and any effects of additional basis differences recorded, prospectively from the date of the repurchase. These scenarios are described in more detail below.

When the repurchase is from shareholders other than the equity method investor (that is, the equity method investor does not participate at all in the share repurchase), it increases the investor's ownership interest in the equity method investee and reduces the investee's net assets for the consideration paid.

The investor may account for the increase in its ownership in the investee and the consequential effects to its basis differences in a manner similar to a step acquisition (see section 6.9 for additional information). Using this method, the change in an investor's basis in the investee's cash (that is, the change in its proportionate claim) resulting from the increased ownership and cash outflows for the repurchase would be treated as the "consideration" in the step acquisition in the "memo accounts." The equity method investment balance would not be affected in total.

This method is shown in Illustration 6-25. However, there is diversity in practice in how investors record these transactions. We believe that the investor should determine an appropriate accounting policy, and once an election is made, it should record similar transactions in the same manner.

If the repurchase from the equity method investor is proportionate to the share repurchase from the other investors, its percentage ownership of the investee does not change. In this case, the cash received by the investor reduces the investment balance.

If the repurchase from the equity method investor is disproportionate to the share repurchase from the other investors and the investor's percentage ownership **increases** (because it sells **fewer** shares than the other investors), it is considered a "net purchaser." We believe the cash received by the investor decreases the investment balance and the net increase in ownership of the investee is accounted for similarly to an acquisition of additional interests. However, the adjustment is reflected in the memo accounts. See section 6.9 for guidance on the accounting for acquiring an additional interest.

If the repurchase from the equity method investor is disproportionate to the share repurchase from the other investors and the investor's percentage ownership **decreases** (because it sells **more** shares than the other investors), it is considered a "net seller." We believe the investor should account for this decrease in its ownership of the investee, inclusive of the net effects of the transaction on its basis differences. That is, since the transaction results in a net decrease in the investor's share ownership percentage in the investee, a gain or loss is recognized upon disposition, as shown in Illustration 6-26.

#### **Illustration 6-25: Investors' accounting for investee repurchase (treasury stock) transactions – the investor does not participate**

##### **Example 1**

Investor A owns a 20% interest in Investee Z. Investor A has the ability to exercise significant influence over Investee Z (the presumption that significant influence exists is not overcome) and applies the equity method. During 20X1, Investee Z purchases 20% of its voting common shares on the open market for \$400,000 and retains these as treasury stock. The repurchase transaction increases Investor A's ownership of Investee Z to 25%. Prospectively, Investor A would record its 25% share of equity method earnings.

For illustration purposes, this is the only transaction that occurs during 20X1. Intra-entity transactions and the effect of income taxes have been ignored to simplify this illustration.

The following table illustrates the accounting for a repurchase transaction using the step-acquisition method. Investee Z purchased the treasury stock with \$400,000 of cash on hand. Accordingly, Investor A's basis in that cash was \$80,000 (20% of \$400,000), which is treated as consideration in the step acquisition. In its "memo" accounts, Investor A would allocate its basis as a result of obtaining a 5% interest in Investee Z and the fair value of Investee Z's net assets on the date of the transaction.

	<b>Fair value</b>	<b>Investor A's incremental 5% equity method basis</b>
Cash	\$ -	\$ (80,000)
Other current assets	100,000	5,000
Plant and equipment	1,000,000	50,000
Intangible assets	800,000	40,000
Accounts payable	(100,000)	(5,000)
Other current liabilities	<u>(200,000)</u>	<u>(10,000)</u>
Net assets	<u>\$ 1,600,000</u>	<u>\$ -</u>

### Example 2

Assume the same facts as in Example 1, except that the fair value of the intangible assets was \$500,000, resulting in total net assets of \$1.3 million. Assume that Investee Z meets the definition of a business.

Investor A's incremental 5% basis in the identifiable net assets of Investee Z is \$65,000 (5% of \$1.3 million). Since its basis in Investee Z's cash decreased by \$80,000, the remaining basis of \$15,000 (\$80,000 - \$65,000) in Investee Z's net assets is allocated to equity method goodwill.

The following table illustrates Investor A's accounting for the repurchase transaction using the step-acquisition method.

	<b>Fair value</b>	<b>Investor A's incremental 5% equity method basis</b>
Cash	\$ -	\$ (80,000)
Other current assets	100,000	5,000
Plant and equipment	1,000,000	50,000
Intangible assets	500,000	25,000
Goodwill	-	15,000
Accounts payable	(100,000)	(5,000)
Other current liabilities	<u>(200,000)</u>	<u>(10,000)</u>
Net assets	<u>\$ 1,300,000</u>	<u>\$ -</u>

### Illustration 6-26: Investors' accounting for investee repurchase (treasury stock) transactions – investor participates and interest decreases

Investor A owns a 40% interest (40,000 of 100,000 shares) in Investee Z. Investor A has the ability to exercise significant influence over Investee Z (the presumption that significant influence exists is not overcome) and applies the equity method. Other unrelated investors own the remaining 60,000 outstanding shares.

During 20X1, Investee Z purchases 30,000 of its outstanding voting common shares from its investors for \$18 per share (\$540,000 in total, or 30,000 \* \$18) and retains these shares as treasury stock. Of the 30,000 shares repurchased by Investee Z, 17,600 are purchased from Investor A for \$316,800 (17,600 \* \$18). The repurchase transaction decreases Investor A's interest in Investee Z to 32%  $((40,000 - 17,600 = 22,400) / (100,000 - 30,000 = 70,000))$ ; therefore, it is considered a "net seller." Investor A would record its 32% share of equity method earnings prospectively. The effect of income taxes has been ignored to simplify this illustration.

On the date of the transaction, the investment has a carrying amount of \$420,000. Investee Z has net assets of \$800,000 (\$8/share). This carrying amount is greater than Investor A's interest in the net assets of Investee Z of \$320,000 (\$800,000 x 40%). Assume that the basis difference of \$100,000 (\$420,000 - \$320,000) relates to plant and equipment (\$80,000) and goodwill (\$20,000) in the memo accounts of Investor A.

The following worksheet illustrates how the \$100,000 difference between Investor A's cost basis of \$420,000 and its basis in the underlying equity in net assets of Investee Z of \$320,000 was attributed on the date of the transaction before the treasury stock repurchase.

**Before the transaction:**

	<b>Investee Z book value</b>	<b>Investor A's 40% share of Investee Z's book value</b>	<b>Investor A's equity method basis difference</b>	<b>Investor A's total basis in the memo accounts</b>
Cash	\$ 600,000	\$ 240,000	\$ -	\$ 240,000
Other current assets	200,000	80,000	-	80,000
Plant and equipment	1,000,000	400,000	80,000	480,000
Accounts payable	(300,000)	(120,000)	-	(120,000)
Other current liabilities	(700,000)	(280,000)	-	(280,000)
Goodwill	-	-	20,000	20,000
	<u>\$ 800,000</u>	<u>\$ 320,000</u>	<u>\$ 100,000</u>	<u>\$ 420,000</u>

Investee Z purchased the treasury stock with \$540,000 of cash. Accordingly, immediately after the transaction, the net assets of Investee Z were \$260,000 (\$800,000 - \$540,000), and Investor A's basis in Investee Z's net assets is \$83,200 (32% of \$260,000). The following table illustrates the decrease in the equity method investment using the "net seller" method.

	<b>Change in Investor A's equity method investment balance</b>
Investor A's post-transaction basis in Investee Z (before basis differences)	\$83,200
Investor A's pre-transaction basis in Investee Z (before basis differences)	(320,000)
Adjustment for plant and equipment basis difference (see below)	(16,000)
Adjustment for goodwill basis difference (see below)	<u>(4,000)</u>
Decrease in equity method investment	<u><u>\$(256,800)</u></u>

The basis differences should be decreased to reflect the change in ownership from 40% to 32%. One method to allocate the decrease is proportionately to each component comprising the basis difference at the date of the transaction. Because the percentage ownership decreased by 20%  $((40\% - 32\%) / 40\%)$ , the basis difference also decreases by 20% or \$20,000 (20% \* \$100,000). The \$20,000 decrease is allocated proportionately between plant and equipment ( $\$80,000 / \$100,000 = 80\%$ ) and goodwill ( $\$20,000 / \$100,000 = 20\%$ ). That is, the basis difference related to plant and equipment decreases by \$16,000 (80% \* \$20,000), and the equity method goodwill decreases by \$4,000 (20% \* \$20,000), such that the basis differences after adjustment are \$64,000 (\$80,000 - \$16,000) related to plant and equipment and \$16,000 (\$20,000 - \$4,000) of equity method goodwill.

The following worksheet illustrates how the \$80,000 basis difference between Investor A's new carrying amount of \$163,200 (\$420,000 - \$256,800) and its basis in the underlying equity in the net assets of Investee Z of \$83,200 would be allocated in the memo accounts after the treasury stock transaction.

After the transaction:

	Investee Z book value	Investor A's 32% share of Investee B's book value	Investor A's equity method basis difference	Investor A's total basis in the memo accounts
Cash	\$ 60,000	\$ 19,200	\$ -	\$ 19,200
Other current assets	200,000	64,000	-	64,000
Plant and equipment	1,000,000	320,000	64,000	384,000
Accounts payable	(300,000)	(96,000)	-	(96,000)
Other current liabilities	(700,000)	(224,000)	-	(224,000)
Goodwill	-	-	16,000	16,000
	<u>\$ 260,000</u>	<u>\$ 83,200</u>	<u>\$ 80,000</u>	<u>\$ 163,200</u>

Investor A's gain on the transaction is \$60,000 (\$316,800 - \$256,800); therefore, Investor A would record the following journal entry to account for the treasury stock transaction:

Cash	\$ 316,800	
Investment in Investee Z		\$ 256,800
Gain on dilution of equity method investment		60,000

### 6.10.3.2

#### Investee's transactions with noncontrolling interests

An equity method investee may be a parent and may consolidate non-wholly owned subsidiaries, and therefore may present noncontrolling interests in its financial statements. Under ASC 810-10-45-23, changes in a parent's ownership interest in a subsidiary while the parent retains its controlling interest in the subsidiary that are in the scope of ASC 810 are accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). The carrying amount of the noncontrolling interest is adjusted to reflect the changes. Any difference between the fair value of the consideration received or paid and the adjustment to the noncontrolling interest is recognized in equity attributable to the parent. Recognizing this transaction will change the investee's net assets. For more guidance, see section 18 of our FRD, Consolidation.

While the investor does not directly participate in the transactions described above, the adjustment recorded by the investee also changes the investor's claim on the investee's net assets, as a result of the change in the investee's equity described above. The investor should determine an appropriate accounting policy to account for these transactions. We believe that the following approaches may be acceptable:

- ▶ The investor reflects the change in the investor's claim on the investee's net assets as an adjustment to the equity method investment and in the investor's own equity, consistent with the guidance in ASC 323-10-35-15, which states that 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.
- ▶ The investor does not recognize an adjustment but tracks the difference between the equity method investment and the investor's claim on net assets as a reconciling item in the "memo accounts."

We believe it would not be acceptable for the investor to recognize an equity method gain or loss for the change in its claim on the investee's net assets, given that the investee did not recognize a gain or loss and there has been no realization event for the investor.

Under both approaches, the investor recognizes its share of the investee's net income. The investor would also have to consider the effects of the investee's transaction on the investor's previously identified basis differences related to the investee's subsidiary, if applicable, when recording these entries.



**Illustration 6-27: Investor's accounting for investee transactions with noncontrolling interests**

Investor A owns a 30% interest in Investee Z. Investor A has the ability to exercise significant influence over Investee Z and applies the equity method. Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this example. Assume for simplicity that Investee Z has no net income for the year, so there are no equity method earnings or losses.

Investee Z has cash of \$500 and owns an 80% interest in a subsidiary, which has net assets of \$4,000. The carrying amount of Investee Z's noncontrolling interest in the subsidiary is \$800. Therefore, Investor A's claim on Investee Z's net assets is \$1,110 ( $30\% * \$3,700^a$ ).

Investee Z acquires an additional 10% interest in the subsidiary from the noncontrolling interest for \$500, increasing its controlling interest to 90%. As a result, Investee Z would decrease its noncontrolling interest by \$400 ( $\$4,000 * 10\%$ ), decrease cash by \$500, and record the remaining difference of \$100 as a decrease to its additional paid-in capital. Investor A's claim on Investee Z's net assets after the transaction is \$1,080 ( $30\% * \$3,600^b$ ). Therefore, Investor A's claim on Investee Z's net assets as a result of the transaction decreased by \$30.

Under the first approach, Investor A recognizes a \$30 decrease to its equity method investment and decreases its equity to recognize its proportion of the change in Investee Z's equity.

Under the second approach, Investor A does not recognize any entry and tracks the \$30 difference between the equity method investment and its claim on net assets as a reconciling item.

Under both approaches, Investor A recognizes its share of the investee's net income.

<sup>a</sup> Investee Z's net assets before the transaction are \$3,700, which comprises cash of \$500 and an investment in subsidiary of \$3,200 ( $80\% * \$4,000$ ).

<sup>b</sup> Investee Z's net assets after the transaction are \$3,600, which is its investment in subsidiary ( $90\% * \$4,000$ ).

**6.10.3.3****Investee issues stock options or restricted stock units to its employees or nonemployees**

An investee may issue share-based payments (e.g., stock options, restricted stock units (RSUs)) to its employees or nonemployees. As the awards vest, the investee recognizes the compensation cost in accordance with ASC 718 and increases additional paid-in capital.<sup>36</sup> When the investee recognizes the compensation cost as an expense, it decreases retained earnings (through decreased net income), and these entries offset (i.e., there is no net change in the investee's equity prior to the exercise of any options).

An investor recognizes its proportionate share of the compensation expense when it recognizes its proportionate share of the investee's net income, thereby reducing its equity method investment. However, there is diversity in practice in how investors consider the effect of the investee's increase to its additional paid-in capital when the investors apply the equity method. The investor should determine an appropriate accounting policy to account for these transactions. We believe that the following approaches may be acceptable:

- ▶ As the share-based payments vest and the compensation expense is recognized, the investor reflects the change in the investor's claim on the investee's net assets as an adjustment to the equity method investment and in the investor's own equity. This approach is consistent with the guidance in ASC 323-10-35-15, which states that 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. This entry, together with recognizing equity method earnings, has no net effect on the equity

<sup>36</sup> The FASB issued ASU 2021-07 to add a practical expedient to ASC 718 for nonpublic entities. See section 6.2.6.2 when the investor is a PBE.

method investment. This is consistent with the fact that the recognition of share-based payment expense and corresponding increase to additional paid-in capital, prior to the exercise of any options, does not affect the investor's claim on the investee's net assets.

- ▶ The investor does not recognize an adjustment but tracks the difference between the equity method investment and the investor's claim on net assets as a reconciling item within the "memo accounts," similar to the approach outlined in section 6.10.3.1.

We do not believe it would be acceptable for the investor to recognize an equity method gain or loss for the change in its claim on the investee's net assets, given that the investee did not recognize a gain or loss and there has been no realization event for the investor.

Under both approaches, the investor recognizes its proportionate share of compensation expense and also recognizes a dilution gain or loss when shares are issued (e.g., stock options are exercised, the RSUs vest). See section 7.5.

The following examples illustrate the two approaches described above for the investor's accounting when the investee grants stock options for services.

#### **Illustration 6-28: Investor's accounting for investee stock option transactions**

Investor A owns a 20% interest in Investee Z. Investor A has the ability to exercise significant influence over Investee Z and applies the equity method. During 20X1, Investee Z grants stock options that have a fair value of \$100,000 and vest over one year. Investee Z recognizes this compensation cost as an expense. This is the only transaction that occurs during 20X1, so Investee Z's net loss for the year is \$100,000. Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this example. Under both approaches described above, the investor's equity method loss is \$20,000 ( $20\% * \$100,000$ ).

Under the first approach, Investor A recognizes a \$20,000 increase to its equity method investment and increases its equity to recognize its proportion of the change in Investee Z's equity. The net effect of these entries is an equity method loss of \$20,000 and an increase to Investor A's equity. There is no net change in the equity method investment, since the only transaction recognized by the investee during 20X1 did not affect net assets.

Under the second approach, the investor does not recognize any additional entries and tracks the \$20,000 difference between the equity method investment and the investor's claim on net assets as a reconciling item.

Under both approaches, Investor A recognizes a dilution gain or loss upon exercise of the options.

## 6.11 Fair value option

ASC 825-10 allows entities to elect to measure certain financial assets and financial liabilities (as well as certain nonfinancial instruments that are similar to financial instruments) at fair value. Equity method investments are generally eligible for the fair value option as they represent recognized financial assets, even though the underlying assets of the investee may be primarily nonfinancial (e.g., real estate). If the fair value option is elected for an instrument, all subsequent changes in fair value for that instrument are reported in earnings.

The fair value election is generally made on an instrument-by-instrument basis and is irrevocable. However, if the fair value option is applied to an investment that would otherwise be accounted for under the equity method, ASC 825-10-25-7 requires that the fair value option be applied to all of the investor's eligible interests in that investee (e.g., equity and debt, including guarantees). When the fair value option

is elected for the equity method investment, the investor also would be required to measure any guarantee at fair value, with changes in fair value reported through earnings. This treatment differs from the subsequent measurement of guarantees required under ASC 460-10.

While the fair value option is irrevocable, ASC 825-10-25-4 does identify certain specific events that give rise to an election decision after initial recognition. One of these events is when an investment becomes subject to the equity method of accounting. As such, when an investor obtains the ability to exercise significant influence over an investee in which it had a pre-existing interest, the investor may decide whether to elect the fair value option for the entire investment, even if that investment was previously accounted for under the measurement alternative in ASC 321. In addition, if an investor had a pre-existing interest accounted for at fair value under the fair value option, but did not have the ability to exercise significant influence or joint control over the investee, the investor would have the option to either elect the fair value option, or apply equity method accounting. An investor can also elect the fair value option on the date when it ceases to consolidate a subsidiary, but retains an interest in the entity that would otherwise be accounted for as an equity method investment.

Once an investor elects to measure an equity method investment at fair value, it is required to continue to measure any equity interests (and all other eligible financial interests) in the investee at fair value, even if it no longer has the ability to exercise significant influence over the investee. See our Accounting Manual section F1.2 for guidance on applying the fair value option.

While equity method investments are generally eligible for the election of the fair value option within ASC 825-10, the SEC staff and the FASB staff have indicated that prior to electing the fair value option for an equity method investment, investors should carefully analyze whether a substantive nonfinancial performance obligation is embedded in the instrument. At the 2007 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed the application of the fair value option to equity investments that have embedded features or performance obligations. For example, in certain partnership arrangements the general partner's interest may include an embedded feature that provides the general partner with a disproportionate allocation of returns (e.g., carried interest). If the general partner has a substantive performance obligation to the investee, such as obligation to provide management services, the carried interest may represent compensation for services to be performed. The SEC staff noted that applying the fair value option to such a financial instrument could inappropriately recognize or accelerate revenue associated with future performance. As such, in these cases, the SEC staff believes careful consideration is required to determine whether the fair value option under ASC 825 is even available.<sup>37</sup> For example, if an equity investment includes a substantive performance obligation to the investee and the embedded feature is deemed to represent compensation for services to be performed, we do not believe that the fair value option could be elected.

Determining the fair value of an equity method investment can be complex. Therefore, depending on the facts and circumstances, we encourage companies to use valuation experts. Additional considerations regarding the determination of the fair value of an equity method investment are discussed in section 6.8.3. In addition, see our FRD, *Fair value measurement*, for additional discussion of determining fair value and the required disclosures.

ASC 825-10-50-28(f) requires that an entity that elects the fair value option to account for its investees is still required to disclose summarized financial information or separate financial statements for investees that are individually, or in the aggregate, material to the financial position or results of operations of the investor, as required by ASC 323-10-50-3(c). See section 8.3 for additional information. In addition, such investments continue to be subject to SEC reporting requirements as described in section 8.5.

---

<sup>37</sup> Statement made by Sandie E. Kim, Professional Accounting Fellow at the SEC, 10 December 2007, at the 2007 AICPA National Conference on Current SEC and PCAOB Developments.

# 7 Disposition or dissolution

## 7.1 Overview

An investor may sell all, or a portion of, an equity method investment or may lose the ability to exercise significant influence over the investee as a result of the sale of additional stock by the investee, other transactions or changes in circumstances.

When an investor disposes of its equity method investments (or a portion thereof), the accounting on that date and thereafter depends on whether it retains an interest in the investee, and if so, the nature of that interest (e.g., whether it retains significant influence).

When an investor disposes of its equity method investment (or a portion thereof), circumstances sometimes indicate that there are multiple arrangements that should be accounted for as a single transaction (e.g., the loss of significant influence, gain/loss on the transaction, a step acquisition). In determining whether to account for the arrangements as a single transaction, we believe the investor should analogize to the guidance in ASC 810-10-40-6, which includes indicators of when multiple arrangements should be accounted for as a single transaction. See section 19 of our FRD, *Consolidation*, for more discussion of this guidance.

In many cases, investees are designed to have a limited life to achieve a certain strategic objective. In these circumstances, agreements may exist for determining a new basis of segregating the assets and liabilities among the owners or liquidating them and disbursing cash to the owners.

Depending on the facts and circumstances, the disposal of an equity method investment, by itself or with other items, may qualify as a discontinued operation. See our FRD, *Discontinued operations*, for additional guidance.

Unless specified, references to equity method investments and investors also include joint ventures and venturers, respectively, throughout this section.

## 7.2 Disposition causing a loss of significant influence and/or joint control

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-35**

Sales of stock of an investee by an investor shall be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.

##### **323-10-35-37**

Paragraph 323-10-35-39 provides guidance on how an investor shall account for its proportionate share of an investee's equity adjustments for other comprehensive income in all of the following circumstances:

- a. A loss of significant influence
- b. A loss of control that results in accounting for the investment in accordance with Topic 321
- c. Discontinuation of the equity method for an investment in a limited partnership because the conditions in paragraph 970-323-25-6 are met for accounting for the investment in accordance with Topic 321.

**323-10-35-38**

Paragraph 323-10-35-39 does not provide guidance for entities that historically have not recorded their proportionate share of an investee's equity adjustments for other comprehensive income. That paragraph does not provide guidance on the measurement and recognition of a gain or loss on the sale of all or a portion of the underlying investment.

**323-10-35-39**

In the circumstances described in paragraph 323-10-35-37, an investor's proportionate share of an investee's equity adjustments for other comprehensive income shall be offset against the carrying value of the investment at the time significant influence is lost. To the extent that the offset results in a carrying value of the investment that is less than zero, an investor shall both:

- a. Reduce the carrying value of the investment to zero
- b. Record the remaining balance in income.

An investor may lose the ability to exercise significant influence over an investee as a result of the sale of a portion of an investment by the investor, sale of additional stock by an investee or other transactions. On that date, the investor stops recording its share of the earnings or losses of the investee. However, equity method earnings that were previously recorded remain part of the carrying amount of the investment.

When an investor sells its entire equity method investment, a gain or loss equal to the difference between the proceeds and carrying amount of that common stock is recorded. However, consideration should be given to the requirements of ASC 860 before derecognizing the investment and recognizing a gain or loss. ASC 860 relates to the sale or transfer of equity investments, including equity method investments, unless the investment is considered an in substance nonfinancial asset, the transaction does not meet ASC 860's definition of a transfer or another scope exception applies. Under ASC 860, one of the first considerations when determining whether to account for a transfer of financial assets as a sale in the transferor's consolidated financial statements is whether the transferee (including any newly created entity that holds the "disposed" equity method investment) would be consolidated by the transferor. That is because a sale to a consolidated affiliate would not result in a transfer of the risks and rewards of ownership to new owners. Refer to our FRD, *Consolidation*, for guidance on applying ASC 810. For more information on the requirements of ASC 860, see our FRD, *Transfers and servicing of financial assets*.

When calculating any gain or loss, the investor would eliminate any previously recorded adjustments to other comprehensive income for its proportionate share of the investee's accumulated other comprehensive income, which would adjust the gain or loss. Entities also should consider the guidance in section 6.2.1 when the recipient is an equity method investee.

If an investor disposes its ownership interest in an equity method investment in a foreign entity or within a foreign entity (as defined by ASC 830), special considerations apply. A foreign entity may include a subsidiary, division, branch or joint venture that contains an equity method investment or is an equity method investment by itself. That is, a foreign entity as defined by ASC 830 may differ from a legal entity. See section 1.2.2 of our FRD, *Foreign currency matters*, for additional discussion on the definition of a foreign entity under ASC 830, and section 4.4.3 of that FRD for guidance on how to treat any cumulative translation adjustment in this scenario.

## 7.2.1 Sale of an equity method investment in real estate or nonfinancial assets

### Excerpt from Accounting Standards Codification

#### Real Estate – Investments – Equity Method and Joint Ventures

##### *Derecognition*

##### **970-323-40-1**

A sale of an investment in a consolidated **real estate venture** (including the sale of stock in a corporate real estate venture) shall be evaluated under the guidelines set forth in paragraphs 360-10-40-3A through 40-3B. The sale of a noncontrolling investment in a real estate venture that is being accounted for in accordance with Topic 320 on investments–debt securities; Topic 321 on investments–equity securities; Topic 323 on investments–equity method and joint ventures; or Topic 325 on investments–other, shall be accounted for in accordance with the guidance in Topic 860 on transfers and servicing.

Entities do not look through to the underlying assets and liabilities of an equity method investment to determine the applicable derecognition guidance and whether it is an in substance nonfinancial asset. As a result, sellers will generally account for the sale of an equity method investment in real estate under ASC 860 as discussed in the previous section. However, entities will need to consider the scope exceptions in ASC 860. See our FRD, *Transfers and servicing of financial assets*, for more information.

However, if the equity method investment meets the definition of an in substance nonfinancial asset, the transfer will be accounted for under ASC 610-20. This would be the case if the equity method investment is transferred in a contract along with a nonfinancial asset and substantially all of the fair value of the group of assets is concentrated in nonfinancial assets. See section 2.4.1 of our FRD, *Gains and losses from the derecognition of nonfinancial assets (ASC 610-20)*, for further guidance.

Entities also should consider the guidance in section 6.2.1 when the recipient is an equity method investee.

## 7.3 Partial disposition but significant influence is maintained

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-35**

Sales of stock of an investee by an investor shall be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.

An investor may decrease its investment in an investee accounted for under the equity method. A partial sale of an investment will result in a change in the investor's ownership interest, but the investor may retain significant influence. If after the transaction, the investor continues to have significant influence, the retained ownership interest continues to be accounted for using the equity method.

Upon a partial disposition, we believe the investor should reduce the carrying amount of its equity method investment for the proportion sold, and proportionately reduce its equity method basis differences. In addition, an investor should proportionately reduce amounts accumulated in other comprehensive income related to the equity method investment sold.

ASC 323 states that the investor would recognize a gain or loss for the difference between the proceeds and the carrying amount of the equity method investment that was sold. However, consideration should be given to the requirements of ASC 860 before derecognizing the partial investment and recognizing a gain or loss. Under ASC 860, one of the first considerations when determining whether to account for a transfer of financial assets as a sale in the transferor's consolidated financial statements is whether the transferee (including any newly created entity that holds the "disposed" the equity method investment) would be consolidated by the transferor. That is because a sale to a consolidated affiliate would not result in a transfer of the risks and rewards of ownership to new owners. Refer to our FRD, *Consolidation*, for guidance on applying ASC 810. For more information on the requirements of ASC 860, see our FRD, *Transfers and servicing of financial assets*. Entities also should consider the guidance in section 6.2.1 when the recipient is an equity method investee.

After the partial disposition, an investor would prospectively adjust its share of earnings and losses of the investee using the reduced ownership interest in the investee. In determining its equity method earnings or losses in an investee, the investor would include adjustments (e.g., depreciation, depletion, amortization, accretion) related to the proportionately reduced basis differences.

When the consideration received upon the partial disposal indicates that the fair value of the equity method investment is less than its carrying amount, that is an indicator of an other-than-temporary impairment. See section 6.8 for additional guidance.

If an investor partially disposes its ownership interest in an equity method investment in a foreign entity or within a foreign entity (as defined by ASC 830), special considerations apply. A foreign entity may include a subsidiary, division, branch or joint venture that contains an equity method investment or is an equity method investment by itself. That is, a foreign entity as defined by ASC 830 may differ from a legal entity. See section 1.2.2 of our FRD, *Foreign currency matters*, for additional discussion on the definition of a foreign entity under ASC 830, and section 4.4.3 of that FRD for guidance on how to treat any cumulative translation adjustment in this scenario.

#### **Illustration 7-1: Partial disposition but significant influence is maintained**

An investor purchases a 45% investment in the voting common stock of an investee on 1 January 20X1 and accounts for the investment as an equity method investment. On June 30 20X2, the investor sells a 15% interest in the voting common stock of the investee on to a third party for \$250, reducing its interest to 30%. The investor retains the ability to exercise significant influence over the investee after the decrease in its interest (the presumption that significant influence exists is not overcome); therefore, the investor continues to apply the equity method. Assume the derecognition requirements in ASC 860 are met.

On 30 June 20X2, the investor would proportionately reduce its equity method investment, including a proportion of its basis differences, from a 45% interest to a 30% interest. In addition, the investor would eliminate a proportion of the recorded adjustments in other comprehensive income for the proportion of the investment sold, which would offset the gain or loss recorded.

As of the date of sale, the carrying amount of the equity method investment was \$600. In addition, there was a \$120 credit included in accumulated other comprehensive income (OCI), representing the investor's share of the investee's prior-period pension activity.

The investor would record a gain on the sale of \$90 by reducing proportionately its carrying amount for \$200 (1/3 of \$600) and the realization of \$40 of the accumulated OCI (1/3 of \$120) as follows:

Cash	\$	250	
Accumulated other comprehensive income		40	
Investment			\$ 200
Gain on sale			90

The investor would continue to account for its retained 30% interest, which would have a carrying amount of \$400, using the equity method. Prospectively from 30 June 20X2, the investor would adjust its share of earnings and losses of the investee to reflect that it only owns 30% of the investee. In determining its equity method earnings or losses in an investee, the investor would include adjustments (e.g., depreciation, depletion, amortization, accretion) related to the proportionately reduced basis differences.

### 7.3.1 Partial disposition of investment with losses in excess of investment carrying amount but significant influence is maintained (added July 2023)

An investor may dispose a portion of its investment for which it has temporarily suspended the recognition of equity method losses after reducing its investment to zero. Upon a partial disposition, we believe the investor should reduce the amount of losses tracked in the memo accounts to reflect the reduction in ownership interest in the investee. The remaining suspended equity method losses represent the amount of unrecognized equity method losses based on the retained ownership interest. As discussed in section 7.3, entities should also consider equity method basis differences or amounts accumulated in other comprehensive income related to the equity method investment sold.

#### **Illustration 7-2: Partial disposition of investment with losses in excess of investment carrying amount but significance influence is maintained**

An investor purchased a 45% investment in the voting common stock of an investee on 1 January 20X1 for \$450 and accounts for the investment as an equity method investment. The investee incurred operating losses since the investor purchased the voting common stock and the investor's share of those losses through 30 June 20X2, when it sold a 15% interest in the voting common stock of the investee, was \$480. As a result, the equity method investment has a carrying amount of \$0 on the date of sale with losses in excess of the carrying amount of \$30 (\$450 investment - \$480 in equity method losses) tracked in the memo accounts.

The partial sale reduced the investor's interest in the investee to 30%. The investor retained the ability to exercise significant influence over the investee after the partial sale. Therefore, the investor continues to apply the equity method. Assume the derecognition requirements in ASC 860 are met. For simplicity, we have also assumed there is no accumulated other comprehensive income or other basis differences related to this investment and the investor appropriately suspended recognition of its portion of the equity method losses when its share of the equity method losses exceeded the carrying amount of its investment.

The investor would reduce the losses within the memo accounts by the portion of the investment sold. In this case, the investor sold one-third of its investment (i.e.,  $15\% / 45\% = 33\%$ ). As a result, the investor would reduce the losses tracked in the memo accounts by one-third or \$10 (i.e.,  $33\% * \$30 = \$10$ ).



The investor would recognize a gain on the sale of \$250 for the amount paid by the third-party to purchase 15% of the investor's share of the investment in the investee as follows:

Cash	\$ 250	
Gain on sale		\$ 250

After the partial sale, the carrying amount of the investment is \$0 and the revised losses tracked in the memo accounts are \$20. The investor would subsequently account for its share of earnings and losses of the investee based on its 30% retained interest.

## 7.4 Loss of significant influence with retained investment (updated July 2023)

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Subsequent Measurement*

##### **323-10-35-36**

An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. Upon the discontinuance of the equity method, an investor shall remeasure the retained investment in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable. For purposes of applying paragraph 321-10-35-2 to the investor's retained investment, if the investor identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer that results in it discontinuing the equity method, the entity shall remeasure its retained investment at fair value immediately after discontinuing the equity method. Topic 321 also addresses the subsequent accounting for investments in equity securities that are not consolidated or accounted for under the equity method.

#### Investments – Debt and Equity Securities – Overall

##### *Initial Measurement*

##### ***Equity Securities Previously Accounted for under the Equity Method – Equity Method Is No Longer Appropriate***

##### **321-10-30-1**

If an **equity security** no longer qualifies to be accounted for under the equity method (for example, due to a decrease in the level of ownership), the security's initial basis for which subsequent changes in fair value are measured shall be the previous carrying amount of the investment. Paragraph 323-10-35-36 states that the earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment and that the investment account shall not be adjusted retroactively. Upon discontinuance of the equity method, an entity shall remeasure the equity security in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable. For purposes of applying paragraph 321-10-35-2 to the investor's retained investment, if the investor identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer that results in it discontinuing the equity method, the entity shall remeasure its retained investment at fair value immediately after it no longer applies the guidance in Topic 323.

When an investor loses the ability to exercise significant influence over an investee, the investor should discontinue the use of equity method accounting. The investor then determines the appropriate accounting method for the financial asset under ASC 320, ASC 321 or ASC 325. See our FRD, ***Certain investments in debt and equity securities***, for additional information.

Once an investor stops applying the equity method, the carrying amount of the investment is *not* adjusted retroactively as a result of the change from equity method to another method of accounting. Instead, the investor's proportionate share of an investee's accumulated other comprehensive income is offset against the carrying amount of the investment at that date. If the offset would result in a carrying amount less than zero, the remaining balance is recorded as income. See section 4.4.3 of our FRD, ***Foreign currency matters***, for an example of this scenario in which the accumulated other comprehensive income relates to foreign currency translation adjustments. Entities also should consider the guidance in section 6.2.1 when the recipient is an equity method investee.

If the retained investment is in the scope of ASC 321, the investor remeasures the retained investment under that guidance. Generally, entities are required to measure equity investments (other than equity method investments, financial interests that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value in net income. However, entities may elect a measurement alternative for equity investments that do not have readily determinable fair values and do not qualify for the practical expedient in ASC 820 to estimate fair value using the NAV per share. Under the measurement alternative, investments are measured at cost less any impairment, but if there are observable price changes in orderly transactions for an identical or similar issuer (i.e., an observable transaction), the entity must remeasure the investment to fair value in accordance with ASC 820 as of the date that the observable transaction occurs.

ASC 323-10-35-33 states that an entity that applies the measurement alternative in ASC 321 must consider all observable transactions, including those that require it to apply or discontinue the equity method. If a transaction occurs that results in discontinuing the equity method, the entity determines whether the transaction represents an observable transaction. If it determines that the transaction is an observable transaction, the entity must remeasure the retained investment to fair value in accordance with ASC 820. See section 3.6.1 of our FRD, ***Certain investments in debt and equity securities***, for additional information.

**Illustration 7-3: Loss of significant influence with retained investment that does not have a readily determinable fair value**

An investor has a 30% interest in the voting common stock of an investee. The investor has the ability to exercise significant influence (the presumption that significant influence exists is not overcome) and applies the equity method of accounting.

On 30 June 20X1, the investor sells 20% of the voting common stock of the investee to a third party (or 2/3 of its investment) for \$42, reducing its interest to 10%. The investor determines that based on its retained 10% interest and facts and circumstances, the presumption that it no longer has the ability to exercise significant influence is not overcome. Therefore, it will discontinue using equity method accounting. Assume the derecognition requirements in ASC 860 are met.

As of the date of sale, the carrying amount of the equity method investment was \$60. In addition, there was a \$12 credit included in AOCI, representing the investor's share of prior-period gains or losses in available-for-sale debt securities held by the investee.

The common stock of the investee does not have a readily determinable fair value and the investor's retained investment in the investee does not qualify for use of the practical expedient in ASC 820 to estimate fair value using NAV per share. On 30 June 20X1, the date the investor discontinues use of the equity method, it elects the measurement alternative to account for its retained 10% interest in the investee.

First, the investor records a gain on the sale by reducing proportionately its carrying amount by \$40 (2/3 of \$60) and the realization of \$8 of the accumulated OCI (2/3 of \$12) as follows:

Cash	\$	42	
Accumulated other comprehensive income		8	
Equity method investment			\$ 40
Gain on sale			10

Second, since the investor lost its ability to exercise significant influence as of 30 June 20X1, the investor will offset its carrying amount of the investment with the remaining amount recorded in AOCI (\$4), as follows:

Accumulated other comprehensive income	\$	4	
Equity method investment			\$ 4

Third, based on the facts and circumstances, the investor determines that the disposal transaction represents an observable transaction and that the fair value of the investor's 10% retained interest is \$21. Therefore, the investor also records an unrealized gain of \$5 (\$21 less carrying amount of \$16):

Investment	\$	5	
Unrealized gain			\$ 5

Therefore, in summary, the journal entry is as follows:

Cash	\$	42	
Equity security accounted for under measurement alternative		21	
Accumulated other comprehensive income		12	
Equity method investment			\$ 60
Gain on sale (P/L)			10
Unrealized gain on sale (P/L)			5

If the common stock of the investee had a readily determinable fair value, the investor would remeasure the retained investment to fair value in the same manner as shown above.

## 7.5

### Issuance of shares by an equity method investee

#### Excerpt from Accounting Standards Codification

##### Investments – Equity Method and Joint Ventures – Overall

##### *Derecognition*

##### **323-10-40-1**

An equity method investor shall account for a share issuance by an investee as if the investor had sold a proportionate share of its investment. Any gain or loss to the investor resulting from an investee's share issuance shall be recognized in earnings.

An equity investee may issue shares of its common stock to a third party in a public or private offering, an acquisition or another transaction (including the exercise of stock options, vested restricted stock units, conversion of convertible debt and similar transactions) for cash or other consideration. In these

situations, the investor should record a gain/loss associated with the dilution of its investment, if the issuance qualifies as a sale of shares. However, if the issuance represents a financing, as would be the case if the shares were sold subject to a forward contract to repurchase them, the investor would not recognize a gain or loss.

As a result of the transaction, we believe the investor should proportionately reduce its equity method basis differences for the effect of dilution. Additionally, because of the transaction, the investor should adjust its basis differences in the underlying net assets of the investee, if necessary. Adjustments to the investor's basis differences resulting from dilution will reduce the amount of future amortization or impairment of the investor's basis differences.

Although SAB 51's guidance for the accounting upon a sale of shares by a subsidiary has been superseded, we believe that the concepts remain applicable for the sale of shares by an equity method investee. As a result, we believe that gain recognition may not be appropriate when the transaction is a part of a broader corporate reorganization by the investee (and its parent, if applicable) and does not represent a broader sale of shares by the investee.

If the investor recognizes a loss upon the issuance of shares by the investee, the investor should consider whether the loss represents an impairment indicator that would require an OTTI on the retained interest. See section 6.8 for additional discussion.

If an investor's ownership interest in an equity method investment is diluted and that investment is in a foreign entity or within a foreign entity (as defined by ASC 830), special considerations apply. A foreign entity may include a subsidiary, division, branch or joint venture that contains an equity method investment or is an equity method investment by itself. That is, a foreign entity as defined by ASC 830 may differ from a legal entity. See section 1.2.2 of our FRD, *Foreign currency matters*, for additional discussion on the definition of a foreign entity under ASC 830, and section 4.4.3 of that FRD for guidance on how to treat any cumulative translation adjustment in this scenario.

#### **Illustration 7-4: Issuance of shares by an equity method investee to a third party**

An equity method investee has 100 shares outstanding and the equity method investor owns 30 shares (30%) of the investee. The investor has the ability to exercise significant influence (the presumption that significant influence exists is not overcome) and applies the equity method of accounting. The carrying amount of the equity method investment is \$450 (\$15 per share), which includes the original cost of the equity method investment and all subsequent equity method earnings/losses. The investee sells 50 new shares to a third party for \$1,000 (\$20 per share). Therefore, the investee's change in net equity as a result of the sale is \$1,000. Basis differences, intra-entity transactions and the effect of income taxes have been ignored to simplify this example.

After the sale of the new shares by the investee, the investor owns a 20% (30/150) interest in the investee. The investor would calculate its gain on dilution of its investment based on its retained ownership percentage of 20%. The gain is calculated as if the investor sold 10 shares (30% – 20% \* 100 shares) at \$20 when the investor's carrying amount was \$15 for each share. Thus, the gain would be \$50 ((10 x \$20) – (10 x \$15)). The gain would increase the carrying amount of the equity method investment to \$500 (\$450 + \$50).

Alternatively, the investor's new carrying amount could be calculated as a step acquisition, that is, \$500 (20% x (((\$15 x 100) + (\$20 x 50))) with a gain of \$50 (\$500 – \$450).

## 7.6 Nonmonetary transactions and transfers

In some cases, an investor may exchange an equity method investment in one entity for an equity method investment in a different entity. See section 5.2.3.3 for guidance.

## 7.7 Dissolution

Upon dissolution of an investee, the investors would need to determine whether the items received meet the definition of a business.

If an investor receives assets that meet the definition of a business or obtains a controlling financial interest in a VIE, the investor accounts for the net assets obtained under ASC 805. The investor would measure the fair value of the equity method investment at dissolution, which effectively becomes the consideration transferred. The investor would then measure the fair value of the assets and liabilities received, including any identifiable intangible assets, and recognize goodwill if the set of acquired assets and assumed liabilities meet the definition of a business. This treatment would result in a gain (or loss) upon dissolution, generally calculated as the difference between the fair value of the equity method investment and its carrying amount. See our FRD, ***Business combinations***, and section 13 of our FRD, ***Consolidation***, for further guidance.

If the assets received do not meet the definition of a business and the investor does not obtain a controlling financial interest in a VIE, the transaction may be in the scope of ASC 805-50, ASC 845 or ASC 860, or other US GAAP, depending on the nature of the assets and the transaction.

# 8 Presentation and disclosure

## 8.1 Overview

An equity method investment is presented in the balance sheet of an investor as a single amount. An investor's share of earnings or losses from its equity method investment is generally presented as a single amount.

When an investor has an equity method investment, ASC 323 requires certain disclosures about that investment. Additional considerations apply if the investor is a public company.

Unless specified, references to equity method investments and investors also include joint ventures and venturers, respectively, throughout this section.

## 8.2 Financial statement presentation

### Excerpt from Accounting Standards Codification

#### Investments – Equity Method and Joint Ventures – Overall

##### *Other Presentation Matters*

##### **323-10-45-1**

Under the equity method, an investment in **common stock** shall be shown in the balance sheet of an **investor** as a single amount. Likewise, an investor's share of earnings or losses from its investment shall be shown in its income statement as a single amount.

##### **323-10-45-2**

The investor's share of accounting changes reported in the financial statements of the **investee** shall be classified separately.

##### **323-10-45-3**

An investor may combine its proportionate share of investee other comprehensive income amounts with its own other comprehensive income components and present the aggregate of those amounts in the statement in which other comprehensive income is presented.

Equity method investments in common stock and in-substance common stock are presented in the balance sheet of an investor as a single amount, unless the investment qualifies for and the reporting entity elects proportionate consolidation (see section 3.4.2). In addition, the investor's share of earnings or losses from the investment is presented as a single amount in the income statement, except for the investor's share of accounting changes and other comprehensive income.

In accordance with ASC 323, the investor's share of accounting changes reported in the financial statements of the investee is classified separately on the investor's financial statements.

We believe that an investor would record its share of discontinued operations of an investee as part of the single amount presented in the income statement representing the investor's share of earnings or losses from the investment. This is because earnings (or losses) of an investee is defined in ASC 323-10-20 as net income (or net loss) of an investee determined in accordance with US GAAP, and net income (or net loss) would include any income or loss from discontinued operations in the investee's financial statements.

S-X Rule 5-03(b)(12) requires equity method earnings to be presented after income tax expense and within (before) income from continuing operations (unless the discontinued operations criteria are met), except when circumstances justify presenting it in a different manner. For example, the SEC staff has indicated that presentation within income from operations may be appropriate if the equity method investee is “operationally integral” to the operations of the investor. Presentation as revenue generally is prohibited and should be limited to when an entity’s business is operating primarily through equity method investments.<sup>38</sup>

If the equity method investee is a taxable entity, equity method earnings include the investor’s share of the investee’s income tax expense (benefit), regardless of whether the equity method earnings are presented before or after the investor’s income tax expense (benefit). Separately, the investor’s own income tax expense (benefit) related to the equity method investment is presented with the investor’s income tax expense (benefit) and is not presented with the equity method earnings. For example, the investor presents the deferred tax effects of the difference between the book and tax bases of an equity investment (i.e., the outside basis difference) in the investor’s income tax provision. See section 14 of our FRD, *Income taxes*, for further discussion.

Depending on the facts and circumstances, the disposal of an equity method investment, by itself or with other items, may qualify as a discontinued operation. See our FRD, *Discontinued operations*, for additional guidance.

Proportionate consolidation presentation is not appropriate when accounting for an equity method investment except for certain industries, as discussed in section 3.4.2.

An investor may combine its proportionate share of an investee’s other comprehensive income amounts with its own other comprehensive income components. An investor should present any other-than-temporary impairments that were recorded relating to its equity method investment on the same line that it presents equity method earnings in the income statement.

An investor also should disclose the sale of an investee in its financial statements. We believe that gains or losses recognized by the investor upon the sale of an equity method investment may be presented as either:

- ▶ A separate line within other (nonoperating) income/loss, gross of tax
- ▶ Within the same line item in which the equity method earnings are presented

## 8.2.1 Earnings per share

If an equity method investee has issued options, warrants or convertible securities that enable their holders to obtain common stock of the investee or the investor upon exercise or conversion, there may be an effect on the earnings per share (EPS) reported by the investor under ASC 260. Such securities generally do not affect basic EPS, but may affect diluted EPS. See section 6 of our FRD, *Earnings per share*, for additional guidance.

---

<sup>38</sup> Section XI, B, “Classification of Equity Earnings within Operations” of the 11 March 2003 AICPA SEC Regulations Committee joint meeting with the SEC staff.

## 8.3

## Disclosures

**Excerpt from Accounting Standards Codification****Investments – Equity Method and Joint Ventures – Overall***Disclosure***323-10-50-1**

Paragraph 323-10-15-3 explains that references in this Subtopic to **common stock** refer to both common stock and **in-substance common stock** that give the **investor** the ability to exercise **significant influence** over operating and financial policies of an **investee** even though the investor holds 50 percent or less of the common stock or in-substance common stock (or both common stock and in-substance common stock).

**323-10-50-2**

The significance of an investment to the investor's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate.

**323-10-50-3**

All of the following disclosures generally shall apply to the equity method of accounting for investments in common stock:

- a. Financial statements of an investor shall disclose all of the following parenthetically, in notes to financial statements, or in separate statements or schedules:
  1. The name of each investee and percentage of ownership of common stock.
  2. The accounting policies of the investor with respect to investments in common stock. Disclosure shall include the names of any significant investee entities in which the investor holds 20 percent or more of the voting stock, but the common stock is not accounted for on the equity method, together with the reasons why the equity method is not considered appropriate, and the names of any significant investee corporations in which the investor holds less than 20 percent of the voting stock and the common stock is accounted for on the equity method, together with the reasons why the equity method is considered appropriate.
  3. The difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.
- b. For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price usually shall be disclosed. This disclosure is not required for investments in common stock of **subsidiaries**.
- c. If investments in common stock of **corporate joint ventures** or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be disclosed in the notes or in separate statements, either individually or in groups, as appropriate.
- d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants, and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises, or contingent issuances shall be disclosed in notes to financial statements of an investor.



Investors should disclose the methods used to account for their investments (e.g., equity method) and make all applicable disclosures.

In addition to disclosing the name of any significant investees, an investor should disclose the following:

- ▶ The reasons why the equity method is **not** considered appropriate, when an investor holds 20% or more (or 3% to 5% for investments in limited partnerships, limited liability companies, trusts and similar entities) of the voting stock in the investee
- ▶ The reasons why the equity method is considered appropriate, when an investor holds less than 20% (or 3% to 5% for investments in limited partnerships, limited liability companies, trusts and similar entities) of the voting stock and the common stock of an investee
- ▶ The reasons why the equity method is considered appropriate, when an investor holds more than 50% of the voting common stock of an investee (that is, why the investor does not control and consolidate the investee). For example, this may be the case when an investee is a VIE and the investor is not the primary beneficiary.

The significance of an investment to the investor's financial position and results of operations should be considered in evaluating the extent of disclosures of the financial position and results of operations of an equity method investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate.

ASC 825-10-50-28(f) requires an entity that elects the fair value option to account for its investees that would have been accounted for under the equity method if the investor had not chosen to apply the fair value option to disclose the information required by paragraph 323-10-50-3 (excluding the disclosures in paragraph 323-10-50-3(a)(3); (b); and (d)). For example, an entity would disclose summarized financial information or separate financial statements for investees that are individually, or in the aggregate, material to the financial position or results of operations of the investor.

An investor is required to disclose the difference between the amount at which an investment is carried and the amount of underlying equity in net assets. In such cases, we believe it would be appropriate to disclose the terms and effects of any material substantive profit-sharing arrangement, as discussed in section 6.7. We also believe an investor should disclose the equity method losses not recognized when the investment and any net advances are reduced to zero (see section 6.4 for further guidance). We also believe investors should disclose where the elimination of intra-entity profits and losses is recorded (i.e., as a reduction of the equity method investment, equity method earnings or other line items in the financial statements).

If the fair value of the consideration transferred to acquire an equity method investment is less than the fair value of the identifiable assets acquired (a bargain purchase), we believe an investor should disclose its accounting policy for the transaction. We believe the investor should consider disclosing the factors that led to the bargain purchase, as discussed in section 5.5.

### 8.3.1 SEC areas of focus

The SEC staff has requested additional disclosures in certain areas related to equity method investments, as discussed below.

In making disclosures related to equity method investments, an investor should describe any significant rights or obligations it has with respect to the investee, any relationships with other investors or the investee (such as common management or ownership) and rights held by other investors with respect to the investee, such as substantive participating rights.

When an investor has significant intra-entity transactions with an investee, the investor should disclose the nature of the transactions and the investor's accounting policy for these transactions, as described in section 6.2.1 and the amount of any revenue recognized. An investor also should consider disclosing whether receivables from the investee represent advances to the investee that form part of the cost of its investment, as described in section 6.3.2.

When an investor evaluates an equity method investment for other-than-temporary impairment, as discussed in section 6.8 the investor should consider disclosing significant judgments and estimates in that evaluation, even when an impairment is not recorded. Additional disclosures are required if the investment is measured at fair value as a result of recording an OTTI, under ASC 820. See our FRD, ***Fair value measurement***, for further interpretive guidance on these disclosures.

When an investor loses control of a subsidiary and retains an equity method investment in it, the investor is required to determine the fair value of that investment under ASC 810. In this case, consideration should be given to the terms of the deconsolidation transaction and the requirements of ASC 820. See our FRD, ***Fair value measurement***, for additional discussion on determining fair value and the required disclosures.

When an investor is the general partner in an investee and applies the equity method of accounting, the SEC staff has asked the investor to disclose the reasons why the equity method, rather than consolidation, is considered appropriate. A general partner may not consolidate an investee when the investee is a voting interest entity, as discussed in section 11.2.2 of our FRD, ***Consolidation***.

When an investee does not qualify to be proportionately consolidated, the SEC staff has objected to presenting pro forma financial statements prepared using proportionate consolidation as a non-GAAP disclosure in Management's discussion and analysis of financial condition and results of operations.

### 8.3.2

## Reporting a change in the investee's fiscal year end, or a change in or the elimination of a lag in reporting of an equity method investee's results

### Excerpt from Accounting Standards Codification

#### Consolidation – Overall

#### *Other Presentation Matters*

#### *Disclosure*

#### **810-10-50-2**

An entity should make the disclosures required pursuant to Topic 250. This paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

While not specifically addressed in ASC 323, we believe the guidance in ASC 810 should be considered when reporting a change in the investee's fiscal year end, or a change in or the elimination of a lag in reporting of an equity method investee's results.

Therefore, an investor should report a preferable change to the investee's fiscal year end, or a change to or the elimination of, a difference between the reporting period of an investor and the reporting period of an equity method investee in the investor's consolidated financial statements as a change in accounting principle in accordance with ASC 250. In addition, an investor should make the disclosures required pursuant to that subtopic. An entity may change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. See section 6.2.8 and ASC 250 for further discussion.

### 8.3.3 Other required disclosures (updated July 2023)

The table below provides a summary of the other significant disclosures an equity method investor should consider with respect to its equity method investment. In addition to the disclosures listed below, investors should consider industry-specific disclosure requirements (e.g., oil and gas, banking).

Other required disclosures to be considered for equity method investments			
ASC Topic reference	Relates to	Description	Interpretive guidance
ASC 740-10-S99-1(2)	Effective income tax rate reconciliation	If an equity method investment held by a registrant has an effective tax rate that differs by more than 5% from the applicable statutory federal income tax rate, disclosure should be made whenever the tax components are known and material to the investor's (registrant's) financial position or results of operations.	See SAB Topic 6.I (2), <i>Taxes of investee company</i> .
ASC 280-10-50	Segment reporting	Certain disclosures may be required if the equity method investment is a reportable segment. In addition, equity method earnings and equity method investments should be included in relevant measures for the reportable segments, if included in the measures reviewed by the chief operating decision maker.	See our FRD, <b><i>Segment reporting</i></b> , for further interpretive guidance.
ASC 323-740-50	Qualified affordable housing project investments (before adoption of ASU 2023-02)	Disclosures are required for all investments in qualified affordable housing projects, regardless of the accounting method used for those investments.	See section 4.2.7.5.6 of our FRD, <b><i>Income taxes</i></b> , for guidance.
ASC 323-740-50	Proportional amortization method (after adoption of ASU 2023-02)	Disclosures are required for investments that generate income tax credits and other income tax benefits from a tax credit program for which a reporting entity has elected on a tax-credit-program by tax-credit-program basis to apply the proportional amortization method, including those investments in an elected tax credit program(s) that do not meet the conditions to use proportional amortization method (i.e., they are accounted for using the equity method or ASC 321).	See section 4.2.7.5.5A of our FRD, <b><i>Income taxes</i></b> , for guidance.
ASC 460-10	Guarantees	Certain disclosures are required when an investor issues a guarantee to benefit an equity method investee.	See ASC 460-10.
ASC 740-10-S99-2	Tax holidays	An investor should disclose when an equity method investment conducts business in a foreign jurisdiction that attracts industry by granting a "holiday" from income taxes for a specified period. The investor must disclose the aggregate dollar and per-share effects of the tax holiday and briefly describe the factual circumstances including the date on which the special tax status will terminate.	See SAB Topic 6.I (2), <i>Taxes of investee company</i> .
ASC 810-10-50	Deconsolidation	Certain disclosures are required related to any gain (or loss) recognized on the deconsolidation of a subsidiary or derecognition of a group of assets. Certain additional disclosures are required for the fair value measurements relating to the retained investment upon deconsolidation.	See our FRD, <b><i>Consolidation</i></b> , for further interpretive guidance.
ASC 810-10-50	Variable interest entities	Certain disclosures are required, if the investee is determined to be a VIE.	See our FRD, <b><i>Consolidation</i></b> , for further interpretive guidance.

Other required disclosures to be considered for equity method investments			
ASC Topic reference	Relates to	Description	Interpretive guidance
ASC 820-10	Fair value measurement	For equity method investments that are measured at fair value on a nonrecurring basis in periods after initial recognition (for example, upon impairment), the investor is required to disclose information that enables users of its financial statements to assess the valuation techniques and inputs used to develop those measurements.  Investments that are measured at fair value on a recurring basis, such as upon election of the fair value option, are subject to additional disclosure requirements.	See our FRD, <i>Fair value measurement</i> , for further interpretive guidance.
ASC 850-10	Related parties	Related parties include: <ul style="list-style-type: none"> <li>▸ Entities for which investments in their equity securities would be required to be accounted for by the equity method absent the investor's election of the fair value option</li> <li>▸ Other parties with which the investor may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests</li> <li>▸ Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests</li> </ul>	See ASC 850-10-50 for specific disclosure requirements for all material related-party transactions, with the exception of compensation arrangements, expense allowances, intercompany transactions that are eliminated in consolidation and other similar items incurred in the ordinary course of business.

## 8.4

## Cash flow presentation

## Excerpt from Accounting Standards Codification

## Statement of Cash Flows – Overall

*Other Presentation Matters***230-10-45-12**

All of the following are cash inflows from investing activities...

- b. Receipts from sales of equity instruments of other entities (other than certain equity instruments carried in a trading account as described in paragraph 230-10-45-18 and certain donated equity instruments received by NFPs as discussed in paragraph 230-10-45-21A) and from returns of investment in those instruments...

**230-10-45-13**

All of the following are cash outflows for investing activities...

- b. Payments to acquire equity instruments of other entities (other than certain equity instruments carried in a trading account as described in paragraph 230-10-45-18)...

When reporting cash flows from operating activities by the indirect method, which is the predominant practice, most entities present the reconciliation from net income to cash flows from operating activities on the face on the statement of cash flows. An investor's equity method earnings affect net income, but do not affect cash flows related to operating activities. Therefore, equity method earnings are presented as a reconciling item.

Distributions received that represent returns *on* the investor's investment (i.e., dividends) are presented as cash flows from operating activities in the investor's statement of cash flows. Distributions received that represent returns *of* the investor's investment are presented as cash flows from investing activities in the investor's statement of cash flows. Therefore, it is important for investors to assess whether a distribution of cash from an equity method investee is a return *on* the investment or a return *of* the investment when classifying the distribution in the statement of cash flows. See section 5.4.2 of our FRD, **Statement of cash flows**, for guidance on this assessment.

In addition, when an investor has significant intra-entity transactions with an equity method investee, the SEC staff has requested that the investor disclose the cash used in or provided from these transactions separately. An investor also should consider disclosing the nature of the cash proceeds classified within operating activities from an equity method investment (e.g., dividends, management fee arrangements), as well as the reconciling items between the amounts presented in the cash flow statement and the change in the equity method investment balance.

In accordance with ASC 230-10-45-13(b), an investor should present payments to acquire equity instruments of other entities (e.g., equity method investees) within investing activities.

## 8.5 SEC reporting considerations (updated June 2024)

For domestic registrants,<sup>39</sup> additional considerations with respect to presentation and disclosure requirements for equity method investments are summarized below. See our **2023 SEC annual reports – Form 10-K** publication for additional discussion of these requirements, including the determination of whether an equity method investee is “significant.”

These rules are summarized in the table below:

Reporting type	Financial statement type	SEC rule	Type of test	Applied individually or in the aggregate	Threshold for significance	EY FRD section reference
Acquisitions	Financial statements	S-X Rule 3-05	Asset Investment Income	Individually	20%	Section 8.5.1
	Pro forma financial information	S-X Article 11	Asset Investment Income	Individually	20%	Section 8.5.1
Dispositions	Pro forma financial information	S-X Article 11	Asset Investment Income	Individually	20%	Section 8.5.2
Annual	Financial statements	S-X Rule 3-09	Investment Income	Individually	20%	Section 8.5.3
Annual	Summarized financial statement information	S-X Rule 4-08(g)	Asset Investment Income	Individually Aggregate	10%	Section 8.5.4
Interim	Summarized income statement information	S-X Rule 10-01(b)(1)	Investment Income	Individually	20%	Section 8.5.4.1

The SEC rules listed in the table above and in more detail in the sections below do not apply to smaller reporting companies (SRCs). SRCs can use the scaled (generally 'reduced') disclosure and reporting requirements as specified in Article 8 of Regulation S-X. See section 9 of our publication **2023 SEC annual reports – Form 10-K** for further guidance.

<sup>39</sup> For additional disclosure considerations for foreign private issuers, please refer to Form 20-F and its instructions.

### 8.5.1 S-X Rule 3-05 and Article 11 – financial information for significant equity method investment acquisitions

Under Rule 3-05, *Financial Statements of Businesses Acquired or to be Acquired* (Rule 8-04 for SRCs), a registrant that determines that it has acquired an interest in a business, including one accounted for under the equity method (including when the fair value option has been elected), is required to provide separate audited financial statements if the acquisition is more than 20% significant to the registrant. In addition, a registrant generally must present pro forma financial information complying with Article 11 of Regulation S-X whenever audited financial statements of an acquired business are required. The significance of the acquired business to the registrant is measured using the asset test, the investment test and the income test, as described in S-X Rule 1-02(w). The number of audited years and unaudited interim periods required is determined by the significance of the acquired business.

Under SEC rules, the evaluation of whether a business is identified (and therefore whether audited financial statements are required) is based on all available facts and circumstances, including whether sufficient continuity of the acquired entity's operations exists before and after the acquisition so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, subsidiary, division, investment accounted for under the equity method, or a working interest in oil and gas property is a business. The definition of a business used by the SEC differs from the definition in ASC 805.

Rule 3-05 financial statements and pro forma financial information must be filed on Form 8-K and in certain registration and proxy statements. See our Technical Line, [\*Applying the SEC's requirements for significant acquired businesses\*](#), and our SEC Financial Reporting Series, [\*2023 Pro forma financial information: A guide for applying Article 11 of Regulation S-X\*](#), for more guidance.

### 8.5.2 Article 11 – financial information for significant equity method investment dispositions (added June 2024)

Article 11 pro forma financial information is required if a disposition of a significant equity method investment by sale, abandonment or distribution to shareholders has occurred or is probable. The requirements to provide pro forma financial information are triggered when a disposal is more than 20% significant to a registrant. The significance of a disposed equity method investment to the registrant is measured using the asset test, the investment test and the income test, as described in Rule 1-02(w) of Regulation S-X. See our SEC Financial Reporting Series, [\*2023 Pro forma financial information: A guide for applying Article 11 of Regulation S-X\*](#), for more information.

### 8.5.3 S-X Rule 3-09 – separate financial statements for investees

#### Excerpt from Accounting Standards Codification

##### S-X Rule 3-09(a)

If any of the conditions set forth in §210.1-02(w), substituting 20 percent for 10 percent in the tests used therein to determine a significant subsidiary, are met for a majority-owned subsidiary not consolidated by the registrant or by a subsidiary of the registrant, separate financial statements of such subsidiary must be filed. Similarly, if either the first or third condition set forth in §210.1-02(w)(1), substituting 20 percent for 10 percent, is met by a 50 percent or less owned person accounted for by the equity method either by the registrant or a subsidiary of the registrant, separate financial statements of such 50 percent or less owned person must be filed.

S-X Rule 3-09, *Separate Financial Statements of Subsidiaries not Consolidated and 50 Percent or Less Owned Persons*, requires that registration statements and annual SEC reporting forms contain separate financial statements and schedules prepared in accordance with Regulation S-X for individually significant equity method investments.

Investees are considered individually significant if either the investment test or the income test exceeds the 20% level. Generally, when an investee meets this significance threshold, separate Rule 3-09 financial statements are required for the same dates and for the same periods as the registrant (required by S-X Rule 3-01 and 3-02). Investee financial statements must be audited only for periods where significance exceeds 20%. Additionally, a registrant should only provide financial statements for periods in which the registrant had an equity method interest in the investee. S-X Rule 3-09 applies to all investees, regardless of whether the investment is held by the registrant, a subsidiary or another investee. Accordingly, separate financial statements are required for any investee of the registrant in which the registrant's proportionate share of such investee meets the significance test relative to the consolidated financial statements of the registrant.

An equity method investment must be evaluated for significance under S-X Rule 3-09 until it is disposed of by the investor or otherwise becomes eligible to be accounted for as a financial asset, including in the year of disposal. When measuring significance in the year of disposal, the gain on disposal of the equity method investee should not be included in the evaluation.

Registrants may request that the SEC staff waive the application of specific financial statement requirements when strict application of the significance test produces an anomalous result or when separate financial statements may be impracticable to obtain and not relevant for investors.

See section 6.4 of our publication *2023 SEC annual reports – Form 10-K* for additional guidance on the application of S-X Rule 3-09.

SRCs are not required to provide separate S-X Rule 3-09 financial statements of significant equity method investees. However, summarized financial data may be required under Rule 8-03(b)(3) for equity method investments of an SRC greater than 20% significant in both annual and interim financial statements.<sup>40</sup> See section 9.3 of our publication *2023 SEC annual reports – Form 10-K* and section 7 of our publication *2024 SEC quarterly reports – Form 10-Q* for additional guidance.

## 8.5.4

### S-X Rule 4-08 – summarized financial information for investees

#### Excerpt from Securities and Exchange Commission rules and regulations

##### S-X Rule 4-08(g)

##### *Summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons.*

- (1) The summarized information as to assets, liabilities and results of operations as detailed in §210.1-02(bb) shall be presented in notes to the financial statements on an individual or group basis for:
  - (i) Subsidiaries not consolidated; or
  - (ii) For 50 percent or less owned persons accounted for by the equity method by the registrant or by a subsidiary of the registrant, if the criteria in §210.1-02(w) for a significant subsidiary are met:
    - (A) Individually by any subsidiary not consolidated or any 50% or less owned person; or
    - (B) On an aggregated basis by any combination of such subsidiaries and persons.
- (2) Summarized financial information shall be presented insofar as is practicable as of the same dates and for the same periods as the audited consolidated financial statements provided and shall include the disclosures prescribed by §210.1-02(bb). Summarized information of subsidiaries not consolidated shall not be combined for disclosure purposes with the summarized information of 50 percent or less owned persons.

<sup>40</sup> Section 2420.9 of the SEC's Division of Corporation Finance Financial Reporting Manual, *Smaller Reporting Companies - Annual and Interim Financial Statements*.

**S-X 1-02(bb)*****Summarized financial information.***

- (1) Except as provided in paragraph (bb)(2) of this section, *summarized financial information* referred to in this part shall mean the presentation of summarized information as to the assets, liabilities and results of operations of the entity for which the information is required. Summarized financial information shall include the following disclosures, which may be subject to appropriate variation to conform to the nature of the entity's business:
  - (i) Current assets, noncurrent assets, current liabilities, noncurrent liabilities, and, when applicable, redeemable preferred stocks (see §210.5-02.27) and noncontrolling interests (for specialized industries in which classified balance sheets are normally not presented, information shall be provided as to the nature and amount of the majority components of assets and liabilities);
  - (ii) Net sales or gross revenues, gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues), income or loss from continuing operations, net income or loss, and net income or loss attributable to the entity (for specialized industries, other information may be substituted for sales and related costs and expenses if necessary for a more meaningful presentation); and
- (2) Summarized financial information for unconsolidated subsidiaries and 50 percent or less owned persons referred to in and required by §210.10-01(b) for interim periods shall include the information required by paragraph (bb)(1)(ii) of this section.

Registrants with equity method investments that are more than 10% significant individually or on an aggregated basis under any of the three significance tests described in Rule 1-02(w) of Regulation S-X are required to disclose the following summarized financial information:

- ▶ Balance sheet – Current assets, noncurrent assets, current liabilities, noncurrent liabilities and, when applicable, redeemable preferred stocks and noncontrolling interests
- ▶ Income statement – Net sales or gross revenues, gross profit, income or loss from continuing operations, net income or loss, and net income or loss attributable to the entity

For specialized industries in which classified balance sheets are normally not presented, the investor provides the nature and amount of the majority components of assets and liabilities. Other information may be substituted for sales and related costs and expenses if necessary for a more meaningful presentation.

The summarized financial information generally is presented as of the same dates and for the same periods as the audited consolidated financial statements provided by the registrant, if practicable. See sections 6.2.7 and 6.2.8 for additional discussion on the maximum allowable differences when an investor and investee have different reporting periods, or when the investor reports its equity method earnings on a lag, respectively.

Separate financial statements of a significant equity method investee (as discussed in section 8.5.2) can be provided instead of the summarized financial information required by Rule 4-08(g). However, summarized financial information for any remaining investees may still be required. See section 6.4 of our publication [\*2023 SEC annual reports – Form 10-K\*](#) for additional information.

**8.5.4.1****Summarized financial information – interim reporting**

Under Rule 10-01(b)(1) of Regulation S-X, registrants with equity method investments that are more than 20% significant individually under either the investment test or income test are required to include summarized income statement information for those equity method investees in the notes to the interim financial statements in a Form 10-Q. See section 3.3 of our publication [\*2024 SEC quarterly reports – Form 10-Q\*](#) for additional discussion.



## 8.5.5 Other SEC reporting considerations (updated June 2024)

A registrant that holds an equity method investment may also need to consider the following guidance, if applicable:

- ▶ S-X Rule 3-14, *Special instructions for financial statements of real estate operations acquired or to be acquired*, is similar to S-X Rule 3-05 and requires registrants to present the audited financial statements of significant consummated and probable acquisitions of real estate operations. When a registrant acquires (or it is probable that the registrant will acquire) an equity interest in a business (including a pre-existing legal entity, such as a partnership, LLC or corporation) that generates substantially all of its revenues through the leasing of real property (i.e., a real estate operation), financial statements of the real estate operation (e.g., the underlying property) meeting the requirements of S-X 3-14 should be provided instead of S-X 3-05 financial statements, if the acquisition is significant.
- ▶ S-X Rule 4-08(e)(2), *Restrictions which limit the payment of dividends by the registrant*, requires a registrant to disclose the amount of consolidated retained earnings that represents undistributed earnings of equity method investees.
- ▶ S-K Item 601(b)(10), *Material contracts*, may require an SEC registrant to file a joint venture agreement.
- ▶ Form 8-K Item 2.06, *Material impairments*, requires a registrant to report a material impairment charge, including an impairment of an equity method investment, in certain circumstances.

# A

## Abbreviations used in this publication

<u>Abbreviation</u>	<u>FASB Accounting Standards Codification</u>
ASC 220	FASB ASC Topic 220, <i>Income Statement – Reporting Comprehensive Income</i>
ASC 230	FASB ASC Topic 230, <i>Statement of Cash Flows</i>
ASC 250	FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i>
ASC 260	FASB ASC Topic 260, <i>Earnings Per Share</i>
ASC 280	FASB ASC Topic 280, <i>Segment Reporting</i>
ASC 310	FASB ASC Topic 310, <i>Receivables</i>
ASC 320	FASB ASC Topic 320, <i>Investments – Debt Securities</i>
ASC 321	FASB ASC Topic 321, <i>Investments – Equity Securities</i>
ASC 323	FASB ASC Topic 323, <i>Investments – Equity Method and Joint Ventures</i>
ASC 323-30	FASB ASC Topic 323-30, <i>Investments – Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities</i>
ASC 323-740	FASB ASC Topic 323-740, <i>Investments – Equity Method and Joint Ventures – Income Taxes</i>
ASC 325	FASB ASC Topic 325, <i>Investments – Other</i>
ASC 326	FASB ASC Topic 326, <i>Financial Instruments – Credit Losses</i>
ASC 350	FASB ASC Topic 350, <i>Intangibles – Goodwill and Other</i>
ASC 350-20	FASB ASC Topic 350-20, <i>Intangibles – Goodwill and Other – Goodwill</i>
ASC 360	FASB ASC Topic 360, <i>Property, Plant, and Equipment</i>
ASC 440	FASB ASC Topic 440, <i>Commitments</i>
ASC 450-20	FASB ASC Topic 450-20, <i>Contingencies – Loss Contingencies</i>
ASC 460	FASB ASC Topic 460, <i>Guarantees</i>
ASC 505	FASB ASC Topic 505, <i>Equity</i>
ASC 605-35	FASB ASC Topic 605-35, <i>Revenue Recognition—Provision for Losses on Construction-Type and Production-Type Contracts</i>
ASC 606	FASB ASC Topic 606, <i>Revenue from Contracts with Customers</i>
ASC 610-20	FASB ASC Topic 610-20, <i>Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets</i>
ASC 718	FASB ASC Topic 718, <i>Compensation – Stock Compensation</i>
ASC 730	FASB ASC Topic 730, <i>Research and Development</i>
ASC 740	FASB ASC Topic 740, <i>Income Taxes</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 805-30	FASB ASC Topic 805-30, <i>Business Combinations – Goodwill or Gain from Bargain Purchase, Including Consideration Transferred</i>
ASC 805-50	FASB ASC Topic 805-50, <i>Business Combinations – Related Issues</i>
ASC 810	FASB ASC Topic 810, <i>Consolidation</i>
ASC 815	FASB ASC Topic 815, <i>Derivatives and Hedging</i>
ASC 820	FASB ASC Topic 820, <i>Fair Value Measurement</i>
ASC 825	FASB ASC Topic 825, <i>Financial Instruments</i>
ASC 830	FASB ASC Topic 830, <i>Foreign Currency Matters</i>
ASC 830-30	FASB ASC Topic 830-30, <i>Foreign Currency Matters – Translation of Financial Statements</i>

<b>Abbreviation</b>	<b>FASB Accounting Standards Codification</b>
ASC 835	FASB ASC Topic 835, <i>Interest</i>
ASC 835-20	FASB ASC Topic 835-20, <i>Interest – Capitalization of Interest</i>
ASC 842	FASB ASC Topic 842, <i>Leases</i>
ASC 845	FASB ASC Topic 845, <i>Nonmonetary Transactions</i>
ASC 850	FASB ASC Topic 850, <i>Related Party Disclosures</i>
ASC 860	FASB ASC Topic 860, <i>Transfers and Servicing</i>
ASC 910	FASB ASC Topic 910, <i>Contractors – Construction</i>
ASC 932	FASB ASC Topic 932, <i>Extractive Activities – Oil and Gas</i>
ASC 932-360	FASB ASC Topic 932-360, <i>Extractive Activities – Oil and Gas – Property, Plant, and Equipment</i>
ASC 946	FASB ASC Topic 946, <i>Financial Services – Investment Companies</i>
ASC 946-323	FASB ASC Topic 946-323, <i>Financial Services – Investment Companies – Investments – Equity Method and Joint Ventures</i>
ASC 954-810	FASB ASC Topic 954-810, <i>Health Care Entities – Consolidation</i>
ASC 958-810	FASB ASC Topic 958-810, <i>Not-for-Profit-Entities – Consolidation</i>
ASC 970	FASB ASC Topic 970, <i>Real Estate – General</i>
ASC 970-323	FASB ASC Topic 970-323, <i>Real Estate – General – Investments – Equity Method and Joint Ventures</i>
ASC 970-810	FASB ASC Topic 970-810, <i>Real Estate – General – Consolidation</i>
ASC 970-835	FASB ASC Topic 970-835, <i>Real Estate – General – Interest</i>
ASC 974-323	FASB ASC Topic 974-323, <i>Real Estate – Real Estate Investment Trusts – Investments – Equity Method Investments and Joint Ventures</i>
<b>Abbreviation</b>	<b>Other Authoritative Standards</b>
ASU 2010-02	Accounting Standards Update No. 2010-02, <i>Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary – a Scope Clarification</i>
ASU 2014-01	Accounting Standards Update No. 2014-01, <i>Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects</i>
ASU 2016-01	Accounting Standards Update No. 2016-01, <i>Financial Instruments–Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities</i>
ASU 2016-13	Accounting Standards Update No. 2016-13, <i>Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments</i>
ASU 2017-05	Accounting Standards Update No. 2017-05, <i>Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets</i>
ASU 2020-01	Accounting Standards Update No. 2020-01, <i>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</i>
ASU 2021-07	Accounting Standards Update No. 2021-07, <i>Compensation – Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards</i>
ASU 2023-02	Accounting Standards Update No. 2023-02, <i>Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method</i>

<b>Abbreviation</b>	<b>Other Authoritative Standards</b>
ASU 2023-05	Accounting Standards Update No. 2023-05, Business Combinations – <i>Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement</i>
Regulation S-X	SEC Regulation S-X, <i>Form and content of and requirements for financial statements</i>
Rule 1-02	Definition of terms used in Regulation S-X (17 CFR Part 210)
Rule 3-01	Consolidated balance sheets
Rule 3-02	Consolidated statements of income and cash flows
Rule 3-05	Financial statements of businesses acquired or to be acquired
Rule 3-09	Separate financial statements of subsidiaries not consolidated and 50 percent or less owned persons
Rule 3-14	Special instructions for real estate operations to be acquired
Rule 4-08	General notes to financial statements
Rule 5-03	Income statements
Rule 8-03	Interim financial statements
Rule 8-04	Financial statements of businesses acquired or to be acquired
Rule 10-01	Interim financial statements
Regulation S-K	SEC Regulation S-K, <i>Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975</i>

<b>Abbreviation</b>	<b>Other Non-Authoritative Standards</b>
SAB Topic 1.B	SEC Staff Accounting Bulletin Topic 1-B, <i>Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity</i>
SAB Topic 5.T	SEC Staff Accounting Bulletin Topic 5-T, <i>Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)</i>
SAB Topic 5.M	<i>Other Than Temporary Impairment of Certain Investments in Equity Securities</i>
SAB Topic 6.I	SEC Staff Accounting Bulletin Topic 6-I, <i>Accounting Series Release No. 149 – Improved Disclosure Of Income Tax Expense (Adopted November 28, 1973 And Modified By ASR 280 Adopted On September 2, 1980)</i>
SAB Topic 12.C	SEC Staff Accounting Bulletin Topic 12-C, <i>Methods of Accounting by Oil and Gas Producers</i>
Statement 133	FASB Statement No. 133, <i>Accounting for Derivative Instruments and Hedging Activities</i>
EITF 00-01	EITF Issue No. 00-1, <i>Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures</i>
EITF 02-14	EITF Issue No. 02-14, <i>Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock</i>
EITF 08-6	EITF Issue No. 08-6, <i>Equity Method Investment Accounting Considerations</i>
EITF 19-A	EITF Issue No. 19-A, <i>Financial instruments: clarifying the interactions between Topic 321 and Topic 323</i>
Q&A section 7100.08	Q&A section 7100.08, <i>Definition of a Public Business Entity, 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) (AICPA, Technical Questions and Answers)</i>
SOP 78-9	AICPA Statement of Position 78-9, <i>Accounting for Investments in Real Estate Ventures</i>

# B Index of ASC references in this publication

ASC Reference	Section	
220-10-S99-4	6.6	Investee costs paid for by equity method investor
230-10-45-12	8.4	Cash flow presentation
230-10-45-13	8.4	Cash flow presentation
310-10-25-19	3.4.3	Acquisition, development and construction loan arrangements
310-10-25-27	3.4.3	Acquisition, development and construction loan arrangements
320-10-S99-1	6.8.1	Identifying an other-than-temporary impairment
320-10-30-4	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
320-10-35-3	6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee
321-10	6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee
321-10-30-1	7.4	Loss of significant influence with retained investment
323-10-15-3	3.1	Overview
323-10-15-4	2.4	Put or call options
323-10-15-4	3.5	Scope exceptions
323-10-15-5	3.3	Investments in general partnerships, limited partnerships, limited liability companies, trusts and other entities that maintain specific ownership accounts
323-10-15-6	3.2	Evaluation of whether 'significant influence' exists
323-10-15-6	3.2.1	Holding less than a 20% interest
323-10-15-7	3.2	Evaluation of whether 'significant influence' exists
323-10-15-8	3.2	Evaluation of whether 'significant influence' exists
323-10-15-8	3.2.1	Holding less than a 20% interest
323-10-15-9	3.2	Evaluation of whether 'significant influence' exists
323-10-15-10	3.2	Evaluation of whether 'significant influence' exists
323-10-15-10	3.2.2	SEC staff views
323-10-15-11	3.2	Evaluation of whether 'significant influence' exists
323-10-15-13	2.2	Characteristics of an investment in in-substance common stock
323-10-15-14	2.2	Characteristics of an investment in in-substance common stock
323-10-15-15	2.2	Characteristics of an investment in in-substance common stock
323-10-15-16	2.3	Reconsideration events
323-10-15-17	2.3	Reconsideration events
323-10-15-18	2.3	Reconsideration events
323-10-25-2A	5.5.1	Contingent consideration associated with a bargain purchase

ASC Reference	Section	
323-10-25-3	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-25-4	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-25-5	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-25-7	6.2.6	Different accounting policies under US GAAP
323-10-30-2	5.2	Initial measurement
323-10-30-2	5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received
323-10-30-2A	5.3	Contingent consideration
323-10-30-2B	5.5.1	Contingent consideration associated with a bargain purchase
323-10-30-3	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-35-4	6.2	Earnings or losses of an investee
323-10-35-5	6.2	Earnings or losses of an investee
323-10-35-6	6.2.8	Reporting lag
323-10-35-7	6.2.1	Elimination of intra-entity profits
323-10-35-7	6.2.11	Reciprocal interests
323-10-35-8	6.2.1	Elimination of intra-entity profits
323-10-35-9	6.2.1	Elimination of intra-entity profits
323-10-35-10	6.2.1	Elimination of intra-entity profits
323-10-35-10	6.2.1.2	Determining whether a transaction is at arm's length
323-10-35-11	6.2.1	Elimination of intra-entity profits
323-10-35-13	5.4	Equity method basis differences
323-10-35-13	5.5	Bargain purchase
323-10-35-13	6.7	Non-pro rata profit or loss allocations
323-10-35-13	6.7.2	Investments in partnership or other pass-through entities that generate investment tax credits
323-10-35-14A	5.5.1	Contingent consideration associated with a bargain purchase
323-10-35-15	6.10.3	Transactions in the investee's equity
323-10-35-15	6.10.3.2	Investee's transactions with noncontrolling interests
323-10-35-15	6.10.3.3	Investee issues stock options or restricted stock units to its employees or nonemployees
323-10-35-16	6.2	Earnings or losses of an investee
323-10-35-17	6.2.4	Investee's dividends and distributions
323-10-35-18	6.2.3	Investee's other comprehensive income (loss)
323-10-35-19	6.4	Investee losses in excess of investment carrying amount plus advances
323-10-35-20	6.4	Investee losses in excess of investment carrying amount plus advances
323-10-35-21	6.4	Investee losses in excess of investment carrying amount plus advances
323-10-35-22	6.4	Investee losses in excess of investment carrying amount plus advances
323-10-35-23	6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee

ASC Reference	Section	
323-10-35-24	6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-35-25	6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-35-26	6.4.1	Application of the equity method when the investment has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-35-27	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-35-28	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-35-29	6.4.4	Subsequent investments not resulting in a controlling interest after suspension of equity method loss recognition
323-10-35-30	6.4.4	Subsequent investments not resulting in a controlling interest after suspension of equity method loss recognition
323-10-35-31	6.8	Other-than-temporary impairment
323-10-35-32	6.2.2	Effect of basis differences on equity method earnings
323-10-35-32	6.8	Other-than-temporary impairment
323-10-35-32A	6.8	Other-than-temporary impairment
323-10-35-32A	6.10.1	Impairments recorded by investee
323-10-35-33	5.6.1	Change from financial asset to equity method
323-10-35-33	6.9	Acquisition of additional ownership interests
323-10-35-33	7.4	Loss of significant influence with retained investment
323-10-35-34	5.4.1	Equity method goodwill
323-10-35-35	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
323-10-35-35	7.2	Disposition causing a loss of significant influence and/or joint control
323-10-35-35	7.3	Partial disposition but significant influence is maintained
323-10-35-36	7.4	Loss of significant influence with retained investment
323-10-35-37	7.2	Disposition causing a loss of significant influence and/or joint control
323-10-35-38	7.2	Disposition causing a loss of significant influence and/or joint control
323-10-35-39	7.2	Disposition causing a loss of significant influence and/or joint control
323-10-40-1	7.5	Issuance of shares by an equity method investee
323-10-45-1	6.1	Overview
323-10-45-1	8.2	Financial statement presentation
323-10-45-2	6.1	Overview
323-10-45-2	8.2	Financial statement presentation
323-10-45-3	8.2	Financial statement presentation
323-10-50-1	8.3	Disclosures
323-10-50-2	8.3	Disclosures
323-10-50-3	6.11	Fair value option

ASC Reference	Section	
323-10-50-3	8.3	Disclosures
323-10-55-3	2.2.1	Subordination
323-10-55-4	2.2.1	Subordination
323-10-55-5	2.2.1	Subordination
323-10-55-6	2.2.1	Subordination
323-10-55-7	2.2.2	Risks and rewards of ownership
323-10-55-8	2.2.2	Risks and rewards of ownership
323-10-55-9	2.2.2	Risks and rewards of ownership
323-10-55-10	2.2.2	Risks and rewards of ownership
323-10-55-11	2.2.2	Risks and rewards of ownership
323-10-55-12	2.2.2	Risks and rewards of ownership
323-10-55-13	2.2.2	Risks and rewards of ownership
323-10-55-14	2.2.2	Risks and rewards of ownership
323-10-55-15	2.2.3	Obligation to transfer value
323-10-55-16	2.2.3	Obligation to transfer value
323-10-55-17	2.2.3	Obligation to transfer value
323-10-55-18	2.2.3	Obligation to transfer value
323-10-55-20	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-21	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-22	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-23	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-24	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-25	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-26	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-10-55-27 through 29	6.2.1	Elimination of intra-entity profits
323-10-55-27	6.2.1.1	Examples of intra-entity profit elimination
323-10-55-28	6.2.1.1	Examples of intra-entity profit elimination
323-10-55-29	6.2.1.1	Examples of intra-entity profit elimination
323-10-55-30 through 47	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-48	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-49	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee



ASC Reference	Section	
323-10-55-50	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-51	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-52	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-53	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-54	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-55	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-56	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-55-57	6.4.2	Share of equity method earnings recorded when the investment in common stock has been reduced to zero and the investor has loans to and investments in other securities of the investee
323-10-S99-4	6.5	Share-based payments granted by investors to employees and nonemployees of an equity method investee
323-30-15-4	3.3.5	Scope exclusion for interests in entities that hold securitized assets
323-30-25-1	3.3	Investments in general partnerships, limited partnerships, limited liability companies, trusts and other entities that maintain specific ownership accounts
323-30-25-1	3.3.1	Partnerships and other unincorporated joint ventures
323-30-35-3	3.3.3	Limited liability companies
323-30-35-3	3.3.4	Trusts and other entities that maintain specific ownership accounts
323-30-S99-1	3.3.2	Limited partnerships
323-740-25-1	3.4.4	Qualified affordable housing projects (before the adoption of ASU 2023-02)
323-740-25-1	6.8.5	Impairment of an investment in a qualified affordable housing project (before ASU 2023-02)
323-740-25-3	3.4.5	Tax equity investments (after the adoption of ASU 2023-02)
323-740-55-8	3.4.5	Tax equity investments (after the adoption of ASU 2023-02)
323-740-55-8	6.8.5	Impairment of an investment in a qualified affordable housing project (before ASU 2023-02)
323-740-55-9	3.4.5	Tax equity investments (after the adoption of ASU 2023-02)
323-740-55-9	6.8.5	Impairment of an investment in a qualified affordable housing project (before ASU 2023-02)

ASC Reference	Section	
323-740-S99-2	3.4.4	Qualified affordable housing projects (before the adoption of ASU 2023-02)
350-20-35-39	5.4.1	Equity method goodwill
350-20-35-58	5.4.1	Equity method goodwill
460-10-55-23	5.2.1	Commitments and guarantees
605-35-15-2	3.4.2	Undivided interests and proportionate consolidation
605-35-15-3	3.4.2	Undivided interests and proportionate consolidation
605-35-15-4	3.4.2	Undivided interests and proportionate consolidation
605-35-15-5	3.4.2	Undivided interests and proportionate consolidation
606-10-S65-1	6.2.6.1	Adoption of new accounting standards
610-20-15-4	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
610-20-15-5	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
610-20-15-5	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
610-20-15-6	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
610-20-15-6	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
610-20-15-7	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
610-20-15-8	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
610-20-15-10	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
610-20-32-2	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
610-20-32-4	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
740-10-S99-1	8.3.3	Other required disclosures
740-10-S99-2	8.3.3	Other required disclosures
805-30-25-2	5.5	Bargain purchase
810-10-30-3	6.9.1	Assessment of control
810-10-30-4	6.9.1	Assessment of control
810-10-40-3A	5.2	Initial measurement
810-10-40-3A	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
810-10-40-3A	5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received
810-10-40-3A	5.2.3.5	Transactions in the scope of other guidance
810-10-40-3A	6.2.1	Elimination of intra-entity profits
810-10-40-3B	5.2	Initial measurement
810-10-40-3B	5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received

ASC Reference	Section	
810-10-40-3B	6.2.1	Elimination of intra-entity profits
810-10-40-4	5.2	Initial measurement
810-10-40-4	5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received
810-10-40-4	6.2.1	Elimination of intra-entity profits
810-10-40-4A	5.2	Initial measurement
810-10-40-4A	5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received
810-10-40-4A	6.2.1	Elimination of intra-entity profits
810-10-40-5	5.2	Initial measurement
810-10-40-5	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
810-10-40-5	5.2.3.2	Control of a business or a nonprofit activity is given up and an equity method investment is retained or received
810-10-40-5	6.2.1	Elimination of intra-entity profits
810-10-40-6	7.1	Overview
810-10-45-12	6.2.7	Differing fiscal year ends
810-10-45-12	6.2.8	Reporting lag
810-10-45-13	6.2.7	Differing fiscal year ends
810-10-45-14	3.4.2	Undivided interests and proportionate consolidation
810-10-45-21A	5.2.3	Contribution of businesses or assets for an investment in an equity method investee
810-10-45-21A	6.2.1	Elimination of intra-entity profits
810-10-45-22	6.2.1	Elimination of intra-entity profits
810-10-45-23	6.2.1	Elimination of intra-entity profits
810-10-45-23	6.10.3.2	Investee's transactions with noncontrolling interests
810-10-45-24	6.2.1	Elimination of intra-entity profits
810-10-50-2	8.3.2	Reporting a change in the investee's fiscal year end, or a change in or the elimination of a lag in reporting of an equity method investee's results
825-10-25-4	6.11	Fair value option
825-10-25-7	6.11	Fair value option
825-10-50-28	6.11	Fair value option
825-10-50-28	8.3	Disclosures
830-10-15-5	6.2.10	Equity method investments in entities with different functional currencies
830-30-45-13	6.8.6	Treatment of currency translation adjustment balance in impairment review
830-30-45-14	6.8.6	Treatment of currency translation adjustment balance in impairment review
830-30-45-15	6.8.6	Treatment of currency translation adjustment balance in impairment review
835-20-15-5	6.3.1	Capitalization of interest costs
835-20-15-6	6.3.1	Capitalization of interest costs

ASC Reference	Section	
835-20-30-6	6.3.1	Capitalization of interest costs
835-20-35-2	6.3.1	Capitalization of interest costs
910-10-15-3	3.4.2	Undivided interests and proportionate consolidation
910-10-15-4	3.4.2	Undivided interests and proportionate consolidation
932-10-S99-3	3.4.2	Undivided interests and proportionate consolidation
946-323-45-1	3.5.1	Investment companies
946-323-45-2	3.5.1	Investment companies
954-810-15-3	3.5.3	Investments held by not-for-profit entities and health care entities
958-810-15-4	3.5.3	Investments held by not-for-profit entities and health care entities
970-323-25-12	3.4.2	Undivided interests and proportionate consolidation
970-323-30-3	5.2.3.4	Nonfinancial assets or in substance nonfinancial assets are given up and an equity method investment is received
970-323-30-7	6.2.1	Elimination of intra-entity profits
970-323-35-2	6.2	Earnings or losses of an investee
970-323-35-2	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-3	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-4	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-5	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-8	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-9	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-10	6.4	Investee losses in excess of investment carrying amount plus advances
970-323-35-12	6.8	Other-than-temporary impairment
970-323-35-14	6.2.1	Elimination of intra-entity profits
970-323-35-15	6.2.1	Elimination of intra-entity profits
970-323-35-16	6.7	Non-pro rata profit or loss allocations
970-323-35-17	6.7	Non-pro rata profit or loss allocations
970-323-35-20	6.2.5	Investee's accounting basis is not US GAAP
970-323-35-22	6.3.2	Interest on in-substance capital contributions
970-323-40-1	7.2.1	Sale of an equity method investment in real estate or nonfinancial assets
970-810-25-3	3.3.2	Limited partnerships
970-810-45-1	3.4.2	Undivided interests and proportionate consolidation
970-835-35-1	6.3.2	Interest on in-substance capital contributions
974-323-25-1	3.5.2	Investments held by real estate investment trusts

# C Summary of important changes

The following highlights important changes to this publication since the July 2023 edition of our FRD, *Equity method investments and joint ventures*:

- ▶ Section 3.1 was updated to include a table that summarizes the evaluation for determining whether the equity method of accounting applies for each legal form of an investee.
- ▶ Section 3.4.2 was updated to clarify governance considerations for LLCs when applying proportionate consolidation.
- ▶ Section 4 was updated to remove guidance on the definition of a joint venture, which was moved to Appendix D of our Business combinations FRD.
- ▶ Section 6.2.6.1 was updated to reflect the adoption of ASU 2015-14 and 2016-02.
- ▶ Sections 6.4.1 and 6.4.2 were updated to reflect the adoption of ASU 2016-13.
- ▶ Section 8.5 was updated to clarify existing SEC reporting guidance for equity method investments.
- ▶ Appendix D, Accounting by the joint venture at formation, was removed in light of the issuance of ASU 2023-05. See Appendix D of our Business combinations FRD for guidance on the accounting for joint venture formations after adoption of ASU 2023-05.

# D Glossary

This Appendix includes a list of terms defined in the Master Glossary of ASC 323 (shown as an excerpt from the ASC), followed by a list of selected additional terms defined in other sections of the ASC Master Glossary and used in this publication. Note that if a defined term is repeated in more than one Subtopic, it is listed below only in the first Subtopic in which it appears as a defined term. For example, “Noncontrolling Interest” is included in the Glossary section of Subtopics 323-10, 610-20 and 970-323, but is listed only in the 323-10-20 section below.

## **Excerpt from Accounting Standards Codification**

### **Investments – Equity Method and Joint Ventures – Overall**

#### *Glossary*

#### **310-10-20**

##### **Expected Residual Profit**

The amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by a lender.

#### **323-10-20**

##### **Common Stock**

A stock that is subordinate to all other stock of the issuer. Also called common shares.

##### **Corporate Joint Venture**

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

##### **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).

##### **In-Substance Common Stock**

An investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock.

**Investee**

An entity that issued an equity instrument that is held by an investor.

**Investor**

A business entity that holds an investment in voting stock of another entity.

**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.

**Parent**

An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)

**Significant Influence**

Paragraphs 323-10-15-6 through 15-11 define significant influence.

**Standstill Agreement**

An agreement signed by the investee and investor under which the investor agrees to limit its shareholding in the investee.

**Subsidiary**

An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

**Investments – Equity Securities – Overall****321-10-20****Equity Security**

Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

- a. Written equity options (because they represent obligations of the writer, not investments)
- b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
- c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

**Readily Determinable Fair Value**

An equity security has a readily determinable fair value if it meets any of the following conditions:

- a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.

- b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
- c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

### **Security**

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.

### **Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets**

#### *Glossary*

#### **610-20-20**

#### **In-Substance Nonfinancial Asset**

Paragraphs 610-20-15-5 through 15-8 define an in substance nonfinancial asset.

#### **Contract**

An agreement between two or more parties that creates enforceable rights and obligations.

#### **Transaction price**

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

### **Consolidation – Overall**

#### *Glossary*

#### **810-10-20**

#### **Legal Entity**

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

#### **Participating Rights (VIE Definition)**

The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.



**Participating Rights (Voting Interest Entity Definition)**

Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

**Protective Rights (VIE Definition)**

Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

- a. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Examples include both of the following:
  1. A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.
  2. Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.
- b. The ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity.
- c. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

**Protective Rights (Voting Interest Entity Definition)**

Rights that are only protective in nature and that do not allow the limited partners or noncontrolling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

**Revenue**

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

**Fair Value Measurement – Overall*****Glossary*****820-10-20****Fair value**

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

## Foreign Currency Matters - Overall

### *Glossary*

#### 830-10-20

### Foreign Currency Translation

The process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.

### Functional Currency

An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. (See paragraphs 830-10-45-2 through 45-6 and 830-10-55-3 through 55-7.)

### Translation

See **Foreign Currency Translation**

## Interest - Capitalization of Interest

### *Glossary*

#### 835-20-20

### Activities

The term activities is to be construed broadly. It encompasses physical construction of the asset. In addition, it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities. It also includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation.

### Interest Cost

Interest cost includes interest recognized on obligations having explicit interest rates, interest imputed on certain types of payables in accordance with Subtopic 835-30, and interest related to a **finance lease** determined in accordance with Topic 842. With respect to obligations having explicit interest rates, interest cost includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

## Nonmonetary Transactions - Overall

### *Glossary*

#### 845-10-20

### Joint Venture

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

**Owners**

Used broadly to include holders of ownership interests (**equity interests**) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities.

**Related Party Disclosures – Overall****Glossary****850-10-20****Related Parties**

Related parties include:

- a. Affiliates of the entity
- b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of section 825-10-15, to be accounted for by the equity method by the investing entity
- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- d. Principal owners of the entity and members of their immediate families
- e. Management of the entity and members of their immediate families
- f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

**Real Estate – General****Glossary****970-323-20****Acquisition, Development, and Construction Arrangements**

Acquisition, development, or construction arrangements, in which a lender, usually a financial institution, participates in expected residual profit from the sale or refinancing of property.

**General Partnership**

An association in which each partner has unlimited liability

**Limited Partnership**

An association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.

**Real Estate Venture**

Any of the following: a joint venture, a general partnership, a limited partnership, and an undivided interest.

**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.

**Real Estate – Real Estate Investment Trusts – Investments – Equity Method and Joint Ventures****Glossary****974-323-20****Real Estate Investment Trust**

Real estate investment trusts generally are formed as trusts, associations, or corporations. They employ equity capital, coupled with substantial amounts of debt financing, in making real estate loans and investments. Real estate investment trusts must distribute substantially all of their taxable income to their shareholders annually in order to retain their favorable tax status (that is, dividends paid are treated as deductions in arriving at taxable income).

**Service Corporation**

A real estate investment trust may establish a service corporation to perform services for the real estate investment trust or for third parties. Service corporations may provide property management and leasing services, as well as services to acquire, develop, construct, finance, or sell real estate projects.

**Master Glossary****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.

**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.

In addition to the terms defined in US GAAP, the following terms are included in this publication:

**Bargain purchase** – An acquisition of an equity method investment in which the initial cost of the equity method investment is less than the fair value of the identifiable net asset of the investee.

**Basis difference** – A difference in the cost basis of an equity method investment and the underlying equity in net assets of the investee, which is assigned to the underlying assets and liabilities of the investee, or to equity method goodwill when the investee is a business.

**Equity method goodwill** – Any excess cost of an equity method investment over the proportional fair value of the identifiable assets acquired and liabilities assumed of the investee (when the investee is a business), which is recognized as in the “memo” accounts of the equity method investment.

**Memo accounts** – Subsidiary ledger accounts (outside of the general ledger) that are used to track the identified basis differences, related depreciation and amortization, and equity method goodwill, for an equity method investment.

**Outside basis difference** – A difference between the carrying amount of an equity method investment in the financial statements, and the tax basis of that investee, which creates a temporary difference for which deferred taxes are recorded.

**Step acquisition** – An acquisition in which the investor obtains incremental interests in an investee through a series of two or more different investments; a step acquisition may ultimately result in the investor obtaining control of the investee.

## EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via [ey.com/privacy](https://ey.com/privacy). EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit [ey.com](https://ey.com).

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2024 Ernst & Young LLP.  
All Rights Reserved.

SCORE no. 02230-161US  
(Revised June 2024)

This and many of the publications produced by our US Professional Practice Group, are available free on AccountingLink at [ey.com/en\\_us/technical/accountinglink](https://ey.com/en_us/technical/accountinglink).

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.