No. 2023-10
30 August 2023

To the Point

FASB — final guidance

FASB requires joint ventures to measure most assets and liabilities at fair value upon formation

The final standard applies to a joint venture's financial statements and does not affect the accounting by the investors.

What you need to know

- The FASB issued final guidance requiring certain joint ventures to apply a new basis of accounting upon formation by recognizing and initially measuring most of their assets and liabilities at fair value.
- The guidance applies to joint ventures that meet the definition in ASC 323, except those that may be proportionately consolidated by one or more investors and those that are not-for-profit entities or collaborative arrangements in the scope of ASC 808 not conducted in a separate legal entity.
- The ASU does not amend the definition of a joint venture or change the accounting by the investors in a joint venture.
- The guidance is effective for all joint venture formations with a formation date on or after 1 January 2025. Early adoption is permitted. Joint ventures formed before the effective date have the option to apply it retrospectively, while those formed after the effective date are required to apply it prospectively.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an **Accounting Standards Update**[1] **(ASU)** requiring 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. The ASU does not affect the accounting by the joint venture's investors.

EY
Building a better working world

The guidance is intended to address diversity in practice. Because US GAAP did not address how a joint venture should recognize and initially measure contributed assets and assumed liabilities upon its formation, some joint ventures initially measured their assets at fair value, while others accounted for their net assets at the investors' carrying amounts.

Key considerations

The guidance requires certain joint ventures, upon formation, to use a new basis of accounting by applying most aspects of the acquisition method for business combinations. This means that joint ventures generally will recognize and initially measure their assets and liabilities at fair value, with certain exceptions consistent with the business combinations guidance.

The ASU does not change the definition of a joint venture, the accounting by the investors for their investments in a joint venture (e.g., equity method accounting) or the accounting by a joint venture for contributions received after its formation.

Scope and key terms

The guidance applies to the formation of joint ventures as defined in Accounting Standards Codification (ASC) 323,[2] except for those that may be proportionately consolidated by one or more investors and those that are not-for-profit entities or collaborative arrangements in the scope of ASC 808[3] that are not conducted in a separate legal entity. The Board clarified that the proportionate consolidation exception is intended to exclude joint ventures where investors can (but don't necessarily) account for their interests through proportionate consolidation.[4] Proportionate consolidation is permitted only for unconsolidated investments in unincorporated legal entities (e.g., partnerships) in the extractive or construction industries.

Definition of a joint venture

The ASU does not change the definition of a joint venture as stated in ASC 323, which describes characteristics generally present in joint ventures.[5] Based on that definition, we believe a joint venture is required to have all of the following characteristics:

- The arrangement is organized within a separate legal entity.
- The entity is under the joint control of its investors.
- The investors are able to exercise joint control of the entity through their equity investments.
- The entity's purpose, design and other characteristics are consistent with the definition of a joint venture.

The Securities and Exchange Commission (SEC) staff has also said that each of the characteristics in the ASC 323 definition should be met for an entity to be considered a joint venture. The staff also said it would object to a conclusion that joint control is the only defining characteristic of a joint venture.[6]

How we see it

Although the term joint venture is often used loosely in practice to describe many types of arrangements and may appear in legal documents and public statements by management, we believe the definition of a joint venture in US GAAP is fairly narrow. An entity that is similar to a joint venture but does not meet the definition of a joint venture would not apply the guidance.

Formation date

Under the guidance, a joint venture determines its formation date and accounts for its formation as of that date. The formation date is the date on which an entity initially meets the definition of a joint venture, which is not necessarily the inception date of the legal entity.

Accounting by a joint venture upon its formation

Initial measurement

The guidance requires a newly-formed joint venture to apply a new basis of accounting upon formation in its standalone financial statements and measure its total net assets upon formation as the fair value of the joint venture as a whole, which would equal the fair value of 100% of the joint venture's outstanding equity interests.

Upon formation, a joint venture generally recognizes and initially measures its identifiable assets and liabilities at fair value, generally consistent with the acquisition method for business combinations. The excess of the fair value of the joint venture's outstanding equity interests over the fair value of its identifiable assets and liabilities is recognized as goodwill, regardless of whether the joint venture meets the definition of a business. The guidance also allows a joint venture to apply the measurement period guidance, which is consistent with the acquisition method for business combinations.

Goodwill is recognized as the excess of fair value of the joint venture as a whole over the fair value of the identifiable net assets recognized by the joint venture.

Illustration: A joint venture's accounting at its formation date

Company A and Company B form Joint Venture C, which meets the definition of a joint venture under ASC 323 and is a for-profit entity. Upon formation, Company A contributes a business that manufactures automotive parts, and Company B contributes a business that distributes automotive parts. Company A and Company B each receive equity in Joint Venture C in exchange for their contributions and apply the equity method to account for their investments in the joint venture.

Under the new guidance, Joint Venture C determines the fair value of the joint venture as a whole by estimating the fair value of 100% of its equity immediately after formation. Joint Venture C then separately measures the identifiable assets and liabilities, including any identifiable intangible assets, consistent with the acquisition method for business combinations.

Assume that Joint Venture C determines that the fair value of 100% of its equity is $200, and the fair value of its identifiable net assets is $180. Joint Venture C also recognizes $20 of goodwill to reflect the difference between the fair value of the joint venture as a whole and the fair value of the identifiable net assets.

How we see it

The guidance in ASC 323 requires that when an investor contributes a business or nonfinancial assets in exchange for an equity interest in a joint venture, the investor recognizes the equity investment at fair value in accordance with ASC 810[7] or ASC 610-20,[8] respectively. Accordingly, the Board decided that one of the benefits of requiring a new basis of accounting (i.e., fair value accounting) for the joint venture upon formation is that it would reduce equity method basis differences for the investors. In addition, the Board believes that the joint venture is able to leverage the investors' measurements to reduce the overall costs of applying fair value at formation.[9]

Disclosure

The guidance requires a joint venture to disclose information that enables users of its financial statements to understand the nature and financial effect of the joint venture formation in the period that includes the formation date. The required disclosures include the formation date, a description of the purpose for which the joint venture was formed, the fair value of the joint venture as a whole, a description of the assets and liabilities recognized by the joint venture, and a description of the factors that make up the goodwill recognized. If the initial accounting for the joint venture formation is incomplete and the amounts recognized in the joint venture standalone financial statements are provisional, disclosures are required, consistent with the requirements for business combinations.

Transition and effective date

The ASU is effective for all joint ventures with a formation date on or after 1 January 2025. Early adoption is permitted in any interim or annual period in which financial statements have not yet been issued or made available for issuance, either prospectively or retrospectively. Joint ventures formed before the effective date can apply the guidance retrospectively, and those formed on or after the effective date are required to apply it prospectively.

How we see it

If a joint venture formation occurs before the effective date and the joint venture would like to recognize and initially measure the contributed assets and assumed liabilities at fair value, we believe it should early adopt the ASU rather than apply other fair value measurement approaches under current practice.

Endnotes:

[1] ASU 2023-05, *Business Combinations — Joint Venture Formations (Subtopic 805-60)*

[2] ASC 323, *Investments — Equity Method and Joint Ventures*.

[3] ASC 808, *Collaborative Arrangements*.

[4] Paragraph BC29 in the ASU's Background and Basis for Conclusions.

[5] The term joint venture is defined in the ASC Master Glossary as "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."

[6] See ASC 845-10-S99-2 and remarks by Christopher F. Rogers, Professional Accounting Fellow, Office of the Chief Accountant at the 2014 AICPA National Conference on Current SEC and PCAOB Developments, 8 December 2014.

[7] ASC 810, *Consolidation*.

[8] ASC 610-20, *Other Income — Gains and Losses on Involuntary Conversions*.

[9] Paragraph BC26.

EY | Building a better working world

© 2023 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 20806-231US

ey.com/en_us/assurance/accountinglink

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. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

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.