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Preface

November 2018

To the clients, friends, and people of Deloitte:

We are pleased to present the inaugural edition of *A Roadmap to Accounting for Equity Method Investments and Joint Ventures*. This Roadmap provides Deloitte’s insights into and interpretations of the guidance on accounting for equity method investments and joint ventures. Although Chapter 6 in this publication covers the presentation and disclosure requirements for equity method investments for SEC registrants, readers who wish to explore this topic in depth may consult Deloitte’s *A Roadmap to SEC Reporting Considerations for Equity Method Investees*.

The accounting principles related to equity method investments and joint ventures have been in place for many years, but they can be difficult to apply. The lack of prescriptive guidance surrounding initial measurement upon formation of a joint venture and accounting for equity method basis differences, as well as on the calculation of an investor’s share of earnings or losses of an investee, particularly in complex capital structures, has resulted in diversity in practice. For these reasons, accounting for equity method investments and joint ventures can be a particularly challenging aspect of U.S. GAAP.

This Roadmap includes pending guidance in several Accounting Standards Updates (ASUs) issued by the FASB, including, but not limited to, ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*; ASU 2014-09, *Revenue From Contracts With Customers*; and ASU 2017-05, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*. Within each applicable section, we provide an overview of significant changes that may result from the adoption of these ASUs; however, the interpretive guidance within this Roadmap reflects U.S. GAAP before the ASUs’ adoption.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

Although this Roadmap is intended to be a helpful resource, it is not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

We hope that you find this Roadmap a valuable resource when considering the accounting guidance on equity method investments and joint ventures.

Sincerely,

Deloitte & Touche LLP
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Chapter 1 — Overview

**ASC 323-10**

05-4 Investments held in stock of entities other than subsidiaries, namely corporate joint ventures and other noncontrolling entities usually are accounted for by one of three methods — the cost method (addressed in Subtopic 325-20), the fair value method (addressed in Topic 320), or the equity method. This Subtopic provides guidance on application of the equity method. The equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles (GAAP) in the economic resources underlying the investments. Furthermore, the equity method of accounting more closely meets the objectives of accrual accounting than does the cost method because the investor recognizes its share of the earnings and losses of the investee in the periods in which they are reflected in the accounts of the investee. The equity method also best enables investors in corporate joint ventures to reflect the underlying nature of their investment in those ventures.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

05-4 Investments held in stock of entities other than subsidiaries, namely corporate joint ventures and other noncontrolling entities usually are accounted for in accordance with either the recognition and measurement guidance in Subtopic 321-10 or the equity method. This Subtopic provides guidance on application of the equity method. The equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles (GAAP) in the economic resources underlying the investments. Furthermore, the equity method of accounting closely meets the objectives of accrual accounting because the investor recognizes its share of the earnings and losses of the investee in the periods in which they are reflected in the accounts of the investee. The equity method also best enables investors in corporate joint ventures to reflect the underlying nature of their investment in those ventures.

05-5 The equity method tends to be most appropriate if an investment enables the investor to influence the operating or financial decisions of the investee. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee. Influence tends to be more effective as the investor’s percent of ownership in the voting stock of the investee increases. Investments of relatively small percentages of voting stock of an investee tend to be passive in nature and enable the investor to have little or no influence on the operations of the investee.

05-6 In addition to the joint venture guidance included in this Topic, the accounting and reporting for real estate joint ventures is addressed in Subtopic 970-323.
When determining the appropriate accounting for its ownership interest in an investee, the investor must consider the substance of the transaction as well as the legal form of the investee. If the investor does not control the investee and is not required to consolidate it (see Deloitte's *A Roadmap to Consolidation — Identifying a Controlling Financial Interest* for further information regarding considerations on whether consolidation is required), the investor accounts for such an investment as an equity method investment, a cost method investment, or an investment at fair value (if the equity security has a readily determinable fair value).

**Changing Lanes**

In January 2016, the FASB issued ASU 2016-01, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new guidance requires that entities, upon the effective date of the ASU (after December 15, 2017, for public entities and after December 15, 2018, for all other entities, with early adoption permitted), carry all investments in equity securities — including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies (LLCs) — at fair value through net income. This requirement does not apply to investments (1) that qualify for the equity method of accounting, (2) that result in consolidation of the investee, or (3) for which the reporting entity has elected the practicability exception to fair value measurement. Therefore, ASU 2016-01 does not have an impact on the equity method of accounting. However, once ASU 2016-01 is effective, investments can no longer be classified as cost method investments.

Generally, the equity method of accounting should be applied when the investor has the ability to exercise significant influence over the operating and financial decisions of the investee. The ability to exercise significant influence over the investee is mainly driven by the investor’s ownership interest in the investee (see Section 3.2); however, when determining whether it has the ability to exercise significant influence over an investee, the investor must also consider its investments in common stock and in-substance common stock (see Section 2.5). There are also other factors that may indicate that the investor has the ability to exercise significant influence, such as board representation, participation in policy-making processes, veto rights, material intra-entity transactions, interchange of managerial personnel, technological dependency, and others (see Section 3.3). Therefore, when determining whether it has an ability to exercise significant influence over the investee, the investor must consider all relationships and interests (voting and nonvoting) that involve the investee.

In addition, the legal form of an investor’s investment is important in the determination of whether the equity method of accounting is appropriate. Although ASC 323-10 provides guidance on investments in common stock of corporations (including corporate joint ventures), many of the provisions in ASC 323-10 also apply to investments in noncorporate entities, such as partnerships, LLCs, and unincorporated joint ventures (see Section 2.2). For example, partnerships and certain LLCs that maintain specific ownership accounts for each investor have unique rules that can result in an investor applying the equity method of accounting with as little as 3 percent to 5 percent of the ownership interest in the investee.

The flowchart below illustrates the relevant questions to be considered in the determination of whether the investment should be accounted for under the equity method of accounting.

---

1 Throughout this Roadmap, “investee” refers to the entity that issued the equity instrument that is being analyzed for potential accounting under the equity method of accounting.
2 Throughout this Roadmap, “investor” refers to the party applying or determining whether it should apply the equity method of accounting to its investment.
3 For the full titles of standards, topics, and regulations used in this publication, see Appendix C. For a list of abbreviations used in this publication, see Appendix D.
4 Unless stated otherwise, throughout this Roadmap, references to common stock include in-substance common stock.
The presentation of equity method investments is often referred to as a “one-line consolidation.” The equity method investment is initially recorded at cost; however, the investor must account for the differences between the cost of an investment and the underlying equity in the net assets of the investee (i.e., basis differences) as if the investee was a consolidated subsidiary (see Chapter 4). Subsequently, the carrying amount of the equity method investment is adjusted to recognize the investor’s proportionate share of the investee’s earnings or losses or changes in capital (see Chapter 5). Given that the proportionate share of the earnings and losses of the investee is generally recognized in the periods in which they are reflected in the accounts of the investee (rather than in the period in which an investee declares a dividend, as is the case under the cost method of accounting), the equity method better reflects the investor’s return on its investment.

ASC 323-10 also outlines additional disclosure requirements that must be considered (see Chapter 6).

Some investors are affected by both U.S. GAAP and IFRS® Standards. Significant differences between the guidance in ASC 323-10 and the equivalent guidance under IFRS Standards are discussed in Appendix B.
Appendix A of this Roadmap includes defined terms from the glossaries of ASC 323-10, ASC 970-323, and ASC 974-323.

**Connecting the Dots**
Throughout this Roadmap, “joint ventures” refers to “corporate joint ventures,” as defined by ASC 323-10-20. The investors (i.e., venturers) in a joint venture typically apply the equity method of accounting to their investment. Although the provisions for the equity method are usually the same for joint ventures as for any other legal entity, there are some unique accounting considerations for the venturers and the joint venture itself. We address the distinctive characteristics of joint ventures in Section 7.2 and the related accounting by the venturers and the joint venture in Chapters 9 and 8, respectively.
Chapter 2 — Scope and Scope Exceptions

2.1 Overview

ASC 323-10

| 15-2 | The guidance in the Investments — Equity Method and Joint Ventures Topic applies to all entities. |
| 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). |

This chapter discusses considerations related to scope — that is, which investments should and should not be accounted for under the equity method of accounting.

ASC 323-10 may apply to any entity that has an investment in the common stock and in-substance common stock of an investee. As defined in the standard’s glossary, common stock (or common shares) is “a stock that is subordinate to all other stock of the issuer.” Holders of common stock generally have the right to elect members of the board of directors and to vote on corporate policy, both of which allow those shareholders to influence the operating and financial policies of an investee. Because common stock represents the residual value of an investee, in the event of liquidation, common shareholders have rights to a company’s assets only after all other senior claims (e.g., those of bondholders, preferred shareholders, and other debt holders) are paid in full. In-substance common stock represents an instrument that, although not in the legal form of common stock, has characteristics that are substantively similar to those of common stock.

Before an investor applies ASC 323-10 to an investment in an investee, it should evaluate whether any scope exceptions apply (see Section 2.3) and, if not, whether it has the ability to exercise significant influence over the operating and financial policies of that investee (see Chapter 3). An investor is precluded from applying the equity method of accounting if it has the ability to exercise significant influence over the operating and financial policies of an investee through an investment that does not qualify as common stock or in-substance common stock.

Many of the provisions in ASC 323-10 apply to investments in the common stock of corporations (including corporate joint ventures), as well as to investments in noncorporate entities, such as partnerships, LLCs, unincorporated joint ventures (see Section 2.2), and any other form of legal entity.

Corporate and unincorporated joint ventures (collectively, “joint ventures”) are a common form of business enterprise. Although an investor in a joint venture will generally account for its investment in
2.2 Investments in Partnerships, Unincorporated Joint Ventures, and LLCs

ASC 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.

ASC 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.

An investor should first consider ASC 810-10 to evaluate whether the investee should be consolidated, regardless of percentage owned. (See Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest to determine whether the guidance in ASC 810-10 applies to the investment.) If an investor determines that the investee should not be consolidated, the investor should consider the guidance in ASC 323-10 or other guidance as appropriate.

Investments in partnerships (general or limited), unincorporated joint ventures, and LLCs that maintain specific ownership accounts for each investor are excluded from the scope of ASC 323-10. However, if an investor has the ability to exercise significant influence over these types of investments, it generally should apply the principles of accounting for equity method investments by analogy to ASC 323-10. In addition, ASC 970-323 provides similar guidance relative to various forms of investments in real estate development projects.\(^1\) However, the presumed level of ownership interest that allows an investor to exercise significant influence over an investee for these types of entities differs from the presumed levels of ownership for corporations. This topic is further discussed in Section 3.2.

2.2.1 Limited Liability Companies

ASC 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 using the cost method or the equity method.

Pending Content (Transition Guidance: ASC 825-10-65-2)

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.

\(^1\) See ASC 970-323-25-3 through 25-8.
A limited liability company generally has the following characteristics:

a. It is an unincorporated association of two or more persons.
b. Its members have limited personal liability for the obligations or debts of the entity.
c. It is classified as a partnership for federal income tax purposes.

Limited liability companies have characteristics of both corporations and partnerships but are dissimilar from both in certain respects. The following discussion compares characteristics typical of many limited liability company structures with characteristics of corporations or partnerships; however, those characteristics may not be present in all limited liability company structures.

Like a corporation, the members (that is, owners) of a limited liability company generally are not personally liable for the liabilities of the limited liability company. However, like a partnership, the members of a limited liability company — rather than the entity itself — are taxed on their respective shares of the limited liability company's earnings. Unlike a limited partnership, it is generally not necessary for one owner (for example, the general partner in a limited partnership) to be liable for the liabilities of the limited liability company. Also, unlike a limited partnership in which the general partner manages the partnership, or a corporation in which the board of directors and its committees control the operations, owners may participate in the management of a limited liability company. Members may participate in a limited liability company's management but generally do not forfeit the protection from personal liability afforded by the limited liability company structure. In contrast, the general partner of a limited partnership has control but also has unlimited liability, whereas the limited partners have limited liability like the members of a limited liability company. Additionally, all partners in a general partnership have unlimited liability. Like a partnership, financial interests in most limited liability companies may be assigned only with the consent of all of the limited liability company members. Like a partnership, most limited liability companies are dissolved by death, bankruptcy, or withdrawal of a member.

As stated in ASC 272-10-05-3, LLCs may “have characteristics of both corporations and partnerships but are dissimilar from both in certain respects.” Thus, when assessing whether the investment in an LLC should be accounted for under the equity method, an investor must first determine whether the LLC is more akin to a corporation or a partnership. In making that determination, the investor should consider whether the LLC maintains specific ownership accounts for each investor. A specific ownership account is one in which an individual investor’s capital transactions (e.g., contributions and distributions) and share of LLC profits and losses are allocated in a manner similar to the way they would be in a partnership capital account structure.

### 2.2.1.1 LLC That Does Maintain Specific Ownership Accounts

If an investor has an investment in an LLC that does maintain specific ownership accounts for each investor, the investment should be evaluated in the same manner as one in a partnership (see **Section 2.2.2**). The same evaluation would be performed for an investment in an entity other than a partnership or LLC if that entity also maintains a specific ownership account structure (such as a common trust fund).

See **Section 3.2.3** for further discussion of the evaluation of significant influence over an investee that has the legal form of a partnership.
2.2.1.2 **LLC That Does Not Maintain Specific Ownership Accounts**

If an investor has an investment in an LLC that does not maintain specific ownership accounts for each investor, the investment should be evaluated in the same manner as one in a corporation.

See Section 3.2.1 for further discussion of the evaluation of significant influence over an investee that has the legal form of a corporation.

It should be noted that ASC 810-10 specifically requires an investor to consider multiple factors when assessing whether the LLC more closely resembles a corporation or partnership. However, the evaluation under ASC 323-10 considers only whether a specific ownership account structure exists.

### Limited Partnership Interests in Partnerships and Similar Entities

<table>
<thead>
<tr>
<th>ASC 970-323</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-6</strong> The equity method of accounting for investments in general partnerships is generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner’s interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate.</td>
</tr>
</tbody>
</table>

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

| **25-6** The equity method of accounting for investments in general partnerships is generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner’s interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, the limited partner should account for its investment in accordance with Topic 321. |

**Changing Lanes**

The pending content for ASC 970-323-25-6 relates to ASU 2016-01, which will eliminate the cost method of accounting. See Chapter 1 for details about this ASU.

Investments in partnerships and similar entities (e.g., unincorporated joint ventures or LLCs that maintain specific ownership accounts for each investor) are accounted for under the equity method of accounting in accordance with ASC 970-323-25-6 unless the investor’s interest is “so minor that the limited partner may have virtually no influence over partnership operating and financial policies.” While the guidance in ASC 970-323 is specific to real estate partnerships, ASC 323-30-S99-1 clarifies the SEC’s view that “investments in all limited partnerships should be accounted for pursuant to paragraph 970-323-25-6.” Therefore, we believe that it is appropriate for investors to apply this guidance to all partnerships and similar entities (not only real estate investees).

See Section 3.2.3 for further discussion of the presumed levels of ownership that allow an investor in a partnership or other similar entities to exercise significant influence.
2.2.3 General Partnership Interests in Partnerships

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 323-30-599-1).

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.

In February 2015, the FASB issued ASU 2015-02, which had a significant effect on the consolidation framework in ASC 810. For public business entities (PBEs), the guidance in ASU 2015-02 is effective for annual periods beginning after December 15, 2015, and interim periods therein. For entities other than PBEs, the guidance is effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. For further information about ASU 2015-02's effective date and transition guidance, see Chapter 12 of Deloitte's A Roadmap to Consolidation — Identifying a Controlling Financial Interest. While ASU 2015-02 is now effective for most companies (generally, it is effective in 2016 for public entities and 2017 for private entities, with early adoption permitted), the guidance in this Roadmap is written as if adoption has occurred.

If a partnership is not a variable interest entity (VIE) or if a partnership is a VIE but the general partner (GP) is not the primary beneficiary, the GP should account for its interest in the partnership under the equity method. We are unaware of a situation in which the cost method would be used to account for a general partnership interest.

2.2.4 Corporate Joint Ventures

All joint venture investments in which an investor shares in joint control, whether they are incorporated or unincorporated, should be accounted for under the equity method without regard to the investor's ownership percentage.

2.3 Scope Exceptions

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

a. An investment accounted for in accordance with Subtopic 815-10

b. An investment in common stock held by a nonbusiness entity, such as an estate, trust, or individual


c. An investment in common stock within the scope of Topic 810

d. Except as discussed in paragraph 946-323-45-2, an investment held by an investment company within the scope of Topic 946.
One of the steps in the determination of whether an investment is subject to the equity method of accounting is an evaluation of whether the investment meets one of the scope exceptions to the requirements in ASC 323-10.

There are certain investments for which the equity method of accounting generally does not apply, even though an investor may have the ability to exercise significant influence over an investee. The determination of whether an investment is within the scope of ASC 323-10 may require judgment and should be based on an evaluation of all facts and circumstances.

### 2.3.1 Investment Accounted for in Accordance With ASC 815-10

An investment that is a derivative within the scope of ASC 815-10 is generally accounted for at fair value (unless a scope exception under ASC 815 exists) and, accordingly, is not within the scope of ASC 323-10.

### 2.3.2 Investments in Common Stock Held by a Nonbusiness Entity

An investor is not required to use the equity method to account for an investment in common stock held by a nonbusiness entity, such as an estate, trust, or individual (even if that investment allows the investor to exercise significant influence over the investee). The use of the cost or the fair value method for such investments may better depict the financial position and changes in the financial position of nonbusiness entities, especially given the diverse nature of such entities. However, a nonbusiness entity is not precluded from applying the equity method of accounting if its investment permits it to exercise significant influence over the investee and does not constitute a controlling financial interest. The use of the equity method of accounting by a nonbusiness entity is a policy election, and if elected, should be applied consistently for similar investments. However, the equity method of accounting would generally be applied to investments held by a nonbusiness entity for long-term operating purposes (as opposed to a portfolio or similar investment).

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

Real estate investment trusts (REITs) are typically formed as trusts, associations, or corporations and are considered business entities (rather than nonbusiness entities) because they have business activities in the form of income-producing real estate or real estate–related assets and are capitalized through the use of a combination of equity and borrowed capital. Since REITs are considered business entities, in the absence of another scope exception, their investments should be analyzed to determine whether the equity method of accounting under ASC 323-10 should be applied.

In some cases, a REIT, to retain its qualification as such, will establish a service corporation to perform services for the REIT or for third parties. As discussed above, such corporations are considered business entities and are within the scope of ASC 323-10. However, a REIT should consider the factors in ASC 974-323-25-1 and the facts and circumstances of each investment to determine whether it has the ability to exercise significant influence over a service organization and therefore should apply the equity method of accounting to its investment in the service corporation (see Section 3.2.4).

### 2.3.3 Investments in Common Stock Within the Scope of ASC 810

It would be inappropriate for an investor to use the equity method of accounting to account for an investment in common stock that represents a controlling financial interest. Such an investment should
be consolidated in accordance with ASC 810-10. This topic is discussed in Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

However, ASC 323-10 may apply to majority-owned legal entities (1) that are not consolidated because of the exclusions of ASC 810-10-15-10, (2) if the minority shareholder or shareholders have certain approval or veto rights qualifying as substantive participating rights under ASC 810-10-25-1 through 25-14, or (3) if the majority shareholder is determined not to be the primary beneficiary of a VIE under ASC 810-10-25-38 through 25-41. In such instances, the equity method would apply if an investor exercises significant influence over the majority-owned subsidiary. In the rare circumstance that an investor owning a majority of a subsidiary does not exercise significant influence over that subsidiary, the investment would be accounted for under ASC 320 at fair value (if the security has a readily determinable fair value) or under ASC 325 as a cost method investment.

### Changing Lanes

ASU 2016-01 requires that entities, upon the effective date of the ASU (generally after December 15, 2017, for public entities and after December 15, 2018, for all other entities, with early adoption permitted), carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and LLCs, at fair value through net income. This requirement does not apply to investments that qualify for the equity method of accounting or to those that result in consolidation of the investee or for which the investor has elected the practicability exception to fair value measurement. Therefore, once ASU 2016-01 is effective, investments can no longer be classified as cost method investments.

#### 2.3.4 Investments Held by Investment Companies Within the Scope of ASC 946

**ASC 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.

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.

2.3.4.1 **Investor Is an Investment Company**

If an investor qualifies as an investment company under ASC 946, it is precluded from using the equity method to account for an investment in an investee, irrespective of whether the investee is an investment company. Investment companies account for their investments in operating companies (other than those providing services to the investment companies) at fair value in accordance with the specialized accounting guidance in ASC 946, regardless of whether the investment companies have the ability to exercise significant influence over the investees. An exception to this rule is if the investment company has an investment in an entity that is providing services to the investment company, such as

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an investment adviser or a transfer agent. In such instances, the investment company should apply the equity method of accounting if all other criteria are met.

### 2.3.4.2 Investor Is Not an Investment Company

An investor that has an interest in an investment company but is not itself an investment company under ASC 946 should apply the equity method of accounting if all other criteria are met.

### 2.3.5 Investments in Certain Securitization Entities

<table>
<thead>
<tr>
<th>ASC 860-20</th>
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<tbody>
<tr>
<td>35-2 Financial assets, except for instruments that are within the scope of Subtopic 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables. Interest-only strips and similar interests that meet the definition of securities are included in the scope of that Topic. Therefore, all relevant provisions of that Topic (including the disclosure requirements) shall be applied. See related implementation guidance beginning in paragraph 860-20-55-33.</td>
</tr>
</tbody>
</table>

Investments in certain securitization entities (whether in the form of an LLC, partnership, trust, or similar entity) that can be contractually settled in such a way that the investor may not recover substantially all of its recorded investment are outside the scope of equity method of accounting and are instead accounted for as debt securities under ASC 320 (i.e., classified as available-for-sale (AFS) or trading securities) or as a derivative within the scope of ASC 815-10, if applicable.

### 2.4 Applicability of Equity Method to Other Investments

#### 2.4.1 Investments Held by Not-for-Profit Entities

<table>
<thead>
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<th>ASC 958-810</th>
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| 15-4 Additional guidance for reporting relationships between NFPs and for-profit entities resides in the following locations in the Codification:

  c. An NFP that owns 50 percent or less of the voting stock in a for-profit entity shall apply the guidance in Subtopic 323-10 unless that investment is reported at fair value in conformity with the guidance described in (e).

  d. An NFP with a more than minor noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar legal entity shall report its noncontrolling interests in such entities using the equity method in accordance with the guidance in Subtopic 970-323 unless that interest is reported at fair value in conformity with the guidance described in (e). An NFP shall apply the guidance in paragraph 970-810-25-1 to determine whether its interests in a general partnership are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I to determine whether its interests in a for-profit limited partnership, limited liability company, or similar legal entity are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraph 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a limited liability company or a similar legal entity should be accounted for in accordance with Subtopic 970-323 or Subtopic 323-10. |

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3 Note that although some entities may not have implemented the provisions of ASU 2015-02, the guidance here (i.e., ASC 958-810-15-4) is included and indicated as current, as if all entities have implemented the ASUs provisions.
**ASC 958-810 (continued)**

e. An NFP may be required to report an investment described in (c) at fair value in conformity with paragraph 958-320-35-1, or may be permitted to make an election in accordance with paragraph 825-10-25-1. In addition, NFPs other than those within the scope of Topic 954 may be permitted to report the investments described in (b), (c), or (d) at fair value in conformity with Section 958-325-35.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

15-4 Additional guidance for reporting relationships between NFPs and for-profit entities resides in the following locations in the Codification: . . .

c. An NFP that owns 50 percent or less of the voting stock in a for-profit entity shall apply the guidance in Subtopic 323-10 unless the investment is measured at fair value in accordance with applicable GAAP, including the guidance described in (e). If the NFP is unable to exercise significant influence, the NFP shall apply the guidance for equity securities in Topic 321.

d. An NFP with a more than minor noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar legal entity shall report its noncontrolling interests in such entities using the equity method in accordance with the guidance in Subtopic 970-323 unless that interest is reported at fair value in accordance with applicable GAAP, including the guidance described in (e). An NFP shall apply the guidance in paragraph 970-810-25-1 to determine whether its interests in a general partnership are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I to determine whether its interests in a for-profit limited partnership, limited liability company, or similar legal entity are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraph 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a limited liability company or a similar legal entity should be accounted for in accordance with Subtopic 970-323 or Subtopic 323-10.

e. An NFP that is not within the scope of Topic 954 on health care entities may elect to report the investments described in (b) through (d) and paragraph 958-325-15-2 at fair value, provided that all such investments are measured at fair value.

An investor that meets the definition of a not-for-profit entity (NFP) should apply the guidance in ASC 323-10 to its investments that represent 50 percent or less of the voting stock of a for-profit entity, unless the investor is required or chooses to account for such investments at fair value. If an NFP has an interest in an investee that maintains specific ownership accounts for each investor, the NFP should evaluate the investee in a manner similar to the way it would a partnership (see the discussion in Section 2.2.1). If the investee does not have specific ownership accounts, the NFP should evaluate the investee in a manner similar to the way it would a corporation.

While the above guidance is specific to NFPs, ASC 954-810-15-3 provides similar guidance for investments held by not-for-profit business-oriented health care entities.

**Changing Lanes**

The guidance above will be amended by the adoption of ASU 2016-01, which will add a new subtopic, ASC 958-321. The amendments above are limited to changing the reference to this new subtopic; they do not affect the scope or application of the equity method of accounting.
2.4.2 Equity Method Investments Eligible for Fair Value Option

**ASC 825-10**

15-4 All entities may elect the fair value option for any of the following eligible items:
   a. A recognized financial asset and financial liability. . . .

25-2 The decision about whether to elect the fair value option:
   a. Shall be applied instrument by instrument, except as discussed in paragraph 825-10-25-7
   b. Shall be irrevocable (unless a new election date occurs, as discussed in paragraph 825-10-25-4)
   c. Shall be applied only to an entire instrument and not to only specified risks, specific cash flows, or portions of that instrument.

An entity may decide whether to elect the fair value option for each eligible item on its election date. Alternatively, an entity may elect the fair value option according to a preexisting policy for specified types of eligible items.

ASC 825-10-15-4 allows an investor to elect the fair value option for a recognized financial asset, which includes equity method investments. If an investor elects the fair value option, its investment must be recorded at fair value at each reporting period with subsequent changes in fair value reported in earnings. In addition, electing the fair value option requires additional disclosures, which are further discussed in Section 6.3.1.

An investor may have an investment in an equity method investee that holds primarily nonfinancial assets and liabilities. However, when determining whether an equity method investment is eligible for the fair value option, an investor is not required to “look through” the financial statements of the investee to understand whether the assets and liabilities owned by the investee are financial given that the fair value option is available for equity method investments regardless of the nature of the investee’s assets and liabilities.

ASC 825-10-25-4 lists election dates (dates when an investor may elect to apply the fair value option to eligible assets or liabilities), and ASC 825-10-25-5 lists events that may create an election date. Under ASC 825-10-25-4, if an investor’s investment in equity securities that had previously been accounted for in accordance with ASC 320 or the cost method becomes subject to the equity method of accounting, the investor may either apply the equity method of accounting or elect the fair value option under ASC 825-10 for the securities. This could occur, for example, (1) upon initial acquisition of an investment, (2) upon acquisition of an additional interest in an investee in which the investor had a preexisting interest, (3) if the governing provisions of the investee are modified in such a way that the investor, postmodification, has significant influence over the investee, or (4) when an investor loses control of but retains significant influence over an investee.

Once an investor elects the fair value option, it may not be revoked unless an event creating a new election date occurs.

2.4.2.1 Availability of the Fair Value Option for Financial Instruments With a Substantive Future Services Component

Sometimes, in addition to providing the investor with an equity-like residual return, certain equity investments subject to the equity method of accounting may also compensate the investor for future services. For example, a GP will often have an interest in a limited partnership and, in addition, have substantive management responsibilities over the limited partnership for which it is entitled to a management fee, which may include a “carried interest.”
Financial instruments with substantive service components are not eligible for the fair value option under ASC 825-10. If an investor were permitted to apply the fair value option to investments in these types of instruments, that investor may inappropriately recognize gains that represent, in part, compensation for future services. This view is consistent with that expressed in a speech by Sandie Kim, then professional accounting fellow in the SEC’s Office of the Chief Accountant (OCA), at the 2007 AICPA Conference on Current SEC and PCAOB Developments and with conclusions reached in informal discussions with the FASB’s staff.

An investor should consider all relevant circumstances and exercise judgment when determining whether a financial instrument includes a substantive future service component, particularly when the service component is not explicitly stated in the contract terms or the investee’s articles of incorporation. The investor’s obligation to provide services may be established in a different contract from that of the equity ownership interest, or the service contract may contain only a portion of the economic compensation, with the remainder intended to be an element of the “equity instrument.” Accordingly, the investor should consider the substance of the arrangement and whether the financial instrument and the contract for services are inseparable.

The following are some indicators that a significant component of the equity investment consists of compensation for the investor’s future services:

- The fair value of the investment includes a return that is disproportionately greater than the return to other passive investors, and the services that the investor provides to the investee affect the future payout under the provision.
- The fair value of the interest at inception is greater than the investor’s investment, and the investor is expected to provide services to the investee that are beyond those ordinarily expected of an investor acting solely as a nonmanagement owner.

Because ASC 825-10-25-2 requires an investor to apply the fair value option to an entire instrument, there is no opportunity for the investor to separate the element for future services and elect the fair value option for the portion of the instrument that is purely financial unless the instrument must be bifurcated under other U.S. GAAP. In such instances, investors have generally applied the guidance in EITF Topic D-96 (codified in ASC 605-20-S99-1) when accounting for the service arrangement (i.e., the carried interest).

Although the investor is unable to apply the fair value to its equity method investment, it is not precluded from electing the fair value option relative to its other interests in the investee (e.g., equity and debt instruments), to the extent it is permitted to do so under other applicable U.S. GAAP.

Example 2-1

Manager A is the only GP of Partnership X. Manager A invested a nominal amount, 1 percent of the total capital, for its GP interest. The GP interest entitles A to 5 percent of the net income of X. Manager A does not provide any services to X other than some insignificant administrative tasks; X’s assets are managed by an unrelated third party. Manager A receives a disproportionately higher return than the LPs because of its unlimited liability as GP for the partnership’s obligations. Manager A estimates the fair value of its GP interest to be equal to the amount invested at inception. The GP interest does not appear to include substantive future services. The GP interest is eligible for the fair value option under ASC 825-10.

An investor can elect the fair value option on an investment-by-investment basis. The election is not required to be made for identical investments the investor may have in other investees. However, as stated in ASC 825-10-25-7(b), the election for an equity method investment may be applied only if the investor elects the fair value option for all its eligible interests in the same investee (e.g., equity and debt instruments, guarantees, and so forth). In other words, the investor must make the election on a legal-entity-by-legal-entity basis.

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<th>Example 2-1</th>
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Manager A is the only GP of Partnership X. Manager A invested a nominal amount, 1 percent of the total capital, for its GP interest. The GP interest entitles A to 5 percent of the net income of X. Manager A does not provide any services to X other than some insignificant administrative tasks; X’s assets are managed by an unrelated third party. Manager A receives a disproportionately higher return than the LPs because of its unlimited liability as GP for the partnership’s obligations. Manager A estimates the fair value of its GP interest to be equal to the amount invested at inception. The GP interest does not appear to include substantive future services. The GP interest is eligible for the fair value option under ASC 825-10.

An investor can elect the fair value option on an investment-by-investment basis. The election is not required to be made for identical investments the investor may have in other investees. However, as stated in ASC 825-10-25-7(b), the election for an equity method investment may be applied only if the investor elects the fair value option for all its eligible interests in the same investee (e.g., equity and debt instruments, guarantees, and so forth). In other words, the investor must make the election on a legal-entity-by-legal-entity basis.

4 Election of the fair value option would result in the investor’s measuring the guarantee at fair value, with changes in fair value reported in earnings, which is different from the subsequent measurement of guarantees in accordance with ASC 460.
Example 2-2

Manager A is the GP of Partnership Y. Manager A invested a nominal amount, 1 percent of the total capital, for its GP interest. The GP interest entitles A to 10 percent of Y’s net income and provides significant additional compensation if Y’s operating margin reaches certain thresholds (i.e., a “carried interest”). Manager A estimates that the fair value of the GP interest is greater than the amount invested at inception. Manager A also manages Y’s assets through a separate services contract and receives a servicing fee. In addition, there are certain restrictions on the sale of the GP’s interest during the term of the services contract.

Manager A also holds a limited partnership interest in Y. Manager A invested the same amount in, and receives the same return on, its limited partnership interest as the other LPs. Manager A estimates that the fair value of the limited partnership interest is equal to the amount invested for this instrument. Manager A has significant influence over Y.

Manager A could not elect the fair value option to account for its GP interest because the interest includes compensation for future services.

In the absence of a GP interest, A could elect to measure its limited partnership interest at fair value under the fair value option in ASC 825-10 because the interest does not include substantive future services.

Changing Lanes

On the basis of informal discussions with the SEC staff, we understand that the staff would not object to a conclusion that carried interests in the form of incentive-based capital allocation arrangements may be accounted for within the scope of either ASC 606 or ASC 323 if certain considerations are met, and that this is an accounting policy choice that should be made when EITF Topic D-96 is rescinded upon the adoption of ASC 606. In evaluating whether application of ASC 323 is appropriate, entities should consider the nature and legal form of such arrangements — specifically, whether the incentive fee is an attribute of an equity interest in the fund (e.g., a disproportionate allocation of fund returns to a capital account owned by the investor-manager). When the incentive fee is not an allocation of fund returns among holders of equity interests (e.g., when the fee is in the form of a contractual arrangement with the fund), it should be accounted for under ASC 606 (see Section 3.2.6 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for further discussion). Note that if application of ASC 323 is deemed appropriate, an investor would still apply the guidance described above in evaluating whether the fair value option for its investment may be applied (i.e., financial instruments with substantive service components remain ineligible for the fair value option under ASC 825-10).

2.4.2.2 Change From the Equity Method to Cost Basis Accounting

An investor may lose the ability to exercise significant influence over an investee. This could occur, for example, if the investor divests itself of an equity investment or otherwise reduces its ownership interest in the investee, or if the governing provisions of the investee are modified. Loss of significant influence does not represent an election date event under ASC 825-10. If the investor does lose the ability to exercise significant influence over the investee and had previously elected to account for its investment at fair value, it must continue accounting for its retained investment (and other eligible financial interests) at fair value (i.e., an investor’s investment and other eligible financial interests in an investee would not be eligible to be accounted for under the cost method or any other U.S. GAAP).

If the investor has not elected the fair value option, it should refer to ASC 323-10-35-36, which provides guidance on situations in which the investor’s investment in common stock falls below the level at which the investor should apply the equity method of accounting. See Section 4.5.1 for further discussion.

Although the SEC has not made a formal announcement regarding the rescission of EITF Topic D-96, we expect this to occur in due course.
2.4.3 Qualified Affordable Housing Project Investments

A reporting entity that invests in qualified affordable housing projects through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) provided all of the following conditions are met:

a. It is probable that the tax credits allocable to the investor will be available.
   aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.
   aaa. Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment).

b. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.

c. 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.

Many investors invest in qualified affordable housing projects (QAHPs) through limited liability entities. These are typically structured as “flow-through” entities for tax purposes, which entitles the investors to directly receive tax benefits in the form of tax deductions from operating losses and tax credits. As stated in ASC 323-740-05-3, if a sufficient number of housing units are rented to qualifying tenants, such tax credits may be applied to the investors' tax return each year over a 10-year period; however, those credits are subject to recapture if conditions for earning them are not satisfied over a 15-year period, starting with the first year the tax credits are earned.

Investments in a QAHP should be accounted for in accordance with ASC 970-323, which generally requires the use of the equity method of accounting for limited partnership real estate investments unless the LP's interest is so minor that it has essentially no influence over the investee. In that case, the cost method would typically be used (see Section 2.2.2). However, ASC 323-740 permits an investor to make an accounting election to account for its investment in a QAHP by using an effective yield or proportional amortization method, depending on the investor's adoption date of ASU 2014-01, as long as certain criteria are met.

The decision to apply one of the accounting alternatives is an accounting policy election that must be applied consistently to all investments that meet the specified conditions.

2.4.3.1 Before the Adoption of ASU 2014-01

Before the adoption of ASU 2014-01, an investor could have elected, if certain criteria were met, to account for its investment in a QAHP by using the effective yield method. Under this method, tax credits are applied to (recognized in) the investor's tax return over a 10-year period and the investor's initial cost of investment is amortized in a way that provides a constant effective yield over the same 10-year period.

2.4.3.2 After the Adoption of ASU 2014-01

ASU 2014-01 replaces the effective yield method. Under the ASU, an investor can elect to account for its investment in a QAHP by using a proportional amortization method, which requires that the investor's initial cost of investment be amortized in proportion to the tax credits and other tax benefits received.

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6 ASU 2014-01 was effective for public entities in fiscal years beginning after December 15, 2014, and interim periods therein. For nonpublic entities, the ASU was effective in years beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption was permitted.
As a practical expedient, the investor may choose to “amortize the initial cost of the investment in proportion to only the tax credits allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to” the one that would have resulted if it had applied the full proportional amortization method.

To apply the proportional amortization method, an investor must meet the criterion that it does not have the ability to exercise significant influence over the operating and financial policies of the entity. ASC 323-740-25-1A requires an investor to consider the indicators in ASC 323-10-15-6 (see Section 3.3) when determining whether it has significant influence. However, the general presumptions on voting stock ownership levels (see Section 3.2) are not applicable for this evaluation. Therefore, an investor that holds the majority of the limited partnership interest (e.g., 99 percent of the LP units) in a QAHP may be able to conclude that it does not have the ability to exercise significant influence over the operating and financial policies of the QAHP.

Although the provisions of ASU 2014-01 were required to be applied retrospectively, an investor that used the effective yield method to account for its QAHP investments before adopting ASU 2014-01 may continue to apply that method for those prior investments.

For further information about accounting for QAHP investments, see Chapter 13 of Deloitte’s A Roadmap to Accounting for Income Taxes.

### 2.4.4 Proportionate Consolidation Method

**ASC 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.

**ASC 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.
An investor in a separate entity (including an unincorporated legal entity) that has significant influence generally applies the equity method of accounting. Because the guidance in ASC 323-10 applies only to ownership in the form of common stock (or in-substance common stock), an investor that owns an undivided interest in each asset and is proportionately liable for its share of each liability of an investee should not apply the equity method of accounting to such an investment. However, an investor that holds an interest in an unincorporated legal entity (as opposed to an undivided interest in each asset and liability) in the construction or extractive industries may elect to apply the proportionate consolidation method (if certain criteria are met) and record its proportionate share of the investee’s assets, liabilities, revenues, and expenses in each applicable line item in its financial statements (as opposed to the single line item equity investment presentation). Specifically, to apply proportionate consolidation, the investor must have an undivided interest in each asset and be proportionately liable for its share of each liability of the investee. In addition, in the extractive industry, the investee’s activities must be limited to the extraction of mineral resources (such as oil and gas exploration and production). If its activities include refining, marketing, or transporting extracted mineral resources, the investor should not apply proportionate consolidation.

Proportionate consolidation may be acceptable in the real estate industry even when the investment is an undivided interest in real property as opposed to an investment in an entity if the undivided interest is not subject to joint control and the other conditions in ASC 970-810-45-1 are met. However, as described in ASC 970-323-25-12, most real estate ventures in the form of undivided interests are subject to some form of joint control. In those instances, the equity method of accounting is required.

An investor may proportionately consolidate an investment that qualifies for such treatment even if another party consolidates the investment in accordance with ASC 810-10. Proportionate consolidation requires an investor to apply typical consolidation procedures, which are further discussed in Section 5.1.5.1 and in Chapter 10 of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*. If a PBE investor proportionately consolidates its undivided interest, the proportionately consolidated information must comply with the PBE accounting requirements (see Section 5.1.3.2), including those related to the timing of the adoption of new accounting standards (see Section 5.1.3.4).

### 2.5 Investments in In-Substance Common Stock

#### 2.5.1 Characteristics of In-Substance Common Stock

**ASC 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.
ASC 323-10 (continued)

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 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.

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.

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.

Over time, the type and form of investment vehicles have expanded beyond basic voting common stock to include convertible debt, preferred equity securities, options, warrants, interests in unincorporated entities, complex licensing and management arrangements, and a host of other financial instruments. EITF Issue 02-14 (codified in ASC 323-10) noted:

These investment vehicles can convey — by contract, articles of incorporation, indenture, or other means — any combination of rights, privileges, or preferences including (a) the right to vote with common stockholders, (b) the right to appoint members of the board of directors, (c) substantive participating rights . . . , (d) protective rights . . . , (e) cumulative and participating dividends, and (f) liquidation preferences.

Some of these rights may give an investor the ability to exercise significant influence over the operating and financial policies of an investee without holding an investment in the investee's voting common stock. When an investment in other than common stock has all the factors in ASC 323-10-15-13, it is considered to be “in-substance” common stock, and the investor should apply the equity method if it also has significant influence over the investee. If the investment does not have all the factors in ASC 323-10-15-13, it would not be within the scope of ASC 323-10, and the equity method of accounting would be inappropriate even if the holder of the investment has significant influence over the investee.
Examples of investments that may have the characteristics of in-substance common stock include convertible stock or warrants (with no barriers to exercise), stock with a nonsubstantive liquidation preference, and participating stock redeemable at the holder's option. Examples of investments that would generally not be considered in-substance common stock include mandatorily redeemable stock, stock with an embedded non-fair-value put option, stock with a substantive liquidation preference, and nonparticipating, nonconvertible preferred stock.

An investor may also hold an instrument (such as a call or a put option) that gives it the ability to purchase or sell the voting common stock of an investee at some point. In evaluating whether such instruments represent in-substance common stock, an investor must first determine whether the put or call option is a freestanding instrument. If the instrument is not freestanding, the investor should further determine whether the put or call option is an embedded feature within a host arrangement that requires bifurcation and separate accounting. The equity method of accounting does not apply to either a freestanding instrument or bifurcated embedded feature since those instruments are accounted for in accordance with ASC 815 (see Section 2.3). Put and call options, as well as other instruments that are not accounted for under ASC 815 (i.e., the host instrument), may have the characteristics in ASC 323-10-15-13 and therefore represent in-substance common stock.

ASC 323-10 contains examples that illustrate the evaluation of whether an investment is in-substance common stock (see Sections 2.5.1.1 through 2.5.1.3). Each example assumes that the investor is not required to consolidate the investee under ASC 810-10, that it has the ability to exercise significant influence over the operating and financial policies of the investee (see Chapter 3), and that its investment does not meet the definition of a derivative instrument under ASC 815.

It is important to note that EITF Issue 02-14 provided the initial guidance on the evaluation of in-substance common stock. Paragraph 5 of EITF Issue 02-14 stated, in part:

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.

We believe that the EITF Issue 02-14 scoping guidance continues to be applicable and, accordingly, the in-substance common stock guidance in ASC 323-10-15-3 through 15-5 should be applied only to investments in corporations. Thus, it would not apply, for example, to investments in partnerships, LLCs, trusts, or other unincorporated entities that maintain specific ownership accounts (see Section 2.2) or to investments within the scope of ASC 815 (see Section 2.2.1).

### 2.5.1.1 Subordination

<table>
<thead>
<tr>
<th><strong>ASC 323-10</strong></th>
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<tbody>
<tr>
<td><strong>Case A: Subordination Substantially Similar to Common Stock</strong></td>
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<tr>
<td><strong>55-3</strong></td>
</tr>
</tbody>
</table>

**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.
**ASC 323-10 (continued)**

**Case B: Subordination Not Substantially Similar to Common Stock**

**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.

**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.

To determine whether a liquidation preference is substantive, an investor should consider the significance of the stated liquidation preference in relation to the purchase price of the investment as well as the significance of the fair value of the subordinated equity (i.e., common stock) of the investee. The table below summarizes indicators (not all inclusive) of whether an investment's subordination characteristics are substantially similar to those of common stock.

<table>
<thead>
<tr>
<th>Substantially Similar</th>
<th>Not Substantially Similar</th>
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</thead>
<tbody>
<tr>
<td>• The stated liquidation preference is not significant in relation to the purchase price (or there is no stated liquidation preference).</td>
<td>• The stated liquidation preference is significant in relation to the purchase price.</td>
</tr>
<tr>
<td>• There is little or no fair value associated with the investee's common stock; therefore, in the event of liquidation, the investment would most likely participate in substantially all of the investee's losses. ASC 323 does not provide a definition of &quot;little or no value.&quot; However, Case A above does provide an example in which the investee's common stock was 1 percent of the preferred stock, which was concluded to be nonsubstantive. Although we do not believe that 1 percent is a bright line, and all facts and circumstances should be considered, the example provides insight into a threshold that would be considered &quot;little or no value.&quot;</td>
<td>• The fair value of the investee's common stock is significant. Therefore, in the event of liquidation, the investment would be protected since common stock would most likely absorb a substantial portion of the investee's losses.</td>
</tr>
</tbody>
</table>

**2.5.1.2 Risks and Rewards of Ownership**

**ASC 323-10**

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

**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.
ASC 323-10 (continued)

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.

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.

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

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.

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.
**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.

**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.

To determine whether an investment is substantially similar to common stock, the investor should assess whether the investment is expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner substantially similar to how an investment in the investee’s common stock would participate. The table below summarizes indicators (not all inclusive) of when an investment has risks and rewards of ownership that are substantially similar to those of common stock.

<table>
<thead>
<tr>
<th>Substantially Similar</th>
<th>Not Substantially Similar</th>
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<tr>
<td>• The investment participates in an investee's dividend payments in a manner substantially similar to how an investment in the investee's common stock would participate, and it is expected that the investee will pay dividends.</td>
<td>• The investment is not entitled to dividend payments in which the common stockholders participate, and it is expected that the investee will pay dividends.</td>
</tr>
<tr>
<td>• The investment can be converted into the investee's common stock without any significant restrictions or contingencies, thereby allowing the investor to participate in the capital appreciation in a manner substantially similar to how common shareholders would participate.</td>
<td>• The investment is entitled to dividend payments that common shareholders do not receive.</td>
</tr>
<tr>
<td>• The current fair value of the investee's common stock is substantially similar to the current fair value of the investment (on an equivalent unit basis).</td>
<td>• There are significant restrictions or contingencies related to conversion of the investment into the investee's common stock that prohibit the investor from participating in the capital appreciation in a manner substantially similar to how common shareholders would participate.</td>
</tr>
<tr>
<td>• The current fair value of the investee's common stock is not substantially similar to the current fair value of the investment (on an equivalent unit basis).</td>
<td>• The participation in dividends is a relevant indicator only if the investor expects the investee to pay dividends to its common shareholders (e.g., during the warrant's exercise period).</td>
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2.5.1.3 **Obligation to Transfer Value**

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<th>ASC 323-10</th>
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**Case E: Investee Not Obligated to Transfer Substantive Value**

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.

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**

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.

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.

If the investee is expected to transfer substantive value to an investor and the common shareholders do not participate in a similar manner, an investment is not considered to be substantially similar to common stock. The table below summarizes indicators (not all inclusive) of when an investment is substantially similar to common stock.

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<thead>
<tr>
<th>Substantially Similar</th>
<th>Not Substantially Similar</th>
</tr>
</thead>
<tbody>
<tr>
<td>• An investment has a redemption provision that is not substantive when compared with the fair value of the investment.</td>
<td>• An investment has a redemption provision (such as a fixed-price mandatory redemption or a non-fair-value put option) that is substantive when compared with the fair value of the investment.</td>
</tr>
<tr>
<td>• The holders of the subordinated equity (i.e., common shareholders) participate in a redemption in a similar manner.</td>
<td>• A substantive redemption provision is not available to common shareholders. As a result, if redemption of the investment were to occur, the investee would be obligated to transfer substantive value to the investment holder, however, the common and preferred shareholders (i.e., the holders of the subordinated equity) would not be provided the same benefit.</td>
</tr>
</tbody>
</table>
Only substantive provisions should be considered in the evaluation. Thus, provisions to transfer value should be evaluated carefully to determine whether they are substantive. For example, as stated in ASC 323-10-15-13(c), “[p]REFERRED STOCK WITH A MANDATORY REDEMPTION IN 100 YEARS, SHALL NOT BE CONSIDERED AN OBLIGATION TO TRANSFER SUBSTANTIVE VALUE,” since an obligation to transfer value at a date so far into the future is not considered to be substantive. Further, if, as of the date an investment was made, an investee does not have the ability to pay the amount to which the investor is (or will be) entitled, the provision would not be substantive.

2.5.2 Initial Determination and Reconsideration Events

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
</table>
| **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.
| **15-17** The determination of whether an investment is similar to common stock shall not be reconsidered solely due to losses of the investee.
| **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.

An investor must perform its initial evaluation of whether its investment represents in-substance common stock when it determines that it has the ability to exercise significant influence over the operating and financial policies of an investee (see Chapter 3 for further discussion of significant influence). This date may be after the date its initial investment was acquired.

The investor should continually monitor events and circumstances to determine whether its initial conclusion should be reconsidered. This reassessment should be performed only if one of the events in ASC 323-10-15-16 occurs. Although investee losses can significantly change (i.e., reduce or eliminate) the investee's capital structure, the investor should not reconsider its initial determination solely because of such losses (see Section 5.2 for further discussion).
At the time of the initial determination and of any subsequent reassessment, an investor should perform its evaluation on the basis of all facts and circumstances. Accordingly, the investor would consider its cumulative interest in the investee as opposed to only those interests that were recently acquired. The total fair value of an investment as of the date of a reconsideration event should be used in the reconsideration analysis. As a result of the occurrence of a reconsideration event, and on the basis of the investor’s reassessment at that time, an investment that was previously determined not to be in-substance common stock may become in-substance common stock (or vice versa).
Chapter 3 — Applying the Equity Method of Accounting

3.1 Overview

ASC 323-10

25-2 An investor shall recognize an investment in the stock of an investee as an asset. The equity method is not a valid substitute for consolidation. The limitations under which a majority-owned subsidiary shall not be consolidated (see paragraphs 810-10-15-8 through 15-10) shall also be applied as limitations to the use of the equity method.

If an investor does not possess a controlling financial interest over an investee but has the ability to exercise significant influence over the investee’s operating and financial policies, the investor must account for such an investment under the equity method of accounting regardless of its intent, or lack thereof, to exercise such influence. In addition, in contrast to the consolidation guidance that states that only one investor can consolidate an investee, there can be multiple investors that have the ability to exercise significant influence over the operating and financial policies of an investee (even if another investor has a controlling financial interest in, and therefore consolidates, that investee).

As discussed in Chapter 2, the equity method of accounting is applicable only for investments in common stock of corporations, corporate joint ventures, and, to a certain extent, entities other than corporations, such as partnerships, LLCs, trusts, and other entities that maintain specific ownership accounts. The ability to exercise significant influence over an investee is mainly driven by an investor’s voting powers in that investee.

The presumed levels of ownership that give an investor the ability to exercise significant influence differ depending on the legal form of an investee (see Section 3.2 below). However, other factors may also indicate that an investor has the ability to exercise significant influence (see Section 3.3).

This chapter provides guidance to assist an investor in its evaluation of whether it has the ability to exercise significant influence over an investee.

3.2 General Presumption

ASC 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.
An investor may have investments in an investee that include common stock or in-substance common stock and instruments other than common stock (e.g., preferred stock, warrants, or debentures). The equity method of accounting is applicable only when the investor has an investment in common stock or in-substance common stock and, accordingly, should not be applied when an investment in common stock does not exist, even if the investor holds other investments that allow it to exercise significant influence over the investee. However, if the investor holds both common stock and other investments, it should consider the rights provided by all such instruments in evaluating whether, in combination, they provide it with the ability to exercise significant influence over the investee. In addition, as further discussed in Section 3.2.7, only existing voting rights should be considered.

The ability to exercise significant influence over the operating and financial policies of an investee is primarily driven by an investor's ownership interest and the associated voting rights held through its investment in the investee’s common stock. The presumed levels of ownership that provide the investor with the ability to exercise significant influence vary depending on the legal form of the investee.

The table below summarizes presumed levels of ownership for each legal form of an investee that typically allow an investor to exercise significant influence. Intended as a general guide, the table does not establish bright lines at specific ownership levels (e.g., the difference between a 20 percent and a 19.9 percent investment in common stock or in-substance common stock or both may not be substantive). Therefore, evaluating an investor's ability to exert significant influence requires judgment, and the investor should evaluate all facts and circumstances when determining how to account for any investment.

Table 3-1  Presumed Levels of Ownership Based on the Legal Form of the Investee That Generally Allow an Investor to Exercise Significant Influence

<table>
<thead>
<tr>
<th>Legal Form of an Investee</th>
<th>Roadmap Discussion</th>
<th>Investment in Common Stock or In-Substance Common Stock (Assuming Consolidation Is Not Required)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporations (other than joint ventures)</td>
<td>Section 3.2.1</td>
<td>5% or Less: Rebuttable presumption exists that an investor does not have significant influence.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>&gt;5% to &lt;20%: Rebuttable presumption exists that an investor does have significant influence.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>20% to 50%: Rebuttable presumption exists that an investor does have significant influence.</td>
</tr>
<tr>
<td>LLCs:</td>
<td>Section 3.2.2</td>
<td>That do not maintain specific ownership accounts (e.g., similar to partnership capital accounts):</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5% or Less: Rebuttable presumption exists that an investor does not have significant influence.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>&gt;5% to &lt;20%: Rebuttable presumption exists that an investor does have significant influence.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>20% to 50%: Rebuttable presumption exists that an investor does have significant influence.</td>
</tr>
</tbody>
</table>
### Investment in Common Stock or In-Substance Common Stock (Assuming Consolidation Is Not Required)

<table>
<thead>
<tr>
<th>Legal Form of an Investee</th>
<th>Roadmap Discussion</th>
<th>5% or Less</th>
<th>&gt;5% to &lt;20%</th>
<th>20% to 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>• That do maintain specific ownership accounts (e.g., similar to partnership capital accounts)</td>
<td></td>
<td>Equity method required unless interest is “so minor” (per ASC 323-30-599-1) that investor has virtually no influence (generally less than 3 percent), in which case cost method is acceptable (but not required).</td>
<td>Equity method required.</td>
<td></td>
</tr>
<tr>
<td>Partnerships and unincorporated joint ventures</td>
<td>Section 3.2.3</td>
<td>Equity method required unless interest is “so minor” (per ASC 323-30-599-1) that investor has virtually no influence (generally less than 3 percent), in which case cost method is acceptable (but not required).</td>
<td>Equity method required.</td>
<td></td>
</tr>
<tr>
<td>General partnership interests in partnerships</td>
<td>Section 3.2.4</td>
<td></td>
<td></td>
<td>Equity method required.</td>
</tr>
<tr>
<td>Entity that meets the definition of corporate joint venture (i.e., shared control)</td>
<td>Section 3.2.5</td>
<td></td>
<td></td>
<td>Equity method required.</td>
</tr>
</tbody>
</table>

Although a presumption may exist that an investor has the ability to exercise significant influence, such a presumption may be overcome (see Section 3.3.1 for conditions indicating lack of significant influence). Similarly, a presumption may not exist given that an investor does not meet the levels of ownership described above; however, that ownership interest, in combination with other interests and indicators (see Section 3.3), may indicate that the investor has the ability to exercise significant influence. Each of the types of investment described in the table above is discussed further below.
3.2.1 Corporations

ASC 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.

If an investor holds more than a 20 percent interest (directly or indirectly, as discussed in Section 3.2.6) in an investee that has a legal form of a corporation, it is presumed that the investor has the ability to exercise significant influence in the absence of evidence to the contrary (see Section 3.3.1). Similarly, if the same investor holds less than a 20 percent interest in an investee, it may, in combination with other indicators, have the ability to exercise significant influence over that investee (see Section 3.3).

3.2.2 Limited Liability Companies

As discussed in Section 2.2.1, an investment in an LLC that does not maintain specific ownership accounts for each investor should be evaluated in the same manner as an investment in a corporation, which is further discussed in Section 3.2.1 above. An investment in an LLC that does maintain specific ownership accounts for each investor should be evaluated in the same manner as an investment in a partnership, which is further discussed in Section 3.2.3 below.

3.2.3 Partnerships and Unincorporated Joint Ventures

ASC 323-30 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Accounting for Limited Partnership Investments

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.

In EITF Topic D-46 (codified in ASC 323-30-S99-1), the SEC acknowledged that, in practice, investments in limited partnerships of more than 3 percent to 5 percent have generally been viewed as “more than minor” and thus are subject to the equity method. Because profits and losses are allocated to individual partner accounts, the partner’s share of earnings is allocated for income tax purposes, and the nature of partnership interests usually gives rise to some degree of influence (stated or unstated), it is presumed that either consolidation or the equity method should be used to account for all partnership interests. This approach de-emphasizes significant influence, instead requiring the equity method of accounting because it enables noncontrolling investors to reflect the underlying nature of their investments.

Because of the SEC staff’s reference in EITF Topic D-46 to a range of “3 to 5 percent,” investments of more than 3 percent to 5 percent have generally been viewed as “more than minor.” Thus, any investment of more than 5 percent is subject to the equity method, and any investment from 3 percent to 5 percent should be accounted for by the equity method unless the presumption of significant
influence is overcome. However, an investment of less than 3 percent is typically considered “minor” and therefore may be accounted for under the cost or equity method in accordance with ASC 970-323-25-6.

**Changing Lanes**
The guidance in ASC 970-323-25-6 will be amended by the adoption of [ASU 2016-01](#), which will eliminate the cost method of accounting. Therefore, once ASU 2016-01 is effective, investments can no longer be classified as cost method investments.

While the guidance in EITF Topic D-46 applies to public entities, in practice, it is generally applied to investments held by nonpublic entities.

### 3.2.4 General Partnership Interest in Partnerships

If a GP does not control the partnership, it should account for its investment in the partnership under the equity method of accounting, regardless of its ownership percentage (see Section 2.2.3).

### 3.2.5 Corporate Joint Ventures

All joint venture investments in which the investor shares in joint control, incorporated or unincorporated, should be accounted for under the equity method without regard to the investor's ownership percentage.

### 3.2.6 Potential Voting Rights

**ASC 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.

An investor may hold certain rights that allow it to acquire additional voting interests in an investee. For example, an investor may have a call option to purchase additional equity in an investee that is not a partnership, or an LP may have the contractual right to purchase partnership interests held by other partners. Potential voting rights may also exist through other types of securities that are convertible into voting interests (e.g., convertible securities).

In the determination of whether significant influence exists, ASC 323-10-15-9 applies only to “[a]n investor’s voting stock interest” and not to potential voting interests, such as stock options, convertible debt, or derivatives thereof. However, ASC 323-10-15-13 lists several characteristics that might indicate that an investment (other than an investment in common stock) is in-substance common stock (see Section 2.5). Therefore, when determining whether the use of the equity method is appropriate, an investor should consider investments in common stock and investments that are in-substance common stock, which may include, but not be limited to, the following:

- As stated in Section 3.2, if an investor holds both common stock and other investments (including in-substance common stock), it should consider the rights afforded by all such instruments in evaluating whether, in combination, they provide it with the ability to exercise significant influence over an investee. To be considered in the assessment, such voting rights must be currently exercisable.

- An investor with an investment that qualifies as in-substance common stock may be able to exercise its voting rights on an as-if-converted basis or may be precluded from exercising voting rights until the in-substance common stock is converted into common stock. In the
latter instance, despite the investment’s qualifying as in-substance common stock, such voting rights would not be considered in the assessment of significant influence because they are not currently exercisable (i.e., the voting rights are contingent upon conversion).

Example 3-1

Entity A holds a 15 percent voting common stock interest in Entity B, as well as convertible preferred stock that will allow it to acquire an additional 10 percent voting common stock interest in B in three years. Entity A’s ownership of the convertible preferred stock, if converted, would give A a 25 percent voting common interest in B. However, this would not lead to a presumption that A exercises significant influence over B given that A’s investment in convertible preferred stock does not provide it with exercisable voting rights because of the time restriction and the requirement to convert the instrument to exercise the voting rights.

Although the convertible preferred stock may qualify as in-substance common stock in three years when the conversion feature becomes exercisable, A would continue to be precluded from considering the potential voting rights in assessing significant influence at that time because A will possess such voting rights only upon conversion.

3.2.7 Direct and Indirect Interest in an Investee

In determining whether it has the ability to exercise significant influence over an investee, an investor should consider all voting interests, which include investments that are both direct and indirect (i.e., those held by the investor’s other investees). In certain instances, an investor that does not have the ability to exercise significant influence through its direct interests may have such ability through a combination of direct and indirect interests.

The examples below illustrate the consideration of direct and indirect interests. Each example assumes that the investor and the investee(s) are corporations.

Example 3-2

Direct Investment in an Investee’s Consolidated Subsidiary

Entity A owns a 30 percent voting interest in Entity B that is accounted for under the equity method of accounting (i.e., A has the ability to exercise significant influence over B) and a 15 percent voting interest in Entity C. Entity B owns an 80 percent voting interest in C that is considered a controlling financial interest, requiring B to consolidate C under ASC 810-10.

Because B controls C, and A has the ability to exercise significant influence over B, A has the ability to exercise significant influence over C, despite the fact that A has only a 15 percent direct voting interest in C. Therefore, A should account for its investment in C under the equity method of accounting.
Example 3-3

Investment of 20 Percent or Greater That Does Not Qualify for Equity Method of Accounting

Assume the same facts as in Example 3-2, except that B owns an 18 percent voting interest in C. In this scenario, A has a 20.4 percent interest in C (the sum of its 15 percent direct interest and 5.4 percent indirect interest (30 percent × 18 percent) through B).

As reflected in Table 3-1, an investment in common stock of 20 percent or greater leads to a presumption that an investor has the ability to exercise significant influence and should therefore apply the equity method of accounting. However, in the example above, the ownership percentage alone would not provide A with the ability to exercise significant influence over C since neither A nor B has that ability. Although A has significant influence over B, that does not indicate that it has the ability to significantly influence how B exercises its 18 percent voting interest in C. Entity A should evaluate other indicators of significant influence (see Section 3.3) to determine whether it has significant influence over C. If not, A should not account for its investment in C under the equity method of accounting.

Example 3-4

Investment Held by Commonly Controlled Subsidiaries

Entity A has a controlling financial interest in, and therefore consolidates each of, Entity B, Entity C, and Entity D under ASC 810-10. Entities B, C, and D each own a 10 percent voting interest in Entity E.

Entity A indirectly owns less than a 20 percent voting interest in E (i.e., 6 percent through B, 7 percent through C, and 6 percent through D). However, given that A consolidates B, C, and D, A effectively controls 30 percent of the voting interests in E. Thus, it is presumed that A has the ability to exercise significant influence over E (in the absence of evidence to the contrary).

Entity A’s ability to exercise significant influence over E, however, is not determinative as to how each subsidiary should account for its individual investments in preparing its stand-alone financial statements. Thus, each subsidiary should separately evaluate its individual facts and circumstances in determining whether it has the ability to exercise significant influence over E. Investments held by related parties may be one of the factors to consider in such an evaluation (see Section 3.3).
3.2.7.1 **Earnings or Losses of an Investee’s Subsidiary**

If an investor accounts for direct interests in both an investee and an investee’s subsidiary under the equity method of accounting, it should ensure that it does not double count the earnings or losses of the investee’s subsidiary. That is, the investor should record only its proportionate share of (1) the earnings or losses of the investee and (2) the earnings or losses of the investee’s subsidiary. When determining its proportionate share of the investee’s earnings or losses, the investor should adjust the investee’s financial information to exclude the earnings or losses of the investee’s subsidiary in which the investor has a direct interest. See additional considerations related to subsequent measurement in this scenario in Section 5.1.7.2.

3.3 **Other Indicators of Significant Influence**

<table>
<thead>
<tr>
<th>ASC 323-10</th>
<th>Ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:</th>
</tr>
</thead>
</table>
| 15-6 | 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). |

As discussed in Section 3.2, there are presumed levels of ownership (depending on the legal form of the investee) that generally provide an investor with the ability to exercise significant influence over the investee. For example, an investment of less than 20 percent leads to a presumption that, in the absence of evidence to the contrary, an investor does not have the ability to exercise significant influence over a corporate investee. However, the determination of whether the investor has the ability to exercise significant influence over the investee’s reporting and financial policies should not be limited to the evaluation of voting rights (which can be conferred by instruments other than common stock as discussed in Section 2.5) given that significant influence may be exhibited through other means. Accordingly, the investor should consider all facts and circumstances, including, but not limited to, those outlined in ASC 323-10-15-6 and further discussed in the table below when determining whether it has the ability to exercise significant influence over the investee.

**Table 3-2  Indicators of Significant Influence**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Representation on the board of directors</td>
<td>Representation on the board of directors (through contractual agreement or otherwise) allows an investor to influence the operating and financial policies of an investee through its presence and participation at the board of directors’ meetings. However, not all representation on the board of directors carries the same weight. For example, if an investor had 1 out of 4 seats (25 percent representation) on a board, that would be more indicative of significant influence than if that same investor had 1 out of 10 seats (10 percent representation) on that board. Other indicators of significant influence might include the ability of an investor to appoint a disproportionately higher number of directors as compared with its ownership percentage or if an investor, in addition to its board representation, participates on significant investee committees, such as the executive committee or the finance committee.</td>
</tr>
</tbody>
</table>
### Participation in policy-making processes

An investor can participate in policy-making processes through its voting rights, veto rights, and other participating rights. The right and ability to participate in these processes are fundamental to the analysis; the investor is not required to participate. Further, the investor may not assert that it does not have significant influence merely because it does not have the intent to exercise its rights.

If an investor does not have a right to appoint a board member but may appoint an “observer” to the board of directors’ meetings (a right that generally does not provide the observer with voting ability), the investor should exercise judgment when determining whether the observer seat allows it to exercise significant influence over the investee. The investor’s access to the confidential information discussed at the board meeting would usually not, in and of itself, mean that the investor would have the ability to exercise significant influence.

Sometimes, an investor holding a minority interest is granted substantive participating veto rights over certain actions that are described with phrases such as “other than in the ordinary course of business.” When such a phrase, describing what would otherwise be “participating rights” under ASC 810-10-25-12, is vaguely defined, it does not, in the SEC staff’s view, cause a participating veto right to be considered nonparticipating.

### Material intra-entity transactions

Routine, intra-entity transactions that involve nonspecialized goods or services (i.e., goods or services that are readily available in the market), even if material to the investee (as either a purchaser or supplier of such goods or services), may not give the investor the ability to exercise significant influence over the investee. However, other factors related to intra-entity transactions may suggest that the investor, along with its interest in voting common stock, has significant influence over the investee. These factors may include, but are not limited to, the following:

- The level of specialization associated with the good or service. Consideration should be given in the context of the investee’s providing or acquiring such goods or services to or from the investor.
- Market availability of the goods or services provided by the investor to the investee and the potential cost to the investee of switching service providers or suppliers. The scarcer a good or service is in the market, the more likely it may be that the investee is dependent on the investor.
- Investee sales to the investor (generally of more specialized goods or services) as a percentage of total sales as well as the total number of investee customers (including consideration of the investee’s substantive ability to expand its customer base).

### Interchange of managerial personnel

When an investor’s management also serves in a management capacity at an investee (e.g., CEO, CFO, COO), it may indicate that the investor has the ability to exercise significant influence over the investee. However, such a determination requires significant judgment. Among other things, the investor should consider the level of responsibility given to individuals in management. It should also consider the role, responsibilities, and composition of the investee’s board of directors, including its level of oversight and control over management and its level of independence from the investor’s board of directors (i.e., the existence of interchange of managerial personnel at the board level).
### Indicator | Comment
--- | ---
Technological dependency | An investor may provide technology to an investee that is critical to its operational ability. Such a situation may cause the investee to be technologically dependent on the investor and, as a result, allow the investor to exert some level of influence over the investee. When determining the level of influence it can exercise, the investor should consider the terms of the licensed technology. For example, the technology granted to the investee for a period that would give the investor an option not to renew such a license would be more indicative of significant influence than if the investee had already obtained a perpetual license to such technology. As mentioned in “Material intra-entity transactions” above, when evaluating whether the investee’s technological dependency provides the investor with significant influence, the investor should also consider the technology alternatives available to the investee and the costs that the investee might reasonably be expected to incur were it to license alternative technology. For example, if the investee could license similar technology from other companies without incurring significant costs, such a licensing agreement would usually not provide the investor with the ability to exercise significant influence over the operating and financial policies of the investee.

Extent of ownership by an investor in relation to the concentration of other shareholdings | An investor should consider its extent of ownership in relation to the concentration of other shareholdings. A majority ownership interest in the investee may be concentrated among a small group of investors. Alternatively, the voting interests may be widely dispersed (with no investor holding a significant voting interest). Accordingly, an investor holding less than a 20 percent voting interest in a widely dispersed corporate investee may have the ability to exercise significant influence when all other investors, individually, have considerably smaller ownership interests. In addition, although one investor may hold a majority ownership interest in an investee (e.g., 70 percent), that does not necessarily preclude other investors with smaller ownership interests (e.g., 30 percent) from having the ability to exercise significant influence over that investee.

In addition to the indicators noted above, the following conditions may indicate that an investor can exercise significant influence over an investee:

- The investee is, in effect, a joint venture in which the investor shares in joint control.
- The investor has a firm agreement to increase the investment to 20 percent or greater in the subsequent year.
- The investor’s significant stockholders, parent company, other subsidiaries of a common parent, or officers hold additional investments in the investee.
- The investor has exercised significant influence over decisions of the investee on several occasions.

ASC 323-10 does not address whether related-party interest should be included in an investor’s ownership percentage in the evaluation of whether the investor has significant influence over the investee. While investments held by related parties (e.g., a parent company, other subsidiaries of a common parent, or officers) are one of the conditions indicating that significant influence could exist, we believe that the interest held by the investor’s related parties should not automatically be included in the evaluation of whether the investor has significant influence over the investee. Rather, the purpose and reason for the related party’s holding the interest should be considered in such an evaluation (i.e., does the related party hold the interest to structure and separate power and economics so it can avoid accounting for the investment under the equity method).
3.3.1 Conditions Indicating Lack of Significant Influence

ASC 323-10

15-10 Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary. Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.

b. The investor and investee sign an agreement (such as a standstill agreement) under which the investor surrenders significant rights as a shareholder. (Under a standstill agreement, the investor usually agrees not to increase its current holdings. Those agreements are commonly used to compromise disputes if an investee is fighting against a takeover attempt or an increase in an investor's percentage ownership. Depending on their provisions, the agreements may modify an investor's rights or may increase certain rights and restrict others compared with the situation of an investor without such an agreement.)

c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.

e. The investor tries and fails to obtain representation on the investee's board of directors.

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.

ASC 323-10-15-10 lists several indicators (not all-inclusive) that may suggest that the significant influence presumption is overcome when an investor holds 20 percent or more of the outstanding voting common stock of an investee. In addition, the following conditions may indicate that an investor lacks the ability to exercise significant influence:

- The chairman of the investee owns a large, but not necessarily controlling, block of the investee's outstanding stock; the combination of the chairman's substantial shareholding and his position with the investee may preclude the investor from being able to influence the investee.

- Adverse political and economic conditions exist in foreign countries (especially restrictions on the repatriation of dividends) in which the investee is located.

- The investor has less than 20 percent ownership of the investee with an option to acquire additional ownership that would increase the investor's stake to 20 percent or more, but there is no substantive plan or agreement to do so in the near future.

- The investee is to settle its litigation, particularly when that litigation involves bankruptcy, by issuing shares to the settling parties, and it is probable that the new shares, when issued, will reduce the investor's ownership percentage to less than 20 percent.

- The investee actively and publicly resists the exercise of influence by the investor.
None of the circumstances above are necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. The investor should evaluate all facts and circumstances related to the investment when determining whether the presumption of significant influence over the investee is overcome.

In addition, the fact that an investor has not exercised significant influence in the past or does not intend to exercise it in the future does not indicate that the general presumption of significant influence is overcome.

### 3.4 Considerations Related to Certain Investments

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

**ASC 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 not account for its investment in the service corporation using the cost method.

- 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.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

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.
The views of the real estate investment’s management influence the operations of the service corporation.

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.

REITs, which can be formed as trusts, associations, or corporations, should consider the guidance in ASC 974-323-25-1 in addition to the ownership interest and other factors of significant influence (see Section 3.3) when evaluating whether they have the ability to exercise significant influence over the operating and financial policies of the service corporation, as discussed above.

Changing Lanes

The guidance in ASC 974-323-25-1 will be amended by the adoption of ASU 2016-01, which will eliminate the cost method of accounting. However, the pending content above does not change prior guidance. In other words, a REIT would consider the indicators in ASC 974-323-25-1 in assessing whether it has significant influence over the investee.

### 3.4.2 Investment in an Entity That Invests in QAHPs

Under ASC 323-740-25-1 as amended by ASU 2014-01, an investor may elect to use the proportional amortization method to account for its investments in QAHPs through limited liability entities (“QAHP entities”) if certain conditions are met. As discussed in Section 2.4.3, one of the criteria that the investor must meet to apply the proportional amortization method is that the investor does not have the ability to exercise significant influence over the operating and financial policies of the entity.

While an investment in a QAHP entity may exceed thresholds that generally result in the presumption of significant influence when the guidance on equity method investments is applied, the guidance in ASC 323-740-25-1A excludes reference to any such thresholds. As noted in paragraph BC12 of ASU 2014-01, the EITF’s intent in reaching the conclusions in the ASU was “to identify those investments that are made for the primary purpose of receiving tax credits and other tax benefits” and to allow an investor to elect the proportional amortization method to account for such investments. Further, the EITF believed that “an investor who has the ability to influence the operating and financial policies of the [QAHP] entity should not be precluded from [electing the proportional amortization method] as long as that investor does not have the ability to exercise significant influence.” In accordance with its objective, the EITF concluded that the significant influence presumption at 20 percent or more voting stock ownership would not be applicable to investments in QAHP entities since that presumption “was intended for application to investments in common stock and not to investments in limited liability partnership...
interests.” Although the EITF did not indicate that the quantitative thresholds typically associated with an investor possessing significant influence over a partnership would not be applicable to an investment in a QAHP entity, it is reasonable to conclude, on the basis of the EITF’s stated objective, that an investor in a QAHP entity would not be required to consider the guidance in ASC 323-30 that a 3 percent to 5 percent ownership interest in a partnership constitutes significant influence over the partnership.

As a result, we believe that an investor’s analysis should focus on whether the investor participates in the policy-making processes of the QAHP entity rather than solely on the investor’s ownership interest in the QAHP entity. If the investor concludes that it participates in the policy-making processes, it would be deemed to have significant influence and would not be eligible to apply the proportional amortization method to account for its investment in the QAHP entity. In addition to the indicators of significant influence discussed in Section 3.3, factors to consider in the determination of whether an investor participates in the policy-making processes of a QAHP entity include the following:

- Does the investor have the ability to make decisions about the day-to-day operations of the QAHP entity (e.g., accepting tenants, setting rent)?
- Does the investor have the ability to remove the GP of the QAHP entity without cause?
- Does the investor have the unilateral ability to veto the operating and capital budgets or otherwise prevent the GP from making decisions about the day-to-day operations of the QAHP entity without cause?

The existence of protective rights (e.g., the ability to remove the GP with cause or to veto the sale of a property owned by the QAHP entity for significantly less than its fair value) would not provide the investor with significant influence over the QAHP entity.

For additional information on accounting for investments in QAHP entities that qualify for proportional amortization, see Chapter 13 of Deloitte’s A Roadmap to Accounting for Income Taxes.

3.5 Reassessment of the Ability to Exercise Significant Influence

The determination of whether an investor has the ability to exercise significant influence over an investee’s reporting and financial policies is a continual process. Accordingly, upon a change in facts and circumstances, the investor should determine whether its conclusion regarding the ability to exercise significant influence has changed. For example, in addition to a change in the ownership percentage, (1) a change in the investee’s governance or equity structure, (2) the investee’s becoming subject to significant foreign exchange restriction or other governmentally imposed uncertainties, or (3) the investee’s filing for bankruptcy may indicate that the investor’s conclusion regarding its ability to exercise significant influence over the investee’s reporting and financial polices is no longer appropriate.

3.6 SEC Staff’s Views on Application of the Equity Method of Accounting

Many questions arise about whether to apply the equity method or the cost method of accounting, particularly in situations involving a less than 20 percent investment in common stock that may be coupled with one or more contractually provided seats on the board of directors.
The SEC staff does not use bright-line tests in the application of ASC 323-10. In a 1999 speech, then Professional Accounting Fellow in the OCA Paul Kepple noted that when considering whether an investor must apply the equity method of accounting to an investment in common stock, the staff has evaluated:

- The nature and significance of the investments, in any form, made in [an] investee. The staff does not consider the difference between a 20 percent common stock investment and a 19.9 percent investment to be substantive, as some have asserted in applying [ASC 323-10]. The staff will consider whether [an] investor has other forms of investments or advances, such as preferred or debt securities, in [an] investee in determining whether significant influence results. In addition, the staff will consult the guidance in ASC 323-10-15-13 through 15-19 to determine whether other forms of investments or advances are in-substance common stock. See Section 2.5 for further discussion on investments in in-substance common stock.

- The capitalization structure of [an] investee. The staff would consider whether [an] investee effectively is being funded by common or [noncommon] stock investments and how critical the investments made by [an] investor are to the investee's capitalization structure (e.g., whether the investor is the sole funding source).

- Voting rights, veto rights, and other protective and participating rights held by [an] investor. The greater the ability of [an] investor to participate in the financial, operating, or governance decisions made by [an] investee, via any form of governance rights, the greater the likelihood that significant influence exists.

- Participation on [an] investee's board of directors (or equivalent), whether through contractual agreement or not. The staff would consider, in particular, whether any representation is disproportionate to the investment held. For example, an investor that is contractually granted 2 of 5 board seats, coupled with a 15 percent common stock investment, will [most] likely be viewed [as having] significant influence over [an] investee.

- Other factors as described in [ASC 323-10-15]. . .

While the starting point in any evaluation of significant influence is [an] investor's common stock ownership level in [an] investee, the staff does not believe that a "bright line" approach is appropriate and will consider . . . all of the factors noted above in [reaching conclusions about any] given set of facts and circumstances. [Footnotes omitted]
Chapter 4 — Initial Measurement

4.1 Overview

ASC 323-10-30 describes how investments in which the investor is deemed to have the ability to exercise significant influence over the operating and financial policies of the investee should initially be measured (see Section 4.2).

An equity method investment is presented on the balance sheet as a single amount. However, an investor is required to account for any difference between the cost of the investment and the underlying equity in net assets of an investee, referred to as basis differences, as if the investee were a consolidated subsidiary (see Section 4.5).

An investor that had previously accounted for an investment on a basis other than the equity method may subsequently be required to apply the equity method to that investment. For example, an investor holding an investment accounted for as a cost method investment or marketable equity security may obtain the ability to exercise significant influence over such an investee by obtaining or otherwise increasing an ownership interest in the investee’s voting common stock. If the investor is subsequently required to apply the equity method, it should apply the initial measurement principles discussed within this chapter.

4.2 Initial Measurement

**ASC 323-10**

30-2 Except as provided in the following sentence, an investor shall measure an investment in the common stock of an investee (including a joint venture) initially at cost in accordance with the guidance in Section 805-50-30. An investor shall initially measure, at fair value, 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.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

30-2 Except as provided in the following sentence, an investor shall measure an investment in the common stock of an investee (including a joint venture) initially at cost in accordance with the guidance in Section 805-50-30. An investor shall initially measure, at fair value, the following:

a. A retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with paragraphs 810-10-40-3A through 40-5

b. An investment in the common stock of an investee (including a joint venture) recognized upon the derecognition of a distinct nonfinancial asset or distinct in substance nonfinancial asset in accordance with Subtopic 610-20.
ASC 805-50

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

Pending Content (Transition Guidance: ASC 606-10-65-1)

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

30-2 Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

Pending Content (Transition Guidance: ASC 606-10-65-1)

30-2 Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued) and no other generally accepted accounting principles (GAAP) apply (for example, Topic 845 on nonmonetary transactions or Subtopic 610-20), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

Changing Lanes

The pending content included in the ASC excerpts within this section relates to ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. Partial sales are sales or transfers of a nonfinancial asset (or an in-substance nonfinancial asset) to another entity in exchange for a noncontrolling ownership interest in that entity. The newly established guidance in ASC 610-20 (which consists of guidance in ASU 2014-09, as amended by ASU 2017-05) conforms the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard (ASC 606, as amended).
Before adopting the new revenue standard, entities account for partial sales principally under the transaction-specific guidance in ASC 360-20 on real estate sales, the industry-specific guidance in ASC 970-323, and (sometimes) ASC 845-10-30. ASU 2014-09 (as amended by ASU 2017-05) simplifies the accounting treatment for partial sales (i.e., entities will use the same guidance to account for similar transactions) by (1) amending the guidance in ASC 970-323 to align it with the requirements in ASC 606 and ASC 610-20, (2) significantly limiting the scope of ASC 360-20 to be applicable only for sale-leaseback transactions, and (3) eliminating the guidance in the Exchanges of a Nonfinancial Asset for a Noncontrolling Ownership Interest subsections of ASC 845-10. As a result of these changes, any transfer of a nonfinancial asset (or an in-substance nonfinancial asset) in exchange for a noncontrolling ownership interest in another entity (including a noncontrolling ownership interest in a joint venture or other equity method investment) should be accounted for in accordance with ASC 610-20 as long as none of the scope exceptions in ASC 610-20-15-4 apply.

ASU 2017-05 is effective at the same time as the amendments in the new revenue standard. Therefore, for public entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein. For all other entities, the amendments are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. An entity must apply the amendments in ASU 2017-05 at the same time that it applies the amendments in ASU 2014-09. See Chapter 17 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for further information regarding the application of ASC 610-20.

Investors must initially measure investments accounted for under the equity method of accounting by using a cost accumulation model. With the exception of nonmonetary transactions (see Section 4.3), cost includes the amount paid (i.e., cash or other consideration paid) and the direct transaction costs incurred to acquire the investment.

Direct transaction costs include incremental “out-of-pocket” costs paid to third parties directly associated with the investment’s acquisition. Such costs may include appraisal fees, fees paid to external consultants for legal and accounting services, and finder’s fees paid to brokers. All other costs, including internal costs (regardless of whether they are incremental and directly related to the acquisition) should be expensed as incurred. In addition, debt or equity issuance costs incurred by the investor to acquire the investment should not be included as a cost of the investment and should be accounted for in accordance with other debt and equity issuance–related accounting guidance.

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1 The amendments in ASU 2016-02, the new leasing standard, superseded ASC 360-20.
2 If an equity method investment is obtained as part of a business combination in accordance with ASC 805, the investor should recognize such an investment at fair value on the date of acquisition under ASC 820.
Example 4-1

An investor purchases a 30 percent interest in an investee for $800,000 in cash and will account for its investment under the equity method. The investor incurred the following costs to acquire the investment:

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal legal costs for preparation of the investment acquisition agreement</td>
<td>$2,000</td>
</tr>
<tr>
<td>Broker fee for identifying the acquisition opportunity</td>
<td>$10,000</td>
</tr>
<tr>
<td>Fee paid to external valuation specialist to determine the fair value of the investment</td>
<td>$10,000</td>
</tr>
<tr>
<td>Employee travel costs directly related to the acquisition</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

The investment acquisition agreement was reviewed by external legal counsel, to whom the investor pays a monthly retainer fee of $5,000.

Because the broker fee and external valuation specialist fee are costs paid to third parties that are directly associated with the investment's acquisition, the investor would include such amounts in the cost of its investment and would record its initial investment at $820,000. Although the internal legal costs ($2,000) and employee travel costs ($1,000) are incremental to the investment's acquisition, the investor would expense them since they are not paid to third parties (i.e., they are internal costs). Although the investment acquisition agreement was reviewed by external legal counsel, the monthly retainer fee ($5,000) would have been incurred regardless of whether the investment was acquired and, accordingly, should be expensed as incurred.

An investor should differentiate between the incremental costs incurred to acquire the investment and the incremental costs incurred on behalf of the investee. See Section 5.4 for a discussion of the accounting for costs incurred on behalf of an investee.

4.2.1 Commitments and Guarantees

ASC 460-10

25-4 At the inception of a guarantee, a guarantor shall recognize in its statement of financial position a liability for that guarantee. This Subsection does not prescribe a specific account for the guarantor's offsetting entry when it recognizes a liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. See paragraph 460-10-55-23 for implementation guidance.

55-23 Although paragraph 460-10-25-4 does not prescribe a specific account, the following illustrate a guarantor's offsetting entries when it recognizes the liability at the inception of the guarantee: . . .

   c. 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. . . .

When accounting for its equity method investment, an investor should also consider any commitments to make future contributions to the investee and guarantees issued to a third party on behalf of the equity method investee. However, commitments to make future contributions are usually not included in the initial measurement of the investment unless required by other authoritative accounting literature.

If an investor issues a guarantee to a third party (e.g., a bank) on behalf of an investee or to the investee itself, it should consider the guidance in ASC 460, which requires a liability (credit) be recognized in an amount equal to the fair value of the guarantee.
For example, an investor’s proportionate guarantee of a line of credit held by its equity method investee may be recorded as a guarantee in accordance with ASC 460. Specifically, ASC 460-10-15-4(a)-(d) list the types of guarantee contracts that are within the scope of ASC 460. ASC 460-10-15-4(b) states that such contracts include those that “contingently require a guarantor to make payments (as described in [ASC 460-10-15-5]) to a guaranteed party based on another entity’s failure to perform under an obligating agreement (performance guarantees).”

Guarantees of an equity method investee’s debt generally do not meet any of the scope exceptions from the initial recognition and measurement provisions of ASC 460. Most notably, the scope exception in ASC 460-10-25-1(g) for guarantees made by a parent on a subsidiary’s debt to a third party is not applicable since an investor would not be considered the parent of its equity method investee.

In addition, situations can arise in which the investee must obtain the investor’s approval before drawing on the line of credit. In these instances, the guidance in ASC 460 is not applicable until the investor grants its approval. At that point, the investor cannot avoid its obligation under the guarantee and must recognize a guarantee under ASC 460. This conclusion is analogous to paragraph A9 of the Basis for Conclusions of FASB Interpretation 45 (codified in ASC 460), which notes that loan commitments are outside Interpretation 45’s scope partly because those instruments typically contain material adverse change clauses or similar provisions that enable the issuing institution (the guarantor) to avoid making payments. By analogy, if the investor can avoid its stand-ready obligation to perform, no obligation has been incurred under ASC 460. However, if the investee does not need to obtain approval from the investor to draw on the line of credit, the investor cannot avoid its obligation to pay at the time it enters into the guarantee of repayment under the line of credit.

If a guarantee is issued by the investor in conjunction with the equity method investee’s formation or issued after formation as required by the formation documents, we generally believe that, in the absence of substantive evidence to the contrary, the value of the guarantee would be included in the initial measurement of the equity method investment (i.e., the debit entry would be recorded to the equity method investment account rather than to expense) given that it is more likely that the guarantee was issued to balance the investor’s investment in the investee. However, if there is substantive evidence that suggests that the investor issued the guarantee as a means to protect its investment while protecting other investors, rather than to balance its investment in the investee, the investor should use judgment to allocate the initial fair value of the guarantee between its interest in the equity method investee (debit recorded to equity method investment) and that of other investors (debit recorded to expense). After initial recognition of the guarantee, the investor should separately account for it by using the guidance in ASC 460. See Section 5.2.1 for further discussion of the accounting for guarantees that are issued after the equity method investee’s formation.

**Example 4-2**

Entity A, an SEC registrant, acquires 30 percent of the voting stock of Investee B upon B’s formation in exchange for a combination of $600 in cash and the issuance of a guarantee for B’s indebtedness to an unrelated third party. The guarantee, which is within the scope of ASC 460, obligates A to make payments to the third party if B is unable to make debt payments. The fair value of the guarantee is $200. Entity A has the ability to exercise significant influence over B and accounts for its investment under the equity method.

Entity A should record its equity method investment in B initially at $800, which represents the $600 paid in cash and the $200 fair value of the guarantee at inception. After B’s formation, A should account for the guarantee in accordance with ASC 460, separately from its equity method investment.
4.3 Contribution of Nonmonetary Assets

An investor may contribute one or more nonmonetary assets in exchange for an equity method investment. Unlike the accounting for monetary contributions, the accounting for nonmonetary contributions depends on the nature of the asset that was contributed.

The flowchart below illustrates the relevant questions for the determination of the accounting that should be applied when an investor contributes nonmonetary assets in exchange for an equity method investment. It is important to note that there are specific accounting considerations associated with the contribution of nonmonetary assets to a joint venture upon formation. See Chapter 8 for details.
4.3.1 Contribution of a Nonmonetary Asset That Constitutes a Business or Nonprofit Activity

**ASC 845-10**

30-25 The following transactions shall be accounted for as a deconsolidation in accordance with paragraphs 810-10-40-3A through 40-5, except if the transaction is the sale of in substance real estate (for guidance on a sale of in substance real estate, see Subtopic 360-20 or 976-605) or is a conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights, see Subtopic 932-360):

a. An entity transfers a subsidiary that is a business or nonprofit activity to a second entity in exchange for a noncontrolling interest in that second entity

b. An entity transfers a group of assets that constitute a business or nonprofit activity to a second entity in exchange for a noncontrolling interest in that second entity.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

30-25 Paragraph superseded by Accounting Standards Update No. 2017-05.

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**Changing Lanes**

The pending content included in the ASC excerpt above relates to ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. See Section 4.2 for details about this ASU. A transfer of a subsidiary or group of assets that constitutes a business or nonprofit activity is one of the scope exceptions in ASC 610-20-15-4 and therefore will continue to be accounted for in accordance with ASC 810-10-40 upon adoption of ASU 2014-09 and ASU 2017-05.

The contribution of a nonmonetary asset that constitutes a subsidiary or a group of assets that is a business or a nonprofit activity (as defined in ASC 810-10-20) is within the scope of ASC 810. Therefore, any interest retained in the contributed asset should be accounted for at fair value in accordance with the guidance in ASC 810-10-40-5 unless fair value is not determinable within reasonable limits, in which case an equity investment is recorded at the carrying amount of the asset(s) contributed.

The deconsolidation and derecognition guidance in ASC 810-10-40-5 also applies to the contribution of an interest in a subsidiary that holds a nonfinancial asset that is not a nonprofit activity or a business unless the substance of the transaction is addressed by other U.S. GAAP, which would include, but not be limited to, the following:

- Revenue transactions (ASC 605 or ASC 606 upon adoption of ASU 2014-09).
- Exchanges of nonmonetary assets (ASC 845). See Section 4.3.2.
- Transfers of financial assets (ASC 860). See Section 4.3.3.
- Conveyances of mineral rights and related transactions (ASC 932).
- Sales of in-substance real estate (ASC 360, ASC 970-323, or ASC 610-20 upon adoption of ASU 2014-09, as amended by ASU 2017-05).

In essence, an investor should not ignore other U.S. GAAP that would otherwise have been applicable simply because, for example, the investor transferred an equity interest in a subsidiary to effect the transaction.

The application of the derecognition guidance in ASC 810-10 is discussed in further detail in Appendix F of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.
4.3.2 Contribution of Nonfinancial Assets That Do Not Constitute a Business

**ASC 845-10**

15-4 The guidance in the Nonmonetary Transactions Topic does not apply to the following transactions: . . .

b. A transfer of nonmonetary assets solely between entities or persons under common control, such as between a parent and its subsidiaries or between two subsidiaries of the same parent, or between a corporate joint venture and its owners

c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an entity under Subtopics 718-10 and 505-50 . . .

e. A transfer of assets to an entity in exchange for an equity interest in that entity (except for certain exchanges of a nonfinancial asset for a noncontrolling ownership interest, see paragraph 845-10-15-18). . . .

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

15-4 The guidance in the Nonmonetary Transactions Topic does not apply to the following transactions: . . .

b. A transfer of nonmonetary assets solely between entities or persons under common control, such as between a parent and its subsidiaries or between two subsidiaries of the same parent, or between a corporate joint venture and its owners

c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an entity under Subtopics 718-10 and 505-50 . . .

e. Subparagraph superseded by Accounting Standards Update No. 2017-05. . . .

**Changing Lanes**

The pending content included in the ASC excerpts above relates to ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. See Section 4.2 for details about this ASU. Under ASC 610-20, the entity transferring nonfinancial assets should account for any noncontrolling ownership interest received as noncash consideration, which should be measured at fair value in a manner consistent with the guidance on noncash consideration in ASC 606. The measurement date for noncash consideration is different under the new revenue standard. For example, legacy guidance generally requires an entity receiving customer equity instruments in lieu of cash consideration for goods or services provided to measure the fair value of the equity instruments when performance is complete (i.e., when the equity instruments vest). By comparison, ASC 606-10-32-21 requires an entity to measure the fair value of noncash consideration at contract inception. In addition, the sequence that determines the fair value of noncash consideration is reversed under the new standard. Specifically, ASC 606-10-32-21 and 32-22 require an entity to first measure the estimated fair value of the noncash consideration received and then consider the stand-alone selling price of the goods or services promised to the customer only when the entity is unable to reasonably estimate the fair value of the noncash consideration received. In contrast, under legacy guidance, an entity is required to first consider the fair value of the goods or services surrendered and then look to the fair value of the asset acquired (i.e., the fair value of the noncash consideration received) only if it is more evident than the fair value of the goods or services surrendered. See Chapter 17 of Deloitte’s [A Roadmap to Applying the New Revenue Recognition Standard](#) for further information regarding the application of ASC 610-20.
The guidance on nonmonetary transactions in ASC 845 addresses accounting for exchanges of nonfinancial assets that do not constitute a business for a noncontrolling ownership interest. Generally, accounting for such nonmonetary transactions is based on the fair value of the contributed assets (or services), which is the same basis as that used in monetary transactions. Accordingly, the fair value of the nonfinancial assets surrendered (or, if more readily determinable, the fair value of ownership interest received) is used to determine the accounting for the ownership interest received by an investor. However, nonmonetary transactions should be accounted for at carryover basis of the nonmonetary asset(s) surrendered if the following conditions in ASC 845-10-30-3(a) and (c) are met:

- “The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits.”
- “The transaction lacks commercial substance.”

ASC 845-10-30-4 provides guidance on the assessment of commercial substance and states that “[a] nonmonetary exchange has commercial substance if the entity’s future cash flows are expected to significantly change as a result of the exchange.”

### 4.3.2.1 Gain or Loss on a Nonmonetary Exchange of Nonfinancial Assets for a Noncontrolling Ownership Interest

**ASC 845-10**

**Exchanges of a Nonfinancial Asset for a Noncontrolling Ownership Interest**

30-25A Except for exchanges described in the preceding paragraph, if an exchange of a nonmonetary asset for a noncontrolling ownership interest in a second entity is accounted for at fair value, full or partial gain recognition is required. Paragraphs 845-10-30-26 through 30-27 provide guidance on how the gain or loss is to be determined.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

30-25A Paragraph superseded by Accounting Standards Update No. 2014-09.

30-26 If the fair value of the asset or assets given up (or of the ownership interest received if that asset’s fair value is more readily determinable) is greater than their carrying value, then either of the following should take place:

a. A gain in the amount of that difference shall be recognized if the entity accounts for the ownership interest received using the cost method.

b. A partial gain shall be recognized if the entity accounts for the ownership interest received using the equity method.

The partial gain shall be calculated as the amount described in (a) less the portion of that gain represented by the economic interest (which may be different from the voting interest) retained. For example, if Entity A exchanges an asset with a carrying value of $1,000 and a fair value of $2,000 for a 30 percent economic interest in Entity B, Entity A shall recognize a gain of $700 ([$2,000 – $1,000] × 70%). Thus, the amount recorded for the ownership interest received is partially based on its fair value at the exchange date and partially based on the carryover amount of the asset(s) surrendered.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

30-26 Paragraph superseded by Accounting Standards Update No. 2017-05.

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3 The carryover amount of the asset(s) surrendered should be reduced (if appropriate) for an indicated impairment value as discussed in ASC 360-10-40-4.
**ASC 845-10 (continued)**

**30-27** If the fair value of the nonfinancial asset or assets given up (or of the ownership interest received if the fair value of that asset is more readily determinable) is less than their carrying value, that difference shall be recognized as a loss.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

**30-27** Paragraph superseded by Accounting Standards Update No. 2017-05.

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**Changing Lanes**

The pending content included in the ASC excerpts above relates to ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. See Section 4.2 for details about this ASU.

When an investor transfers nonfinancial assets in exchange for a noncontrolling ownership interest in another entity, it should recognize a partial gain in an amount equal to the difference between the fair value of the nonfinancial assets surrendered (or, if more readily determinable, the fair value of the ownership interest received) and the carrying amount of the asset(s) given up multiplied by the economic interest deemed sold. We generally believe that gain recognition is appropriate unless the fair values are not determinable within reasonable limits or the transaction lacks commercial substance (in which case an equity investment is recorded at the carrying amount of the asset(s) contributed). When an exchange transaction has commercial substance, we generally believe that the exchange should be accounted for at fair value; however, we acknowledge that ASU 2012-04 introduced a potential policy election for the use of either fair value or carryover basis. Specifically, although paragraph 113 of ASU 2012-04 was not codified into ASC 845, it states, in part:

> [A]n entity is not precluded from using the carryover basis of measurement when accounting for an exchange of a nonmonetary asset for a noncontrolling ownership interest... [A]n entity is required to follow the guidance in paragraph 845-10-30-25A if it chooses to account for its noncontrolling ownership interest at fair value.

In addition, although paragraph 24 of EITF Issue 01-2 was not incorporated into the Codification, it states:

> The SEC Observer emphasized that any gain recognition is heavily dependent on a careful analysis of specific facts and circumstances. Gain recognition would not be appropriate if a significant uncertainty exists regarding realization or the enterprise has an actual or implied commitment to support the operations of the new entity in any manner...

If an investor has an actual or implied commitment, financial or otherwise, to support the operations of an equity method investee, the investor should carefully consider the nature and substance of the commitment to determine whether a gain arising from the exchange transaction should be recognized or deferred. If the gain is deferred, the investor should carefully consider the nature of the commitment to determine the point in time or period over which the gain should be recognized.
Chapter 4 — Initial Measurement

Example 4-3

This example was developed from the illustration in ASC 845-10-30-26.

Entity A contributes an asset with a carrying value of $1,000 and a fair value of $2,000 in exchange for a 30 percent interest in Entity B. Entity A’s investment will be accounted for under the equity method. Entity A should calculate a partial gain equal to the difference between the fair value and the book value of the asset contributed to form B, limited to the interest deemed economically sold, which in this case was 70 percent. That is, A should recognize a gain of $700 [($2,000 − $1,000) × 70 percent]. Entity A should record the following journal entries:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method investment</td>
<td>1,700*</td>
</tr>
<tr>
<td>Asset</td>
<td>1,000</td>
</tr>
<tr>
<td>Gain</td>
<td>700</td>
</tr>
</tbody>
</table>

* Entity A’s equity method investment is calculated as 70 percent of the fair value of the asset transferred (70% × $2,000), which is the portion deemed economically sold, plus 30 percent of the carrying value of the asset transferred (30% × $1,000).

If the carrying value of the nonfinancial asset surrendered exceeds the fair value of such an asset (or, if more readily determinable, the fair value of the ownership interest received), the investor should recognize the loss as the difference between the fair value and the carrying value of the contributed nonfinancial asset(s) in accordance with ASC 845-10-30-27.

Example 4-4

Entity A contributes nonfinancial assets to Entity B in exchange for 45 percent of the outstanding shares in B. The book value of A’s nonfinancial assets is approximately $5 million. The fair value of the shares on the announcement date is approximately $10 million (B’s shares are quoted on the national exchange). Because the book value of A’s nonfinancial assets exceeds the fair value of the nonmonetary assets exchanged (i.e., the fair value of the ownership interest received, which is more readily determinable), A should recognize a loss of $500,000, equal to the difference between the carrying value of the nonfinancial assets that were contributed ($5 million) and the fair value of B’s shares received ($4.5 million).

4.3.2.2 Gain Recognition Involving the Exchange of Nonfinancial Assets and Monetary Consideration for a Noncontrolling Ownership Interest

ASC 845-10

Monetary Exchange of a Nonfinancial Asset for a Noncontrolling Ownership Interest

25-9 In a monetary exchange (required to be accounted for at fair value) in which an entity (Entity A) transfers a nonfinancial asset (or assets) to another entity (Entity B) in exchange for a noncontrolling ownership interest in the other entity (Entity B), full or partial gain recognition is required.

Pending Content (Transition Guidance: ASC 606-10-65-1)

Editor’s Note: Paragraph 845-10-25-9 will be superseded upon transition, together with its heading:

Monetary Exchange of a Nonfinancial Asset for a Noncontrolling Ownership Interest

25-9 Paragraph superseded by Accounting Standards Update No. 2017-05.
25-10 If Entity A has no actual or implied commitment, financial or otherwise, to support the operations of the new Entity B in any manner, the amount of gain recognized, if applicable, may exceed the amount that would be computed pursuant to the guidance for the preceding paragraph.

Pending Content (Transition Guidance: ASC 606-10-65-1)

25-10 Paragraph superseded by Accounting Standards Update No. 2017-05.

25-11 A transaction is committed to if the parties to the transaction have signed a binding, written agreement that specifically sets forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, or are subsequently changed, such a preliminary agreement does not qualify as a commitment for purposes of this guidance.

Pending Content (Transition Guidance: ASC 606-10-65-1)


25-12 See Example 1 (paragraph 845-10-55-27) for illustration of the application of the gain recognition guidance discussed in this Subsection.

Pending Content (Transition Guidance: ASC 606-10-65-1)

25-12 Paragraph superseded by Accounting Standards Update No. 2017-05.

Monetary Exchange of a Nonfinancial Asset for a Noncontrolled Ownership Interest

30-22 In a monetary exchange (required to be accounted for at fair value), the gain recognized on a monetary exchange under paragraph 845-10-25-9 shall be computed in a manner consistent with the guidance in paragraphs 845-10-30-26 through 30-27.

Pending Content (Transition Guidance: ASC 606-10-65-1)

Editor’s Note: Paragraph 845-10-30-22 will be superseded upon transition, together with its heading:

Monetary Exchange of a Nonfinancial Asset for a Noncontrolled Ownership Interest

30-22 Paragraph superseded by Accounting Standards Update No. 2017-05.

55-27 This Example illustrates the guidance in paragraph 845-10-25-9.

Pending Content (Transition Guidance: ASC 606-10-65-1)

Editor’s Note: Paragraph 845-10-55-27 will be superseded upon transition, together with its headings:

Illustrations

Example 1: Monetary Exchange of a Nonfinancial Asset for a Noncontrolled Ownership Interest

ASC 845-10 (continued)

55-28 Entity A transfers its ownership of an individual nonfinancial asset (or assets) to a newly created entity (Entity B) in exchange for an ownership interest in Entity B that will be accounted for by the equity method and monetary consideration. The monetary consideration received exceeds the fair value of the portion of the surrendered nonfinancial asset that has been sold in the exchange. The excess monetary consideration is funded by proceeds from nonrecourse financing within the newly created entity. Subsequent to the transfer, Entity A does not control Entity B. The specifics of the transaction are as follows:

a. Entity A owns equipment with a book basis of $100 and an appraised value of $400.

b. Entity A, previously unrelated to Entity A, creates a new subsidiary, Entity X, and transfers cash of $60 to Entity X.

c. Entity A transfers the equipment to Entity X in exchange for shares of Entity X stock that represent a 40 percent ownership interest in Entity X. Simultaneously, Entity X borrows $300 with recourse to only the equipment and pays Entity A $360 cash.

Paragraph 845-10-25-10 requires that if Entity A has no actual or implied commitment, financial or otherwise, to support the operations of Entity B in any manner, a gain of $260 shall be recognized. The investor's basis in the new entity shall be no less than zero. The gain calculation is illustrated as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of interest in equipment sold ($400 × 60%)</td>
<td>$240</td>
</tr>
<tr>
<td>Less: Cost of interest in equipment sold ($100 × 60%)</td>
<td>(60)</td>
</tr>
<tr>
<td>Plus: Additional gain to the extent of the negative investment</td>
<td>80</td>
</tr>
<tr>
<td>Total gain recognized</td>
<td>$260</td>
</tr>
</tbody>
</table>

The additional gain is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of equipment</td>
<td>$100</td>
</tr>
<tr>
<td>Less: Cost of interest in equipment sold</td>
<td>(60)</td>
</tr>
<tr>
<td>Remaining cost</td>
<td>40</td>
</tr>
<tr>
<td>Less: Cash received in excess of 60% of the equipment's fair value ($360 – $240)</td>
<td>(120)</td>
</tr>
<tr>
<td>Negative investment</td>
<td>$80</td>
</tr>
</tbody>
</table>

Specific facts and circumstances may affect gain recognition and that it would be impractical to consider all possible variations of the basic transaction described above.

Pending Content (Transition Guidance: ASC 606-10-65-1)

55-28 Paragraph superseded by Accounting Standards Update No. 2017-05.

Changing Lanes

The pending content included in the ASC excerpts above relates to ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. See Section 4.2 for details about this ASU.

An exchange of nonfinancial assets for a noncontrolling ownership interest in an investee may involve monetary consideration, or “boot.” Even though the exchange is essentially nonmonetary, if the boot exceeds 25 percent of the fair value of the exchange, the exchange should be considered monetary and the gain, if any, should be computed in a manner consistent with the guidance in ASC 845-10-30-26 and 30-27 (see Section 4.3.2.1).
Further, in a monetary transaction, ASC 845-10-55-28 indicates that an incremental gain can be recognized to the extent of any negative investment balance that would have resulted from such an exchange (i.e., the monetary consideration received exceeds the fair value of the portion of the nonfinancial asset that has been sold in the exchange). That is, the gain is computed as the sum of (1) the excess of fair value over carrying value for the portion of the assets sold (i.e., the portion in which no economic interest is retained) and (2) the negative investment balance, if any, in the investee.

However, if there is an actual or implied commitment, financial or otherwise, to support the investee's operations, the investor should carefully consider the nature and substance of the commitment to determine whether a gain arising from the exchange transaction should be recognized or deferred. If the gain is deferred, the investor should carefully consider the nature of the commitment to determine the point in time or period over which the gain should be recognized.

**Example 4-5**

This example is a continuation of the example in ASC 845-10-55-28. The journal entries to be recorded by Entity A are illustrated below.

**Step 1: Record the partial gain on transfer of the equipment**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>Entity A's equity method investment</td>
<td>Equipment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Gain</td>
<td>180</td>
</tr>
</tbody>
</table>

Entity A's equity method investment is calculated as 60 percent of the fair value of the equipment transferred (60% × $400), which is the portion deemed economically sold, plus 40 percent of the carrying value of the asset transferred (40% × $100). The gain is calculated as $180 ([($400 − $100) × 60%].

**Step 2: Record the additional gain to the extent of A's negative equity method investment**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Cash</td>
<td>360</td>
</tr>
<tr>
<td></td>
<td>Equity method investment</td>
<td>280</td>
</tr>
<tr>
<td></td>
<td>Gain</td>
<td>80</td>
</tr>
</tbody>
</table>

Because the cash received ($360) exceeds the amount of the equity method investment recorded in step 1 ($280), an additional gain of $80 is recognized.

**4.3.3 Exchange of an Equity Method Investment for an Equity Method Investment**

When an equity method investment is exchanged for another equity method investment, generally the investor should first consider whether derecognition of the equity method investment being transferred in the exchange is appropriate in accordance with ASC 860, which addresses the transfer of financial assets. This is consistent with guidance in ASC 845-10-55-2, which states that the exchange of an equity method investment for another equity method investment should be accounted for under ASC 860.

However, ASC 860 is intended to apply to exchanges of equity method investments in unrelated investees, in which the substance of the transaction is an exchange of one investment for a “new” investment in an unrelated investee (as discussed in Example 4-6 below). Therefore, when determining the appropriate accounting for the exchange transaction, the investor should evaluate both the form and substance of the transaction. In certain circumstances, the substance of the exchange transaction may be analogous to a partial dilution of the investor’s investment in exchange for another equity method investment, which would result in partial gain recognition in accordance with ASC 323-10-40-1
(see the discussion of change in level of ownership or degree of influence in Section 5.6) rather than full gain recognition under ASC 860. Examples 4-6 and 4-7 illustrate situations in which full gain recognition under ASC 860 and partial gain recognition in accordance with ASC 323-10-40-1, respectively, may be appropriate.

**Example 4-6**

Entity A has a 35 percent interest in Entity B that it appropriately accounts for by using the equity method. Entity C has a 40 percent interest in Entity D that it appropriately accounts for by using the equity method. Entities B and D are in similar industries and perform the same functions. Basis differences, intra-entity profit and loss eliminations, and tax impacts have been ignored for simplicity.

Entity A is contemplating a transaction in which it will transfer a 30 percent interest in B to C in exchange for a 30 percent interest in D. Therefore, after the transaction, A will own 30 percent of D, and C will own 30 percent of B. Both A and C will have the ability to exercise significant influence over their respective investments upon completion of the exchange.

Even though B and D are in similar industries, the substance of this transaction is that A is exchanging its equity method investment for a “new” equity method investment. Therefore, A should account for this transaction in accordance with ASC 860. As long as all the conditions for derecognition under ASC 860 are met, A would recognize the full gain (or loss) equal to the difference between the selling price (fair value of a 30 percent interest in D) and the carrying value of the interest sold at the time of the sale (i.e., book value of a 30 percent interest in B).

**Example 4-7**

Entity A has a 40 percent interest in Entity K. Entity B and Entity C each have a 30 percent interest in K. Entities A, B, and C appropriately account for their investments in K under the equity method. The book values of A’s, B’s, and C’s interests in K are $800,000, $600,000, and $600,000, respectively, and there are no basis differences between their investment balances and underlying interests in K’s net assets. Further, intra-entity profit and loss eliminations and tax impacts have been ignored for simplicity.

Entities A, B, and C entered into a transaction with Entity E to merge K and E into a new entity, Newco. As part of the transaction, A, B, C, and the E shareholders will each contribute their interests in K and E, respectively, to Newco.

After the transaction, Newco’s ownership structure will be as follows (assume that K was the acquirer of E, and therefore, Newco recognized E’s net assets at fair value):

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Ownership Interest</th>
<th>Book Value of Underlying Net Assets</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>25%</td>
<td>$ 800,000</td>
<td>$ 2,000,000</td>
</tr>
<tr>
<td>B</td>
<td>15%</td>
<td>600,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>C</td>
<td>15%</td>
<td>600,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>E shareholders</td>
<td>45%</td>
<td>3,600,000</td>
<td>3,600,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$ 5,600,000</td>
<td>$ 8,000,000</td>
</tr>
</tbody>
</table>

Therefore, upon the transaction’s execution, A’s ownership interest in K effectively decreases from 40 percent to 25 percent. That is, A effectively exchanges 15 percent of its ownership interest in K for a 25 percent interest in E.
Example 4-7 (continued)

Because of the significance of A's retained interest in K through its investment in Newco, we believe that the transaction's substance is analogous to a partial dilution of A's investment in K in exchange for a partial ownership interest in E. The economic outcome is the equivalent of K's acquiring E's business in exchange for its own equity, thereby diluting A's, B's, and C's previously held ownership interest in K.

On the basis of the substance of the transaction, A should account for the transaction as a partial sale of its investment in K and should recognize a gain of $450,000, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>A’s proportionate share of E’s fair value:</td>
<td>$900,000 ($3,600,000 × 25%)</td>
</tr>
<tr>
<td>Less: book value of A’s interest in K that was sold:</td>
<td>$300,000 (($800,000 × 15%) ÷ 40%)</td>
</tr>
<tr>
<td>Gain on change in interest:</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

Entity A's cost basis of its investment in Newco is $1.4 million, calculated as the $500,000 book value of A's 25 percent interest in K that was retained ([$800,000 × 25%] ÷ 40%) plus the $900,000 fair value of A's 25 percent interest in E that was acquired ($3,600,000 × 25%). Therefore, A would record the following journal entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method investment in Newco</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Equity method investment in K</td>
<td>800,000</td>
</tr>
<tr>
<td>Gain</td>
<td>600,000</td>
</tr>
</tbody>
</table>

Conversely, if the transaction's substance were a transfer of a financial asset for another financial asset within the scope of ASC 860 (and derecognition was appropriate), a full gain on the sale of A's equity interest in K of $1.2 million would be recognized, calculated as the difference between the selling price (i.e., fair value of A's interest in Newco of $2 million) and the book value of A’s interest in K that was sold ($800,000).
4.3.4 Contributions of Real Estate, Services, or Intangibles

**ASC 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 the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. An investor shall not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. Some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph 360-20-40-49 on accounting for sales of real estate to a venture by an investor apply to those transactions. An example of such a transaction is one in which investor A contributes to a venture real estate with a fair value of $2,000 and investor B contributes cash in the amount of $1,000 which is immediately withdrawn by investor A, 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 is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor A of a one-half interest in the real estate in exchange for cash.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

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.

30-4 Unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of an earnings process.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

30-4 Paragraph superseded by Accounting Standards Update No. 2017-05.

30-5 An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the carrying amount of the property with the cash contributed by the other investors. That situation might indicate that the investor contributing the property has suffered a loss that should be recognized.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

30-5 Paragraph superseded by Accounting Standards Update No. 2017-05.
ASC 970-323 (continued)

Contribution of Services or Intangibles

30-6 The accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment shall be determined by the investor in the same manner as for an investment in a wholly owned real estate project. The provisions of this Section do not apply to real estate syndication activities in which the syndicators receive or retain partnership interests. Such activities are discussed in Subtopic 970-605.

Pending Content (Transition Guidance: ASC 606-10-65-1)

30-6 The contribution of real property or an intangible to a partnership or joint venture shall be accounted for in accordance with Subtopic 610-20. The contribution of services or real estate syndication activities in which the syndicators receive or retain partnership interests are accounted for in accordance with the guidance in Topic 606 on revenue from contracts with customers.

Changing Lanes

The pending content included in the ASC excerpts above relates to ASU 2014-09 (as amended by ASU 2017-05), which provides guidance on the recognition and measurement of transfers of nonfinancial assets and is codified in ASC 610-20. See Section 4.2 for details about ASU 2014-09. ASU 2017-05 amends the guidance in ASC 970-323 to align it with the requirements in ASC 606 and ASC 610-20. In accordance with ASU 2017-05, the contribution of real property or intangibles to a partnership or joint venture will be accounted for under ASC 610-20; however, under the guidance in ASC 970-323-30-6 above, the contribution of services or real estate syndication activities in which the syndicators receive or retain partnership interests will be accounted for in accordance with ASC 606. See Deloitte's A Roadmap to Applying the New Revenue Recognition Standard for further information regarding the application of ASC 606 and ASC 610-20.

An investor should not recognize profit when exchanging real estate (or services or intangibles) for an equity interest since such transactions do not represent the culmination of the earnings process (i.e., the transactions' economic substance is a contribution of capital and not a sale of real estate). Rather, the investor should recognize its initial investment in the investee in an amount equal to the cost of the contributed real estate, less related depreciation and valuation allowances (i.e., book carrying value).

Partial gain recognition may, however, be appropriate when the capital contribution is, in substance, a sale of real estate. As described in ASC 970-323-30-3, this may occur when an investor contributes real estate and receives a cash payment from other investors for the portion of the value not retained through the ownership interest and is not obligated to reinvest the proceeds. Such a transaction should be accounted for in accordance with the partial sale guidance in ASC 360-20-40-46 through 40-49.

4.4 Contingent Consideration

ASC 323-10

25-2A If an equity method investment agreement involves a contingent consideration arrangement in which the fair value of the investor’s share of the investee’s net assets exceeds the investor’s initial cost, a liability shall be recognized.

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

a. The maximum amount of contingent consideration not otherwise recognized

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

A contingent consideration arrangement should be recognized as a liability and included in the cost of an equity method investment in only two circumstances:

• Authoritative literature other than ASC 805 (e.g., ASC 480, ASC 450, or ASC 815) requires the arrangement to be recognized. For example, if the contingent consideration meets the definition of a derivative under ASC 815, it would be initially recognized at fair value and included in the basis of the equity method investment. Subsequent changes in fair value of the derivative would not be included in the cost of the equity investment, as further discussed in Section 5.1.8.

• The fair value of an investor's share of an investee's net assets exceeds the initial cost of the investment. In such an instance, a liability should be recognized in a manner consistent with ASC 323-10-30-2B (which is consistent with the requirement to recognize an asset acquisition at its cost or the fair value of the asset received, whichever is more reliably measurable). In accordance with ASC 323-10-30-2B, on the date of acquisition, the investor should recognize a liability (with a corresponding increase in the cost of the equity method investment) at the lesser of (1) “the maximum amount of contingent consideration not otherwise recognized” or (2) “the excess of the investor's share of the investee's net assets over the initial cost measurement.” The share of the investee's net assets should be calculated on the basis of fair value and should exclude any calculated equity method goodwill (see Section 4.5).

Example 4-8

Entity A acquires a 25 percent interest in the voting stock of Investee X for cash consideration of $200. The arrangement also includes contingent consideration that meets the definition of a derivative and has a fair value of $20. Entity A has the ability to exercise significant influence over X and accounts for its investment under the equity method of accounting. Because the contingent consideration arrangement meets the definition of a derivative, A must recognize it in accordance with ASC 815 and would record a total initial cost of its investment of $220 ($200 cash consideration plus the $20 fair value of the derivative).

Example 4-9

Entity A acquires an equity method investment for $1,250. Entity A is obligated to pay an additional $100 in the future if certain earnings targets of the investee are reached. Entity A's proportionate share of the investee's net assets is $1,300, which exceeds A's initial cost of $1,250. In accordance with ASC 323-10-30-2B, on the date of acquisition, A records a liability of $50, which is the lesser of (1) the maximum contingent consideration not already recognized ($100) or (2) the excess of A's share of the investee's net assets ($1,300) over the initial cost measurement ($1,250), with a corresponding increase in the cost of the equity method investment.

ASC 323-10-30-2B(b) does not provide specific guidance about whether the investee's net assets are based on book value or fair value. The guidance in ASC 323-10-25-2A and ASC 323-10-30-2A and 30-2B was codified from EITF Issue 08-6, which states, in part:

5. Contingent consideration should only be included in the initial measurement of the equity method investment if it is required to be recognized by specific authoritative guidance other than Statement 141(R).
6. However, 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, an amount equal to the lesser of the following shall be recognized as a liability:
   a. The maximum amount of contingent consideration not otherwise recognized
   b. The excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

In the Codification, which is organized by topics, paragraph 6 from EITF Issue 08-6 is broken out into two separate paragraphs under ASC 323-10: one within the Recognition section (ASC 323-10-25-2A), and the other within the Initial Measurement section (ASC 323-10-30-2B). This separation makes it unclear whether the reference to fair value in ASC 323-10-25-2A also applies in ASC 323-10-30-2B, which has no such reference. Since paragraph 6 of EITF Issue 08-6 does refer to fair value and the Codification was not intended to change existing U.S. GAAP, we believe that investors should apply ASC 323-10-30-2B by using the fair value of the investee's net assets even though the fair value reference is absent.

Another question that may arise is whether equity method goodwill (see Section 4.5.1) should be included in the calculation of the investee's net assets if the liability has to be recognized in accordance with ASC 323-10-25-2A. ASC 323-10-30-2B specifies that the liability should be recognized at the lesser of (1) "[t]he maximum amount of contingent consideration not otherwise recognized" or (2) "[t]he excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized)." If equity method goodwill is included in the calculation of the investee's net assets, the amount calculated in (1) will always equal the amount calculated in (2), thereby rendering the distinction of recognition at the "lesser of" amount irrelevant. Inclusion of equity method goodwill in the calculation of the investee's net assets would be circular and would ignore the guidance's intent to include the distinction of recognizing the liability at the "lesser of" amount. In addition, equity method goodwill for the investment is associated more with an investor rather than with an investee as part of its net assets. Therefore, we believe that equity method goodwill should not be included in the calculation of the investee's net assets when an entity is evaluating ASC 323-10-30-2B.

### 4.5 Basis Differences

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-13</strong> 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. . . .</td>
</tr>
<tr>
<td><strong>35-34</strong> 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.</td>
</tr>
</tbody>
</table>

The amount an investor pays to acquire an equity method investment is often different from the investor's proportionate share of the carrying value of the investee's underlying assets and liabilities. This difference is generally referred to as a “basis difference.” The investor is required to account for this basis difference as if the investee were a consolidated subsidiary in a manner consistent with the provisions of ASC 805; however, the equity method investment should be presented as a single line in an investor's balance sheet.
ASC 805 requires an entity to apply the acquisition method of accounting. Accordingly, an investor should:

1. Identify all investee assets and liabilities, including assets and liabilities not recorded in the investee’s balance sheet, such as previously unrecognized identifiable intangible assets.
2. Determine the acquisition-date fair value of all identifiable assets and liabilities.
3. Calculate its proportionate share of both (1) the fair value and (2) the carrying value of all identifiable assets and liabilities.
4. Calculate the basis difference for each identifiable asset and liability as the difference between the investor’s proportionate share of the fair value and the carrying value, if any, of each asset and liability.

If the investor is unable to attribute all the basis difference to specific assets or liabilities of the investee, the residual excess of the cost of the investment over the proportional fair value of the investee’s assets and liabilities (commonly referred to as “equity method goodwill”) is recognized within the equity investment balance. It is important for the investor to appropriately assign the basis difference to the investee’s assets and liabilities instead of simply allocating the basis difference to equity method goodwill. Failure to do so may result in a misstatement of the subsequent measurement of the investor’s share of the investee’s income because equity method goodwill, unlike basis differences assigned to other assets and liabilities, is generally not amortized, as further discussed in Section 5.1.5.2.

**Example 4-10**

Investor X purchases a 40 percent interest in Investee Z for $2 million and applies the equity method of accounting. The book value of Z’s net assets is $3.5 million. The table below shows the book values and fair values of Z’s net assets (along with X’s proportionate share) as of the investment acquisition date.

<table>
<thead>
<tr>
<th></th>
<th>Book Value of Z’s Net Assets (A)</th>
<th>Fair Value of Z’s Net Assets (B)</th>
<th>X’s 40% Share of Z’s Net Assets (Book Value) (C = A × 40%)</th>
<th>X’s 40% Share of Z’s Net Assets (Fair Value) (D = B × 40%)</th>
<th>X’s Basis Differences (D − C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$—</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>3,000,000</td>
<td>4,000,000</td>
<td>1,200,000</td>
<td>1,600,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>—</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>—</td>
<td>300,000</td>
<td>—</td>
<td>120,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>80,000*</td>
</tr>
<tr>
<td></td>
<td>$3,500,000</td>
<td>$4,800,000</td>
<td>$1,400,000</td>
<td>$1,920,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

*The $600,000 difference between the cost of X’s investment ($2 million) and its proportionate share of the book value of Z’s net assets ($1.4 million) is attributable to Z’s fixed assets ($400,000), Z’s patented technology ($120,000), and equity method goodwill ($80,000). The $80,000 of equity method goodwill represents the excess of X’s purchase price over X’s equity in Z’s net assets that is not attributable to Z’s identifiable net assets. The basis differences, including equity method goodwill, are presented as part of X’s overall investment in Z and subsequently tracked in memo accounts. That is, X would not present the $120,000 and $80,000 separately as “intangible asset” and “goodwill,” respectively, in its balance sheet.
Example 4-10 (continued)

As shown in the table above:

- The book values of Z’s current assets and current liabilities approximate their fair values.
- Investor X determines that Z has patented technology that was internally developed; therefore, costs associated with developing this technology are expensed as incurred rather than recorded as an intangible asset on Z’s books. The patented technology has a fair value of $300,000.
- Investor X determines that the fair value of Z’s fixed assets is $4 million.

See Example 5-10 in Section 5.1.5.2 for a continuation of this example, illustrating subsequent measurement of basis differences.

If a basis difference relates to the investee’s in-process research and development (IPR&D) and the investee is not a business as defined in ASC 805, the investor should immediately expense such a difference if the IPR&D does not have an alternative future use. If the investee meets the definition of a business, the investor should recognize an intangible asset for IPR&D in its calculation of basis differences, regardless of whether the IPR&D has a future alternative use.

Example 4-10 illustrates the allocation of a positive basis difference; however, a basis difference could also be negative. A negative basis difference may exist because the investor’s proportionate share of the fair value of the investee’s net assets is less than its book value. Section 4.5.1 includes discussion of the limited circumstances in which a negative basis difference may represent a bargain purchase gain.

Example 4-11

Investor X purchases a 30 percent interest in Investee Z for $900,000 and applies the equity method of accounting. The book value of Z’s net assets is $3.5 million. The table below shows the book value and fair value of Z’s net assets (along with X’s proportionate share) as of the investment acquisition date.

<table>
<thead>
<tr>
<th></th>
<th>Book Value of Z’s Net Assets (A)</th>
<th>Fair Value of Z’s Net Assets (B)</th>
<th>X’s 30% Share of Z’s Net Assets (Book Value) (C = A × 30%)</th>
<th>X’s 30% Share of Z’s Net Assets (Fair Value) (D = B × 30%)</th>
<th>X’s Basis Differences (D − C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 1,000,000</td>
<td>$ 1,000,000</td>
<td>$ 300,000</td>
<td>$ 300,000</td>
<td>—</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>3,000,000</td>
<td>2,500,000</td>
<td>900,000</td>
<td>750,000</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(150,000)</td>
<td>(150,000)</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$ 3,500,000</td>
<td>$ 3,000,000</td>
<td>$ 1,050,000</td>
<td>$ 900,000</td>
<td>$ (150,000)</td>
</tr>
</tbody>
</table>

As shown in the table above:

- The book values of Z’s current assets and current liabilities approximate their fair values.
- Investor X determines that Z has identified a significant decrease in the market price for its long-lived assets; however, because the investee tests its fixed assets for impairment under ASC 360, which is a two-step impairment model, no impairment charge is recorded given that the fixed assets are determined to be recoverable under the step 1 undiscounted cash flow evaluation. Although no impairment charge is recorded at the investee level, there is a decrease in fair value of the fixed assets, which results in a negative basis difference because the cost of the investment is lower than X’s share of Z’s net assets.
Example 4-11 (continued)

- Entity X should record its investment in Z at its cost of $900,000. The $150,000 negative basis difference between the cost of X's investment ($900,000) and its proportionate share of the book value of Z's net assets ($1,050,000) is entirely attributable to Z's fixed assets.

Basis differences should be tracked in the investor's “memo” account(s) (i.e., a subsidiary ledger to the equity method investment) given that such differences will affect subsequent measurement of the investor's share of investee income. See Section 5.1.5.2 for details regarding the subsequent measurement of basis differences.

If an investee's financial statements are not prepared in accordance with U.S. GAAP, an investor must conform such financial statements to U.S. GAAP before determining whether there are any basis differences. Future investee financial statements should similarly be adjusted to reflect the identified differences with U.S. GAAP.

4.5.1 Bargain Purchase

In certain circumstances, an investor's share of an investee's net assets is higher than the consideration paid and the investor is unable to attribute all the negative basis difference to specific assets or liabilities. Such a scenario is often referred to as a “bargain purchase” and may indicate a potential economic gain to the investor. ASC 323-10 does not address a bargain purchase; nor does it address when (if ever) a bargain purchase gain would be appropriate upon initial measurement of an equity method investment. During the deliberations of EITF Issue 08-6, the Task Force discussed the appropriate accounting for identified bargain purchases but failed to reach a consensus. Therefore, diversity in practice may exist regarding the accounting for bargain purchases. We believe that a bargain purchase should be rare, because it would be unusual for another investor to sell (or an investee to issue) an equity interest at a price that is below its fair (market) value.

In all instances, an investor should first allocate any negative basis difference in a manner consistent with Example 4-11. This requires the investor to perform a full purchase price allocation and measure the investee's assets and liabilities at fair value, including those not recorded by the investee. If, after performing this allocation, the investor determines that there is a remaining economic gain (i.e., the cost paid is less than the fair value of the investment), the investor may be able to support recognizing a bargain purchase gain. That is, we believe that recognizing a gain for the bargain purchase is an acceptable accounting treatment in a circumstance in which the investor has the requisite information to perform a purchase price allocation in a manner consistent with the measurement principles in ASC 805. ASC 323-10-35-13 requires the investor to account for the “difference between the cost of an [equity method] investment and the amount of underlying equity in net assets of an investee . . . as if the investee were a consolidated subsidiary,” which would support recognition of the gain in earnings on the investment date. However, before recognizing the gain, the investor should (1) ensure that all underlying assets acquired and liabilities assumed as part of the equity investment were correctly identified and recognized (in accordance with the guidance in ASC 805) and (2) understand the reasons that led to the bargain purchase gain (i.e., why the seller sold the investment below the fair value of the investee's underlying assets and liabilities). Bargain purchases may occur, for example, because of underpayments for the investment acquired (e.g., in a forced liquidation or distress sale or because of the lack of a competitive bidding process).

If the information necessary to perform a purchase price allocation under ASC 805 for the incremental equity interests is not readily available, it is appropriate for an investor to recognize a pro rata reduction (on a relative fair value basis) to the amounts allocated to an investee's underlying assets. This treatment
is consistent with the cost accumulation model for asset acquisitions prescribed in ASC 805-50-30, which precludes gains or losses upon recognition when consideration is paid in cash.

Further, we believe that it is always acceptable, as an accounting policy, to not recognize bargain purchase gains for equity method investments and instead to allocate the negative basis difference to the investee’s underlying assets, as described above.

4.5.2 Tax Effects of Basis Differences

Basis differences may give rise to deferred tax effects (i.e., tax-related basis differences). There are two categories of tax-related basis differences:

- An “inside” basis difference, which is a temporary difference between the carrying amount, for financial reporting purposes, of individual assets and liabilities and their tax bases that will give rise to a tax deduction or taxable income when the related asset is recovered or liability is settled and reflected in the investee’s financial statements.

- An “outside” basis difference, which is a difference between the carrying amount of an equity method investment and the tax basis of such an investment in the financial statements.

To accurately account for its equity method investment, an investor should consider any inside and outside basis differences in its investment. See Section 3.04 of Deloitte’s A Roadmap to Accounting for Income Taxes for additional guidance on inside and outside basis differences.

Tax-related basis differences are another component of the single equity method line item in an investor’s financial statements. In addition, to accurately measure the tax basis differences (i.e., tax assets and liabilities), the investor should apply ASC 740 to analyze the investee’s uncertain tax positions.

### Example 4-12

Assume the same facts as in Example 4-10. In addition, the effective tax rate of Investor X and Investee Z is 35 percent. Investee Z did not record any deferred tax assets (DTAs) or deferred tax liabilities (DTLs) in its own financial statements. Further, there are no basis differences between the carrying amount of X’s equity method investment in Z for financial statement and tax purposes (i.e., no outside basis differences).

On the basis of the calculations in Example 4-10, the $600,000 difference between the cost of X’s investment ($2 million) and its proportionate share of the book value of Z’s net assets ($1.4 million) is attributable to Z’s fixed assets ($400,000), Z’s patented technology ($120,000), and equity method goodwill ($80,000). Therefore, X recognizes a DTL in its memo accounts as follows:

<table>
<thead>
<tr>
<th>X’s Basis Differences</th>
<th>Effective Tax Rate</th>
<th>DTL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>$ 400,000</td>
<td>35%</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>120,000</td>
<td>35%</td>
</tr>
<tr>
<td>Goodwill</td>
<td>80,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td><strong>$ 600,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Since equity method goodwill is treated as if it were goodwill acquired in a business combination, there is no DTL associated with this basis difference.
Example 4-12 (continued)

Because the total amount of the basis difference between the cost of X's investment ($2 million) and its proportionate share of the book value of Z's net assets ($1.4 million) has not changed, the DTL recognized in the memo accounts increases the basis difference attributable to equity method goodwill in an amount equal to the DTL, as shown in the table below.

<table>
<thead>
<tr>
<th></th>
<th>Book Value of Z's Net Assets (A)</th>
<th>Fair Value of Z's Net Assets (B)</th>
<th>X's 40% Share of Z's Net Assets (Book Value) (C = A × 40%)</th>
<th>X's 40% Share of Z's Net Assets (Fair Value) (D = B × 40%)</th>
<th>X's Basis Differences (D − C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$—</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>3,000,000</td>
<td>4,000,000</td>
<td>1,200,000</td>
<td>1,600,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>—</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>—</td>
<td>300,000</td>
<td>—</td>
<td>120,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>262,000</td>
</tr>
<tr>
<td>DTL</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(182,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>$3,500,000</strong></td>
<td><strong>$4,800,000</strong></td>
<td><strong>$1,400,000</strong></td>
<td><strong>$1,920,000</strong></td>
<td><strong>$600,000</strong></td>
</tr>
</tbody>
</table>

If an investee with a DTA concludes that it is not more likely than not that the net operating losses will be realized, it will recognize a valuation reserve for such DTAs. In such an instance, the investor may be prepared, given its expectation that a net DTA has value greater than the amount recorded by the investee, to pay a premium to acquire an interest in that investee. If such a premium is paid, the investor is not allowed to assign any of the premium paid to the investee's DTAs in the memo accounts because (1) the investor's investment does not provide the investee with a new ability to recover the DTAs for which a valuation allowance was previously recognized and (2) there has also been no change in control at the investee level as a result of the investor's investment.

See Sections 8.8 through 8.13 of Deloitte's *A Roadmap to Accounting for Income Taxes* for additional guidance on tax considerations related to equity method investments.

### 4.5.3 Accumulated Other Comprehensive Income

Changes in value for certain investee assets or liabilities (e.g., derivative financial instruments, AFS securities, and pension or postemployment benefits) may be recorded in the investee's accumulated other comprehensive income (AOCI) in accordance with other U.S. GAAP.

On the date the investor qualifies for application of the equity method of accounting, it should identify and measure all the investee's identifiable assets and liabilities at fair value. Accordingly, the investor would not recognize its proportionate share of the investee's AOCI because such amounts would already be contemplated in the fair value measurement of the respective assets or liabilities identified. However, this will result in additional basis differences that should be tracked in the memo accounts to ensure that subsequent changes in the investee's AOCI are not recognized by the investor when the amounts are reclassified to earnings by the investee. Example 4-13 illustrates this guidance.
Example 4-13

Investor A purchases a 25 percent interest in Investee B and applies the equity method of accounting. Investee B holds an AFS security that was purchased for $1,000 and has a fair value of $1,100 on the date A purchases its interest in B. Therefore, B has recorded $100 in unrealized gains in AOCI. One year later, B sells its AFS security for $1,100.

**Initial Measurement**

On the date A purchases its 25 percent investment in B, A should calculate its proportionate share of the AFS security's fair value ($1,100 × 25% = $275) and its proportionate share of the AFS security's book value ($1,000 × 25% = $250). Investor A should not recognize its proportionate share of the $100 of unrealized gains in B's AOCI balance; however, A should present the $25 basis difference ($275 − $250) as part of its overall investment in B and subsequently track this difference in memo accounts.

**Subsequent Measurement**

Although B will recognize a realized gain of $100 upon the sale of its AFS security, A should not record its proportionate share of B's realized gain. Instead, because A's basis in B's AFS security already reflects the AFS security's appreciation (i.e., recognized as part of the initial measurement), A should reduce its equity in earnings of B by $25 ($100 × 25%).
Chapter 5 — Subsequent Measurement

5.1 Equity Method Earnings and Losses

ASC 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.)

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.

ASC 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.

After initial measurement of an equity method investment, an investor should record its share of an investee's earnings or losses in income on the basis of the amount of common stock and in-substance common stock held by the investor. Potential common stock issued by the investee (i.e., securities such as options, warrants, convertible securities, or contingent stock agreements) should not be included in the calculation of the investor's share of the investee's earnings or losses unless these securities represent in-substance common stock. See Section 2.5 for further discussion related to the determination of whether an investment is in-substance common stock. The investor's equity method investment balance is increased by the investor's share of the investee's income and decreased by the investor's share of the investee's losses in the periods in which the investee reports the earnings and losses rather than in the periods in which the investee declares dividends. In addition, adjustments to the investor's share of equity method earnings or losses (and corresponding adjustments to the carrying value of the equity method investment) are made for certain items as discussed in detail in Section 5.1.5.
While the guidance above requires an investor to recognize its share of an investee’s earnings or losses, it does not prescribe the method by which the allocation should be performed. In some cases, the calculation of the investor’s share of the investee’s earnings or losses may be straightforward (e.g., when there is only one share class and the distributions received by the investors are consistent with their percentage ownership in the investee). However, allocation of earnings or losses on the basis of the investor’s ownership percentage may be more difficult to apply in complex structures in which there are multiple share classes and investors have different rights and priorities. See Sections 5.1.2 and 5.1.2.1 for further discussion of when the allocation of the investee’s earnings or losses is disproportionate in relation to the investor’s ownership interest in the investee.

5.1.1 Impact of Preferred Dividends on an Investor’s Share of Earnings (Losses)

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

An investor is required to calculate its share of an equity method investee’s earnings (losses) after deduction of any investee preferred dividends on cumulative preferred stock, regardless of whether the dividends are declared. Conversely, no adjustment is required for preferred dividends on noncumulative preferred stock unless those dividends have been declared.

5.1.2 Disproportionate Allocation of an Investee’s Earnings or Losses in Relation to an Investor’s Ownership Interest

<table>
<thead>
<tr>
<th>ASC 970-323</th>
</tr>
</thead>
</table>
| 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. |

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.
Chapter 5 — Subsequent Measurement

As noted in Section 5.1, when applying the equity method of accounting, an investor should typically record its share of an investee’s earnings or losses on the basis of the percentage of the equity interest owned by the investor. However, contractual agreements often specify attributions of an investee’s profits and losses, certain costs and expenses, distributions from operations, or distributions upon liquidation that are different from investors’ relative ownership percentages. For example, developers in the renewable energy sector often use limited partnerships or similar structures for tax purposes. A developer of a renewable energy facility that does not generate sufficient taxable income to offset the tax incentives or investment tax credits (ITCs) generated from its operations may monetize these tax credits by identifying investors that are able to use the tax incentives and credits. These renewable “flip” structures are typically set up as tax pass-through entities to give the investors (i.e., tax equity investors) the ability to use the tax benefits of the partnership. Within these structures, there are typically disproportionate equity distributions until a flip date, at which point the distributions change. In addition, the tax benefits that pass through to the investor are not recognized in the investee’s net income but generally affect the claim that the tax equity investor has on the remaining book value. This is just one example of a structure in which the calculation of an investor’s share of an investee’s earnings or losses may involve more complexity.

Although ASC 970-323 was written for equity method investments in the real estate industry, we believe that it is appropriate to refer to this literature for guidance on developing an appropriate method of allocating a non-real-estate equity method investee’s economic results among investors when a contractual agreement, rather than relative ownership percentages, governs the economic allocation of earnings or losses. ASC 970-323 implies that for the allocation of the investee’s earnings or losses to be substantive from a financial reporting perspective, it must hold true and best represent cash distributions over the life of the entity. Reporting entities should focus on substance over form. The investor should consider the substance of all relevant agreements when determining how an increase or decrease in the investee’s net assets will affect cash payments to the investor over the investee’s life and upon its liquidation.

Connecting the Dots

We believe that the guiding principle for allocating an investee’s earnings or losses to equity method investors is to ascertain whether allocations that would otherwise be made in the current year are at significant risk of being unwound in subsequent periods because a different allocation method will be used for subsequent cash distributions. In such instances, professional judgment must be used, and consideration should be given to the facts and circumstances at hand. Preparers should consider consulting with their independent auditors or their professional accounting advisers.

Examples of such considerations are illustrated in ASC 323-10-35-19 (see Section 5.2), ASC 323-10-55-30 through 55-47 (see Section 5.2.3), and ASC 323-10-55-49 through 55-57 (see Section 5.2.3.1).

Overall, when selecting the most appropriate method with which to recognize earnings on an equity method investment, an investor should consider the principal objective of the equity method, which ASC 323-10-35-4 states is to recognize the investor’s “share of the earnings or losses of an investee in the periods for which they are reported by the investee.” That is, the investor should appropriately reflect the effect of investee transactions on an investor for a given reporting period.

Therefore, when cash flows, tax attributes, and earnings are contractually allocated to investors in disparate ways over the life of an investee, it would be inappropriate for the investor to forecast expectations of the investee’s performance to determine a weighted-average expected return on the investor’s investment when allocating current-period earnings. That is, we believe that the allocation
method should generally be consistent with how the contractual provisions allocate earnings in the current period or how the investor's rights to the book value change in that current period.

However, we do not think that this means that contractual earnings allocation provisions should be followed blindly. For example, it may be the case that earnings allocation percentages change contractually over the investee's life while operating and liquidating cash distributions remain constant. In such situations, the substance of the contractual cash distribution provisions may imply relative membership interests in the investee, while earnings are allocated to achieve certain other form-based objectives (e.g., an after-tax return). In summary, when earnings, tax attributes, and cash flows are contractually allocated differently, we think that the substance of those provisions should be carefully considered.

See Section 6.1 of Deloitte's *A Roadmap to Accounting for Noncontrolling Interests* for further discussion of allocations that are disproportionate to ownership interests.

### Example 5-1

Investors A and C have 40 percent and 60 percent equity interests, respectively, in Investee B, a partnership. The investors use the equity method to account for their interests in B. Distributions (including those that would occur if the investee were liquidated) are shared evenly, in accordance with the terms of the partnership agreement.

In this example, A and C would record their proportionate shares of B's profits and losses on the basis of the allocation method specified in the partnership agreement (i.e., equal distribution), since this allocation reflects the substance of the investment. That is, A and C would not record their equity method earnings on the basis of 40 percent and 60 percent, respectively, of B's profits and losses.

### Example 5-2

Investor Z has an equity method investment in an LLC that owns income-producing real estate properties. For financial reporting purposes, the LLC agreement states that 100 percent of depreciation expense and 50 percent of all other income and expense items are to be allocated to Z. However, the agreement states that 50 percent of all cash distributed by the LLC during its operations and upon liquidation should be allocated to Z.

In this example, there is no basis for the allocation of 100 percent of depreciation expense to Z. Therefore, Z would record its equity method earnings on the basis of 50 percent of the LLC's total net profits and losses (including depreciation expense).

### 5.1.2.1 Hypothetical Liquidation at Book Value Method

Although the Codification does not prescribe a specific method for allocating an investee's earnings or losses to investors, reporting entities will often use the hypothetical liquidation at book value (HLBV) method, which is a balance sheet approach to encapsulating the change in an investor's claim on an investee's net assets as reported under U.S. GAAP. Under the HLBV method, changes in the investor's claim on the investee's net assets that would result from the period-end hypothetical liquidation of the investee at book value form the basis for allocating the equity method investor's share of the investee's earnings or losses.

The HLBV method arose in response to increasingly complex capital structures, the lack of prescribed implementation guidance on how an equity method investor should determine its share of earnings or losses generated by the equity method investee, and the ensuing diversity in practice. In an attempt to establish in the authoritative literature the appropriate accounting for equity method investments in entities with complex structures, the AICPA issued a proposed Statement of Position (SOP), *Accounting*
for *Investors’ Interests in Unconsolidated Real Estate Investments*, in November 2000. The proposed SOP, which was not ultimately finalized, was intended for investments of unconsolidated real estate. However, the proposal led to increased use of the HLBV method as an acceptable means to allocate earnings or losses of an equity method investee among its investors when each investor’s right to participate in the earnings or losses of the investee is disproportionate to its ownership interest.

Notwithstanding the HLBV method’s origins (or its absence from the Codification), we believe that given the FASB’s focus on substance over form, the HLBV method will often be an acceptable method for allocating an investee’s earnings or losses. Other methods may also be acceptable depending on the facts and circumstances.

Under the HLBV method, a reporting entity allocates an investee’s earnings or losses to each investor by using the following formula:

\[
\text{Period-end claim on net assets as reported under U.S. GAAP} + \text{Distributions received during the period} - \text{Contributions made during the period} + \text{Prior-period claim on net assets as reported under U.S. GAAP}
\]

Example 5-3 below and Example 5-4 illustrate the calculation of an investor’s equity method earnings or losses under the HLBV method. In addition, Case B from the example in ASC 323-10-55-54 through 55-57 also illustrates, in substance, the application of the HLBV method (see Section 5.2.3.1).

**Example 5-3**

Partnership X was formed to develop and construct a renewable solar energy facility. Partnership X will own the facility and sell electricity at a fixed rate to a local utility under a long-term power purchase agreement. Partnership X is a flow-through entity for tax purposes; therefore, the tax attributes (such as ITCs and accelerated tax depreciation) related to the solar energy facility are allocated to X’s partners in accordance with X’s operating agreement between the partners.

The fair market value of the solar energy facility is $35 million. The tax equity investor and sponsor will contribute $15.5 million and $19.5 million, respectively, to X. Assume that both the tax equity investor and the sponsor account for their investments in X under the equity method.¹

Partnership X has a complex capital structure that requires an allocation of income, gain, loss, tax deductions, and tax credits before and after a “flip date” to the investors that is not consistent with the investors’ relative ownership percentages. The flip date is defined as the point in time when the tax equity investor receives a target after-tax internal rate of return (IRR) on its investment (in this example, tax equity’s target after-tax IRR is 8 percent). The tax equity investor achieves its IRR through cash distributions as well as the allocation of ITCs and other tax benefits.

Under the partnership agreement, income, gain, loss, tax deductions, and tax credits for each tax year will be allocated between the tax equity investor and the sponsor as follows:²

<table>
<thead>
<tr>
<th></th>
<th>Pre-Flip</th>
<th>Post-Flip</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax equity investor</td>
<td>99 percent</td>
<td>5 percent</td>
</tr>
<tr>
<td>Sponsor</td>
<td>1 percent</td>
<td>95 percent</td>
</tr>
</tbody>
</table>

¹ Note, however, that the sponsor will frequently consolidate the partnership and account for the tax equity investor’s interest as a noncontrolling interest in its consolidated financial statements. Nonetheless, the sponsor may attribute income and loss to itself and the noncontrolling interest in a manner consistent with the HLBV method by using the mechanics described herein. See Section 6.1.1 and Example 6-1 in Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests*.

² The partnership operating agreement may call for certain allocations, such as 99:1, in the pre-flip period. However, the tax equity investor and the sponsor must still perform a detailed analysis of the partners’ 704(b) capital accounts and tax basis since the operation of the partnership tax rules/limitations can often result in allocations that do not necessarily match the stated allocation percentages in the operating agreement.
Example 5-3 (continued)

Cash distributions for each tax year, which are not designed to approximate GAAP earnings in each period, will be allocated between the tax equity investor and the sponsor as follows:

<table>
<thead>
<tr>
<th></th>
<th>Pre-Flip</th>
<th>Post-Flip</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax equity investor</td>
<td>25 percent</td>
<td>5 percent</td>
</tr>
<tr>
<td>Sponsor</td>
<td>75 percent</td>
<td>95 percent</td>
</tr>
</tbody>
</table>

Finally, tax gain (or loss) recognized upon the partnership's liquidation will be distributed according to the following waterfall:

- First, to partners with negative Internal Revenue Code Section 704(b) capital accounts, the amount needed to bring their capital accounts to zero.
- Second, to the tax equity investor, an amount necessary to achieve its target IRR.
- Finally, to the partners in accordance with their post-flip tax sharing ratios (95 percent to the sponsor and 5 percent to the tax equity investor), any remaining gain (or loss).

Note that in this example, we assumed a generic set of liquidation provisions in computing HLBV equity method income (loss). In practice, there is tremendous diversity in liquidation provisions from deal to deal since partners develop provisions that more accurately reflect their economic arrangements.

Given X's complex capital structure, both the tax equity investor and the sponsor have elected a policy of calculating their share of X's earnings or losses by using the HLBV method. To determine the amount allocated to each investor under the HLBV method, the tax equity investor and sponsor must perform an analysis of the investors' Section 704(b) capital accounts (as adjusted per the liquidation provisions of the partnership agreement). The mechanics of the HLBV method in this type of flip structure involve a complex combination of U.S. GAAP and tax concepts, typically consisting of the following steps (as of each reporting period end):

1. Determine the investee's period-end U.S. GAAP capital account balance.
2. Determine the investee's and each investor's starting Section 704(b) capital account balance.
3. Calculate the investee's Section 704(b) book gain (loss) on hypothetical liquidation (U.S. GAAP capital account from step 1 less starting Section 704(b) capital account balance from step 2).
4. Allocate the investee's Section 704(b) book gain (loss) from step 3 in the following order (specifics as determined by the liquidation provisions in the relevant agreement):
   a. Allocate the gain to restore negative Section 704(b) capital account balances to zero.
   b. Allocate the gain to the tax equity investor until the target IRR is achieved.
   c. Allocate the remaining gain (loss) in accordance with the appropriate residual sharing percentages.
5. Add/subtract the gain (loss) allocated in step 4 to each investor's Section 704(b) capital account balance determined in step 2.
6. Determine the change in each investor's claim on the investee's book value during the period (adjusted for contributions and distributions).

HLBV equity method income (loss) is calculated for the tax equity investor and the sponsor in years 1 through 3 below. Note that intra-entity profit and loss eliminations and tax impacts have been ignored for simplicity.

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3 Section 704(b) of the Internal Revenue Code discusses special allocations of partnership items.

4 This example represents a simple HLBV waterfall calculation. Depending on the complexity of the liquidation waterfall in the operating agreement, as well as the discrete items in the entity's financial statements, additional steps may be necessary.
Example 5-3 (continued)

### Step 1: Determine the investee's period-end U.S. GAAP capital account balance:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investee's pretax U.S. GAAP net income</strong></td>
<td>$1,000,000</td>
<td>$1,250,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td><strong>U.S. GAAP equity rollforward:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Beginning balance</strong></td>
<td>—</td>
<td>$34,000,000</td>
<td>$33,000,000</td>
</tr>
<tr>
<td><strong>(+ Net income (loss)</strong></td>
<td>1,000,000</td>
<td>1,250,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td><strong>(- Cash distributions</strong></td>
<td>(2,000,000)</td>
<td>(2,250,000)</td>
<td>(2,500,000)</td>
</tr>
<tr>
<td><strong>(+ Capital contributions</strong></td>
<td>35,000,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td>$34,000,000</td>
<td>$33,000,000</td>
<td>$32,000,000</td>
</tr>
</tbody>
</table>

### Step 2: Determine the investee's and each investor's starting Section 704(b) capital account balance:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxable income (loss)</strong></td>
<td>(4,500,000)</td>
<td>(8,000,000)</td>
<td>(2,500,000)</td>
</tr>
<tr>
<td><strong>Investee (Partnership X):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Beginning balance</strong></td>
<td>—</td>
<td>$28,500,000</td>
<td>$18,250,000</td>
</tr>
<tr>
<td><strong>(+ Net income (loss)</strong></td>
<td>(4,500,000)</td>
<td>(8,000,000)</td>
<td>(2,500,000)</td>
</tr>
<tr>
<td><strong>(- Cash distributions</strong></td>
<td>(2,000,000)</td>
<td>(2,250,000)</td>
<td>(2,500,000)</td>
</tr>
<tr>
<td><strong>(+ Capital contributions</strong></td>
<td>35,000,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td>$28,500,000</td>
<td>$18,250,000</td>
<td>$13,250,000</td>
</tr>
<tr>
<td><strong>Tax equity investor:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Beginning balance</strong></td>
<td>—</td>
<td>$10,545,000</td>
<td>$2,062,500</td>
</tr>
<tr>
<td><strong>(+ Net income (loss) × 99%</strong></td>
<td>(4,455,000)</td>
<td>(7,920,000)</td>
<td>(2,475,000)</td>
</tr>
<tr>
<td><strong>(- Cash distributions</strong></td>
<td>(500,000)</td>
<td>(562,500)</td>
<td>(625,000)</td>
</tr>
<tr>
<td><strong>(+ Capital contributions</strong></td>
<td>15,500,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td>$10,545,000</td>
<td>$2,062,500</td>
<td>$(1,037,500)</td>
</tr>
<tr>
<td><strong>Sponsor:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Beginning balance</strong></td>
<td>—</td>
<td>$17,955,000</td>
<td>$16,187,500</td>
</tr>
<tr>
<td><strong>(+ Net income (loss) × 1%</strong></td>
<td>(45,000)</td>
<td>(80,000)</td>
<td>(25,000)</td>
</tr>
<tr>
<td><strong>(- Cash distributions</strong></td>
<td>(1,500,000)</td>
<td>(1,687,500)</td>
<td>(1,875,000)</td>
</tr>
<tr>
<td><strong>(+ Capital contributions</strong></td>
<td>19,500,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
<td>$17,955,000</td>
<td>$16,187,500</td>
<td>$14,287,500</td>
</tr>
</tbody>
</table>

* Although the investee realized U.S. GAAP income in all years shown, the investee typically will pass significant tax losses through to its investors because of accelerated depreciation on the renewable solar energy assets.
**Example 5-3 (continued)**

**Step 3: Calculate the investee’s Section 704(b) book gain (loss) on hypothetical liquidation (U.S. GAAP capital account from step 1 less starting Section 704(b) capital account balance from step 2):**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. GAAP capital account</td>
<td>$34,000,000</td>
<td>$33,000,000</td>
<td>$32,000,000</td>
</tr>
<tr>
<td>Section 704(b) capital account</td>
<td>$28,500,000</td>
<td>$18,250,000</td>
<td>$13,250,000</td>
</tr>
<tr>
<td>Section 704(b) book gain (loss) on liquidation</td>
<td>$5,500,000</td>
<td>$14,750,000</td>
<td>$18,750,000</td>
</tr>
</tbody>
</table>

**Step 4: Allocate the investee’s Section 704(b) book gain (loss) on liquidation:**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain (loss) available to allocate</td>
<td>$5,500,000</td>
<td>$14,750,000</td>
<td>$18,750,000</td>
</tr>
<tr>
<td>Unadjusted Section 704(b) capital accounts:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax equity investor</td>
<td>10,545,000</td>
<td>2,062,500</td>
<td>(1,037,500)</td>
</tr>
<tr>
<td>Sponsor</td>
<td>17,955,000</td>
<td>16,187,500</td>
<td>14,287,500</td>
</tr>
</tbody>
</table>

**Step 4(a): Allocate gain to restore negative capital accounts:**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restore negative capital accounts</td>
<td>$5,500,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Remaining gain (loss) to allocate after step 4(a)</td>
<td>$14,750,000</td>
<td>$18,750,000</td>
<td>$17,712,500</td>
</tr>
</tbody>
</table>

**Step 4(b): Allocate gain to tax equity investor until target after-tax return (IRR) is achieved:**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount necessary to achieve target IRR</td>
<td>$3,500,000</td>
<td>$2,000,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Remaining gain to allocate after step 4(b)</td>
<td>$2,000,000</td>
<td>$12,750,000</td>
<td>$16,212,500</td>
</tr>
</tbody>
</table>

**Step 4(c): Allocate remaining gain (loss) in accordance with appropriate residual sharing percentages:**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax equity investor (5 percent)</td>
<td>$100,000</td>
<td>$637,500</td>
<td>$810,625</td>
</tr>
<tr>
<td>Sponsor (95 percent)</td>
<td>$1,900,000</td>
<td>$12,112,500</td>
<td>$15,401,875</td>
</tr>
<tr>
<td>Remaining gain to allocate after step 4(c)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

**For simplicity, we have included a fixed amount for the amount necessary to achieve the target IRR in the calculation above; however, in practice, determining this amount can be complex.**
Example 5-3 (continued)

**Step 5: Add/subtract the gain (loss) allocated in step 4 to each investor's starting Section 704(b) capital account balance determined in step 2:**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax equity investor:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unadjusted Section 704(b) capital account</td>
<td>$ 10,545,000</td>
<td>$ 2,062,500</td>
<td>($1,037,500)</td>
</tr>
<tr>
<td>Step 4(a) adjustment</td>
<td>—</td>
<td>—</td>
<td>1,037,500</td>
</tr>
<tr>
<td>Step 4(b) adjustment</td>
<td>3,500,000</td>
<td>2,000,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Step 4(c) adjustment</td>
<td>100,000</td>
<td>637,500</td>
<td>810,625</td>
</tr>
<tr>
<td>Adjusted Section 704(b) capital account</td>
<td>$ 14,145,000</td>
<td>$ 4,700,000</td>
<td>$ 2,310,625</td>
</tr>
<tr>
<td><strong>Sponsor:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unadjusted Section 704(b) capital account</td>
<td>$ 17,955,000</td>
<td>$ 16,187,500</td>
<td>$ 14,287,500</td>
</tr>
<tr>
<td>Step 4(a) adjustment</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Step 4(b) adjustment</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Step 4(c) adjustment</td>
<td>1,900,000</td>
<td>12,112,500</td>
<td>15,401,875</td>
</tr>
<tr>
<td>Adjusted Section 704(b) capital account</td>
<td>$ 19,855,000</td>
<td>$ 28,300,000</td>
<td>$ 29,689,375</td>
</tr>
</tbody>
</table>

**Step 6: Determine the change in each investor’s claim on the investee’s book value during the period (adjusted for contributions and distributions):**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax equity investor:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Claim on investee book value (beginning)</td>
<td>$ —</td>
<td>$ 14,145,000</td>
<td>$ 4,700,000</td>
</tr>
<tr>
<td>Claim on investee book value (ending)</td>
<td>14,145,000</td>
<td>4,700,000</td>
<td>2,310,625</td>
</tr>
<tr>
<td>Change in claim on book value</td>
<td>14,145,000</td>
<td>(9,445,000)</td>
<td>(2,389,375)</td>
</tr>
<tr>
<td>(+) Cash distributions</td>
<td>500,000</td>
<td>562,500</td>
<td>625,000</td>
</tr>
<tr>
<td>(–) Capital contributions</td>
<td>(15,500,000)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>HLBV equity method income (loss)</td>
<td>$ (855,000)</td>
<td>$ (8,882,500)</td>
<td>$ (1,764,375)</td>
</tr>
<tr>
<td><strong>Sponsor:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Claim on investee book value (beginning)</td>
<td>$ —</td>
<td>$ 19,855,000</td>
<td>$ 28,300,000</td>
</tr>
<tr>
<td>Claim on investee book value (ending)</td>
<td>19,855,000</td>
<td>28,300,000</td>
<td>29,689,375</td>
</tr>
<tr>
<td>Change in claim on book value</td>
<td>19,855,000</td>
<td>8,445,000</td>
<td>1,389,375</td>
</tr>
<tr>
<td>(+) Cash distributions</td>
<td>1,500,000</td>
<td>1,687,500</td>
<td>1,875,000</td>
</tr>
<tr>
<td>(–) Capital contributions</td>
<td>(19,500,000)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>HLBV equity method income (loss)</td>
<td>$ 1,855,000</td>
<td>$ 10,132,500</td>
<td>$ 3,264,375</td>
</tr>
</tbody>
</table>
Example 5-3 (continued)

Below are the journal entries the tax equity investor and the sponsor would use to record their contributions, equity method earnings or losses, and distributions related to their equity method investments in Partnership X.

**Tax equity investor:**

**Year 1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method investment</td>
<td>15,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>15,500,000</td>
</tr>
<tr>
<td>Equity method loss</td>
<td>855,000</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>855,000</td>
</tr>
<tr>
<td>Cash</td>
<td>500,000</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>500,000</td>
</tr>
</tbody>
</table>

**Year 2**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss</td>
<td>8,882,500</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>8,882,500</td>
</tr>
<tr>
<td>Cash</td>
<td>562,500</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>562,500</td>
</tr>
</tbody>
</table>

**Year 3**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss</td>
<td>1,764,375</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>1,764,375</td>
</tr>
<tr>
<td>Cash</td>
<td>625,000</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>625,000</td>
</tr>
</tbody>
</table>

**Sponsor:**

**Year 1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method investment</td>
<td>19,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>19,500,000</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>1,855,000</td>
</tr>
<tr>
<td>Equity method income</td>
<td>1,855,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>
Example 5-3 (continued)

Year 2
Equity method investment 10,132,500
   Equity method income 10,132,500
Cash 1,687,500
   Equity method investment 1,687,500

Year 3
Equity method investment 3,264,375
   Equity method income 3,264,375
Cash 1,875,000
   Equity method investment 1,875,000

Example 5-4

Investee R, a partnership, is capitalized by equity contributions from Investor V and Investor T as follows:

<table>
<thead>
<tr>
<th>Equity contributions</th>
<th>Investor V</th>
<th>Investor T</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$200</td>
<td>$200</td>
<td>$400</td>
<td></td>
</tr>
</tbody>
</table>

Assets, liabilities, and equity for R as of December 31, 20X4, 20X5, and 20X6, are:

<table>
<thead>
<tr>
<th></th>
<th>December 31, 20X4</th>
<th>December 31, 20X5</th>
<th>December 31, 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$900</td>
<td>$950</td>
<td>$1,250</td>
</tr>
<tr>
<td>Liabilities</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Equity</td>
<td>400</td>
<td>450</td>
<td>750</td>
</tr>
</tbody>
</table>

Investee R had net income of $50 during 20X5 and $300 during 20X6.

Assume that V accounts for its investment in R under the equity method. Investee R is a limited life entity that does not make regular distributions to its investors. Upon liquidation of R, its net assets are distributed as follows:

1. Return of the investors’ capital contributions.
2. Return of $100 to T.
3. Remainder to the investors on a pro rata basis.

Given R’s complex capital structure, V has elected a policy of calculating its share of R’s earnings or losses by using the HLBV method. Thus, net income for 20X5 and 20X6 is allocated on the basis of the hypothetical liquidations of net assets as of December 31, 20X4, 20X5, and 20X6, as depicted in the chart below. Note that intra-entity profit and loss eliminations and tax impacts have been ignored for simplicity.
Example 5-4 (continued)

<table>
<thead>
<tr>
<th>December 31, 20X4</th>
<th>December 31, 20X5</th>
<th>December 31, 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor V</td>
<td>Investor T</td>
<td>Total</td>
</tr>
<tr>
<td>Net assets</td>
<td>$400</td>
<td>$400</td>
</tr>
<tr>
<td>Return of capital</td>
<td>$(200)</td>
<td>$(200)</td>
</tr>
<tr>
<td>Priority return to T</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Pro rata returns</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>HLBV claim</td>
<td>$(200)</td>
<td>$(200)</td>
</tr>
</tbody>
</table>

Investor V's share of R's earnings during 20X5 is zero, because its claim on the book value has remained unchanged during the year (i.e., T was allocated 100 percent of the net income). Investor V's share of R's earnings during 20X6 is $125 (V's $325 claim on December 31, 20X6, net assets less its $200 claim on December 31, 20X5, net assets).

Connecting the Dots

We believe that while it will often be acceptable for an entity to use the HLBV method to allocate an investee's earnings or losses, there may be instances in which it would be inappropriate for an entity to use the HLBV method. Because the HLBV method inherently focuses on how an investee's net assets will be distributed in liquidation, a detailed understanding of the investee's intention with respect to cash distributions is important. We believe that when provisions governing the attribution of liquidating distributions differ significantly from those governing the attribution of ordinary distributions, it would be inappropriate to rely on the HLBV method to allocate the earnings or losses of a going-concern investee if the investee is expected to make significant ordinary distributions throughout its life.

5.1.2.2 Capital-Allocation-Based Arrangements

Capital-allocation-based arrangements are fee arrangements in which one or more parties receives compensation for managing the capital of one or more investors. These arrangements typically include two payment streams: (1) a management fee (usually a fixed percentage of the net asset value of the assets under management) and (2) an incentive-based fee (i.e., a fee based on the extent to which a fund's performance exceeds predetermined thresholds). Often, a private-equity or real estate fund manager (who may be the GP and have a small ownership percentage in the fund) will receive incentive-based fees by way of a disproportionate allocation of capital from a fund's limited partnership interests if certain investment returns are achieved (commonly referred to as “carried interests”). This is an example of a capital-allocation-based arrangement that involves an equity interest (the partnership interests held by the GP).

Before the issuance of ASU 2014-09 (codified as ASC 606), GP investors that did not have a controlling financial interest in the underlying partnership generally accounted for their GP interest, excluding the disproportionate allocation of profits, by using the equity method of accounting as prescribed in ASC 323. With respect to the incentive-based-fee portion of their GP investments, investors usually
applied EITF Topic D-96 (codified in ASC 605-20-S99-1), which specifies two acceptable approaches to accounting for the receipt of fees for performance-based fee arrangements such as an incentive-based fee in a capital-allocation-based arrangement:

- **Method 1** — Because of the possibility that fees earned by exceeding performance targets early in the measurement period may be reversed if performance targets are missed later in the measurement period, no incentive-based-fee income is recorded until the end of the measurement period (which in some cases may be coterminous with the life of the fund under management).

- **Method 2** — Incentive-based-fee income is recorded on the basis of the amount that would be due under the relevant formula at any point in time as if the contract were terminated at that date.

Notwithstanding the above, before the issuance of ASU 2014-09, some investors may have been treating the incentive-based-fee portion of their GP investments within the scope of ASC 323 on the basis of footnote 1 of EITF Topic D-96 (although not codified in ASC 605-20-S99-1), which states:

> The SEC staff understands that in certain entities within the scope of AICPA Statement of Position No. 78-9, Accounting for Investments in Real Estate Ventures, the manager is the general partner in a partnership and receives fees in the form of partnership allocations. If the general partner manager has been accounting for such arrangements on the equity method in accordance with that SOP, the manager may continue to apply that method.

With the issuance of ASU 2014-09, the question has arisen about whether these capital-allocation-based arrangements are within the scope of ASC 606 or whether they would be accounted for under other U.S. GAAP (particularly ASC 323).

We believe that if these capital-allocation-based arrangements are within the scope of ASC 606, the incentive-based-fee portion would represent variable consideration. As illustrated in Example 25 in ASC 606-10-55-221 through 55-225, the application of the variable consideration constraint may result in a delay in recognition of incentive-based fees for entities that previously chose to apply Method 2. In some cases, this delay may be significant. See Section 6.2.3 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for further discussion of constraining estimates of variable consideration.

Notwithstanding Example 25, ASC 606 does not contain explicit guidance on whether capital-allocation-based arrangements that involve an equity interest are within its scope.

We believe that the accounting for an entity's capital-allocation-based arrangements will vary in accordance with the nature and substance of the arrangement. Specifically, certain entities may be able to demonstrate that the incentive-based fee is an attribute of an equity interest. In such instances, the entity would be able to make an accounting policy election to account for the incentive-based fee under the provisions of ASC 606 or ASC 323 since the equity interest, inclusive of the incentive fee, would qualify for the scope exception outlined in ASC 606-10-15-2(c)(3). See Section 2.4.2.1 for further discussion.

Thus, entities should carefully evaluate the scoping guidance within these topics to determine whether their capital-allocation-based arrangements should be accounted for thereunder, particularly ASC 323.

If an investor determines that the incentive-based-fee portion of its capital-allocation-based arrangements is within the scope of ASC 323 (and thus qualifies for the scope exception to ASC 606 noted above), we believe that the scope exception would be applied only to the incentive-based fee. We believe that the management-fee portion of the capital-allocation-based arrangement, if present, should be accounted for under ASC 606.
Application of the equity method under ASC 323-10-35-4 would permit the investor to recognize its share of earnings or losses, inclusive of the incentive-based fee, in the periods in which they are recognized by the underlying investee. The guidance states that “[a]n 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.” However, when an agreement designates allocations among the investors of the investee’s profits and losses, certain costs and expenses, distributions from operations, or distributions upon liquidation that are different from ownership percentages, it may not be appropriate for the investor to record equity method income on the basis of the equity interest owned. Examples of these considerations are illustrated in ASC 323-10-55-30 through 55-47 (see Section 5.2.3), ASC 323-10-55-48 through 55-57 (see Section 5.2.3.1), and ASC 323-10-35-19 (see Section 5.2). ASC 323-10-55-54 through 55-57 also illustrate, in substance, the application of the HLBV method (see Sections 5.2.3.1 and 5.1.2.1). This guidance is consistent with that in ASC 970-323-35-16 and 35-17 (see Section 5.1.2), under which the equity method is applied to investments in entities that have legal agreements designating the allocation of profits and losses and distributions. Given that capital-allocation-based arrangements often provide for a disproportionate allocation of profits on the basis of the fair value of underlying investments in a fund, the investor should carefully determine the most appropriate method of calculating its share of earnings or losses of the investee after considering all of the arrangement’s facts and circumstances.

ASC 323-10-45-1 states that “[u]nder the equity method, an investment in common stock shall be shown in the balance sheet of an investor as a single amount” and that “an investor’s share of earnings or losses from its investment shall be shown in its income statement as a single amount.” Therefore, if the investor has determined that it is appropriate to account for the incentive-based-fee portion of its capital-allocation-based arrangement under ASC 323, we believe that the investor should present its GP investment in the underlying investee as one unit of account in the same line item in the balance sheet. Regarding income statement presentation, we are aware of the following two potentially acceptable views:

- The entire amount of the investor’s share of earnings, including its pro rata allocation of profits as well as allocations under the incentive-based-fee portion of the capital-allocation-based arrangement, represents revenue earned by the investor and should therefore be presented in the revenue total in the income statement. However, since these revenues would be considered outside the scope of ASC 606, the amounts should not be labeled as revenue from contracts with customers in the investor’s financial statements or in the accompanying footnotes and disclosures.

- The entire amount of the investor’s share of earnings, including its pro rata allocation of profits as well as allocations under the incentive-based-fee portion of the capital-allocation-based arrangement, should be reflected in a separate line item outside of revenue in the income statement.

### 5.1.3 Differences Between Investor and Investee Accounting Policies and Principles

An investor and its equity method investee may prepare their financial statements by using different accounting policies and principles. Depending on the circumstances, the investor may be required to make adjustments to the investee’s financial statements when calculating its share of the investee’s earnings or losses.
Chapter 5 — Subsequent Measurement

5.1.3.1 Equity Method Investee Does Not Follow U.S. GAAP

<table>
<thead>
<tr>
<th>ASC 970-323</th>
</tr>
</thead>
</table>

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 term “earnings or losses of an investee” is defined in ASC 323-10-20 as “[n]et income (or net loss) of an investee determined in accordance with U.S. generally accepted accounting principles (GAAP).” Therefore, if an investee is not following U.S. GAAP, an investor that reports under U.S. GAAP must make adjustments to convert the investee’s financial statements into U.S. GAAP so it can apply the equity method and record its share of the investee’s earnings or losses. This situation may arise, for example, when the investee’s financial statements are prepared under IFRS Standards or some other basis of accounting (i.e., in the real estate industry when the investee’s financial statements were prepared by using tax basis information that differs from U.S. GAAP).

Generally accepted accounting principles in some countries other than the United States permit an investor to recognize its share of net income in an equity method investee by using the investee’s basis of accounting, which may be different from that of the investor. For example, a foreign registrant using French GAAP may have an equity method investee that reports under German GAAP. Because a conversion of the investee’s net income into French GAAP is not required under French GAAP, the financial statements of the investor will simply reflect the investor’s share of the investee’s German GAAP net income.

At the 2000 AICPA Conference on Current SEC Developments, the SEC staff indicated that a foreign registrant that is reconciling to U.S. GAAP must convert the net income of its equity method investees into net income prepared under U.S. GAAP and must list the difference as a reconciling item.

5.1.3.2 Investee Has Elected a Private-Company Alternative

The Private Company Council (PCC) determines alternatives to existing nongovernmental U.S. GAAP to address the needs of users of private-company financial statements on the basis of criteria mutually agreed upon by the PCC and the FASB. The FASB has issued certain ASUs that contain these PCC alternatives. When an investor accounts for its interest in an investee, the determination of whether PCC alternatives are allowed and whether there is any impact to the investor’s recognition of its share of the investee’s earnings or losses depends on whether the investor and the investee meet the definition of a PBE.

- **If the investor and the investee are not PBEs** — If both the investor and the investee are not PBEs, the investor and the investee may use PCC alternatives. The investor may conform the investee’s accounting policies with its own to unwind a PCC alternative elected by the investee. However, if the investee does not apply a PCC alternative, the investor may not change the investee’s accounting policies to conform with its own.

- **If the investor is not a PBE but the investee is a PBE** — If the investor is not a PBE but the investee is a PBE, the investor may apply PCC alternatives. The investee is prohibited from applying PCC alternatives in its own separate financial statements. Further, the investor is prohibited from conforming the investee’s accounting policies to its accounting policies (i.e., the investor cannot apply the PCC alternatives to the investee’s financial statements when the investor is preparing its own financial statements).
• **If the investor and the investee are PBEs** — If the investor and the investee are PBEs, both the investor and the investee are prohibited from applying PCC alternatives.

• **If the investor is a PBE but the investee is not a PBE** — If the investor is a PBE but the investee is not a PBE, the investor is prohibited from applying PCC alternatives. The investee may elect to apply PCC alternatives in its separate financial statements; however, when applying the equity method of accounting, the investor may need to make adjustments in certain circumstances.

While not authoritative, the guidance in Section 7100.08 of *AICPA Technical Questions and Answers* distinguishes between when the investor meets criterion (a) versus when it meets criteria (b) through (e) of the ASC master glossary definition of a PBE in the determination of whether any adjustments to equity method pickups would be required.

If the investor is a PBE according to criterion (a) of the ASC master glossary definition, the investor is required to reverse the investee's PCC alternatives when calculating its equity method pickup. The SEC staff has indicated in discussions that PBEs are prohibited from including PCC alternatives in their financial statements on an “indirect” basis when they apply the equity method of accounting. Although the PCC alternatives are considered part of U.S. GAAP, precluding their use by an investor that meets the definition of a PBE (referred to herein as a “PBE investor”) is consistent with requiring investors that apply the equity method to adjust the accounting of an investee that applies other GAAP (e.g., IFRS Standards) (see Section 5.1.3.1).

If the investor is a PBE according to criteria (b) through (e) of the ASC master glossary definition, the investor is not required to reverse the investee's PCC alternatives when calculating its equity method pickup. However, the investor may elect to do so in certain circumstances (e.g., if it plans to go public).

### Example 5-5

Company P holds an interest in Company Q and accounts for it by applying the equity method. Because P is an SEC registrant, it is a PBE for financial reporting purposes according to criterion (a) of the ASC master glossary definition. Company Q is a private company that has elected to amortize goodwill in accordance with ASC 350-20-15-4 in its own financial statements. In addition, P is not required to include Q's separate financial statements in its own SEC filings (in accordance with SEC Regulation S-X, Rule 3-09). Therefore, for P's SEC filing purposes, Q does not explicitly meet criterion (a) of the definition of a PBE because Q is not one of the “other entities whose financial statements or financial information are required to be or are included in a filing.” Company P's accounting under the equity method cannot reflect Q's election to amortize goodwill. Although Q may be eligible to amortize goodwill when it prepares its stand-alone financial statements, Q's accounting must be changed to that of a PBE when P applies the equity method to account for its interest in Q. Thus, P would reverse the amortization recorded by Q (and the related tax effects, if any) and evaluate whether the adjusted carrying value of goodwill on Q's books, without the election to amortize goodwill, would be deemed impaired if Q performed the impairment analysis required of a PBE (i.e., an annual test performed at the reporting-unit level).

See Section 5.1.3.4 for details regarding application of the definition of a PBE to an equity method investee and a discussion of the extent to which PBE effective dates of new accounting standards apply when a PBE investor accounts for its interest in an investee that may or may not be a PBE.

---

5 See Section 6.5 for details.
5.1.3.3 Investee Applies Different Accounting Policies Under U.S. GAAP

While a PBE investor cannot apply the equity method to account for its interest in an investee until it adjusts the investee’s financial statements to eliminate any elected private-company accounting alternatives (as discussed in Section 5.1.3.2), there is no need to align the investee’s accounting policies with those of the investor as long as the investee’s policies can be applied by a PBE. That is, in accordance with the ASC master glossary definition of the term “earnings or losses of an investee,” as long as the investee’s accounting policies are acceptable under U.S. GAAP, the investee’s financial statements should not be adjusted to conform to the accounting policies of the investor.

For instance, if an equity method investee accounts for its inventory under the last-in, first-out method, whereas an investor uses the first-in, first-out method (or vice versa), the investor should not adjust the investee’s financial statements to conform to the investor’s first-in, first-out inventory policy. However, it is important for the investor to understand the impact of these differing accounting policies when calculating equity method earnings and specifically whether any intra-entity profit or loss eliminations are required. See Section 5.1.5.1 for details on intra-entity profit or loss eliminations.

5.1.3.4 Investee Adopts a New Accounting Standard on a Different Date

New accounting standards often establish divergent adoption requirements (e.g., different effective dates) for PBEs and non-PBEs. The determination of whether an investor registrant must adjust an equity method investee’s adoption of a new standard to make it conform to the manner of adoption required of PBEs depends on whether the equity method investee is considered a PBE. For example, an equity method investee whose financial statements are included in a registrant’s filing under SEC Regulation S-X, Rule 3-09, because the equity method investee is significant to the registrant is considered a PBE under U.S. GAAP.

In his remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments, Jonathan Wiggins, associate chief accountant in the OCA, stated, in part:

Whether an entity is a public business entity can have a significant impact on financial reporting, particularly since certain FASB guidance, including the new revenue, leases, and financial instruments standards, have different effective dates for public business entities. You should ensure that all entities that meet the definition of a public business entity adopt such guidance using the effective dates for public business entities for purposes of the financial statements or financial information included in a filing with the SEC.

OCA has received related questions regarding the accounting for equity method investees that do not otherwise meet the FASB’s definition of a public business entity. [Footnotes omitted]

When a PBE investor accounts for its interest in an investee, the determination of whether the PBE effective dates of new accounting standards apply to (1) the investee’s financial statements or financial information filed with or furnished to the SEC and (2) the PBE investor’s recognition of its share of the investee’s earnings or losses depends on whether the investee (1) is a PBE itself, (2) is a PBE because of its relationship with the PBE investor, or (3) is not a PBE.

- If the investee is a PBE itself — If the investee is a PBE itself (i.e., it meets the definition of a PBE regardless of its relationship with the PBE investor), the investor’s equity method of accounting should be based on the financial statements that the investee prepared by applying the specific PBE transition dates and provisions, if any, of the new accounting standard being adopted. In addition, the investee’s financial statements or financial information filed or furnished by the PBE investor must reflect the investee’s adoption of the new accounting standard and its compliance with the specific PBE transition dates and provisions, if any.
• **If the investee is a PBE because of its relationship with the PBE investor** — In some instances, an investee meets the definition of a PBE according to the ASC master glossary “solely because its financial statements or financial information is included in another entity’s filing with the SEC.” For example, an SEC filer may include financial statements or financial information of investees that otherwise would not meet the definition of a PBE (referred to herein as “specified PBEs”) in its own filings with the SEC under the following SEC Regulation S-X rules:
  - 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 3-10(g), “Recently Acquired Subsidiary Issuers or Subsidiary Guarantors.”
  - Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired.”
  - Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”

At the July 20, 2017, EITF meeting, the SEC staff made a narrow-scope announcement that it would not object to elections by specified PBEs to use the non-PBE effective dates for the sole purpose of adopting the FASB’s new standards on revenue (ASC 606) and leases (ASC 842). The SEC staff announcement does not preclude specified PBEs from adopting the provisions of ASC 606 and ASC 842 on the adoption date applicable to all other PBEs if the specified PBEs desire to use the PBE adoption date. The SEC staff announcement on transition related to ASC 606 and ASC 842 is codified in ASC 606-10-S65-1 and ASC 842-10-S65-1, respectively, by ASU 2017-13.

**Example 5-6**

Company A, a publicly traded manufacturer, holds equity method investments in three of its nonpublic suppliers. On the basis of applying the SEC Regulation S-X significance tests, A has determined that it must include summarized financial information for Suppliers X, Y, and Z (under SEC Regulation S-X, Rule 4-08(g)) in its SEC filing. Suppliers X, Y, and Z meet the definition of a PBE only because of the required inclusion of their financial information in A’s SEC filing (i.e., they qualify as specified PBEs). Consequently, X, Y, and Z plan to use the non-PBE adoption dates of ASC 606 and ASC 842 for their own stand-alone financial statement preparation purposes. When including the summarized financial information of X, Y, and Z in its own SEC filing, A is not required to adjust the suppliers’ financial statements to reflect the PBE adoption date of ASC 606 and ASC 842.

While the SEC staff announcement provides relief to registrants preparing to adopt ASC 606 and ASC 842, it is purposely narrow in scope and should not be applied by analogy to the adoption-date assessment for any other standard. Thus, in the absence of any future relief provided by the SEC staff, specified PBEs would be considered PBEs for the determination of the applicable effective dates of other standards. Accordingly, the PBE investor’s equity pickup must be recorded on a PBE basis.

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6 Although the SEC staff announcement does not address the FASB’s new standard on credit losses (ASC 326), the effective-date guidance in ASC 326 is similar to the ASC 606 and ASC 842 effective-date guidance available to specified PBEs as a result of the SEC staff announcement. Specifically, while ASC 326’s transition provisions are not based exclusively on the PBE definition, they distinguish between PBEs that meet the definition of an SEC filer and PBEs that do not meet the definition of an SEC filer. ASC 326-10-20 clarifies that “Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition” (emphasis added). Accordingly, it was not necessary for the SEC staff to include ASC 326 within the scope of the announcement.
Chapter 5 — Subsequent Measurement

• **If the investee is not a PBE** — Mr. Wiggins indicated that in the determination of the applicable
effective dates of accounting standards, he believes that when an SEC registrant uses the equity
method to account for its investment in an entity that is not a PBE, amounts recognized by the
registrant would not be considered financial information included in a filing with the SEC under
the FASB’s definition of a PBE. Thus, the non-PBE equity method investee would not be required
to use PBE effective dates solely to determine the registrant’s application of the equity method
of accounting.

See Section 6.5.2.1 for details regarding form and content considerations.

### 5.1.3.4.1 Application of PBE Adoption Dates to Equity Method Investees With
Different Fiscal Year-Ends

Determining the adoption date for a new accounting standard when a PBE investor and its equity
method investee that meets the definition of a PBE have different fiscal year-end dates can be complex.
Mr. Wiggins noted that when an equity method investee meets the definition of a PBE, the registrant’s
equity method accounting would be expected “to be based on the [investee’s] financial statements
prepared using the public business entity effective dates.” Therefore, we believe that when the investee
has a different fiscal year-end than the investor, it would be appropriate for the investee to use the
adoption date based on the investee’s fiscal year-end, which may be later than the investor’s adoption
date.

**Example 5-7**

Investor K is a PBE that holds an equity method investment in Investee M. Although M is a private company,
it meets the definition of a PBE because its financial statements are included in K’s SEC filing under SEC
Regulation S-X, Rule 3-09, given that M is significant to K. Investor K has a December 31 fiscal year-end, whereas
M has a June 30 fiscal year-end.

In its filing of financial statements for the year ending December 31 with the SEC, K would include M’s financial
statements for the year ending June 30. Because there is a greater-than-three-month lag between K’s and M’s
fiscal year-end dates, the equity method earnings (losses) reported in K’s financial statements are adjusted in
such a way that K is recording M’s equity method earnings (losses) for the 12 months ending December 31.
See Section 5.1.4 for details related to accounting for an investor’s share of earnings on a time lag.

ASC 606 and ASC 842 are effective for PBEs for annual periods beginning after December 15, 2017, and
December 15, 2018, respectively (i.e., calendar periods beginning on January 1, 2018, and January 1, 2019,
respectively), and interim periods therein. Since M meets the definition of a PBE, it must adopt these standards
by using the PBE effective date.

Investee M would not be precluded from adopting ASC 606 and ASC 842 by using its own PBE effective date
(i.e., July 1, 2018, and July 1, 2019, respectively). In the year of adoption, this would result in the reflection in K’s
equity method earnings (losses) in M of six months of M’s accounting before the adoption of ASC 606 and
ASC 842 and six months of M’s accounting after the adoption of ASC 606 and ASC 842. If M were required to
use the PBE adoption date of K (i.e., January 1, 2019), this would effectively cause M to adopt ASC 606 and
ASC 842 as of July 1, 2017, and July 1, 2018, respectively, which is, respectively, one year before its own PBE
effective date and two years before the non-PBE effective date.

### 5.1.3.5 Investee Applies Investment Company Accounting

**ASC 323-10**

25-7 For the purposes of applying the equity method of accounting to an investee subject to guidance in an
industry-specific Topic, an entity shall retain the industry-specific guidance applied by that investee.
Specialized industry accounting allows investment companies to carry their investments at fair value, with changes in the fair value of the investments recorded in the statement of operations. Since ASC 323-10 essentially requires a one-line consolidation, an investor that holds investments that qualify for specialized industry accounting for investment companies (in accordance with ASC 946) should follow that guidance regardless of whether the investment is accounted for under the equity method or is consolidated. Therefore, the investor should record in its statement of operations its share of the earnings or losses, realized and unrealized, as reported by its equity method investees that qualify for specialized industry accounting for investment companies.

5.1.4 Accounting for an Investor’s Share of Earnings on a Time Lag

It is generally acceptable for an investor to apply the equity method accounting by using an equity method investee's financial statements with a different reporting date as long as the reporting dates of the investor and investee are no greater than three months apart. Since equity method accounting generally results in single-line consolidation, ASC 810-10-45-12 provides the following analogous guidance:

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

When the investor reports its share of the results of its equity method investee on a time lag, the investee's results should be for the same length of time as the investor's results. For example, in the investor's 12-month financial statements, the investee's results also would be for the full 12 months, although the results will be for a different 12 months than the investor's stand-alone results. It would not be appropriate to include the investee's results for a period that is greater or less than 12 months. The investor's evaluation of whether to report its share of the equity method investee's financial results on a time lag should be performed for each investment separately. For instance, the investor may use a
reporting time lag for certain equity method investees but not for others. The decision to use a reporting time lag for an equity method investee should be applied consistently for that investee in each reporting period.

The investor should evaluate material events occurring during the time lag (i.e., the period between the investee’s most recent available financial statements and the investor’s balance sheet date) to determine whether the effects of such events should be disclosed or recorded in the investor’s financial statements. By analogy to ASC 810-10-45-12, “recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the [investor’s] financial position or results of operations” (emphasis added). SEC Regulation S-X, Rule 3A-02(b)(1) (codified in ASC 810-10-599-2), contains similar guidance.

An investor may elect a policy of either disclosing all material intervening events or both disclosing and recognizing them. Either policy is acceptable and should be consistently applied to all material intervening events that meet the recognition requirements of U.S. GAAP. When the investor chooses to recognize material intervening events, either in accordance with its elected policy or because the events are so significant that disclosure alone would not be sufficient, it should take care to reflect only the impact of such events. It would generally not be appropriate to present the investor’s share of more than 12 months of operations for the investee in the investor’s financial statements (in addition to the effects of the recognized event or another change in the investor’s accounting for the investee). See Section 11.1.3 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest for further discussion of when recognition or disclosure or both are appropriate for material intervening events.

This guidance applies to material (or significant) intervening events that would affect the investee’s financial results rather than transactions or events of the investor. For instance, if the investor sold its interest in the investee during the reporting lag, the sale is a transaction of the investor. Therefore, in such circumstances, the disposal of the investee should be recognized in the period in which the disposition occurs, regardless of whether a reporting lag exists. It would be inappropriate to defer recognition of the transaction at the investor level because the transaction falls into a different interim or annual period for the investee.

Also, an investor’s other-than-temporary impairment (OTTI) testing of its equity method investments should be performed as of the investor’s balance sheet date, in accordance with ASC 323-10-35-32. The investor should evaluate all impairment indicators that occur during the time lag. See Section 5.5 for additional guidance on evaluating equity method investments for OTTIs, including examples of impairment indicators.
The example below illustrates the adoption of a new accounting standard when an investor records its share of earnings of its equity method investee on a time lag.

### Example 5-8

Investor Q is a public company that has adopted ASC 606 as of January 1, 2018, by using the modified retrospective approach. Investor Q records its share of earnings of its equity method investee, G, on a one-quarter lag. Specifically, for the first quarter of 2018, Q will record its share of G's earnings for the period from October 1, 2017, through December 31, 2017. Because of this time lag, the impact from G's adoption of ASC 606 would not be included in Q's results until April 1, 2018. In this situation, we believe that Q should report its share of the impact from G's adoption of ASC 606 as an adjustment to equity on April 1, 2018. Although Q's ASC 606 adoption date is January 1, 2018, Q records its share of G's earnings on a one-quarter lag. Therefore, it is appropriate that Q's share of G's cumulative equity adjustment because of ASC 606 adoption should also be reported on a lag (on April 1, 2018). We believe that since Q recognizes its share of G's first quarter earnings in the second quarter, Q should also recognize the cumulative equity adjustment resulting from G's adoption of ASC 606 on the first day of the second quarter (April 1, 2018).

Even if an investor's use of a reporting time lag for its equity method investee was appropriate in previous periods, once the equity method investee can produce reliable and timely financial statements that use the same reporting date as the investor, the investor must discontinue use of a reporting time lag.

In addition, ASC 810-10-45-13 requires investors to record the elimination of a reporting time lag “as a change in accounting principle in accordance with the provisions of Topic 250.” ASC 250-10-45-2 indicates that an entity may change an accounting principle only if the change is considered preferable, stating, in part:

A reporting entity shall change an accounting principle only if either of the following apply:

- The change is required by a newly issued Codification update.
- **The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable.** [Emphasis added]

While criterion (b) above refers to preferable methods of applying accounting principles in situations with multiple allowable alternatives, investors should view the application and discontinuance of the reporting time lag as a matter of acceptability rather than preference. That is, the method an investor uses to apply a reporting time lag and its discontinuance or modification of this method are matters of fact and necessity rather than elections among multiple acceptable alternatives. Generally, under ASC 250, voluntary changes in accounting principles must be presented retrospectively.

### 5.1.5 Adjustments to Equity Method Earnings and Losses

As noted in ASC 323-10-35-5 (see Section 5.1), adjustments to the investor's share of equity method earnings or losses (and corresponding adjustments to the carrying value of the equity method investment) should be made for the following:

- Intra-entity profits and losses (see Section 5.1.5.1).
- Amortization or accretion of basis differences (see Section 5.1.5.2).
- Investee capital transactions (see Section 5.1.5.3).
- Other comprehensive income (OCI) (see Section 5.1.5.4).
5.1.5.1 Intra-Entity Profits and Losses

ASC 323-10

35-7 Intra-entity profits and losses shall be eliminated until realized by the investor or investee as if the investee were consolidated. Specifically, intra-entity profits or losses on assets still remaining with an investor or investee shall be eliminated, giving effect to any income taxes on the intra-entity transactions, except for both 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.

Pending Content (Transition Guidance: ASC 606-10-65-1)

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.

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.

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.

35-10 If an investor controls an investee through majority voting interest and enters into a transaction with an investee that is not at arm's length, none of the intra-entity profit or loss from the transaction shall be recognized in income by the investor until it has been realized through transactions with third parties. The same treatment applies also for an investee established with the cooperation of an investor (including an investee established for the financing and operation or leasing of property sold to the investee by the investor) if control is exercised through guarantees of indebtedness, extension of credit and other special arrangements by the investor for the benefit of the investee, or because of ownership by the investor of warrants, convertible securities, and so forth issued by the investee.
ASC 323-10 (continued)

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).

35-12 Example 3 (see paragraph 323-10-55-27) illustrates the application of this guidance.

ASC 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.

35-14 Intra-entity profit shall be eliminated by the investor in relation to the investor's ownership interest in the investee, except that 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.)

Pending Content (Transition Guidance: ASC 606-10-65-1)

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.)

35-15 A sale of property in which the seller holds or acquires an equity interest in the buyer shall result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit shall be recognized if the seller controls the buyer until realized from transactions with outside parties through sale or operations of the property.

Pending Content (Transition Guidance: ASC 606-10-65-1)

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.

Changing Lanes

The pending content included in the ASC excerpts above relates to ASU 2014-09 (as amended by ASU 2017-05), which provides guidance on the recognition and measurement of transfers of nonfinancial assets and is codified in ASC 610-20. See Section 4.2 for details about the general provisions of ASU 2014-09 (as amended by ASU 2017-05). See Deloitte's A Roadmap to Applying the New Revenue Recognition Standard for information regarding the application of ASC 606 and ASC 610-20.
As discussed in Section 10.2.1 of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*, ASC 810-10-45-1 and ASC 810-10-45-18 require intercompany balances and transactions to be eliminated in their entirety. The amount of profit or loss eliminated would not be affected by the existence of a noncontrolling interest (e.g., intra-entity open accounts balances, security holdings, sales and purchases, interest, or dividends). Since consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, the consolidated statements would not include any gain or loss transactions between the entities in the consolidated group.

Although ASC 810 provides for complete elimination of intercompany profits or losses in consolidation, it also states that the elimination of intercompany profit or loss may be allocated proportionately between the parent and noncontrolling interests.

Because the equity method is a one-line consolidation, an investor should eliminate its intra-entity profits or losses resulting from transactions with equity method investees until the investor or the investee realizes the profits or losses through transactions with independent third parties. In applying the equity method, the investor will first need to determine if intra-entity assets remain on the books of either the investor or the investee (e.g., inventory).

If intra-entity assets do not remain on the books of either the investor or the investee, no intra-entity profit or loss elimination is required since the profit or loss has been realized by the investor or the investee through transactions with independent third parties. For instance, an investor may receive a fee for services provided to an equity method investee or vice versa. Such a transaction would generally not result in an intra-entity asset that remains on the books of the investor or the investee. Therefore, a sale by an investor to an equity method investee in which assets do not remain on the books of the investor or the investee is typically recognized in the same manner as a sale to a third party as long as the transaction is conducted at “arm’s length.” Further, in determining whether an investor should recognize the sale, some have historically analogized to the guidance in ASC 970-605-25-3, which requires that the following attributes be present:

a. The substance of the transaction does not significantly differ from its form.

b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.

c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

When performing the analysis about whether an intra-entity sale should be recognized, an investor must determine whether there are any unstated rights or privileges present in the transaction and whether the transaction includes, in whole or in part, a capital contribution or distribution that should be accounted for separately. If recognition of the sale is deemed appropriate, the investor would recognize gross revenue, costs, and profits (or losses) on the transaction, all of which would flow through those respective financial statement line items, as well as its proportionate share of expense recorded by the investee through the application of equity method accounting, which would flow through the same financial statement line item as equity method earnings (losses).

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**Changing Lanes**

Upon an entity’s adoption of ASC 606 and ASC 610-20, ASC 970-605 will be superseded. Therefore, an investor must consider the framework in ASC 606 and ASC 610-20 to determine the appropriate accounting for the provision of services and the sale of assets between an investor and an investee, including whether (1) any elimination is required, (2) the transaction
is at arm's length, and (3) there are any other unstated rights or privileges resulting from the transaction owing to its related-party nature. Further, the investor must consider whether the transaction includes, in whole or in part, a capital contribution or distribution that should be accounted for separately on the basis of the specific facts and circumstances.

If assets do remain on the books of either the investor or investee, the determination of whether all or only the investor's proportionate share of the intra-entity profit or loss is eliminated depends on a careful evaluation of the nature of the relationship between the investor and the investee and whether the intra-entity transaction is conducted at arm's length in the normal course of business. Intra-entity profits or losses eliminated in connection with a sale of assets that are not sold to a third party (e.g., fixed assets) would be recognized over the useful life of those assets. Intra-entity profit or loss elimination is required even if the elimination exceeds the carrying amount of the investor's equity method investment and therefore results in a negative equity method investment balance.

If an intra-entity asset remains on the books of the investor or the investee at the end of the reporting period related to a transaction that is not at arm's length, all the intra-entity profit or loss is eliminated until realized by the investor or investee through transactions with independent third parties.

Changing Lanes
Note that this guidance remains the same upon adoption of ASC 606 and ASC 610-20 (i.e., full elimination is required if the transaction is not at arm's length and an intra-entity asset remains on the books of either the investor or the investee).

The determination of whether an intra-entity transaction is at arm's length involves judgment based on all relevant facts and circumstances. Such a determination would likely include, among other things, (1) an analysis of the transaction's substance, (2) a comparison of the sale price with the fair value of the assets transferred, (3) an evaluation of whether the sale price is collectible, and (4) a comparison of the terms with those of a similar transaction with third parties.

If an intra-entity asset remains on the books of the investor or the investee at the end of the reporting period related to an arm's-length transaction in the normal course of business, the investor would eliminate the intra-entity profit or loss in relation to its proportionate interest in the investee. If the investor is required to eliminate the intra-entity profit or loss only in relation to its proportionate interest, the elimination is the same whether the transaction is “downstream” (i.e., a sale by the investor to the investee) or “upstream” (i.e., a sale by the investee to the investor). The examples below illustrate the elimination of intra-entity profit or loss in both upstream and downstream transactions. Investors and equity method investees that engage in downstream or upstream transactions should consider the related-party disclosure requirements as discussed in Section 6.3.2. Once the intra-entity profit or loss is realized by the investor or investee through transactions with independent third parties (and therefore no intra-entity asset remains), no elimination is required.

Changing Lanes
Upon adoption of ASC 606 and ASC 610-20, if an intra-entity asset remains on the books, the guidance discussed above remains the same (i.e., elimination of the investor's proportionate share of intra-entity profit or loss is required until realized through transactions with third parties when the transaction is (1) at arm's length and (2) either within the scope of ASC 606 or is an upstream transaction within the scope of ASC 610-20). No elimination is required for an intra-entity downstream transaction that is conducted at arm's length and is within the scope of ASC 610-20.
Chapter 5 — Subsequent Measurement

Example 3: Elimination of Intra-Entity Profit

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:

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

Pending Content (Transition Guidance: ASC 606-10-65-1)

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, 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

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

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.

Changing Lanes

The pending content included in the ASC excerpts above relates to the new revenue standard (ASC 606, as amended). The updates within the pending content of the ASC excerpts above simply clarify that 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 ASC 606 on revenue from contracts with customers; however, the analysis and conclusions for the example do not change because of the new revenue standard.
Example 5-9

Investor A holds a 40 percent ownership interest in Investee C and accounts for its investment in C under the equity method. Investee C purchases 10 units of inventory from A in an arm's-length transaction for $1,000 per unit. Investor A's cost associated with each unit of inventory is $600, thus generating an intra-entity profit of $400 for each unit of inventory sold. As of C's balance sheet date, 5 units of inventory were sold to independent third parties and 5 units remain in C's ending inventory. Investor A should eliminate $800 of intra-entity profit ([5 units remaining in C's inventory × $400 profit for each unit of inventory] × A's 40% ownership interest in C).

To reflect this intra-entity profit elimination, A should consider which presentation is most meaningful in the circumstances in accordance with ASC 323-10-55-28. Potential acceptable alternatives for recording the intra-entity profit elimination for this downstream transaction include the following (such alternatives ignore the effect of income taxes):

**Alternative 1:**

<table>
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<tr>
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<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
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<td>800</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>800</td>
</tr>
</tbody>
</table>

**Alternative 2:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>2,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,200</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>800</td>
</tr>
</tbody>
</table>

If the transaction between A and C was not considered to be at arm's length, 100 percent of A's $2,000 profit on the 5 units remaining in C's ending inventory (5 units remaining in ending inventory × $400 profit on each unit) would be eliminated.

The above example represents a downstream transaction; however, if this were an upstream transaction in which C was selling the units of inventory to A, the intra-entity elimination by A could be reflected differently than what is shown depending on the alternative selected by A. Potential acceptable alternatives for recording the intra-entity profit elimination if this were an upstream transaction include the following (such alternatives ignore the effect of income taxes):

**Alternative 1:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method earnings</td>
<td>800</td>
</tr>
<tr>
<td>Equity method investment</td>
<td>800</td>
</tr>
</tbody>
</table>

**Alternative 2:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method earnings</td>
<td>800</td>
</tr>
<tr>
<td>Inventory</td>
<td>800</td>
</tr>
</tbody>
</table>
5.1.5.2 Amortization or Accretion of Basis Differences

ASC 323-10

35-13 A difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary. Paragraph 350-20-35-58 requires that the portion of that difference that is recognized as goodwill not be amortized. However, if a private company elects the accounting alternative in Subtopic 350-20 on goodwill, 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.

35-14 See paragraph 323-10-35-34 for related guidance when an investment becomes subject to the equity method.

ASC 323-10-35-13 requires an investor to account for the “difference between the cost of an [equity method] investment and the amount of underlying equity in net assets of an investee . . . as if the investee were a consolidated subsidiary.” The investor therefore determines any differences between the cost of an equity method investment and the investor’s share of the fair values of the investee’s individual assets and liabilities by using the acquisition method of accounting in accordance with ASC 805. These are known as “investor basis differences” and result from the requirement that the investor allocate the cost of the equity method investment to the investee’s individual assets and liabilities. Any excess of the cost of an equity method investment over the proportional fair value of the investee’s assets and liabilities (commonly referred to as “equity method goodwill”) is recognized in the equity investment balance. See Section 4.5 for details regarding the initial measurement of basis differences.

After initial measurement, ASC 323-10-35-5 specifies that adjustments to the investor’s share of investee earnings or losses (and corresponding adjustments to the carrying value of the equity method investment) are made for amortization or accretion of basis differences (aside from equity method goodwill, which is not amortized unless the PCC alternative is elected — see ASC 323-10-35-13 and Section 5.1.3.2). However, this guidance does not provide specific insights into the determination of the period over which basis differences should be amortized or accreted. Generally, basis differences are amortized or accreted over the life of the underlying assets and liabilities to which the basis differences are attributable. For instance, if a positive basis difference exists because the investor’s proportionate share of the fair value of the investee’s net assets exceeds its book value and the positive basis difference is solely attributable to fixed assets of the equity method investee with an estimated remaining useful life of 25 years, the positive basis difference would be amortized over the 25-year life of those specific fixed assets. The amortization of the positive basis difference would result in increased depreciation expense recognized by the investor related to the fixed assets of the investee to reflect the investor’s basis in the investee, thus reducing the investor’s equity method earnings in each period. Similarly, if a negative basis difference exists because the investor’s proportionate share of the fair value of the investee’s net assets is less than its book value and the negative basis difference is solely attributable to fixed assets of the equity method investee with an estimated remaining useful life of 25 years, the negative basis difference would be accreted over the 25-year life of those specific fixed assets. The accretion of the negative basis difference would result in decreased depreciation expense recognized by the investor related to the fixed assets of the investee to reflect the investor’s basis in the investee, thus increasing the investor’s equity method earnings in each period. See Section 4.5.1 for further discussion of the limited circumstances in which initial negative basis differences are recorded as bargain purchase gains upon initial measurement of an equity method investment.
Example 5-10

Investor X purchases a 40 percent interest in Investee Z for $2 million and applies the equity method of accounting. The book value of Z’s net assets is $3.5 million. The table below shows the book values and fair values of Z’s net assets (along with X’s proportionate share) as of the investment acquisition date.

<table>
<thead>
<tr>
<th>Book Value of Z’s Net Assets (A)</th>
<th>Fair Value of Z’s Net Assets (B)</th>
<th>X’s 40% Share of Z’s Net Assets (Book Value) (C = A × 40%)</th>
<th>X’s 40% Share of Z’s Net Assets (Fair Value) (D = B × 40%)</th>
<th>X’s Basis Differences (D − C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>3,000,000</td>
<td>4,000,000</td>
<td>1,200,000</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>—</td>
<td>300,000</td>
<td>—</td>
<td>120,000</td>
</tr>
<tr>
<td>Equity method goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$3,500,000</td>
<td>$4,800,000</td>
<td>$1,400,000</td>
<td>$1,920,000</td>
</tr>
</tbody>
</table>

* On the basis of the calculations in the above table, the $600,000 difference between the cost of X’s investment ($2 million) and its proportionate share of the book value of Z’s net assets ($1.4 million) is attributable to Z’s fixed assets ($400,000), Z’s patented technology ($120,000), and equity method goodwill ($80,000). The $80,000 of equity method goodwill represents the amount of X’s purchase price in excess of X’s equity in Z’s net assets that is not attributable to Z’s identifiable net assets. The basis differences, including equity method goodwill, are presented as part of X’s overall investment in Z and subsequently tracked in memo accounts. That is, X would not present the $120,000 and $80,000 separately as “intangible asset” and “goodwill,” respectively, on its balance sheet.

As shown in the table above:

- The book values of Z’s current assets and current liabilities approximate their fair values.
- Investor X determined that Z has patented technology that was internally developed; therefore, costs associated with developing this technology were expensed as incurred rather than recorded as an intangible asset on Z’s books. The patented technology has a fair value of $300,000 and a remaining useful life of 30 years as of the investment acquisition date.
- Investor X determined that the fair value of Z’s fixed assets is $4 million with a remaining useful life of 20 years as of the investment acquisition date.

Assume that for the year after the investment acquisition date, Z’s net income is $1 million. Below is a calculation of X’s equity method earnings for the period. Assume that allocations of profit and loss as well as distributions are made in accordance with investor ownership percentages. Further, taxes and intra-entity profit eliminations are ignored for simplicity.
Example 5-10 (continued)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Z's net income</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>X's ownership interest before adjustments</td>
<td>40%</td>
</tr>
<tr>
<td>X's share of Z's net income before adjustments</td>
<td>400,000</td>
</tr>
<tr>
<td><strong>Adjustments for basis differences:</strong></td>
<td></td>
</tr>
<tr>
<td>Fixed assets ($400,000 ÷ 20 years)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Intangible assets ($120,000 ÷ 30 years)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>X's equity method income</td>
<td>$376,000</td>
</tr>
</tbody>
</table>

As shown above, the basis differences attributable to Z's fixed assets and intangible assets are amortized over their estimated remaining useful lives, creating adjustments to X's proportionate share of Z's earnings for the period. As discussed, the $80,000 related to equity method goodwill is not amortized; however, it should be assessed along with the entire equity method investment for impairment in accordance with ASC 323-10-35-32 and 35-32A. See Section 5.5 for further guidance on impairment testing.

5.1.5.3 Investee Capital Transactions

ASC 323-10

35-15 A transaction of an investee of a capital nature that affects the investor's share of stockholders' equity of the investee shall be accounted for on a step-by-step basis.

35-15A For guidance on a share issuance by an investee, see paragraph 323-10-40-1.

Adjustments to an investor's share of equity method earnings or losses (and corresponding adjustments to the carrying value of the equity method investment) may be necessary for certain investee capital transactions, including share issuances, share repurchases, and transactions with noncontrolling interest holders, since all of these transactions may affect the investor's share of the equity method investee's net assets.

5.1.5.3.1 Treasury Share Repurchases

An investee may repurchase its own shares in a treasury stock transaction. This transaction may affect an investor's claim to the investee's net assets.

If the investor participates in the treasury stock transaction (i.e., shares are repurchased from the investor) and it causes a decrease in the investor's claim to the investee's net assets, the investor would need to assess whether the decrease results in a loss of significant influence and account for the decrease accordingly (see Sections 5.6.4 and 5.6.5). If the investor does not participate in the treasury stock transaction (i.e., shares are repurchased from other investors only), there will be an increase in the investor's claim to the investee's net assets; however, there will also be a decrease to the investee's net assets in the amount of consideration paid to repurchase the shares. If there is an increase to the investor's ownership interest with significant influence retained (that is, the investor continues to account for its investment under the equity method), the investor would account for the increase in its claim to the investee's net assets on a step-by-step basis in a manner similar to that in the accounting described in Section 5.6.3. Although the investor has not directly paid consideration for its increase in ownership interest, it has indirectly acquired an additional ownership interest for consideration equal to the investor's proportionate share of the consideration paid by the investee for the repurchase. This transaction would not result in a change to the investor's equity method investment balance, but it would result in a change to the investor's basis differences that are tracked in memo accounts, as illustrated in the example below.
If a treasury stock transaction results in a change to an investor’s ownership interest with significant influence retained, the investor should adjust its share of equity method investee earnings and losses as of the date of the treasury stock transaction to reflect (1) the change in ownership and (2) the impact of any additional basis differences.

**Example 5-11**

Investor X holds a 40 percent interest in Investee Z and applies the equity method of accounting. Investee Z repurchases 10 percent of its outstanding voting common shares from third parties for $500,000, which increases X’s ownership interest in Z to 44 percent. Assume that X does not obtain a controlling financial interest in Z. The book value of Z’s net assets at the time of the repurchase is $4.5 million. Although X has not directly paid consideration for its 4 percent increase in ownership interest, it has indirectly acquired an additional ownership interest for consideration of $200,000, which is equal to its 40 percent proportionate share of the $500,000 of consideration paid by Z for the repurchase. The table below shows the book values and fair values of Z’s net assets at the time of the repurchase (along with a calculation of X’s incremental 4 percent share) as of the share repurchase date. Taxes and intra-entity profit eliminations are ignored for simplicity.

<table>
<thead>
<tr>
<th></th>
<th>Book Value of Z’s Net Assets (A)</th>
<th>Fair Value of Z’s Net Assets (B)</th>
<th>X’s 4% Incremental Share of Z’s Net Assets (Book Value) (C = A × 4%)</th>
<th>X’s 4% Incremental Share of Z’s Net Assets (Fair Value) (D = B × 4%)</th>
<th>X’s Basis Differences (D − C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$40,000</td>
<td>$40,000</td>
<td>—</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>4,000,000</td>
<td>4,400,000</td>
<td>160,000</td>
<td>176,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>—</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>—</td>
<td>100,000</td>
<td>—</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$4,500,000</td>
<td>$5,000,000</td>
<td>$180,000</td>
<td>$200,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

As shown in the table above:

- The book values of Z’s current assets and current liabilities approximate their fair values at the time of repurchase.
- Investor X determined that Z has patented technology that was internally developed; therefore, costs associated with developing this technology were expensed as incurred rather than recorded as an intangible asset on Z’s books. The patented technology has a fair value of $100,000 at the time of repurchase.

On the basis of the calculations in the above table, the $20,000 difference between the cost of X’s investment ($200,000) and its proportionate share of the book value of Z’s net assets ($180,000) is attributable to Z’s fixed assets ($16,000) and Z’s patented technology ($4,000). The basis differences are presented as part of X’s overall investment in Z and subsequently tracked in memo accounts. That is, X would not present the $4,000 separately as an “intangible asset” on its balance sheet.

This transaction would not result in a change to X’s equity method investment balance, but it would result in a change to X’s basis differences that are tracked in memo accounts, as illustrated in the table above. On a prospective basis, X would adjust its share of equity method investee earnings and losses to reflect (1) the 4 percent increase in ownership and (2) the impact of the additional basis differences.
5.1.5.3.2 Shares Issued to Employees of an Investee

If an investee issues additional shares as a result of employees’ exercise of options, an investor should determine the corresponding impact on its ownership interest in the investee. When the investee issues stock compensation awards to its employees, it recognizes stock compensation expense as the awards vest in accordance with ASC 718 with a corresponding increase to additional paid-in capital (APIC) (as long as the awards are classified as equity). During the vesting period, the investor would recognize its share of the stock compensation expense through its equity method pickup; however, there is no guidance regarding the investor’s accounting for the investee’s increase in APIC. Two acceptable methods that are applied in practice are as follows:

- During the vesting period, the investor reflects the change in its share of the investee’s equity as an adjustment to the investor’s equity method investment with a corresponding adjustment to the investor’s own equity. When these adjustments are coupled with the investor’s recognition of its share of the investee’s stock compensation expense through equity earnings (losses), there is ultimately no net impact on the equity method investment account balance. Instead, the resulting net impact is to equity method earnings (losses) and the investor’s own equity.

- During the vesting period, the investor does not make any adjustments to its equity method investment balance but instead tracks its share of the increase in the investee’s APIC as a reconciling item in memo accounts.

We do not believe that the investor should record its share of the investee’s increase in APIC in equity earnings (losses) given that this would essentially negate the impact of recording the investor’s share of the investee’s stock compensation during the vesting period.

Regardless of the method applied during the vesting period, the investor is required to adjust for the change in its share of the investee’s net assets once the options are exercised (shares are issued to the employees in exchange for consideration equal to the exercise price of the options). See Sections 5.6.4 and 5.6.5 for details on accounting for decreases in an investor’s level of ownership or degree of influence.

5.1.5.3.3 Investee Acquisitions and Dispositions of Noncontrolling Interests

An equity method investee may consolidate certain less than wholly owned subsidiaries and present noncontrolling interests in its financial statements. The investee may transact with noncontrolling interest holders, either acquiring or disposing of noncontrolling interests while retaining a controlling financial interest in the subsidiary. As noted in ASC 810-10-45-23, a parent’s acquisition or disposition of any noncontrolling interest should be accounted for as an equity transaction, with any difference between price paid and the carrying amount of the noncontrolling interest reflected directly in equity and not in net income as a gain or loss. Investee-level transactions with noncontrolling interest holders do not directly involve the investor; however, these transactions would affect the investor’s claim to the investee’s net assets because of the change in the investee’s equity.

If the equity method investee acquires a noncontrolling interest while retaining a controlling financial interest in the subsidiary and thereby causes an increase in the equity method investor’s claim to the investee’s net assets, we believe that the investor should account for the increase on a step-by-step basis, as illustrated in Section 5.1.5.3.1.

If the equity method investee’s subsidiary sells existing shares or issues additional shares to another party while retaining a controlling financial interest in the subsidiary (i.e., creates or increases
outstanding noncontrolling interests), the equity method investor should consider the substance of the transaction. We believe that in these circumstances, there are potentially two accounting outcomes:

- If, in substance, the transaction is structured so that the investor essentially sold a portion of its interest in the equity method investee, we believe that it is appropriate to apply ASC 323-10-35-35 and ASC 323-10-40-1, whereby the investor records a gain or loss in equity method earnings (losses). See Section 5.6.4 for details on accounting for decreases in an investor's level of ownership when significant influence is retained.

- We also understand that others believe that the issuance of noncontrolling interests at the investee level while the investee retains a controlling financial interest in the subsidiary generally represents an equity transaction not only for the investee but also for the investor in accordance with ASC 810-10-45-23. Under this accounting outcome, the transaction would be accounted for as a change in the investor's share of the investee's equity as an adjustment to the investor's equity method investment with a corresponding adjustment to the investor's own equity. We believe that either accounting outcome could potentially be acceptable; however, the investor should carefully analyze the transaction and apply the view that best aligns with the substance of the disposal transaction.

For details related to accounting for equity issuances by an investee, see Section 5.6.

5.1.5.4 Other Comprehensive Income

ASC 323-10

35-18 An investor shall record its proportionate share of the investee's equity adjustments for other comprehensive income (unrealized gains and losses on available-for-sale securities; foreign currency items; and gains and losses, prior service costs or credits, and transition assets or obligations associated with pension and other postretirement benefits to the extent not yet recognized as components of net periodic benefit cost) as increases or decreases to the investment account with corresponding adjustments in equity. See paragraph 323-10-35-37 for related guidance to be applied upon discontinuation of the equity method.

An investor should record its proportionate share of an equity method investee's OCI (which may include foreign currency translation adjustments, actuarial gains or losses, and gains and losses on AFS securities, among other items) as an increase or decrease to its equity method investment account for the investee, with a corresponding debit or credit to OCI in its own equity section of the financial statements. See Section 6.2.3 for further discussion of acceptable presentation alternatives related to an investor's share of an equity method investee's OCI. Also, see Section 5.6.5.1 for further discussion of the impact to OCI when there is a decrease in the level of ownership or degree of influence of an equity method investment.

Example 5-12

On December 31, 20X5, Investor G acquires a 25 percent interest in Investee T for $500. Investor G accounts for its investment in T under the equity method. For the year ended December 31, 20X6, T has net income of $1,000 and records a $100 gain in OCI related to an increase in the fair value of its AFS securities. Assuming no basis differences or intra-entity profit or loss eliminations, G should record the following entries for the year ended December 31, 20X6:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method investment</td>
<td>275</td>
</tr>
<tr>
<td>Equity method earnings</td>
<td>250*</td>
</tr>
<tr>
<td>OCI</td>
<td>25**</td>
</tr>
</tbody>
</table>

* This represents G's $250 share of T's net income ($1,000 × 25%), which should be recorded in equity method earnings.

** This represents G's $25 share of T's OCI ($100 × 25%), which should be recorded as a credit in OCI in the equity section of G's balance sheet.
5.1.6 Dividends Received From an Investee

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-17 Dividends received from an investee shall reduce the carrying amount of the investment.</td>
</tr>
</tbody>
</table>

As discussed in Section 5.1, an investor's equity method investment balance is increased by its share of an investee's income and decreased by its share of the investee's losses in the periods in which the investee reports the income and losses rather than in the periods in which the investee declares dividends. Therefore, when dividends or distributions are received from the equity method investee, the investor should record a reduction to its equity method investment balance rather than recording income. See Section 6.2.4 for details related to cash flow classification of dividends and distributions from equity method investees.

To determine whether cash distributions by an equity method investee that exceed an investor's carrying amount should be recorded as income or as a liability, the investor should evaluate whether the following two criteria are met: (1) the distributions are not refundable by agreement, law, or convention\(^7\) and (2) the investor is not liable (and may not become liable) for the obligations of the investee or otherwise committed or expected to provide financial support to the investee. If these two criteria are met, the investor should record the excess cash distributions as income. Otherwise, the investor should record the excess cash distributions as a liability. If the investor suspends equity method loss recognition\(^8\) and has recorded the cash distributions as income or a liability, the investor should record future equity method earnings reported by the investee only after its share of the investee's cumulative earnings during the suspended period exceeds the investor's income or liability recognized for the excess cash distributions.

The guidance above is supported by the AICPA Issues Paper “Accounting by Investors for Distributions Received in Excess of Their Investment in a Joint Venture” (an addendum to the AICPA Issues Paper “Joint Venture Accounting”), issued on October 8, 1979, which states the following in its advisory conclusion:

A noncontrolling investor in a real estate venture should account for cash distributions received in excess of its investment in a venture as income when (a) the distributions are not refundable by agreement or by law and (b) the investor is not liable for the obligations of the venture and is not otherwise committed to provide financial support to the venture.

ASC 970-323-35-3 through 35-10 provide further details about an investor's accounting for its share of losses that are greater than its investment (see Section 5.2). This literature also defines general partnership interests as having unlimited liability; therefore, these interests would meet criterion (2) as described above.

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\(^7\) When the investor is not under a legal obligation to refund its distributions or provide financial support to the investee, it must consider specific facts and circumstances, including the relationship among the investors. For instance, if the investor has a history of refunding distributions provided by the investee or otherwise providing financial support to the investee, the investor may be expected, by convention, to refund its distributions and provide financial support in the future.

\(^8\) In situations in which the investor's share of equity method losses equals or exceeds its equity method investment balance plus any advances, equity method loss recognition should generally be discontinued (that is, the investor should stop reflecting the equity method investee's losses in its financial statements) unless the investor has provided, or committed to provide, the investee additional financial support or the investor has guaranteed the investee's obligations. See Section 5.2 for details.
Example 5-13
Investor A and Investor B form Investee C by investing $1 million each for a 50 percent ownership interest. Investee C is not a VIE under ASC 810-10. Investors A and B both use the equity method to account for their investment in C. Investee C subsequently incurs a U.S. GAAP loss of $2.4 million. As a result, A's and B's investment balances are exceeded by $200,000 each, but because the losses are owing to noncash depreciation expense, C has available cash and distributes $100,000 to both A and B.

The $100,000 distribution made to A is not refundable by agreement, law, or convention, and A is not liable (and may not become liable) for the obligations of C or otherwise committed or expected to provide financial support to C. Therefore, A should reduce its investment in C to zero and record the $100,000 received as income. Investor A would initially record the following journal entry:

```
Equity in earnings/losses of C  1,000,000
Investment in C  1,000,000
Cash  100,000
Income  100,000
```

If C subsequently becomes profitable, A cannot increase its basis in its investment in C until C's cumulative earnings during the suspended period exceed the $100,000 excess distribution. For example, if C subsequently reported earnings of $1.5 million, A would record $450,000 of equity method earnings, which represents A's portion of C's subsequent earnings ($1.5 million × 50% = $750,000), net of A's previously unrecognized losses ($200,000), less income previously recognized by A for the cash distribution ($100,000). The following journal entry would be recorded:

```
Investment in C  450,000
Equity in earnings/losses of C  450,000
```

Example 5-14
Investor A and Investor B form Investee C by investing $1 million each for a 50 percent ownership interest. Investee C is not a VIE under ASC 810-10. Investors A and B both use the equity method to account for their investment in C. Investee C subsequently incurs a U.S. GAAP loss of $2.4 million. As a result, A's and B's investment balances are exceeded by $200,000 each, but because the losses are owing to noncash depreciation expense, C has available cash and distributes $100,000 to both A and B.

The $100,000 distribution made to B is not refundable by agreement, law, or convention, and B is not liable (and may not become liable) for C's obligations. However, B has a history of providing financial support to C. Therefore, B should reduce its investment in C to zero and should record a liability (negative investment balance) of $300,000, representing its initial investment of $1 million less (1) its share of equity in losses of $1.2 million and (2) the cash distributions it received of $100,000. Investor B would initially record the following journal entry:

```
Equity in earnings/losses of C  1,200,000
Investment in C  1,000,000
Liability (negative investment balance)  200,000
Cash  100,000
Liability (negative investment balance)  100,000
```
Example 5-14 (continued)
Investor B would continue to recognize earnings or losses of C under the equity method. However, B would reduce the liability (e.g., negative investment balance) to zero before recording an asset for its share of earnings in C. For example, if C subsequently reported earnings of $1.5 million, B would record $750,000 of equity method earnings, which represents B’s portion of C’s subsequent earnings (50% × $1.5 million). Investor B would record the following journal entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in C</td>
<td>450,000</td>
<td></td>
</tr>
<tr>
<td>Liability (negative investment balance)</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Equity in earnings/losses of C</td>
<td>750,000</td>
<td></td>
</tr>
</tbody>
</table>

Example 5-15
Four investors form Partnership Z, a limited partnership. The table below summarizes the amounts contributed by, and ownership interests of, each investor.

<table>
<thead>
<tr>
<th>Investor</th>
<th>Amount Contributed (in millions)</th>
<th>General Partnership Interest</th>
<th>Limited Partnership Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>$5</td>
<td>1%</td>
<td>4%</td>
</tr>
<tr>
<td>Company B</td>
<td>35</td>
<td></td>
<td>35%</td>
</tr>
<tr>
<td>Company C</td>
<td>30</td>
<td></td>
<td>30%</td>
</tr>
<tr>
<td>Company D</td>
<td>30</td>
<td></td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>$100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Partnership Z is not a VIE under ASC 810-10. Partnership Z acquires an operating real estate project for $180 million, using a nonrecourse mortgage loan to finance the additional $80 million purchase price. Partnership Z subsequently incurs U.S. GAAP losses of $100 million. Therefore, each investor’s investment balance is reduced to zero, but because the losses are owing to noncash depreciation expense, Z has available cash and distributes it to the investors.

As the GP, A is not required to consolidate Z since Z is not a VIE (see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*). Accordingly, A uses the equity method to account for its investment in Z. In these circumstances, A should continue to recognize any future losses of Z and its receipt of the cash distribution by recording a liability (e.g., negative investment balance). For a GP, the existence of nonrecourse debt is not justification for discontinuing the recording of losses or for recognizing a gain for the cash distribution. Because of its general partnership interest, A is legally obligated to provide additional financial support to Z. If A recognizes losses only to the extent of its investment in Z, it would effectively be recognizing a gain on a debt extinguishment that has not occurred, which is prohibited in accordance with ASC 405-20-40-1. Company A would subsequently reduce any liability (negative investment balance) to zero before recording an asset for its share of earnings in Z.

Note that A’s journal entries would be similar to those in Example 5-14.

Company A should also determine whether it is required to absorb any future losses by Z that are otherwise allocable to the other partners. This decision would depend on whether any other partners, by agreement, convention, or otherwise, are required to provide additional support to Z and, if so, whether they have the financial wherewithal to do so.
Example 5-15 (continued)

In accordance with ASC 323-30-S99-1 and ASC 323-30-35-3, B, C, and D also use the equity method to account for their investments in Z. Generally, B, C, and D, as LPs, would not have unlimited liability or a legal or other commitment to further support the partnership. Therefore, B, C, and D should reduce their respective investments to zero and record distributions that exceed their investments as income. If Z subsequently becomes profitable, B, C, and D cannot increase their basis in their investment in Z until Z’s cumulative earnings during the suspended period exceed the excess distribution amount. However, B, C, and D should carefully review contractual arrangements, review past funding practices, and consider other relevant facts and circumstances before reaching this conclusion.

Note that B, C, and D would record journal entries similar to those in Example 5-13.

5.1.7 Interests Held by an Investee

5.1.7.1 Reciprocal Interests

When an investor holds an equity method investment in an investee and the investee concurrently holds an equity method investment in the investor, such investments are known as reciprocal interests. The investor should present reciprocal interests as a reduction of both its investment in the equity method investee and its equity in the investee’s earnings. In practice, there are two methods of calculating the investee’s earnings: the treasury stock method and the simultaneous equations method. Application of the treasury stock method tends to be more common since, as illustrated in Section 6.5 of Deloitte’s A Roadmap to Accounting for Noncontrolling Interests, the simultaneous equations method can be very complex. However, we believe that either method is acceptable as long as an investor applies its selected method consistently to all reciprocal interests. Under the treasury stock method, the equity method investor considers its shares held by the equity method investee to be treasury stock. Therefore, the investor records its share of the investee’s net income exclusive of the equity method earnings from the investee’s equity method investment in the investor. Below is an example illustrating the treasury stock method.

Example 5-16

Entity A owns a 30 percent interest in Entity B, and B owns a 20 percent interest in A. Entity A and B have 10,000 shares and 5,000 shares, respectively, of common stock issued and outstanding, and each entity paid $100 per share for its ownership interests.

Entity A’s basis in its investment in B, B’s basis in A, and A’s corresponding reciprocal interest in A are calculated as follows:

- Entity A’s basis in B = $100/share × (30% × 5,000 shares) = $150,000.
- Entity B’s basis in A = $100/share × (20% × 10,000 shares) = $200,000.
- Entity A’s reciprocal interest in A = 30% × $200,000 = $60,000.

The reduction in A’s investment should be offset by a decrease in retained earnings, and as with treasury stock, the offset to the reduction may be presented as a separate line item in A’s equity section.

**Entity A’s Journal Entries**

**Initial investment in B:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in B</td>
<td>150,000</td>
</tr>
<tr>
<td>Cash</td>
<td>150,000</td>
</tr>
<tr>
<td>To reflect B’s reciprocal interest in A:</td>
<td></td>
</tr>
<tr>
<td>Reciprocal interest in A/treasury stock</td>
<td>60,000</td>
</tr>
<tr>
<td>Investment in B</td>
<td>60,000</td>
</tr>
</tbody>
</table>
Example 5-16 (continued)

Entity B's investment in A and B's reciprocal interest in B would be calculated and accounted for similarly:

- B's basis in A = $100/share × (20% × 10,000 shares) = $200,000.
- A's basis in B = $100/share × (30% × 5,000 shares) = $150,000.
- B's reciprocal interest in B = 20% × $150,000 = $30,000.

**Entity B's Journal Entries**

*Initial investment in A:*

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in A</td>
<td>200,000</td>
<td>Cash</td>
</tr>
<tr>
<td>To reflect A's reciprocal interest in B:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reciprocal interest in B/treasury stock</td>
<td>30,000</td>
<td>Investment in A</td>
</tr>
</tbody>
</table>

If earnings of A, exclusive of any equity in B, total $100,000 ("direct earnings of A") and earnings of B, exclusive of any equity in A, total $50,000 ("direct earnings of B"), net income and EPS for A and B, respectively, are calculated as follows:

**Net income and EPS of A:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Direct earnings of A (before equity in B)</td>
<td>$100,000</td>
</tr>
<tr>
<td>(2) Entity A's equity in direct earnings of B</td>
<td>$15,000</td>
</tr>
<tr>
<td>(3) Net income of A</td>
<td>$115,000</td>
</tr>
<tr>
<td>(4) Entity A's shares for EPS calculation</td>
<td>9,400 shares</td>
</tr>
<tr>
<td>(5) Entity A's EPS</td>
<td>$12.23/share</td>
</tr>
</tbody>
</table>

Although A owns 30 percent of B, A's investment in B is reduced for its ownership interest in itself through B's reciprocal 20 percent ownership interest in A's stock.

**Net income and EPS of B:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Direct earnings of B (before equity in A)</td>
<td>$50,000</td>
</tr>
<tr>
<td>(2) Entity B's equity in direct earnings of A</td>
<td>$20,000</td>
</tr>
<tr>
<td>(3) Net income of B</td>
<td>$70,000</td>
</tr>
<tr>
<td>(4) Entity B's shares for EPS calculation</td>
<td>4,700 shares</td>
</tr>
<tr>
<td>(5) Entity B's EPS</td>
<td>$14.89/share</td>
</tr>
</tbody>
</table>

Although B owns 20 percent of A, B's investment in A is reduced for its ownership interest in itself through A's reciprocal 30 percent ownership interest in B's stock.
5.1.7.2 Earnings or Losses of an Investee’s Subsidiary

As described in Section 3.2.7.1, when an investor accounts for direct interests in both an investee and an investee’s subsidiary under the equity method of accounting, the investor should adjust the investee’s financial information to exclude the earnings or losses of the investee’s subsidiary in which the investor has a direct interest to determine its proportionate share of the investee’s earnings or losses.

Example 5-17

Direct Investment in an Investee’s Consolidated Subsidiary

Entity A owns a 30 percent voting interest in Entity B that is accounted for under the equity method of accounting (i.e., A has ability to exercise significant influence over B) and a 15 percent voting interest in Entity C. Entity B owns an 80 percent voting interest in C that is considered a controlling financial interest, requiring B to consolidate C under ASC 810-10.

Since B controls C, and A has the ability to exercise significant influence over B, A has the ability to exercise significant influence over C, despite the fact that A has only a 15 percent direct voting interest in C. Therefore, A should account for its investment in C under the equity method of accounting.

Entity B’s consolidated financial statements for the year ended 20X6 and A’s proportionate share of earnings (both the correct and incorrect application) are as follows (for simplicity, taxes, intra-entity transactions, and basis differences are ignored):

<table>
<thead>
<tr>
<th>Entity A’s Proportionate Share of Earnings</th>
<th>Correct</th>
<th>Incorrect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from B’s other operations</td>
<td>$500</td>
<td></td>
</tr>
<tr>
<td>Income from C</td>
<td>200</td>
<td>$30 (15% × $200)</td>
</tr>
<tr>
<td>Net income</td>
<td>700</td>
<td>210 (30% × 700)</td>
</tr>
<tr>
<td>Less: Net income attributable to noncontrolling interest in C (20 percent of $200)</td>
<td>(40)</td>
<td></td>
</tr>
<tr>
<td>Net income attributable to controlling interest</td>
<td>660</td>
<td>198 (30% × 660)</td>
</tr>
<tr>
<td>Total share of earnings</td>
<td>$228</td>
<td>$240</td>
</tr>
</tbody>
</table>

The incorrect computation double counts A’s proportionate share of the earnings in C since 100 percent of C’s earnings are included in Net Income (i.e., Net Income has not been adjusted to exclude the net income attributable to the noncontrolling interest, 15 percent of which is attributable to A).
5.1.8 Contingent Consideration

As discussed in Section 4.4, if the acquisition of an equity method investment involves contingent consideration, the contingent consideration is included as part of the initial cost of the equity method investment only if it meets the definition of a derivative instrument under ASC 815 or is required to be recognized by other U.S. GAAP aside from ASC 805. If the contingent consideration arrangement meets the definition of a derivative instrument, the fair value of the derivative is included in the initial cost of the equity method investment. Subsequently, changes to the fair value of the derivative are recorded in the income statement separate from the accounting for the equity method investment. Further, payments under the contingent consideration arrangement represent the settlement of the derivative instrument and therefore should not increase the cost of the equity method investment.

If the contingent consideration arrangement does not meet the definition of a derivative under ASC 815 and is not otherwise required to be recognized by other U.S. GAAP aside from ASC 805, no amounts related to the contingent consideration arrangement should be included as part of the cost of the equity method investment until the contingent consideration payments are made.

If a liability is initially recognized for a contingent consideration arrangement because an investor’s proportionate share of an investee’s net assets is greater than the investor’s initial cost in accordance with ASC 323-10-25-2A, any difference between the ultimate settlement of the contingent consideration and the initial liability recorded should be recognized as an increase or decrease to the cost of the equity method investment.

Example 5-18

Investor Q acquires an equity method investment for $1,250. Investor Q is obligated to pay an additional $100 if certain earnings targets of the investee are reached. Investor Q’s proportionate share of the investee’s net assets is $1,300, which exceeds Q’s initial cost of $1,250. In accordance with ASC 323-10-30-2B, on the date of acquisition, a liability of $50 is recorded (with a corresponding increase to the initial cost of the equity method investment) since this amount is less than the $100 maximum amount of contingent consideration not recognized. If the contingency is resolved after the initial measurement of the equity method investment and a $75 payment related to the contingent consideration arrangement is required, Q would record an increase to its equity method investment of $25. Alternatively, if the contingency is subsequently resolved and only a $20 payment related to the contingent consideration arrangement is required, Q would record a decrease to its equity method investment of $30. The impact to basis differences, if any, should be considered.
5.2  Equity Method Losses That Exceed the Investor's Equity Method Investment Carrying Amount

ASC 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.

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.

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.

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.

ASC 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.

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.

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.
Chapter 5 — Subsequent Measurement

ASC 970-323 (continued)

35-6 An investor in a real estate venture shall report its recorded share of losses in excess of its investment, including loans and advances, as a liability in its financial statements.

35-7 If an investor does not recognize venture losses in excess of its investment, loans, and advances and the venture subsequently reports net income, the investor shall resume applying the equity method only after its share of such net income equals the share of net losses not recognized during the period in which equity accounting was suspended.

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.

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.

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.

35-11 See Section 323-10-35 for additional guidance regarding accounting by equity method investor for investee losses when the investor has both loans and equity interest.

As discussed in Section 5.1, an investor records its proportionate share of an equity method investee’s earnings or losses. In situations in which the investor’s share of equity method losses equals or exceeds its equity method investment balance plus any advances, equity method loss recognition should generally be discontinued (i.e., the investor should stop reflecting the equity method investee’s losses in its financial statements) unless the investor has provided or committed to provide the investee additional financial support or the investor has guaranteed the investee’s obligations. Additional financial support could come in many forms as noted in ASC 323-10-35-19, including additional contributions, investments in common stock, guarantees, loans, and other advances. An obligation or commitment to provide further financial support to the investee could arise because of legal or implied obligations, assumption of liabilities, or other indications, such as reputational concerns or prior funding of losses.

Further, the investor should continue to record its share of the equity method investee’s losses even when its equity method investment balance plus any advances has been reduced to zero when the investee’s imminent return to profitability is assured. This suggests that the decision about whether investors should record the effect of an investee’s losses depends on the extent of the risk (i.e., the risk that the investors ultimately will bear the consequences of continued losses).
If the investor is required to continue recording its share of equity method investee losses, it should present any losses that exceed its equity method investment balance (negative equity method investment) as a liability.

If the investor suspends equity method loss recognition, it should record future equity method earnings reported by the investee only after its share of the investee's earnings equals its share of losses not recognized during the suspended period. Therefore, the investor must ensure it is appropriately tracking its unrecorded losses during the suspended period.

The treatment described in this section is different from the consolidation procedures described in ASC 810-10 when an investor consolidates a less than wholly owned subsidiary. Specifically, noncontrolling interests are considered equity of the consolidated group that participate fully in the risks and rewards of the subsidiary. Accordingly, with limited exception, losses generally continue to be attributed to noncontrolling interests regardless of whether a deficit would be accumulated. See Section 6.2 of Deloitte’s A Roadmap to Accounting for Noncontrolling Interests for details.

The investor should also consider whether it is probable (under ASC 450-20) that other investors will be able to bear their share of the equity method investee's losses. If not, and the investor has provided or committed to provide additional financial support to the investee, the investor should record its share of the losses otherwise attributable to the investors that cannot bear their share of the investee's losses. When the investee subsequently reports income, the investor that absorbed losses attributable to other investors should record the other investors' share (in addition to its own share) of the investee's income until it equals the excess losses previously recorded. The investors that are considered unable to bear their share of losses should nonetheless continue to record their contractual share of losses until they are contractually or legally released from their obligation to fund losses.

The examples below illustrate the evaluation of whether (1) the investor has provided or committed to provide the investee additional financial support or (2) the investor has guaranteed the investee's obligations, thus requiring that the investor continue recording equity method losses that exceed the investor's equity method investment carrying amount.

### Example 5-19

Investor A owns 15 percent of Limited Partnership B and accounts for its investment in B under the equity method in accordance with ASC 323-30-599-1 and ASC 970-323-25-6. Limited Partnership B has incurred, and continues to incur, losses, and A is aware that the other partners in B cannot bear their share of the losses since they lack the financial capacity to fund ongoing operations of B and their capital accounts have been reduced to zero. Because A becomes the sole source of funding to support the continuing operations of B, A should record 100 percent of B's losses in its equity method accounting.
Example 5-20

Investors B, C, D, and E enter into an investor arrangement that does not require any of the investors to guarantee the obligations or to provide for any future funding requirements of the investee. However, a provision does exist whereby B could be required to pay C up to $25 million if certain conditions have been met. Assume that none of those conditions would require B to provide support directly or indirectly to the investee. Also assume that B's investment in the investee is zero.

Investor B should not reduce its investment in the investee to a negative amount for its portion of losses after formation of the investee, despite its potential obligation to C. Equity method investors should not record additional equity method losses when their investment is zero and they are not required to provide further financial support to the investee, as stated in ASC 323-10-35-20. Investor B has not guaranteed the obligations of the investee and is not otherwise obligated to provide it future financial support. Although B could be required to compensate C if certain events occur, B is not obligated to the investee itself. Therefore, B would not be required to reduce its investment below zero for additional investee losses.

Note that B would consider whether the arrangement with C requires accounting under other U.S. GAAP (e.g., as a guarantee under ASC 460).

Example 5-21

Investors B, C, D, and E each have a 25 percent ownership in Investee F and account for their investments under the equity method. Profits and losses are shared equally. Investee F has had continuing operating losses. As a result, B's investment in F has been reduced to zero. Further, B has guaranteed F's line of credit (LOC) jointly and severally with the other investors. Investor B has no collateral or other arrangements with F, the holder of the LOC, or the other investors or their related parties. While F has not yet drawn down on the LOC, it is expected to draw the full amount in the near future. Therefore, B has determined that it should recognize further losses for its investment in F under the provisions of ASC 323-10-35-21.

If the other investors in F are proven to be financially solvent and can fund their pro rata portion, it would be appropriate for B to record its proportionate share of losses in each period, up to its pro rata share of the LOC. However, if one or more of the investors demonstrates questionable financial stability, B should evaluate its risk under the agreement and record losses accordingly.

Further assume that F draws down on the LOC for its full facility of $5 million and reports a loss of $1 million. Investor B concludes that the other investors are financially solvent. Investor B should record a $250,000 loss in its financial statements for its proportionate share of losses. Investor B would continue to record its proportionate share of losses in each period, up to its 25 percent pro rata share of the outstanding amount of the LOC ($1.25 million). If B determines that it is probable that it will pay $5 million to the holder of the LOC because of the financial condition of F and the other investors, B should record a loss of $5 million.

5.2.1 Guarantee of an Equity Method Investee’s Third-Party Debt

See Section 4.2.1 for further discussion of the accounting when a guarantee is issued by the investor in conjunction with the equity method investee's formation or is issued after formation as required by the formation documents. As noted in Section 4.2.1, we generally believe that, in the absence of substantive evidence to the contrary, the value of the guarantee would be included in the initial measurement of the equity method investment (i.e., the debit entry would be recorded to the equity method investment account rather than to expense) given that it is more likely that the guarantee was issued to balance the investor’s investment in the investee.
A guarantee that is not contemplated or required by the formation documents may be issued after the equity method investee’s formation. In such a situation, if the investor does not receive any consideration from the equity method investee or the other investors for issuing the guarantee, the investor should recognize a guarantee liability initially at fair value in accordance with ASC 460-10-25-3 and 25-4 and ASC 460-10-30-2. When the investor initially recognizes a guarantee liability related to a guarantee issued after the investee’s formation, the investor should use judgment to allocate the initial fair value of the guarantee between its interest in the equity method investee and that of other investors. The investor should do the following:

- Expense the portion of the debit entry related to noncontributing investors.
- Record the portion of the debit entry related to the investor’s interest in the equity method investee as an increase in its investment in the equity method investee and amortize that portion over the life of the guarantee.

5.2.2 Collateral of the Investee Held by the Investor When Equity Losses Exceed the Investor’s Investment

An investor may provide a loan to an equity method investee or guarantee a third-party loan held by the investee that is collateralized by the investee’s underlying assets. Further, the appraised value of the assets may be greater than the combined outstanding loan amount.

If the investor’s share of the investee’s cumulative losses exceeds the investor’s equity investment and loan balances, it would not be appropriate for the investor to avoid recording equity losses associated with the guarantee of the investee’s loans because the liquidation value of the collateral it holds exceeds the amount of the guarantee. In other words, the investor should not consider the liquidation value of collateral to offset the guarantee. However, it may be appropriate for the investor to consider the liquidation value of collateral when recognizing investee losses if all the following conditions are met:

- The operations related to the assets that serve as collateral do not represent a large percentage of the investee’s operations, and removal of the assets would not preclude the investee’s continued operations.
- The investor has the ability and intent to take possession of the collateral if it is required to honor the guarantee. That is, the investor has the ability to obtain clear title to the collateral, notwithstanding any potential claims that other third parties may have.
- The investor could use the equipment in its own operations or has sufficient experience with and access to a market for assets that serve as collateral so that it can sell and realize the collateral’s value.

If the collateral is essential to the investee’s operations, the first condition would not be met. We expect that it would be rare for all these conditions to be met.

5.2.3 Investee Losses If the Investor Has Other Investments in the Investee

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-23 The guidance in the following paragraph applies to situations in which both of the following conditions exist:</td>
</tr>
<tr>
<td>a. An investor is not required to advance additional funds to an investee.</td>
</tr>
<tr>
<td>b. Previous losses have reduced the common stock investment account to zero.</td>
</tr>
</tbody>
</table>
### ASC 323-10 (continued)

**35-24** In the circumstances described in the preceding paragraph, 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 Subtopics 310-10 and 320-10 to the other investments, as applicable.

### Pending Content (Transition Guidance: ASC 825-10-65-2)

**35-24** In the circumstances described in the preceding paragraph, 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.

**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 securities classified as trading in accordance with Subtopic 320-10 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 securities first).

### Pending Content (Transition Guidance: ASC 825-10-65-2)

**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).

### Pending Content (Transition Guidance: ASC 326-10-65-1)

**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).
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 scopes of Subtopics 310-10 or 320-10, 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 its seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the 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 and 320-10 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 scopes of Subtopics 310-10 or 320-10.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.
When an investor does not have a requirement or commitment to advance additional funds to an investee and losses have reduced its common stock equity method investment balance to zero, the investor should continue to record its share of equity method losses to the extent the investor has other investments (e.g., preferred stock, loans to the investee, other securities) in the equity method investee. The SEC staff has held that all investments and advances other than receivables are presumed to fund the investee’s operating losses.

Equity method losses should be applied in order of seniority of the investor’s other investments, starting with the most subordinated investment. The investor’s other investments are first adjusted for equity method losses and then may be adjusted further on the basis of the application of other U.S. GAAP to those specific investments (e.g., ASC 310-10, ASC 320-10, and so forth). ASC 323-10-35-25 provides guidance on determining the cost basis of an investor’s other investments and indicates that adjustments should be made to the original cost of the other investments for OTTIs, unrealized gains and losses, and amortization of discounts or premiums on debt securities or loans. The cost basis of the other investments is further adjusted for valuation allowances on investee loans in accordance with ASC 310-10 and cumulative equity method losses.
Once an investee begins to report equity method income, the income should first be applied to the adjusted basis of the investor’s other investments starting with the most senior investment (the reverse order of the application of losses described above).

The example below in ASC 323-10-55-30 through 55-47 illustrates the above guidance.

**Example 4: Investee Losses If the Investor Has Other Investments in Investee**

**55-30** This Example illustrates the application of paragraph 323-10-35-24 to an investment involving all of the following circumstances:

a. Investor owns 40 percent of the outstanding common stock of Investee.

b. The common stock investment has been reduced to zero at the beginning of 20X1 because of previous losses.

c. Investor also has done both of the following:
   1. Invested $100 in preferred stock (classified as an available-for-sale security) of Investee (40 percent of the outstanding preferred stock of Investee)
   2. Extended $100 in loans to Investee (which represent 40 percent of all loans extended to Investee).

d. Investor is not obligated to provide any additional funding to Investee.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

**55-30** This Example illustrates the application of paragraph 323-10-35-24 to an investment involving all of the following circumstances:

a. Investor owns 40 percent of the outstanding common stock of Investee.

b. The common stock investment has been reduced to zero at the beginning of 20X1 because of previous losses.

c. Investor also has done both of the following:
   1. Invested $100 in redeemable preferred stock (that meets the definition of debt security and is classified as an available-for-sale debt security) of Investee (40 percent of the outstanding preferred stock of Investee)
   2. Extended $100 in loans to Investee (which represent 40 percent of all loans extended to Investee).

d. Investor is not obligated to provide any additional funding to Investee.

**55-31** In accordance with paragraphs 323-10-35-7 and 323-10-35-16, Investee's operating income and losses in the following table have been adjusted for intra-entity interest on the loan and dividends received or receivable on the preferred stock. As of the beginning of year 20X1, the carrying value of Investor's total combined investment in Investee is $200, as follows.

<table>
<thead>
<tr>
<th>Carrying Balance</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$ —</td>
</tr>
<tr>
<td>Loan</td>
<td>$ 100</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>$ 100</td>
</tr>
</tbody>
</table>
Assume the following facts for years 20X1 through 20X7.

<table>
<thead>
<tr>
<th>Year</th>
<th>Investee Operating Income (Loss)</th>
<th>Carrying Value of the Loan Under Subtopic 310-10</th>
<th>Fair Value of the Preferred Stock Under Subtopic 320-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$(200)</td>
<td>95</td>
<td>$90</td>
</tr>
<tr>
<td>20X2</td>
<td>(400)</td>
<td>95</td>
<td>90</td>
</tr>
<tr>
<td>20X3</td>
<td>—</td>
<td>60</td>
<td>50</td>
</tr>
<tr>
<td>20X4</td>
<td>400</td>
<td>95</td>
<td>90</td>
</tr>
<tr>
<td>20X5</td>
<td>—</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>20X6</td>
<td>—</td>
<td>95</td>
<td>90</td>
</tr>
<tr>
<td>20X7</td>
<td>1,000</td>
<td>100</td>
<td>(a)</td>
</tr>
</tbody>
</table>

(a) Preferred stock was sold for $90 on January 2, 20X7.

Following are the steps Investor would follow in applying the equity method of accounting to its investment in Investee during the years 20X1 through 20X7.

Investor would make all of the following entries in 20X1:

a. In accordance with this Subtopic, record the equity method loss (40% × $200 = $80) to the cost basis of the preferred stock (the next level of capital) at the time that the common stock investment becomes zero.

   Equity method loss 80
   Preferred stock investment 80

b. In accordance with Subtopic 310-10, record a valuation allowance for the impaired loan.

   Loan loss expense 5
   Loan loss valuation allowance 5

c. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $90 less the carrying amount after entry [a] of $20, equals $70 unrealized gain).

   Preferred stock investment 70
   Unrealized gain — other comprehensive income 70
ASC 323-10 (continued)

Pending Content (Transition Guidance: ASC 326-10-65-1)

55-34 Investor would make all of the following entries in 20X1:

a. In accordance with this Subtopic, record the equity method loss (40% × $200 = $80) to the cost basis of the preferred stock (the next level of capital) at the time that the common stock investment becomes zero.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss</td>
<td>80</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>80</td>
</tr>
</tbody>
</table>

b. In accordance with Subtopic 326-20 on financial instruments measured at amortized cost, record an allowance for credit losses on the loan.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>5</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>5</td>
</tr>
</tbody>
</table>

c. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $90 less the carrying amount after entry [a] of $20, equals $70 unrealized gain).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock investment</td>
<td>70</td>
</tr>
<tr>
<td>Unrealized gain — other comprehensive income</td>
<td>70</td>
</tr>
</tbody>
</table>

55-35 In 20X1, the total profit-and-loss charge is $85 ($80 for the equity method loss and $5 for the loan). Other comprehensive income is credited $70 for the preferred stock investment. The carrying amount of the total combined investment in Investee is reduced to $185 ($0 for the common stock investment, $95 for the loan, and $90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of $70. The adjusted basis of the total combined investment in Investee is reduced to $115 ($0 for the common stock investment, $95 for the loan, and $20 for the preferred stock investment).

55-36 Investor would make both of the following entries in 20X2:

a. In accordance with this Subtopic, record the equity method loss (40% × $400 = $160) to the adjusted basis of the preferred stock of $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 level of capital). The total equity method loss recorded would be limited, however, to the adjusted basis of the total combined investment in Investee of $115; therefore, $45 of equity method losses are unreported.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss</td>
<td>115</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>20</td>
</tr>
<tr>
<td>Loan</td>
<td>95</td>
</tr>
</tbody>
</table>

b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $90 less the carrying amount after entry [a] of $70, equals $20 unrealized gain).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock investment</td>
<td>20</td>
</tr>
<tr>
<td>Unrealized gain — other comprehensive income</td>
<td>20</td>
</tr>
</tbody>
</table>
Chapter 5 — Subsequent Measurement

ASC 323-10 (continued)

55-37 In 20X2, the total profit-and-loss charge is $115 (equity method loss). Other comprehensive income is credited $20 for the preferred stock investment. The carrying amount of the total combined investment in Investee is reduced to $90 ($0 for the common stock investment, $0 for the loan, and $90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of $90. The adjusted basis of the total combined investment in Investee is reduced to $0 ($0 for the common stock investment, $0 for the loan, and $0 for the preferred stock investment).

55-38 In 20X3, there is no equity method income or loss (40% × $0 = $0). Investor would make both of the following entries in 20X3:
   a. Because the adjusted basis of the loan was reduced to zero in 20X2 as a result of applying equity method losses to the loan, no entry is needed to reflect the Subtopic 310-10 reduction in carrying amount from $95 to $60.
   b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $50 less the carrying amount of $90 equals $40 unrealized loss).

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized loss — other comprehensive income</td>
<td>40</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>40</td>
</tr>
</tbody>
</table>

Pending Content (Transition Guidance: ASC 326-10-65-1)

55-38 In 20X3, there is no equity method income or loss (40% × $0 = $0). Investor would make both of the following entries in 20X3:
   a. Because the adjusted basis of the loan was reduced to zero in 20X2 as a result of applying equity method losses to the loan, no entry is needed to reflect the Subtopic 326-20 reduction in carrying amount from $95 to $60.
   b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (fair value of $50 less the carrying amount of $90 equals $40 unrealized loss).

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized loss — other comprehensive income</td>
<td>40</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>40</td>
</tr>
</tbody>
</table>

55-39 In 20X3, other comprehensive income is debited $40 for the preferred stock investment. The carrying amount of the total combined investment in Investee is reduced to $50 ($0 for the common stock investment, $0 for the loan, and $50 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of $50. The adjusted basis of the total combined investment in Investee remains $0.
ASC 323-10 (continued)

55-40 Investor would make both of the following entries in 20X4:

a. In accordance with this Subtopic, record the equity method income (40% × $400 = $160). However, in accordance with this Subtopic, Investor resumes applying the equity method only after its share of that income equals the unreported equity method losses of $45. Therefore, the equity method income to be reported for the period is $115 ($160–$45). The adjusted bases of the other investments are restored in the reverse order of the application of the equity method losses (loan first, then preferred stock).

```
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan</td>
<td>95</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>20</td>
</tr>
<tr>
<td>Equity method income</td>
<td>115</td>
</tr>
</tbody>
</table>
```

b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $90 less the carrying amount of $70 equals $20 unrealized gain).

```
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock investment</td>
<td>20</td>
</tr>
<tr>
<td>Unrealized gain — other comprehensive income</td>
<td>20</td>
</tr>
</tbody>
</table>
```

55-41 In 20X4, the total profit-and-loss credit is $115 (the equity method income after Investor’s share of unreported equity method losses of $45 in 20X2). Other comprehensive income is credited $20 for the preferred stock investment. The carrying amount of the total combined investment in Investee is increased to $185 ($0 for the common stock investment, $95 for the loan, and $90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of $70. The adjusted basis of the total combined investment in Investee is increased to $115 ($0 for the common stock investment, $95 for the loan, and $20 for the preferred stock investment).

55-42 In 20X5, there is no equity method income or loss (40% × $0 = $0). Investor would make both of the following entries in 20X5:

a. In accordance with Subtopic 310-10, record a valuation allowance for the impaired loan.

```
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan loss expense</td>
<td>50</td>
</tr>
<tr>
<td>Loan loss valuation allowance</td>
<td>50</td>
</tr>
</tbody>
</table>
```

b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $55 less the carrying amount of $90 equals $35 unrealized loss).

```
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized loss — other comprehensive income</td>
<td>35</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>35</td>
</tr>
</tbody>
</table>
```

Pending Content (Transition Guidance: ASC 326-10-65-1)

55-42 In 20X5, there is no equity method income or loss (40% × $0 = $0). Investor would make both of the following entries in 20X5:

a. In accordance with Subtopic 326-20, record an allowance for credit loss for the loan.

```
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit loss expense</td>
<td>50</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>50</td>
</tr>
</tbody>
</table>
```

b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $55 less the carrying amount of $90 equals $35 unrealized loss).

```
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized loss — other comprehensive income</td>
<td>35</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>35</td>
</tr>
</tbody>
</table>
55-43 In 20X5, the total profit-and-loss charge is $50 (from the loan). Other comprehensive income is debited $35 for the preferred stock investment. The carrying amount for the total combined investment in Investee is reduced to $100 ($0 for the common stock investment, $45 for the loan, and $55 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of $35. The adjusted basis of the total combined investment in Investee is reduced to $65 ($0 for the common stock investment, $45 for the loan, and $20 for the preferred stock investment).

55-44 In 20X6, there is no equity method income or loss (40% × $0 = $0). Investor would make both of the following entries in 20X6:

a. In accordance with Subtopic 310-10, adjust the valuation allowance for change in the expected future cash flows from the loan.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan loss valuation</td>
<td>50</td>
</tr>
<tr>
<td>Loan loss expense</td>
<td></td>
</tr>
</tbody>
</table>

b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $90 less the carrying amount of $55 equals $35 unrealized gain).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock investment</td>
<td>35</td>
</tr>
<tr>
<td>Unrealized gain — other comprehensive income</td>
<td>35</td>
</tr>
</tbody>
</table>

Pending Content (Transition Guidance: ASC 326-10-65-1)

55-44 In 20X6, there is no equity method income or loss (40% × $0 = $0). Investor would make both of the following entries in 20X6:

a. In accordance with Subtopic 326-20, adjust the allowance for credit losses on the loan.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>50</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td></td>
</tr>
</tbody>
</table>

b. In accordance with Subtopic 320-10, record the changes in fair value for the available-for-sale preferred stock investment (market price of $90 less the carrying amount of $55 equals $35 unrealized gain).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock investment</td>
<td>35</td>
</tr>
<tr>
<td>Unrealized gain — other comprehensive income</td>
<td>35</td>
</tr>
</tbody>
</table>

55-45 In 20X6, the total profit-and-loss credit is $50 (from the loan). Other comprehensive income is credited $35 for the preferred stock investment. The carrying amount of the total combined investment in Investee is increased to $185 ($0 for the common stock investment, $95 for the loan, and $90 for the preferred stock investment), and the balance in accumulated other comprehensive income is a credit of $70. The adjusted basis of the total combined investment in Investee is increased to $115 ($0 for the common stock investment, $95 for the loan, and $20 for the preferred stock investment).
55-46 Investor would make all of the following entries in 20X7:

a. Record the sale of the preferred stock.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>90</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>70</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>90</td>
</tr>
<tr>
<td>Gain on sale of security</td>
<td>70</td>
</tr>
</tbody>
</table>

b. In accordance with this Subtopic, record the equity method income (40% × $1,000 = $400). Although Investor has recorded losses for all prior Investee losses, $80 of such recorded losses (representing the difference between the cost basis of the preferred stock investment of $100 and its adjusted basis of $20) have effectively been reversed in entry (a) by recording a $70 gain on the sale of the preferred stock when an actual loss of $10 (representing the difference between the cost basis of the preferred stock investment of $100 and the proceeds of $90) was incurred. Accordingly, only $320 of equity method income should be recorded ($400–$80).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in investee (common)</td>
<td>320</td>
</tr>
<tr>
<td>Equity method income</td>
<td>320</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan loss valuation allowance</td>
<td>5</td>
</tr>
<tr>
<td>Loan loss expense</td>
<td>5</td>
</tr>
</tbody>
</table>

55-46 Investor would make all of the following entries in 20X7:

a. Record the sale of the preferred stock.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>90</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>70</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>90</td>
</tr>
<tr>
<td>Gain on sale of security</td>
<td>70</td>
</tr>
</tbody>
</table>

b. In accordance with this Subtopic, record the equity method income (40% × $1,000 = $400). Although Investor has recorded losses for all prior Investee losses, $80 of such recorded losses (representing the difference between the cost basis of the preferred stock investment of $100 and its adjusted basis of $20) have effectively been reversed in entry (a) by recording a $70 gain on the sale of the preferred stock when an actual loss of $10 (representing the difference between the cost basis of the preferred stock investment of $100 and the proceeds of $90) was incurred. Accordingly, only $320 of equity method income should be recorded ($400–$80).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in investee (common)</td>
<td>320</td>
</tr>
<tr>
<td>Equity method income</td>
<td>320</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>5</td>
</tr>
<tr>
<td>Credit loss expense</td>
<td>5</td>
</tr>
</tbody>
</table>
In 20X7, the total profit-and-loss credit is $395 ($70 gain from the sale of the preferred stock, $320 for the equity method income, and $5 from the loan). The carrying value of the total combined investment in Investee is increased to $420 ($320 for the common stock investment and $100 for the loan), and the balance in accumulated other comprehensive income is $0. The adjusted basis of the total combined investment in Investee is increased to $420 ($320 for the common stock investment, $100 for the loan, and $0 for the preferred stock investment).

**5.2.3.1 Percentage Used to Determine the Amount of Equity Method Losses**

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.
ASC 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.

When an investor’s common stock equity method investment has been reduced to zero and the investor has other investments in an investee, the amount of equity method loss to be recognized in each period should not be based solely on the percentage of ownership, as stated in ASC 323-10-35-28, which was initially introduced by EITF Issue 99-10. While the EITF did not reach a consensus on a single method of recognition, it acknowledged that various approaches may be acceptable and that an entity should use one entity-wide method that is disclosed in the footnotes to the financial statements. The example below from ASC 323-10-55-48 through 55-57 illustrates two potential acceptable methods of recognition (one based on the ownership level of each specific investment and the other based on the change in the investor’s claim on the investee’s book value).

ASC 323-10

Example 5: Percentage Used to Determine the Amount of Equity Method Losses

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).

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.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>$ 100</td>
</tr>
<tr>
<td>Loan</td>
<td>$ 100</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$(160)</td>
</tr>
<tr>
<td>20X2</td>
<td>$(200)</td>
</tr>
<tr>
<td>20X3</td>
<td>$ 500</td>
</tr>
</tbody>
</table>
**ASC 323-10 (continued)**

g. Investee’s balance sheet is as follows.

<table>
<thead>
<tr>
<th></th>
<th>1/1/X1</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>$ 367</td>
<td>$ 207</td>
<td>$ 7</td>
<td>$ 507</td>
</tr>
<tr>
<td><strong>Loan</strong></td>
<td>$ 167</td>
<td>$ 167</td>
<td>$ 167</td>
<td>$ 167</td>
</tr>
<tr>
<td><strong>Preferred stock</strong></td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td><strong>Common stock</strong></td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td><strong>Accumulated deficit</strong></td>
<td>(300)</td>
<td>(460)</td>
<td>(660)</td>
<td>(160)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 367</td>
<td>$ 207</td>
<td>$ 7</td>
<td>$ 507</td>
</tr>
</tbody>
</table>

**Case A: Ownership Level of Particular Investment**

**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.

**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% × $160 = $80). Investor A would record the following journal entry.

```
Equity method loss                                  80
Preferred stock investment                         80
```

**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% × $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% × $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
```

**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% × $160 = $96), then to the preferred stock until its adjusted basis is restored (50% × $200 = $100), and finally to the common stock (40% × $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**

**55-54** Under this approach, Investor A would recognize equity method losses based on the change in the investor’s claim on the investee’s book value.
### ASC 323-10 (continued)

**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% × $333.33 = $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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss</td>
<td>80</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>80</td>
</tr>
</tbody>
</table>

**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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity method loss</td>
<td>116</td>
</tr>
<tr>
<td>Preferred stock investment</td>
<td>20</td>
</tr>
<tr>
<td>Loan</td>
<td>96</td>
</tr>
</tbody>
</table>

**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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan</td>
<td>96</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>100</td>
</tr>
<tr>
<td>Investment in investee</td>
<td>56</td>
</tr>
<tr>
<td>Equity method income</td>
<td>252</td>
</tr>
</tbody>
</table>
5.2.4 Additional Investment After Suspension of Loss Recognition

**ASC 323-10**

35-29 If a subsequent investment in an investee does not result in the ownership interest increasing from one of significant influence to one of control and, in whole or in part, represents, in substance, the funding of prior losses, the investor should recognize previously suspended losses only up to the amount of the additional investment determined to represent the funding of prior losses (see (b)). Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances. Judgment is required in determining whether prior losses are being funded and all available information should be considered in performing the related analysis. All of the following factors shall be considered; however, no one factor shall be considered presumptive or determinative:

a. Whether the additional investment is acquired from a third party or directly from the investee. If the additional investment is purchased from a third party and the investee does not obtain additional funds either from the investor or the third party, it is unlikely that, in the absence of other factors, prior losses are being funded.

b. The fair value of the consideration received in relation to the value of the consideration paid for the additional investment. For example, if the fair value of the consideration received is less than the fair value of the consideration paid, it may indicate that prior losses are being funded to the extent that there is disparity in the value of the exchange.

c. Whether the additional investment results in an increase in ownership percentage of the investee. If the investment is made directly with the investee, the investor shall consider the form of the investment and whether other investors are making simultaneous investments proportionate to their interests. Investments made without a corresponding increase in ownership or other interests, or a pro rata equity investment made by all existing investors, may indicate that prior losses are being funded.

d. The seniority of the additional investment relative to existing equity of the investee. An investment in an instrument that is subordinate to other equity of the investee may indicate that prior losses are being funded.

35-30 Upon making the additional investment, the investor should evaluate whether it has become otherwise committed to provide financial support to the investee.

In situations in which equity method losses have reduced an investor’s equity method investment balance to zero and the investor makes an additional contribution to an equity method investee for no additional ownership interest, the investor must first determine whether this additional investment provides it with a controlling financial interest in the investee. See Section 5.6 for further discussion related to accounting for changes in the level of ownership or degree of influence of an investee.

If the additional contribution does not result in a change from significant influence to control, the investor must determine whether the additional investment in the investee represents the funding of prior losses. ASC 323-10-35-29 discusses factors to consider in the determination of whether additional investments in an investee represent funding of prior losses when the investor has suspended equity method loss recognition in accordance with ASC 323-10-35-20 and ASC 323-10-35-23 through 35-26. This determination involves significant judgment, and the investor should consider all relevant facts and circumstances.

The factors in ASC 323-10-35-29 suggest that if the additional investment is determined, in substance, to be a funding of prior losses, the investor should recognize any prior suspended losses up to the amount of this investment. The investor should also evaluate whether the additional investment results in a commitment to provide financial support to the equity method investee. If the additional investment is not considered to be a funding of prior losses, the investor should account for the additional investment by using the equity method, including recording its share of equity method losses incurred after the additional investment is made. However, the investor would not recognize any prior suspended losses related to its initial investment.
5.3  Stock-Based Compensation Granted by an Investor to Employees of an Equity Method Investee

ASC 323-10

25-3 The guidance in the following paragraph and paragraph 323-10-25-5 addresses the accounting for stock-based compensation based on the investor's stock granted to employees of an investee accounted for under the equity method if 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 stock-based compensation to employees 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 stock-based compensation granted to employees 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).

Pending Content (Transition Guidance: ASC 718-10-65-11)

Editor's Note: The content of 323-10-25-3 will change upon transition, together with a change in the heading noted below.

Stock-Based Compensation Granted to Employees and Nonemployees of an Equity Method Investee

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).

25-4 In the circumstances described in the preceding paragraph, a contributing investor shall expense the cost of stock-based compensation granted to employees 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.

Pending Content (Transition Guidance: ASC 718-10-65-11)

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.
25-5 In the circumstances described in paragraph 323-10-25-3, other equity method investors in an investee (that is, noncontributing investors) shall recognize income equal to the amount that their interest in the investee’s net book value has increased (that is, their percentage share of the contributed capital recognized by the investee) as a result of the disproportionate funding of the compensation costs. Further, those other equity method investors shall recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf).

Pending Content (Transition Guidance: ASC 718-10-65-11)

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).

25-6 Example 2 (see paragraph 323-10-55-19) illustrates the application of this guidance.

Pending Content (Transition Guidance: ASC 718-10-65-11)

25-6 Example 2 (see paragraph 323-10-55-19) illustrates the application of this guidance for share-based compensation granted to employees of an equity method investee.

30-3 Stock-based compensation cost recognized in accordance with paragraph 323-10-25-4 shall be measured initially at fair value in accordance with Topic 718 and Subtopic 505-50. Example 2 (see paragraph 323-10-55-19) illustrates the application of this guidance.

Pending Content (Transition Guidance: ASC 718-10-65-11)

Editor’s Note: The content of 323-10-30-3 will change upon transition, together with a change in the heading noted below.

Share-Based Compensation Granted to Employees and Nonemployees of an Equity Method Investee

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.

ASC 323-10 — SEC Materials — SEC Staff Guidance

SEC Observer Comment: Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee

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.
Changing Lanes

The pending content included in the ASC excerpts in this section relates to ASU 2018-07, which updates the scope of ASC 718 to include share-based payment transactions for the acquisition of goods or services from nonemployees and supersedes ASC 505-50. ASU 2018-07 is effective for annual periods beginning after December 15, 2018, for PBEs and after December 15, 2019, for all other entities, with early adoption permitted.

Share-based payment awards that are issued to employees of an equity method investee and that are indexed to, or settled in, the equity of the investor are not within the scope of ASC 718. This conclusion is supported by analogy to paragraph 10 of FASB Interpretation 44. While the guidance in Interpretation 44 was nullified by FASB Statement 123(R), the conclusion in paragraph 10 of Interpretation 44 remains applicable by analogy since it is the only available guidance on this issue. Paragraph 10 of Interpretation 44 states, in part:

[Opinion No. 25] does not apply to the accounting by a grantor for stock compensation granted to nonemployees. For example, Opinion 25 does not apply to the accounting by a corporate investor of an unconsolidated investee (or a joint venture owner) for stock options or awards granted by the investor (owner) to employees of the investee (joint venture) accounted for under the equity method because the grantees are not employees of the grantor.

However, since neither Interpretation 44 nor ASC 718 specifically addresses the accounting for these awards, an entity must account for them under other guidance. Such guidance includes ASC 323-10-25-3 through 25-5 and ASC 505-10-25-3, which address the accounting related to the financial statements of the equity method investor, the equity method investee, and the noncontributing investor(s).

5.3.1 Accounting in the Financial Statements of the Contributing Investor Issuing the Awards

ASC 323-10-25-3 and 25-4 indicate that an investor should recognize (1) the entire cost (not just the portion of the cost associated with the investor’s ownership interest) of the share-based payment awards granted to employees of an investee as an expense and (2) a corresponding amount recognized in the investor’s equity. However, the cost associated with the investor’s ownership interest will be recognized as an expense when it records its share of the investee’s earnings (because its share of the investee’s earnings includes the awards’ expense). In addition, the entire cost (and corresponding equity) should be recorded as incurred (i.e., in the same period(s) as if the investor had paid cash to the investee’s employees). The cost of the share-based payment awards is a fair-value-based amount that is consistent with the guidance in ASC 718 and ASC 505-50. In the absence of a performance commitment under ASC 505-50, the awards are remeasured at a fair-value-based amount in each reporting period until performance is complete (i.e., usually the vesting date of the award). As noted in ASC 323-10-S99-4, “[i]nvestors 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.” Although ASC 323-10-S99-4 references SEC registrants, reporting entities that are not SEC registrants should consider applying the same guidance.

5.3.2 Accounting in the Financial Statements of the Investee Receiving the Awards

ASC 505-10-25-3 indicates that an investee should recognize (1) the entire cost of the share-based payment awards incurred by an investor on the investee’s behalf as compensation cost and (2) a corresponding amount as a capital contribution. The cost of the share-based payment awards is a fair-value-based amount that is consistent with the guidance in ASC 718 and ASC 505-50. In addition, the
compensation cost (and corresponding capital contribution) should be recorded as incurred (i.e., in the same period(s) as if the investor had paid cash to the investee's employees). Like the investor, in the absence of a performance commitment under ASC 505-50, the investee would remeasure the awards at a fair-value-based amount in each reporting period until performance is complete.

5.3.3 Accounting in the Financial Statements of the Noncontributing Investors

ASC 323-10-25-5 states that the 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 capital contribution by the investor issuing the awards. In addition, the noncontributing investors “shall recognize their percentage share of earnings or losses in the investee (inclusive of any expense recognized by the investee for the stock-based compensation funded on its behalf).” That is, the noncontributing investors should recognize their share of the investee's earnings or losses (including the compensation cost recognized for the share-based payment awards issued by the equity method investor) in accordance with ASC 323-10. As noted in ASC 323-10-S99-4, “[i]nvestors 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.” Although ASC 323-10-S99-4 references SEC registrants, reporting entities that are not SEC registrants should consider applying the same guidance.

ASC 323-10-55-19 through 55-26 provide an illustrative example of accounting for stock compensation granted by an investor to employees of an equity method investee:

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-19 This Example illustrates the guidance in paragraphs 323-10-25-3 and 323-10-30-3 for stock-based compensation by an investor granted to employees of an equity method investee. This Example assumes that no estimate was made of forfeiture of awards before vesting; Topic 718 requires an estimate of forfeitures to be made.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 718-10-65-6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-19 This Example illustrates the guidance in paragraphs 323-10-25-3 and 323-10-30-3 for stock-based compensation by an investor granted to employees of an equity method investee.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 718-10-65-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Editor's Note:</strong> The content of 323-10-55-19 will change upon transition, together with a change in the heading noted below.</td>
</tr>
<tr>
<td><strong>Example 2: Share-Based Compensation Granted to Employees of an Equity Method Investee</strong></td>
</tr>
<tr>
<td>55-19 This Example illustrates the guidance in paragraphs 323-10-25-3 and 323-10-30-3 for share-based compensation by an investor granted to employees of an equity method investee. This Example is equally applicable to share-based awards granted by an investor to nonemployees that provide goods or services to an equity method investee that are used or consumed in the investee's operations.</td>
</tr>
</tbody>
</table>
**ASC 323-10 (continued)**

**55-20** Entity A owns a 40 percent interest in Entity B and accounts for its investment under the equity method. On January 1, 2001, Entity A grants 10,000 stock options (in the stock of Entity A) to employees of Entity B. The stock options cliff-vest in three years. If an employee of Entity B fails to vest in a stock option, the option is returned to Entity A (that is, Entity B does not retain the underlying stock). The owners of the remaining 60 percent interest in Entity B have not shared in the funding of the stock options granted to employees of Entity B on any basis and Entity A was not obligated to grant the stock options under any preexisting agreement with Entity B or the other investors. Entity B will capitalize the stock-based compensation costs recognized over the first year of the three-year vesting period as part of the cost of an internally constructed fixed asset (the internally constructed fixed asset will be completed on December 31, 2001).

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

**55-20** Entity A owns a 40 percent interest in Entity B and accounts for its investment under the equity method. On January 1, 20X1, Entity A grants 10,000 stock options (in the stock of Entity A) to employees of Entity B. The stock options cliff-vest in three years. If an employee of Entity B fails to vest in a stock option, the option is returned to Entity A (that is, Entity B does not retain the underlying stock). The owners of the remaining 60 percent interest in Entity B have not shared in the funding of the stock options granted to employees of Entity B on any basis and Entity A was not obligated to grant the stock options under any preexisting agreement with Entity B or the other investors. Entity B will capitalize the share-based compensation costs recognized over the first year of the three-year vesting period as part of the cost of an internally constructed fixed asset (the internally constructed fixed asset will be completed on December 31, 20X1).

**55-21** Before granting the stock options, Entity A's investment balance is $800,000, and the book value of Entity B's net assets equals $2,000,000. Entity B will not begin depreciating the internally constructed fixed asset until it is complete and ready for its intended use and, therefore, no related depreciation expense (or compensation expense relating to the stock options) will be recognized between January 1, 2001, and December 31, 2001. For the years ending December 31, 2002, and December 31, 2003, Entity B will recognize depreciation expense (on the internally constructed fixed asset) and compensation expense (for the cost of the stock options relating to Years 2 and 3 of the vesting period). After recognizing those expenses, Entity B has net income of $200,000 for the fiscal years ending December 31, 2001, December 31, 2002, and December 31, 2003.

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

**55-21** Before granting the stock options, Entity A's investment balance is $800,000, and the book value of Entity B's net assets equals $2,000,000. Entity B will not begin depreciating the internally constructed fixed asset until it is complete and ready for its intended use and, therefore, no related depreciation expense (or compensation expense relating to the stock options) will be recognized between January 1, 20X1, and December 31, 20X1. For the years ending December 31, 20X2, and December 31, 20X3, Entity B will recognize depreciation expense (on the internally constructed fixed asset) and compensation expense (for the cost of the stock options relating to Years 2 and 3 of the vesting period). After recognizing those expenses, Entity B has net income of $200,000 for the fiscal years ending December 31, 20X1, December 31, 20X2, and December 31, 20X3.

**55-22** Entity C also owns a 40 percent interest in Entity B. On January 1, 2001, before granting the stock options, Entity C's investment balance is $800,000.

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

**55-22** Entity C also owns a 40 percent interest in Entity B. On January 1, 20X1, before granting the stock options, Entity C's investment balance is $800,000.
Chapter 5 — Subsequent Measurement

ASC 323-10 (continued)

55-23 Assume that the fair value of the stock options granted by Entity A to employees of Entity B is $120,000, $150,000, and $120,000, on December 31, 2001, December 31, 2002, and December 31, 2003, respectively. Under Subtopic 505-50, the fair value of stock-based compensation shall be remeasured at each reporting date until a measurement date occurs. In this Example, assume that the measurement date occurs when the employees of Entity B vest in (complete the performance necessary to earn) the stock options.

Pending Content (Transition Guidance: ASC 718-10-65-11)

55-23 Assume that the fair value of the stock options granted by Entity A to employees of Entity B is $120,000 on January 1, 20X1. Under Topic 718, the fair value of share-based compensation should be measured at the grant date. This Example assumes that the stock options issued are classified as equity and ignores the effect of forfeitures.

55-24 Entity A would make the following journal entries.

<table>
<thead>
<tr>
<th>Date</th>
<th>Entity A (Contributing Investor)</th>
<th>Entity B (Investee)</th>
<th>Entity C (noncontributing investor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2001</td>
<td>Investment in Entity B(a) 16,000</td>
<td>40,000</td>
<td>Investment in Entity B 16,000</td>
</tr>
<tr>
<td></td>
<td>Expense(b) 24,000</td>
<td>—</td>
<td>Contribution income(e) 16,000</td>
</tr>
<tr>
<td></td>
<td>Additional paid-in capital 40,000</td>
<td>60,000</td>
<td>20,000</td>
</tr>
<tr>
<td>12/31/2002</td>
<td>Investment in Entity B 24,000</td>
<td>—</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>Expense 36,000</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Additional paid-in capital 60,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>12/31/2003</td>
<td>Investment in Entity B 8,000</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Expense 12,000</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Additional paid-in capital 20,000</td>
<td>20,000</td>
<td></td>
</tr>
</tbody>
</table>

To record cost of stock compensation and Entity C’s additional investment for costs incurred by Entity A on behalf of investee

To record Entity A’s and Entity C’s share of the earnings of investee (same entry for both Entity A and Entity C)
**ASC 323-10 (continued)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity A</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>96,000</td>
<td>104,000</td>
<td>88,000</td>
</tr>
<tr>
<td>Expense</td>
<td>24,000</td>
<td>36,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>40,000</td>
<td>60,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Equity in earnings of Entity B</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Entity C</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>96,000</td>
<td>104,000</td>
<td>88,000</td>
</tr>
<tr>
<td>Contribution income</td>
<td>16,000</td>
<td>24,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Equity in earnings of Entity B</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
</tbody>
</table>

(a) Entity A recognizes as an expense the portion of the costs incurred that benefits the other investors (in this Example, 60 percent of the cost of $24,000 in 2001, $36,000 in 2002, and $12,000 in 2003) and recognizes the remaining cost (40 percent) as an increase to the investment in Entity B. As Entity B has recognized the cost associated with the stock-based compensation incurred on its behalf, the portion of the cost recognized by Entity A as an increase to its investment in Entity B (40 percent) is expensed in the appropriate period when Entity A recognizes its share of the earnings of Entity B.

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

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

---

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

55-24 Entity A would make the following journal entries.

<table>
<thead>
<tr>
<th></th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity A (Contributing Investor)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>16,000</td>
<td>16,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Expense</td>
<td>24,000</td>
<td>24,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Entity B (investee)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Asset</td>
<td>40,000</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Expense</td>
<td>—</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Entity C (noncontributing investor)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>16,000</td>
<td>16,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Contribution income</td>
<td>16,000</td>
<td>16,000</td>
<td>16,000</td>
</tr>
</tbody>
</table>
### Pending Content (Transition Guidance: ASC 718-10-65-11) (continued)

<table>
<thead>
<tr>
<th></th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>To record Entity A's and Entity C's share of the earnings of investee (same entry for both Entity A and Entity C)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Equity in earnings of Entity B</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Consolidated impact of all the entries made by Entity A and Entity C</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Entity A</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>96,000</td>
<td>96,000</td>
<td>96,000</td>
</tr>
<tr>
<td>Expense</td>
<td>24,000</td>
<td>24,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Equity in earnings of Entity B</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Entity C</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Entity B</td>
<td>96,000</td>
<td>96,000</td>
<td>96,000</td>
</tr>
<tr>
<td>Contribution income</td>
<td>16,000</td>
<td>16,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Equity in earnings of Entity B</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
</tbody>
</table>

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

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

(c) This amount represents Entity C's 40 percent interest in the additional paid-in capital recognized by Entity B related to the cost incurred by the third-party investor. It may be appropriate to classify the credit (income) within the same income statement caption as equity in earnings of Entity B.
### ASC 323-10 (continued)

**55-25** A rollforward of Entity B’s net assets and a reconciliation to Entity A’s and Entity C’s ending investment accounts follows.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net assets of Entity B</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning net assets</td>
<td>$ 2,000,000</td>
<td>$ 2,240,000</td>
<td>$ 2,500,000</td>
</tr>
<tr>
<td>Contributed capital</td>
<td>40,000</td>
<td>60,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Net income</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Ending net assets</td>
<td>$ 2,240,000</td>
<td>$ 2,500,000</td>
<td>$ 2,720,000</td>
</tr>
<tr>
<td>Entity A’s and Entity C’s share</td>
<td>× 40%</td>
<td>× 40%</td>
<td>× 40%</td>
</tr>
<tr>
<td>Entity A’s and Entity C’s equity in net assets of Entity B</td>
<td>896,000</td>
<td>1,000,000</td>
<td>1,088,000</td>
</tr>
<tr>
<td>Entity A’s and Entity C’s ending investment balance</td>
<td>896,000</td>
<td>1,000,000</td>
<td>1,088,000</td>
</tr>
<tr>
<td>Remaining unamortized basis difference</td>
<td>$ —</td>
<td>$ —</td>
<td>$ —</td>
</tr>
</tbody>
</table>

### Pending Content (Transition Guidance: ASC 718-10-65-11)

**55-25** A rollforward of Entity B’s net assets and a reconciliation to Entity A’s and Entity C’s ending investment accounts follows.

<table>
<thead>
<tr>
<th></th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net assets of Entity B</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning net assets</td>
<td>$ 2,000,000</td>
<td>$ 2,240,000</td>
<td>$ 2,480,000</td>
</tr>
<tr>
<td>Contributed capital</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Net income</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Ending net assets</td>
<td>$ 2,240,000</td>
<td>$ 2,480,000</td>
<td>$ 2,720,000</td>
</tr>
<tr>
<td>Entity A’s and Entity C’s share</td>
<td>× 40%</td>
<td>× 40%</td>
<td>× 40%</td>
</tr>
<tr>
<td>Entity A’s and Entity C’s equity in net assets of Entity B</td>
<td>896,000</td>
<td>992,000</td>
<td>1,088,000</td>
</tr>
<tr>
<td>Entity A’s and Entity C’s ending investment balance</td>
<td>896,000</td>
<td>992,000</td>
<td>1,088,000</td>
</tr>
<tr>
<td>Remaining unamortized basis difference</td>
<td>$ —</td>
<td>$ —</td>
<td>$ —</td>
</tr>
</tbody>
</table>
### 55-26 A summary of the calculation of stock-based compensation cost by year follows.

**Calculation of the Stock-Based Compensation Cost by Year**

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>A = Fair Value of Options</th>
<th>B = % Vested</th>
<th>C = (A × B) Amount of Cumulative Compensation Cost to be Recognized</th>
<th>D = Cumulative Cost Previously Recognized</th>
<th>E = C – D Current Year Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$120,000</td>
<td>33%</td>
<td>$40,000</td>
<td>$—</td>
<td>$40,000</td>
</tr>
<tr>
<td>2002</td>
<td>$150,000</td>
<td>66%</td>
<td>$100,000</td>
<td>$40,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>2003</td>
<td>$120,000</td>
<td>100%</td>
<td>$120,000</td>
<td>$100,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

### Pending Content (Transition Guidance: ASC 718-10-65-11)

**55-26 A summary of the calculation of share-based compensation cost by year follows.**

**Calculation of the Stock-Based Compensation Cost by Year**

<table>
<thead>
<tr>
<th>Year Ended</th>
<th>A = Grant Date Fair Value of Options</th>
<th>B = % Vested</th>
<th>C = (A × B) Amount of Cumulative Compensation Cost to be Recognized</th>
<th>D = Cumulative Cost Previously Recognized</th>
<th>E = C – D Current Year Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$120,000</td>
<td>33%</td>
<td>$40,000</td>
<td>$—</td>
<td>$40,000</td>
</tr>
<tr>
<td>20X2</td>
<td>$120,000</td>
<td>66%</td>
<td>$80,000</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>20X3</td>
<td>$120,000</td>
<td>100%</td>
<td>$120,000</td>
<td>$80,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

### Changing Lanes

The pending content included in the ASC excerpts in this section relates to ASU 2016-09 and ASU 2018-07. ASU 2016-09 simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows.

ASU 2016-09 is effective for annual periods beginning after December 15, 2016, for PBEs and after December 15, 2017, for all other entities, with early adoption permitted. The updates in the pending content of the ASC excerpts above simply remove the statement that ASC 718 requires an estimate of forfeitures. Since Example 2 in ASC 323-10-55-19 through 55-26 above assumes that no forfeiture estimates were made before vesting, ASU 2016-09 would have no impact on the guidance in this section.
ASU 2018-07 updates the scope of ASC 718 to include share-based payment transactions for the acquisition of goods or services from nonemployees and supersedes ASC 505-50. See Section 5.3 for details. The updates in the pending content of ASC 323-10-55-19 expand the scope of Example 2 to also be applicable to share-based awards granted by an investor to nonemployees that provide goods or services to an equity method investee that are used or consumed in the investee’s operations.

5.3.4 Stock-Based Compensation Granted by an Investor to Employees of an Equity Method Investee When the Investee Reimburses the Contributing Investor

If an investee reimburses a contributing investor for share-based payment awards, the contributing investor generally records income, with a corresponding amount recorded in equity, in the same periods as the cost that is recognized for issuing the awards. Therefore, the issuance of the awards by the contributing investor and the subsequent reimbursement by the investee may not affect the net income (loss) of the contributing investor. That is, if the reimbursement received by the investor equals the compensation cost recognized for the awards granted, the cost of issuing the awards and the income for their reimbursement will be equal and offsetting and will be recorded in the same reporting periods in the contributing investor’s income statement.

If an investee reimburses a contributing investor for share-based payment awards, the investee generally accrues a dividend to the contributing investor for the amount of the reimbursement in the same periods as the capital contribution from the contributing investor. The recognition of a dividend is generally appropriate given that the issuance of the awards resulted in a capital contribution from the contributing investor. See Section 5.3.2 for a more detailed discussion of the accounting by the investee related to the awards.

If an investee reimburses a contributing investor for share-based payment awards, the noncontributing investor or investors generally recognize a loss equal to the amount by which their interest in the investee’s net book value has decreased (i.e., their percentage share of the distributed capital recognized by the investee) as a result of the reimbursement to the contributing investor. The recognition of a loss by the noncontributing investor is typically appropriate given that its interest in the investee’s net book value has decreased as a result of the reimbursement provided to the investor issuing the awards.

Because U.S. GAAP do not explicitly address the accounting for an arrangement whereby the investee reimburses the contributing investor, other views may be acceptable for the accounting by the contributing investor, the investee, and the noncontributing investor.

5.4 Costs Incurred on Behalf of an Investee

The guidance in ASC 323-10-25-3 through 25-5, which was initially introduced by EITF Issue 00-12 (see Section 5.3), examines situations in which an additional investment made by an investor is not determined to be a funding of prior losses and considers the manner in which (i.e., capitalization or expense), and period(s) over which, the investor should account for any costs incurred on behalf of an investee. The following are two different views proposed by the EITF regarding how an investor should recognize the many types of expenditures it might incur on behalf of an investee:

- **View A** — The investor should record the expenditures as expenses “to the extent that the investor’s claim on the investee’s book value has not been increased.” If the investor’s claim on the investee’s book value has been increased (e.g., when the cost incurred by the investor is capitalized by the investee), the investor should recognize the portion of the expenditures represented by the increase as an additional investment in the investee.
• **View B** — The investor should recognize the expenditures as an increase in its investment in the investee. The investor would then recognize its share of the earnings or losses of the investee, inclusive of the costs incurred, on the basis of its ownership percentage in the investee. The remainder of the cost incurred (the percentage of the cost that benefits the other investors) results in an originated-basis difference between the investor’s investment balance and its underlying equity in net assets of the investee. This difference should be accounted for in a manner similar to that described in ASC 323-10-35-34, whereby the difference is attributed to specific individual assets or liabilities of the investee, and any residual excess of the cost of the investment over the proportional fair value of the investee’s assets and liabilities is treated as equity method goodwill. When attributing the basis difference to the investee’s underlying net assets, the investor should consider the relevant facts and circumstances, including the nature of the expenditures. See Sections 4.5 and 5.1.5.2, respectively, for initial measurement of and subsequent accounting for basis differences.

After the EITF considered these two alternatives, the scope of the discussion and consensus in EITF 00-12 (as codified in ASC 323-10-25-3 through 25-5) was narrowed to focus only on the costs of investor stock-based compensation granted by the investor to employees of the equity method investee, and not on contributions in other forms. When investor stock-based compensation costs are incurred, the consensus of ASC 323-10-25-3 through 25-5 would be followed. That is, the contributing investor would expense the cost of investor stock-based compensation granted to employees of an equity method investee as incurred (i.e., as the contribution is recognized by the investee) to the extent that the investor’s claim on the investee’s book value has not increased (see Section 5.3).

However, for costs that do not represent investor stock-based compensation costs incurred by the contributing investor on behalf of the equity method investee for no additional ownership interest, and when no proportionate funding is provided by the other equity holders, we believe that View B would generally be appropriate, after consideration of the provisions of ASC 323-10-35-29 (see Section 5.2.4). Although the investor’s contribution may not result in an additional ownership interest for that investor, the contribution would presumably be made to enhance the investor’s investment or would result in the investee’s avoiding costs, benefiting the investor indirectly.

Some possible exceptions to View B are when the investor makes a contribution or receives a separate benefit from the equity method investment itself. In such cases, View A should be followed.

---

**Example 5-22**

Investor W holds an investment in Investee M, which owns the mineral rights to an exploratory mining project. Investee M is in the development stage with no revenue or forms of debt financing and has no other assets or activities other than those related to the mining project. Investor W accounts for its investment in M under the equity method. Investor W elects to fund 100 percent of M’s exploration costs incurred for the calendar year. These exploration payments are expected to cover all of M’s exploration program costs and allow M to complete its exploration phase. The exploration payments do not represent a funding of prior losses.

Although W will not receive an additional ownership in M when it funds the exploration costs, these contributions enhance W’s investment because M does not have to bear the economic burden that it would have otherwise incurred if W had not made these contributions. Given M’s capital structure, W will provide all of M’s operating financing during this exploration phase of the mining project. The viability of M, as an entity in the development stage with no revenue or forms of debt financing, depends wholly on W’s equity commitment, and thus the contributions will enhance the value of W’s investment. Therefore, in these circumstances, it is appropriate for W to recognize the exploration payments as an increase to the carrying value of its investment in M in accordance with View B. The costs attributable to the noncontributing investor(s) result in an originated-basis difference between W’s investment balance and its underlying equity in M’s net assets. This basis difference would be attributable to the underlying investee’s mineral rights property asset and would be amortized over the life of that asset.
5.5 Decrease in Investment Value and Impairment

**ASC 323-10**

35-31 A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that shall be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.

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.

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.

**ASC 320-10 — SEC Materials — SEC Staff Guidance**

SAB Topic 5.M, Other Than Temporary Impairment of Certain Investments in Equity Securities

S99-1 The following is the text of SAB Topic 5.M, Other Than Temporary Impairment of Certain Investments in Equity Securities.

Facts: FASB ASC paragraph 320-10-35-33 (Investments—Debt and Equity Securities Topic) does not define the phrase “other than temporary” for available-for-sale equity securities. For its available-for-sale equity securities, Company A has interpreted “other than temporary” to mean permanent impairment. Therefore, because Company A’s management has not been able to determine that its investment in Company B’s equity securities is permanently impaired, no realized loss has been recognized even though the market price of Company B’s equity securities is currently less than one-third of Company A’s average acquisition price.

Question: For equity securities classified as available-for-sale, does the staff believe that the phrase “other than temporary” should be interpreted to mean “permanent”?  

Interpretive Response: No. The staff believes that the FASB consciously chose the phrase “other than temporary” because it did not intend that the test be “permanent impairment,” as has been used elsewhere in accounting practice.\(^\text{[FN8]}\)

\(^{[FN8]}\) [Original footnote removed by SAB 114.]

The value of investments in equity securities classified as available-for-sale may decline for various reasons. The market price may be affected by general market conditions which reflect prospects for the economy as a whole or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the realizable value of its investment in equity securities classified as available-for-sale.

There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The staff believes that the following are only a few examples of the factors which, individually or in combination, indicate that a decline in value of an equity security classified as available-for-sale is other than temporary and that a write-down of the carrying value is required:

a. The length of the time and the extent to which the market value has been less than cost;  

b. The financial condition and near-term prospects of the issuer, including any specific events which 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; or
c. 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. Unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment in equity securities classified as available-for-sale, a write-down to fair value accounted for as a realized loss should be recorded. Such loss should be recognized in the determination of net income of the period in which it occurs and the written down value of the investment in the company becomes the new cost basis of the investment.

Pending Content (Transition Guidance: ASC 825-10-65-2)

*Editor’s Note:* Paragraph 320-10-S99-1 will be superseded upon transition, together with its headings:

**Staff Accounting Bulletins**

*SAB Topic 5.M, Other Than Temporary Impairment of Certain Investments in Equity Securities*


**ASC 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.

35-13 If a transaction with a real estate venture confirms that there has been a loss in the value of the asset sold that is other than temporary and that has not been recognized previously, the loss shall be recognized on the books of the transferor.

**Changing Lanes**

The pending content included for ASC 320-10-S99-1 above relates to **ASU 2018-04**, which supersedes SEC Materials in accordance with SAB 117. SAB 117 conforms existing guidance with ASC 321 and **SEC Final Rule Release No. 33-9273**, which removed SEC Regulation S-X, Rule 3A-05, “Special Requirements as to Public Utility Holding Companies.” The effective date of ASU 2018-04 is the same as the effective date of ASU 2016-01 (see Section 2.3.3).

An investor must determine whether its equity method investment is impaired when certain indications are present even if an investee has not recognized impairments of its assets. In addition, an equity method investment may be impaired in an amount greater than impairments recognized by the investee. Although a current fair value below the recorded investment is an indicator of impairment, the investor should recognize an impairment only if the loss in value is deemed to be an OTTI. As discussed further in Section 5.5.1, the investor may use the SEC guidance in ASC 320-10-S99-1 when determining whether an OTTI exists for an equity method investment. If an impairment of an equity method investment is determined to be other than temporary, the investor must record an impairment charge sufficient to reduce the investment’s carrying value to its fair value, which results in a new cost basis. This new cost basis cannot subsequently be written up to a higher value as a result of increases in fair value. The investor should apply the equity method of accounting to the new cost basis in its investment by recording its share of subsequent income or loss of the investee in a manner consistent with the accounting method used before the OTTI (see Section 5.1).

9 OTTI classification does not mean that the impairment is permanent.
The investor should not test the investee’s underlying assets for impairment; rather, the investor should test the equity method investment for impairment as its own unit of account. Also, ASC 323-10-35-32A requires the investor to “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.” However, the investor must nonetheless ensure that the amounts recognized comply with U.S. GAAP. Therefore, the investor should consider if impairment indicators exist at the investee level that were not recognized but should have been in accordance with U.S. GAAP.

5.5.1 Identifying Impairments

ASC 323-10-35-31 and 35-32 provide certain factors that may be indicative of an impairment, including:

- “A series of operating losses of an investee.”
- The “absence of an ability to recover the carrying amount of the investment.”
- The “inability of the investee to sustain an earnings capacity.”
- “A current fair value of an investment that is less than its carrying amount.”

In addition to these factors, ASC 320-10-S99-1 provides guidance on the other-than-temporary loss in value of an investment and includes three indicators of such a loss:

a. The length of the time and the extent to which the market value has been less than cost;
b. The financial condition and near-term prospects of the issuer, including any specific events which 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; or
c. 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.

SEC Accounting and Auditing Enforcement Release Nos. 309, 316, 370, and 422 provide additional factors to evaluate in the determination of an OTTI, including the following:

- The condition and trend of the economic cycle.
- The issuer’s financial performance and projections.
- Trends in the general market.
- The issuer’s capital strength.
- The issuer’s dividend payment record.
- Whether other adverse conditions at the investee level are further indicators of an other-than-temporary diminution in value, including:
  - Known liquidity crisis.
  - Bankruptcy proceedings.
  - Going-concern commentary in the auditor’s report on the investee’s most recent financial statements.

Although this SEC guidance in ASC 320-10-S99-1 directly relates to securities with readily determinable fair values, the indicators and discussion are helpful for the evaluation of any equity method investment. Any impairment analysis will require a careful consideration of all the facts and circumstances, with no individual factor being determinative. Note, however, that when an equity method investment has a readily determinable value, it is more difficult to overcome the indication of impairment (e.g., by performing an internal discounted cash flow analysis that contradicts the market value).
An investor is required to test certain long-lived assets for recoverability by using undiscounted cash flows as a first step in determining whether an impairment loss should be recognized under ASC 360-10; however, equity method investments are outside the scope of ASC 360-10. At the 2002 AICPA Conference on Current SEC Developments, the SEC staff indicated that it would object to the use of an undiscounted cash flow analysis under ASC 360-10 for the determination of whether an equity method investment is impaired. In addition, at the March 17–18, 2004, EITF meeting, during deliberations of EITF Issue 03-1, the SEC observer stated that registrants “should continue to rigorously assess equity method investments for impairment” and that the “SEC staff will continue to object to inappropriate impairment analyses for such investments, for example a Statement 144 undiscounted cash flow approach.” Thus, it would not be appropriate to conclude that an impairment of an equity method investment does not exist simply because the investment’s undiscounted cash flows exceed its carrying amount. An investor should consider all factors, as well as the severity and duration of the equity method investment’s decline in value, when determining whether an impairment is other than temporary. However, if the equity method investment’s undiscounted cash flows are less than its carrying amount, this is a strong indicator of an impairment.

The table below outlines factors that may indicate that an equity method investment’s decline in value is an OTTI as well as those that may indicate that it is not an OTTI.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>OTTI</th>
<th>Not an OTTI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Length of time that the fair value is below the investor’s carrying value</td>
<td>Prolonged period.</td>
<td>Short period, generally measured in months rather than in years.</td>
</tr>
<tr>
<td>Current expected performance relative to expected performance when the investor initially invested in the investee</td>
<td>Current expected performance is significantly worse than anticipated when the investor initially invested in the investee.</td>
<td>Current expected performance is consistent with the level anticipated when the investor initially invested in the investee.</td>
</tr>
<tr>
<td>Performance relative to peers</td>
<td>The investee is performing significantly worse than peer companies.</td>
<td>The investee is performing in a manner that is commensurate with peer companies.</td>
</tr>
<tr>
<td>Industry performance relative to economy</td>
<td>The investee’s industry is declining and significantly lags the performance of the economy as a whole.</td>
<td>The investee’s industry is performing in a manner that is consistent with the general economy as a whole.</td>
</tr>
<tr>
<td>Credit rating</td>
<td>The investee’s credit rating has been downgraded.</td>
<td>No significant change in the investee’s credit rating has occurred.</td>
</tr>
<tr>
<td>Regulatory action</td>
<td>Adverse regulatory action is expected to substantially reduce the investee’s product demand or profitability.</td>
<td>No significant adverse regulatory actions against the investee have occurred.</td>
</tr>
<tr>
<td>Loss of principal customers or suppliers</td>
<td>The investee has lost significant customers or suppliers with no immediate prospects for replacement.</td>
<td>The investee has maintained significant customers and suppliers or has identified replacements for those expected to be lost.</td>
</tr>
<tr>
<td>Discounted cash flows</td>
<td>The investee’s discounted cash flows are below the investor’s carrying amount.</td>
<td>The investee’s discounted cash flows are greater than the investor’s carrying amount.</td>
</tr>
<tr>
<td>Undiscounted cash flows</td>
<td>The investee’s undiscounted cash flows are below the investor’s carrying amount.</td>
<td>The evaluation of the investee’s undiscounted cash flows would not be determinative of whether an OTTI exists.</td>
</tr>
</tbody>
</table>
5.5.2 Measuring Impairment

ASC 323 requires an investor to measure impairment (if it is determined to be other than temporary) by comparing the carrying value of the investment with its fair value. The investor is prohibited from testing an equity method investee's underlying assets for impairment; instead, the investor must test the total equity method investment for impairment, including any goodwill recognized on the date of initial investment (i.e., equity method goodwill recognized is not separately tested for impairment in accordance with ASC 350 but included as part of the total equity method investment subject to impairment testing under ASC 323).

If an investor uses a cash flow analysis to determine the fair value of an equity method investment, it must discount the cash flows to arrive at a measure of the investment's fair value. A discounted cash flow analysis is similar to the present value techniques described in ASC 820-10-55-5(c) and ASC 820-10-55-5(d) and incorporates the time value of money and risk premiums that market participants would take into account when pricing the asset. The time value of money generally cannot be incorporated into an estimate of future cash flows but must be incorporated into the discount rate used to measure fair value under the discounted cash flow method. Certain risk factors are also usually included in the discount rate. However, it is inappropriate for an investor to use an undiscounted cash flow approach since such a valuation method would not take into account the considerations described above and would not result in a correct measurement of the “loss in value” of an equity method investment.

Depending on the facts and circumstances, there may be other acceptable ways to determine the fair value of an equity method investment for impairment, such as the market approach or other income approach methods described in ASC 820 (e.g., a discount rate adjustment technique or probability-weighted techniques). However, if the investment has a readily determinable fair value, it would be inappropriate for the investor to modify the amount of impairment measured by using the readily determinable fair value by substituting another valuation technique (e.g., discounted cash flows).

5.5.2.1 Consideration of Basis Differences After Recognizing an Impairment

As discussed in Section 5.5, equity method investments are tested for impairment as a single unit of account (i.e., the investment rather than individual assets or basis differences). However, the recognition of an impairment charge will often affect existing basis differences or give rise to new ones. For example, if an investor has a positive basis difference allocated to various assets and equity method goodwill greater than an impairment, the impairment will be likely to reduce the existing positive basis differences and affect their subsequent amortization. ASC 323 does not provide guidance on how the impact of an impairment charge should be allocated to basis differences. Therefore, an investor should select an accounting policy to allocate impairment charges to basis differences and apply it consistently. As illustrated in the example below, it would be appropriate to allocate on the basis of the fair value at the time of impairment.

**Example 5-23**

As of December 31, 20X1, Investor X has a 40 percent interest in Investee Z with a carrying value of $2.376 million, which consists of the following:

- Share of underlying net assets: $1.8 million.
- Basis differences: $576,000.
  - Fixed assets: $380,000.
  - Intangible assets: $116,000.
  - Goodwill: $80,000.
Example 5-23 (continued)

Investor X concludes that the fair value of its investment in Z is $1.84 million, and the decline in value is other than temporary. Investor X would record a $536,000 impairment charge and allocate it on the basis of the fair value of Z's underlying assets as follows:

<table>
<thead>
<tr>
<th>Book Value of Z's Net Assets (A)</th>
<th>Fair Value of Z's Net Assets (B)</th>
<th>X's 40% Share of Z's Net Assets (Book Value) (C = A × 40%)</th>
<th>X's 40% Share of Z's Net Assets (Fair Value) (D = B × 40%)</th>
<th>X's New Basis Difference (D – C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 2,000,000</td>
<td>$ 800,000</td>
<td>$ 800,000</td>
<td>—</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>3,000,000</td>
<td>1,200,000</td>
<td>1,220,000</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>—</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>—</td>
<td>20,000</td>
<td>20,000</td>
<td>—</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$ 4,500,000</td>
<td>$ 1,800,000</td>
<td>$ 1,840,000</td>
<td>$ 40,000</td>
</tr>
</tbody>
</table>

After comparing the new basis differences with the carrying value immediately before the impairment, X would allocate the impairment to the existing basis differences as follows:

<table>
<thead>
<tr>
<th>Beginning Balance</th>
<th>Impairment</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>$ 380,000</td>
<td>$ (20,000)</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>116,000</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>80,000</td>
<td>—</td>
</tr>
</tbody>
</table>

Conversely, if an investor does not have any positive basis differences or the impairment exceeds the existing basis differences, the recognition of an impairment charge will result in the creation of a negative basis difference. The write-down may affect the amortization of basis differences. Subsequent increases in the investment's value as a result of increases in fair value not related to the amortizable basis differences would not be recognized until realized (i.e., disposal of the investment). See Section 5.5 for details related to recording an OTTI.
Example 5-24

Assume the same facts as in Example 5-23, except the following:

As of December 31, 20X1, Investor X concludes that the fair value of its investment in Investee Z is $1.76 million, and the decline in value is other than temporary. Investor X would record a $616,000 impairment charge and allocate it on the basis of the fair value of Z’s underlying assets as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book Value of Z’s Net Assets (A)</th>
<th>Fair Value of Z’s Net Assets (B)</th>
<th>X’s 40% Share of Z’s Net Assets (Book Value) (C = A × 40%)</th>
<th>X’s 40% Share of Z’s Net Assets (Fair Value) (D = B × 40%)</th>
<th>X’s New Basis Difference (D – C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 2,000,000</td>
<td>$ 2,000,000</td>
<td>$ 800,000</td>
<td>$ 800,000</td>
<td>–</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>3,000,000</td>
<td>2,900,000*</td>
<td>1,200,000</td>
<td>1,160,000</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>(500,000)</td>
<td>(500,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>–</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$ 4,500,000</td>
<td>$ 4,400,000</td>
<td>$ 1,800,000</td>
<td>$ 1,760,000</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

* Such a scenario may arise since Z would evaluate fixed assets for impairment on the basis of an undiscounted cash flows model as outlined in ASC 360.

After comparing the new basis differences with the carrying value immediately before the impairment, X would allocate the impairment to the existing basis differences as follows:

<table>
<thead>
<tr>
<th></th>
<th>Beginning Balance</th>
<th>Impairment</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>$ 380,000</td>
<td>$ 40,000</td>
<td>$ 420,000</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>116,000</td>
<td>—</td>
<td>116,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>80,000</td>
<td>—</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Because the basis difference attributable to fixed assets was $380,000 immediately before the recognition of the impairment, the recognition created a $40,000 negative basis difference. This difference will be amortized over the remaining useful life of the underlying fixed assets.

5.5.2.2 Consideration of Cumulative Translation Adjustment in an Impairment Analysis

An equity method investment may generate cumulative translation adjustment (CTA) balances given that the investee may be a foreign operation or hold interests in foreign operations. ASC 830 provides specific guidance regarding how CTA balances should be assessed during an impairment review. ASC 830-30-45-13 states that “[a]n 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.” However, ASC 830-30-45-14 states 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.” Therefore, a CTA balance should be considered in an impairment analysis only when the investment’s recoverability is predicated on a plan to dispose of the investment.
Example 5-25

Investor A determines that there are indicators of impairment for Investee B. Investor A's investment in B has a carrying value of $60 million and a CTA debit balance of $10 million. Investor A has no plan to sell its investment in B or any other transaction that would cause reclassification of the CTA. Therefore, A would consider only the carrying value of $60 million when testing its investment in B for impairment.

Example 5-26

Assume the same facts as in Example 5-25, except that Investor A plans to sell its investment in Investee B within one year. Investor A would consider the carrying value of $60 million and the CTA debit balance of $10 million (i.e., the total carrying value of $70 million must be compared with the fair value) when testing its investment in B for impairment.

5.5.2.3 Consideration of Nonrecourse Debt

The existence of nonrecourse debt or other similar financing structures does not affect the amount of impairment recognized. If an investor considered nonrecourse financing in determining an impairment charge of an equity method investment, the investor would, in substance, be accounting for the effects of a debt extinguishment before the threshold in ASC 405-20-40-1 was reached.

Example 5-27

Investor A and Investor B each contribute $6 million of cash in Investee C (a real estate project), which is financed, in part, by $10 million of nonrecourse financing. Assume that C has break-even operations after the original contribution. If A's and B's investment in C is determined to be other-than-temporarily impaired to such a degree that its value is reduced from $12 million to $8 million, A and B must write their investment down beyond the $10 million nonrecourse financing amount to $4 million each. The existence of nonrecourse debt is not justification for limiting the impairment charge. If A and B were to write their investment down to only $5 million each, they effectively would be recognizing a $2 million gain on a debt extinguishment that has not yet occurred, which is prohibited by ASC 405-20-40-1.

5.5.3 Impairment of Investee Goodwill

ASC 350-20-35-48 requires a goodwill impairment loss recognized at a subsidiary level to be recognized in the consolidated financial statements only if the goodwill of the reporting unit in which the subsidiary resides is also impaired. However, whether an impairment is ultimately recognized in the consolidated financial statements of the subsidiary's parent does not affect whether an impairment is recognized by an equity method investor. Thus, if an equity method investee recognizes a goodwill impairment charge in its separate financial statements, the investor should recognize its share of the impairment in its financial statements in the same manner in which it recognizes other earnings of the investee.

5.5.4 Events During a Lag Period — Impact on Impairment Evaluation

Investors are permitted in certain instances to record their share of earnings on a lag (so long as the intervening period is no more than three months); see Section 5.1.4. However, the testing of an equity method investment for impairment should be considered up to the investor's balance sheet date. Generally, the investor should evaluate its equity method investments as of its balance sheet date to determine whether an OTTI exists. Significant events during the period between the financial statements used to record an equity method investment and the balance sheet date may raise questions about
whether an impairment charge is necessary. The investor should follow the guidance in ASC 810-10-45-12 to account for transactions or events in the intervening period. It states, in part:

[R]ecognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.

SEC Regulation S-X, Rule 3A-02(b)(1), contains similar guidance. Thus, investors should carefully evaluate whether material intervening events are disclosed in the notes to the financial statements or recognized in the statements themselves as an adjustment to the investment. The following events in the intervening period may require further considerations in the context of impairment evaluation:

- Loss or bankruptcy of a significant customer or supplier.
- Adverse credit event (e.g., downgraded rating, default on lending agreements).
- Impairment of investee assets (e.g., property destroyed by fire and no insurance proceeds expected).

Additional factors may also require further consideration.

An investor may hold investments that qualify for specialized industry accounting under ASC 946. Under this guidance, investments are measured at fair value, and changes in fair value are recognized in current-period earnings. An investor holding equity method investments in entities applying accounting under ASC 946 would record its equity method earnings and losses on the basis of amounts reported by an investee, including the investor's proportionate share of the change in fair value of the investee's assets.

Typically, changes in the fair value of the investee's assets arising from events occurring after the date of the investee's most recent available financial statements should not be considered an OTTI of the investor's equity method investment. An OTTI is the difference between the equity method investment's carrying value and its fair value. In the absence of a reporting time lag, a difference would not exist as of the investor's balance sheet date for the effects of fair value changes because the investee's accounting under ASC 946 (i.e., fair value) is retained in the investor's application of the equity method of accounting. That is, there is no impairment charge, since carrying value and fair value would be the same.

However, if the investee and the investor have different reporting dates, the fair value reported in the investee's most recent available financial statements may not be indicative of the fair value as of the investor's balance sheet date. Therefore, the investor would need to evaluate the OTTI indicators to determine whether an impairment should be recognized.

### 5.5.5 QAHP Investments

<table>
<thead>
<tr>
<th>ASC 323-740</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-1</strong> This guidance addresses the methodology for measuring an investment in a qualified affordable housing project through a limited liability entity that is accounted for using the proportional amortization method.</td>
</tr>
<tr>
<td><strong>35-2</strong> Under the proportional amortization method, the investor amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits allocated to the investor. The amortization amount shall be calculated as follows:</td>
</tr>
<tr>
<td>a. The initial investment balance less any expected residual value of the investment, multiplied by</td>
</tr>
<tr>
<td>b. The percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment.</td>
</tr>
</tbody>
</table>
As noted in Section 2.4.3, investments in a QAHP should be accounted for in accordance with ASC 970-323, which generally requires the use of the equity method of accounting for limited partnership real estate investments unless the LP’s interest is so minor that it has essentially no influence over the investee. In that case, the cost method would typically be used (see Section 2.2.2). However, ASC 323-740 permits an investor to make an accounting election to account for its investment in a QAHP by using an effective yield or proportional amortization method, depending on the investor’s adoption date of ASU 2014-01, as long as certain criteria are met. As discussed in Section 2.4.3, one of the criteria that must be met for the investor to apply the proportional amortization method is that the investor does not have the ability to exercise significant influence over the operating and financial policies of the entity. See Section 3.4.2 for further discussion regarding evaluation of this criterion. For additional information on accounting for investments in QAHP entities that qualify for proportional amortization, see Chapter 13 of Deloitte’s A Roadmap to Accounting for Income Taxes.

Investments in QAHPs are usually recovered through tax credits. Therefore, the impairment assessment of such investments will often focus on future tax credits. However, secondary markets for such investments exist, and therefore recovery may occur through sale. Thus, when developing the guidance in ASU 2014-01, the EITF was cognizant of the various methods of recovery and referred to “fair value” in the guidance. Further, ASC 323-740-55-8 provides an example of possible impairment assessments, including an undiscounted cash flow method. As noted in ASC 323-740-55-9, this guidance is solely applicable to investments that qualify for, and are accounted for under, the proportional amortization method and should not be used by analogy for any other investment not within the scope of ASC 323-740. See Section 6.4 for details regarding the presentation and disclosure considerations for QAHP investments.

5.6 Change in Level of Ownership or Degree of Influence

An investor’s ownership and degree of influence may change as a result of a variety of transactions, including, but not limited to, the following:

- The investor directly acquires or disposes of an investment.
- The investee carries out a stock repurchase program resulting in an increase in the investor’s relative ownership percentage (e.g., the investor does not sell any shares back to the investee or sells fewer than do other investors).
• The investee emerges from bankruptcy. The investor accounted for its investment under the cost method during the bankruptcy because it was unable to exercise significant influence over the investee. However, upon emergence, the investor may be able to exercise significant influence again.

• The investor’s representation on the investee’s board of directors increases without a corresponding increase in the investor’s investment (e.g., a board member resigns and is not replaced, thereby increasing the investor’s relative representation, or, alternatively, the investor is given or gains another seat on the board for no consideration).

The above changes in the investor’s level of influence will result in the following accounting changes, which are further discussed in this section:

• Increase in influence over an equity method investment results in control over the investment (equity method to consolidation): See Section 5.6.1.

• Increase in influence over a cost, trading, or AFS investment results in significant influence over the investment (cost, trading, or AFS to equity method): See Section 5.6.2.

• Increase in influence over an equity method investment results in the continued application of the equity method of accounting (significant influence retained): See Section 5.6.3.

• Decrease in influence over an equity method investment results in the continued application of the equity method of accounting (significant influence retained): See Section 5.6.4.

• Decrease in influence over an equity method investment results in the application of the cost, trading, or AFS method of accounting (equity method to cost, trading, or AFS): See Section 5.6.5.

5.6.1 Increase in Level of Ownership or Degree of Influence — Control Initially Obtained (Equity Method to Consolidation)

If an investor obtains a controlling financial interest in accordance with ASC 810, it should consolidate the investee. Such a transaction would meet the definition of a business combination, and thus, ASC 805 should be applied to determine the recognition and initial measurement of the consolidated subsidiary.

5.6.2 Increase in Level of Ownership or Degree of Influence — Significant Influence Initially Obtained (Cost, Trading, or AFS to Equity Method)

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-12 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 in accordance with paragraph 323-10-15-3 by an increase in the level of ownership described in that paragraph (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). See paragraph 323-10-35-33 for guidance on all changes in an investor’s level of ownership or degree of influence.</td>
</tr>
</tbody>
</table>
When an investor obtains an additional interest that provides it with significant influence, it must apply the equity method of accounting. This is the case regardless of whether the transaction that leads to significant influence is undertaken by the investor (e.g., a purchase of additional shares) or the investee (e.g., a change in the structure of the board of directors that provides the investor with increased relative influence).

The guidance in the ASC excerpts above within this section is affected by the adoption of ASU 2016-01, which eliminates the AFS method of accounting. After the adoption of ASU 2016-01, an investor will recognize investments in equity securities at fair value unless it applies a practical expedient for investments without a readily determinable fair value. If the investment was previously accounted for as an AFS security, any unrealized gain or loss recognized in AOCI should be recognized in earnings upon transition to the equity method of accounting. However, once ASU 2016-01 is adopted, the AFS method of accounting will no longer be applicable and thus, guidance regarding the treatment of unrealized gain or loss upon the transition to the equity method of accounting will no longer be needed.
The guidance requires the equity method to be applied prospectively from the date an investor obtains significant influence. When an investment qualifies for the equity method (as a result of an increase in the level of ownership interest or degree of influence), the cost of acquiring the additional interest in an investee would be added to the current basis of the investor’s previously held interest, and the equity method would be applied subsequently from the date on which the investor obtains the ability to exercise significant influence over the investee. The guidance further requires unrealized holding gains or losses in AOCI related to an AFS security that becomes eligible for the equity method to be recognized in earnings as of the date on which the investment qualifies for the equity method as illustrated in the example below.

**Example 5-28**

Investor A acquires a 5 percent interest in Investee B at the beginning of the fiscal year for $5 million and then acquires an additional 20 percent interest two years later for $24 million, at which time the fair value of the original 5 percent interest, accounted for as an AFS security, is $6 million. Investor A would recognize the difference between the initial purchase price of the 5 percent interest ($5 million) and the current fair value ($6 million) of $1 million in earnings. The $6 million would then be added to the $24 million to represent a $30 million equity method investment. Investor A would also undertake a purchase price allocation to determine any basis difference as of the date significant influence is obtained.

While there is explicit guidance on AFS securities, the accounting for cost method investments upon the transition to the equity method of accounting is less clear. ASC 323-10-35-33 states that “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.” If the investor’s claim to the investee’s carrying value is more than the total cost basis after the addition of the cost of acquiring the additional interest, a negative basis difference will exist. This could result, for example, because a cost method investment would not have picked up any of the accumulated earnings before qualifying for the equity method of accounting. Retrospective recognition of those previous earnings is not permitted. Before the adoption of ASU 2016-01, it is unclear how an investor should account for the negative basis difference related to the original cost method investment. We do not believe that it would be acceptable to recognize the negative basis difference immediately in earnings. That is, we do not believe that this circumstance (i.e., an increase in value since the original investment) is akin to a bargain purchase gain as discussed in Section 4.5.1. Rather, the investor should account for the negative basis difference in a manner similar to the amortization or accretion of any other negative basis difference (see Section 5.1.5.2). In some instances, it may be appropriate to defer the recognition of negative basis differences until the investment’s disposal.

**Example 5-29**

Assume the same facts as in Example 5-28, except that Investor A accounted for the initial investment as a cost method investment. Assume that as of the acquisition of the additional 20 percent interest, the original 5 percent interest represented $6 million of underlying net assets of Investee B and that there is no basis difference related to the $24 million additional investment. In total, the cost basis of A’s interest is $29 million, but its share of B’s underlying net assets is $30 million, resulting in a $1 million negative basis difference entirely related to the original cost method investment. Depending on the facts and circumstances, A would develop an appropriate method to prospectively account for the basis difference. Such a method may include amortization over the period of B’s related assets.
Changing Lanes

After the adoption of ASU 2016-01, investments in equity securities (including cost method investments) are recognized at fair value unless a practical expedient is applied for investments without a readily determinable fair value.¹¹ In Example 5-29, the additional investment leading to significant influence represents an observable price change. Therefore, immediately before applying the equity method of accounting, an investor would remeasure the original investment on the basis of the valuation implied by the additional investment. This may reduce, but not eliminate, the significance of basis differences caused by the investor’s not retroactively applying the equity method of accounting. Further, qualification for the equity method of accounting can occur without an observable price change (e.g., an increase in level of influence without an acquisition of an additional interest). Therefore, the investor must analyze any remaining basis differences after applying ASU 2016-01 in a manner consistent with the discussion above.

5.6.2.1 Investee Bankruptcy

Other transactions, such as the bankruptcy of an investee and its subsequent emergence from bankruptcy, also may result in the discontinuation of the equity method of accounting and its subsequent reinstatement upon the investee’s emergence from bankruptcy.

Example 5-30

Investor A owns a 50 percent interest in Investee B, a joint venture, and uses the equity method to account for its interest. An unrelated company, Investor C, owns the remaining 50 percent interest in B. In 20X7, B voluntarily files for Chapter 11 bankruptcy protection as a result of litigation.

Other than the significant exposure to loss that B could face through adverse findings associated with the litigation, B generates positive earnings and cash flows. However, no distributions are made to equity investors during the bankruptcy proceedings. Investor A is not the guarantor of any obligations of B, nor is A otherwise committed to provide financial support to B. However, as a result of the Chapter 11 filing, A concluded in 20X7 that there was substantial doubt about whether its investment in B would be recovered. Therefore, A wrote off its entire investment in B in accordance with ASC 323-10-35-32.

Investor A concluded that it lost significant influence over B during the bankruptcy proceedings. Therefore, A derecognized the equity method investment, which was fully impaired, and recognized a cost method investment at the historical cost (see Section 5.6.5 for further discussion of the loss of significant influence), which was zero because of the impairment recognized. Investee B is expected to emerge from bankruptcy in 20X9 with a positive equity balance and no change in its ownership structure (i.e., A and C will each continue to own 50 percent of B).

Investor A began to account for its investment in B under the cost method during the bankruptcy period because it could no longer exercise significant influence over B. As a result, B’s emergence from bankruptcy is a significant transaction that affects both the cost basis of the investment and the accounting method for the investment; therefore, the emergence from bankruptcy, although not an equity event, is included within the scope of ASC 323-10-35-33 (i.e., an “other transaction”). Accordingly, when B emerges from bankruptcy and A begins applying the equity method of accounting, A should account for any difference between its investment and its share of equity in B’s net assets in accordance with ASC 323-10-35-34, which requires that this difference be assigned and subsequently accounted for in the same manner as a business combination (i.e., basis differences). Assume that A’s share of B’s underlying net assets at emergence is $50 million and A’s share of B’s earnings during the bankruptcy proceedings is $10 million.

In accordance with ASC 323-10-35-33, A would apply the equity method of accounting prospectively. Therefore, the investment balance would be zero at emergence (because the investment was fully impaired and the cost method was applied throughout the bankruptcy proceedings). Since the investment balance would be zero, A would have a $50 million negative basis difference.

¹¹ See footnote 10.
5.6.3 Increase in Level of Ownership or Degree of Influence — Significant Influence Retained

When an investor increases its level of ownership and the equity method of accounting is applicable both before and after the transaction, the investor would account for the acquisition of the additional interest in a manner consistent with that used to account for an initial investment in an equity method investee. The equity method of accounting requires the use of a cost accumulation model, whereby the purchase price is recognized as the initial investment. To the extent the purchase price differs from the share of the investee's underlying net assets, the investor must account for any new basis differences accordingly (see Sections 4.5 and 5.1.5.2 for the initial and subsequent measurement, respectively, of basis differences). Since investments accounted for under the equity method are excluded from the fair value measurement objective in ASU 2016-01, the investor may not remeasure the existing equity method investment.

Example 5-31

At the beginning of year 1, Investor A purchases a 25 percent interest in Investee B and accounts for its investment under the equity method of accounting. The purchase price of the investment is $900 million, which includes $100 million of positive basis differences related to fixed assets (with an average useful life of 10 years). In year 1, B earns $200 million in profit. Therefore, A recognizes $40 million in earnings ($50 share of net income partially offset by a $10 million amortization of the fixed asset basis difference). At the end of year 1, A's carrying value of the investment is $940 million, composed of an $850 million share of B's underlying net assets and a $90 million unamortized basis difference related to fixed assets.

At the beginning of year 2, A purchases an additional 5 percent stake in B from a third party for $200 million. Assume that A's share of B's underlying net assets (related only to the incremental 5 percent interest) is $170 million. Investor A would record the incremental $200 million purchase price, bringing its aggregate investment to $1.14 billion, which consists of $1.02 billion of A's share of B's underlying net assets ($850 million in existing investment + $170 million in incremental investment) and $120 million in basis differences ($90 million in existing investment + $30 million in incremental investment). On the basis of the purchase price paid for the incremental 5 percent interest ($200 million), A's existing 25 percent interest is worth $1 billion [($200 million + 5%) × 25%]. However, A may not adjust the existing interest to fair value since the equity method of accounting requires a cost accumulation approach.

5.6.4 Decrease in Level of Ownership or Degree of Influence — Significant Influence Retained

ASC 323-10

35-35 Sales of stock of an investee by an investor shall be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.

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 investor’s ownership of or influence over an investee may decline as a result of its own action or the investee’s actions. For example, direct sales of interests by the investor will result in a decline in ownership or influence. Similarly, sales of additional shares by the investee will dilute the investor’s influence and ownership. In either case, a gain or loss should be recognized on the basis of the deemed selling price.

12 Accounting for the sale of an equity method investment may fall within the scope of ASC 860. The guidance provided herein discusses the impact on the application of the equity method of accounting; however, financial statement preparers should also consider the requirements of ASC 860 when determining the appropriate accounting treatment for the sale transaction.
**Example 5-32**

**Investor Sells Shares to a Third Party**

Investor A holds a 40 percent interest in Investee B. Investor A sells a 5 percent stake in B to a third party for $120 million. Immediately before the sale, the carrying value of A's 40 percent interest in B was $800 million, including a $100 million positive basis difference. Investor A would derecognize a proportionate share of the carrying value, including basis difference, or $100 million \( [(5\% ÷ 40\%) × 800 \text{ million}] \). The difference between the cash proceeds (i.e., $120 million) and the carrying value derecognized (i.e., $100 million) represents a gain on the disposal transaction (i.e., $20 million).

**Example 5-33**

**Investee Sells Additional Shares to a Third Party**

Investor X holds 10,000 shares of Investee Y, which represents a 40 percent ownership interest. Investee Y issues an additional 5,000 shares to a third party for $650 million. Immediately before the issuance, Y's net asset balance was $1.75 million. The carrying value of X's 40 percent interest in Y was $800 million, including a $100 million positive basis difference. The calculation of X's dilution, share of proceeds, and investment balance after share issuance is shown in the chart below.

| A = Investor X's shares of Investee Y | 10,000 |
| B = Investee Y's shares outstanding before issuance | 25,000 |
| C = Investee Y's shares outstanding after issuance | 30,000 |
| D = Investee Y's proceeds for share issuance | $650 million |
| E = Investor X's ownership percentage before issuance | 40% |
| F = Investor X's ownership percentage after issuance | 33.33% |
| G = Investor X's dilution \( [1 – (F ÷ E)] \) | 16.67% |
| H = Investor X's investment balance before issuance | $800 million |
| I = Investor X's dilution of existing investment, including share of net assets and basis difference \( (G × H) \) | $133.36 million |
| J = Investor X's share of proceeds \( (F × D) \) | $216.65 million |
| K = Investor X's investment balance after share issuance \( [(H – I) + J] \) | $883.29 million |

Investee Y's issuance of shares diluted X's ownership interest from 40 percent to 33.33 percent, resulting in X's having effectively disposed of 16.67 percent \( [1 – (33.33\% ÷ 40\%)] \) of its interest. Investor X's investment in Y was $800 million before the transaction. Therefore, X must derecognize $133.36 million of its investment because of dilution. However, X would also share in the increase of Y's net assets (i.e., the proceeds received from the sale of shares by Y), resulting in an increase in the investment of $216.65 million.

The net effect of the transaction would be recorded as follows:

- Equity method investment (share of proceeds) 216.65 million
- Equity method investment (dilution) 133.36 million
- Gain on disposal of equity method investment 83.29 million
5.6.5 Decrease in Level of Ownership or Degree of Influence — Significant Influence Lost (Equity Method to Cost, Trading, or AFS)

5.6.5.1 Before the Adoption of ASU 2016-01

**ASC 323-10**

35-36 An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. However, paragraph 325-20-35-3 requires that dividends received by the investor in subsequent periods that exceed the investor's share of earnings for such periods be applied in reduction of the carrying amount of the investment (see paragraph 325-20-35-1). Topic 320 addresses the accounting for investments in equity securities with readily determinable fair values that are not consolidated or accounted for under the equity method.

**ASC 320-10**

30-4 If it is determined that a marketable equity security should no longer be accounted for under the equity method (for example, due to a decrease in the level of ownership), the security's initial basis 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 shall remain as a part of the carrying amount of the investment and that the investment account shall not be adjusted retroactively. Subsequently, the security shall be accounted for pursuant to paragraph 320-10-35-1.

**ASC 325-20**

35-3 As discussed in paragraph 323-10-35-36, an investment in voting stock of an investee entity 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 (see paragraphs 323-10-15-6 through 15-11 for guidance in determining significant influence). That paragraph requires that an investor discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. That paragraph also requires 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. However, dividends received by the investor in subsequent periods that exceed the investor's share of earnings for such periods shall be applied in reduction of the carrying amount of the investment (see paragraph 325-20-35-1).

5.6.5.2 After the Adoption of ASU 2016-01

**ASC 323-10**

35-36 An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. Topic 321 addresses the accounting for investments in equity securities that are not consolidated or accounted for under the equity method.
Chapter 5 — Subsequent Measurement

**ASC 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 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. Subsequently, the security shall be accounted for pursuant to paragraph 321-10-35-1.

**35-1** Except as provided in paragraph 321-10-35-2, investments in equity securities shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for equity securities shall be included in earnings.

**35-2** An entity may elect to measure an equity security without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. An election to measure an equity security in accordance with this paragraph shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this paragraph, the entity shall continue to apply the measurement guidance in this paragraph until the investment does not qualify to be measured in accordance with this paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59). The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measured in accordance with this paragraph.

**Pending Content (Transition Guidance: ASC 825-10-65-3)**

**35-2** An entity may elect to measure an equity security without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. An election to measure an equity security in accordance with this paragraph shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this paragraph, the entity shall continue to apply the measurement guidance in this paragraph until the investment does not qualify to be measured in accordance with this paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59). The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measured in accordance with this paragraph. If an entity measures an equity security in accordance with this paragraph (and the security continues to qualify for measurement in accordance with this paragraph), the entity may subsequently elect to measure the equity security at fair value. If an entity subsequently elects to measure an equity security at fair value, the entity shall measure all identical or similar investments of the same issuer, including future purchases of identical or similar investments of the same issuer, at fair value. The election to measure those securities at fair value shall be irrevocable. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

An investor can lose significant influence in various circumstances, including a drop in ownership interest below a certain threshold or a loss in the degree of influence over an investee. In all instances, the investor may no longer apply the equity method of accounting as of the date that the threshold for applying the equity method no longer exists. That is, the investor must no longer recognize its share of earnings or losses prospectively from that date forward. However, the investor is precluded from reversing any previously recognized earnings or losses; instead, the carrying amount of any remaining investment becomes the new cost basis for the retained interest.
If the investor fully sells its ownership interest, any gain or loss is measured by comparing the carrying amount of the equity method investment with the proceeds from the sale. If the investor retains an interest, any gain or loss is calculated by deducting the carrying value of the portion of the investment disposed from the transaction's proceeds, which may include either amounts received directly by the investor or the investor's proportionate share of the increase in the investee's equity.

### Changing Lanes

ASU 2016-01 amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. The ASU requires that entities, upon its effective date (generally after December 15, 2017, for public entities and after December 15, 2018, for all other entities, with early adoption permitted), carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and LLCs, at fair value through net income. This requirement does not apply to investments that qualify for the equity method of accounting or to those that result in the investee's consolidation or for which the reporting entity has elected the practicability exception to fair value measurement. Therefore, ASU 2016-01 does not have an impact on the equity method of accounting. However, the ASU does affect the accounting when there is a decrease in an investor's level of ownership or degree of influence in such a way that significant influence is lost (equity method to cost, trading, or AFS).

Before the adoption of ASU 2016-01, the subsequent accounting for the investor's retained interest depends on whether the investment has a readily determinable fair value (as defined by ASC 320-10-20). If so, the investor would subsequently account for its investment as either a trading or AFS security in accordance with ASC 320-10-35-1. If the retained investment is not within the scope of ASC 320, the investor would subsequently account for the interest as a cost method investment under ASC 325-20-35-3. This accounting preserves the carrying amount of the equity method investment immediately before the transaction that caused the discontinuation of the equity method as the cost basis under ASC 320 or ASC 325, respectively.

After the adoption of ASU 2016-01, the cost method classification was removed, requiring all equity securities (excluding equity method investments) to be recognized at fair value unless the practical expedient for an equity security without a readily determinable fair value is elected under ASC 321-10-35-2. In addition, changes in fair value are recognized in earnings, thereby removing the potential classification of an equity security as AFS. Although the previous carrying amount of the equity method investment becomes the cost basis under ASC 321, the fair value measurement objective will frequently result in the remeasurement of the entire retained interest to fair value through earnings. See **Example 5-35** for an illustration of the accounting both before and after the adoption of ASU 2016-01.
Example 5-34

Investor Sells Shares to a Third Party

Investor X holds 10,000 shares (a 25 percent interest) in Investee Y and sells 4,000 shares to a third party for $250 million. The sale results in X’s ceasing to have significant influence. Investor X must discontinue the application of the equity method of accounting, recognize a gain or loss for the interest disposed of, and account for the remaining interest. Assume the following:

<table>
<thead>
<tr>
<th></th>
<th>Immediately Before Sale of Shares</th>
<th>Investor X Sells Shares of Investee Y</th>
<th>Immediately After Sale of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>A = Investor X's shares of Investee Y</td>
<td>10,000</td>
<td>(4,000)</td>
<td>6,000</td>
</tr>
<tr>
<td>B = Investee Y's shares outstanding</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>C = Investor X's ownership interest (A ÷ B)</td>
<td>25%</td>
<td>(10%)</td>
<td>15%</td>
</tr>
<tr>
<td>D = Investee Y's net assets</td>
<td>$2.2 billion</td>
<td>$2.2 billion</td>
<td>$2.2 billion</td>
</tr>
<tr>
<td>E = Investor X's share of Investee Y's net assets (C × D)</td>
<td>$550 million</td>
<td>($220 million) [$550 million × (10% ÷ 25%)]</td>
<td>$330 million</td>
</tr>
<tr>
<td>F = Investor X's basis difference</td>
<td>$50 million</td>
<td>($20 million) [$50 million × (10% ÷ 25%)]</td>
<td>$30 million</td>
</tr>
<tr>
<td>G = Investor X's net investment (E + F)</td>
<td>$600 million</td>
<td>($240 million)</td>
<td>$360 million</td>
</tr>
</tbody>
</table>

The difference between the carrying value of $240 million derecognized and the cash proceeds of $250 million represents a gain on the disposal transaction of $10 million. The initial carrying value of the retained interest would be $360 million.

Before the Adoption of ASU 2016-01

The retained interest would be accounted for in accordance with ASC 320 (if the retained interest has a readily determinable fair value) or ASC 325 (if the retained interest does not have a readily determinable fair value).

After the Adoption of ASU 2016-01

The retained interest would be accounted for in accordance with ASC 321. If the retained interest has a readily determinable fair value, X would immediately adjust the carrying value of the retained interest to fair value, with any gain or loss recognized in earnings. If the retained interest does not have a readily determinable fair value and X elects the practical expedient, the sale of shares to a third party would be likely to provide sufficient observable evidence of the fair value of the retained interest, resulting in a gain recognized in earnings to adjust the initial carrying value to the fair value implied by the transaction.

13 See footnote 10.
Example 5-35

**Investee Sells Additional Shares**

Investor X holds 10,000 shares (a 25 percent interest) in Investee Y. Investee Y issues 15,000 additional shares to a third party for $950 million, which causes X to lose significant influence. Investor X must discontinue the application of the equity method of accounting, recognize a gain or loss for the deemed sale of a portion of its interest, and account for the remaining interest. Assume the following:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Investor X's shares of Investee Y</td>
<td>10,000</td>
</tr>
<tr>
<td>B</td>
<td>Investee Y's shares outstanding before issuance</td>
<td>40,000</td>
</tr>
<tr>
<td>C</td>
<td>Investee Y's shares outstanding after issuance</td>
<td>55,000</td>
</tr>
<tr>
<td>D</td>
<td>Investee Y's proceeds for share issuance</td>
<td>$950 million</td>
</tr>
<tr>
<td>E</td>
<td>Investor X's ownership percentage before issuance</td>
<td>25%</td>
</tr>
<tr>
<td>F</td>
<td>Investor X's ownership percentage after issuance</td>
<td>18.18%</td>
</tr>
<tr>
<td>G</td>
<td>Investor X's dilution ([1 - (F ÷ E)])</td>
<td>27.28%</td>
</tr>
<tr>
<td>H</td>
<td>Investor X's investment balance before issuance</td>
<td>$600 million</td>
</tr>
<tr>
<td>I</td>
<td>Investor X's dilution of existing investment, including share of net assets and basis difference ((G \times H))</td>
<td>$163.68 million</td>
</tr>
<tr>
<td>J</td>
<td>Investor X's share of proceeds ((F \times D))</td>
<td>$172.71 million</td>
</tr>
<tr>
<td>K</td>
<td>Investor X's balance after share issuance ([(H - I) + J])</td>
<td>$609.03 million</td>
</tr>
</tbody>
</table>

Investor X will record a gain of $9.03 million, equal to the difference between (1) the deemed proceeds from the issuance of $172.71 million ($950 million × 18.18%) and (2) the carrying value of X's net investment sold of $163.68 million ($600 million × 27.28%). The initial carrying value of the retained interest would be $609.03 million.

**Before the Adoption of ASU 2016-01**

The retained interest would be accounted for in accordance with ASC 320 (if the retained interest has a readily determinable fair value) or ASC 325 (if the retained interest does not have a readily determinable fair value).

**After the Adoption of ASU 2016-01**

The retained interest would be accounted for in accordance with ASC 321. If the retained interest has a readily determinable fair value, X would immediately adjust the carrying value of the retained interest to fair value, with any gain or loss recognized in earnings. If the retained interest does not have a readily determinable fair value and X elects the practical expedient, the sale of shares to a third party would be likely to provide sufficient observable evidence of the fair value of the retained interest, resulting in a gain recognized in earnings to adjust the initial carrying value to the fair value implied by the transaction.

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14 See footnote 10.
5.6.5.3 OCI Upon Discontinuation of the Equity Method of Accounting

**ASC 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 the retention of a cost method investment  
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 applying the cost method.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

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.

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.

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.

**Changing Lanes**

The guidance above will be amended by the adoption of ASU 2016-01, which will eliminate the cost method of accounting but will not affect the treatment of AOCI upon a change from the equity method of accounting to another method.

When an investor disposes of its entire interest in an investee, accounting for AOCI is straightforward. Upon disposition, the investor's share of the investee's AOCI should be reclassified and recognized in income by the investor. For partial disposals, a similar concept applies: The investor would determine the proportion of its investment that has been disposed and reclassify and recognize in income a proportional amount of AOCI. However, upon transition from the equity method of accounting, the investor must also adjust the AOCI related to the retained investment. Specifically, the investor's share of AOCI related to the retained investment must be reclassified as an offset to the carrying value of the retained investment. To the extent this reclassification reduces the carrying amount to zero, any excess would be recognized in income. To the extent the reclassification increases the carrying amount (i.e., a loss is reclassified from AOCI), the investor should consider whether an impairment indicator exists.
**Example 5-36**

**Investor Sells Shares to a Third Party**

Investor X holds a 25 percent interest in Investee Y that is accounted for under the equity method of accounting. Investor X sells a 10 percent interest in Y to a third party for $250 million, which results in X's investment's no longer qualifying for the equity method. In addition to the facts and entries made in Example 5-34, assume that X has recognized a $50 million gain in AOCI related to its investment in Y. Since X has disposed of 40 percent (10% ÷ 25%) of its interest, $20 million of the gain in AOCI will be recognized in income upon the discontinuance of the equity method of accounting. The remaining $30 million of gain in AOCI will be reclassified against the carrying value of the retained interest ($360 million), resulting in a carrying amount of $330 million.

**Example 5-37**

**Investor Sells Shares to a Third Party**

Assume the same facts as in Example 5-36, except the amount of the gain deferred in AOCI is $700 million. Since Investor X has disposed of 40 percent of its interest, $280 million of the gain in AOCI will be recognized in income upon loss of significant influence. The remaining $420 million of gain in AOCI will be reclassified against the carrying value of the retained interest ($360 million), resulting in a carrying amount of nil and an additional gain of $80 million.

### 5.7 Real Estate Investments

#### 5.7.1 Sale of an Investment in a Real Estate Venture

**ASC 970-323**

40-1 A sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and shall be evaluated under the guidelines set forth in Subtopic 360-20.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

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 and 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.

**Pending Content (Transition Guidance: ASC 825-10-65-2)**

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.
Changing Lanes

The pending content in the ASC excerpts above includes guidance for both before and after the adoption of ASU 2016-01. While the effective dates for ASU 2016-01 and ASU 2017-05 are the same, ASU 2017-05 may be adopted early (i.e., before ASU 2016-01), necessitating the two sections of transition guidance.

Under current U.S. GAAP, the sale of an investment in real estate, including an investment accounted for under the equity method, is treated as a sale of the underlying real estate. Therefore, ASC 360-20 would apply, including the specific requirements therein regarding derecognition of the investment and recognition of profit or loss from the sale. This may result in substantial differences in timing and amount of gains recognized in the sale of investments in real estate versus those recognized in the sale of investments in other assets or operations.

ASU 2017-05 is effective for PBEs for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, ASU 2017-05 is effective for fiscal years beginning after December 15, 2018, including interim periods thereafter. The dates are aligned with the required adoption of the new revenue recognition standard. ASU 2017-05 significantly affects the accounting framework for transfers of investment in real estate ventures. Regardless of whether the underlying investee represents a business or whether the investee’s assets are in-substance nonfinancial assets, once ASU 2017-05 is effective, the transfer must be accounted for under the guidance in ASC 860 on transfers of financial assets.
Chapter 6 — Presentation and Disclosure

6.1 Overview
The presentation of equity method investments is often referred to as a “one-line consolidation.” While this principle is relatively straightforward, there are several nuances financial statement preparers must consider when determining the appropriate presentation of equity method investments. ASC 323 outlines additional disclosure requirements that must be evaluated. Further, SEC registrants must take into account several reporting requirements specific to equity method investments. This chapter discusses these matters.

6.2 Presentation
6.2.1 Balance Sheet

**ASC 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. . . .

**SEC Rules, Regulations, and Interpretations**

**Regulation S-X, Rule 5-02, Balance Sheets**
The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4-01(a)).

**Regulation S-X, Rule 5-02(12)**
Other investments. The accounting and disclosure requirements for non-current marketable equity securities are specified by generally accepted accounting principles. With respect to other security investments and any other investment, state, parenthetically or otherwise, the basis of determining the aggregate amounts shown in the balance sheet, along with the alternate of the aggregate cost or aggregate market value at the balance sheet date.

Unless an investment qualifies for proportionate consolidation as discussed in Section 2.4.4, an entity should classify equity method investments as a single amount on its balance sheet, including the impact of any basis differences and equity investee impairments recorded by the investor. Multiple investments should be aggregated into a single line item. In circumstances in which an investor has committed to fund an equity method investee's losses, the application of the equity method of accounting may result in a negative investment balance. In such instances, the entity would recognize the liability as a single amount in a manner consistent with the recognition of equity method investment assets. However, the entity should not offset an investment in an asset position with an investment in a liability position given that separate investments would not meet the offset criteria outlined in ASC 210-20.
6.2.1.1 SEC Registrants

SEC Regulation S-X, Rule 5-02(12), indicates that the investor should disclose a separate line item for “[o]ther investments.” SEC Regulation S-X, Rule 4-02, provides that “[i]f the amount which would otherwise be required to be shown with respect to any item is not material, it need not be separately set forth. The combination of insignificant amounts is permitted.” Therefore, SEC registrants would generally present equity method investments within a separate investment line item. If this line item includes other investments that do not reflect the equity method of accounting, disclosure of the composition of the line item in the footnotes may be necessary. Further, the investment balance may be included in another line item such as “Other Assets” subject to the materiality consideration outlined in SEC Regulation S-X, Rule 4-02.

6.2.1.2 Other Entities

Entities other than SEC registrants may consider the guidance in SEC Regulation S-X, Rule 5-02(12), by analogy.

6.2.2 Income Statement

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>45-2 The investor’s share of accounting changes reported in the financial statements of the investee shall be classified separately.</td>
</tr>
</tbody>
</table>

SEC Rules, Regulations, and Interpretations

<table>
<thead>
<tr>
<th>Regulation S-X, Rule 5-03, Income Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) The purpose of this rule is to indicate the various line items which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the income statements filed for the persons to whom this article pertains (see § 210.4-01(a)).</td>
</tr>
</tbody>
</table>

Unless an investment qualifies for proportionate consolidation, as discussed in Section 2.4.4, an entity should classify equity method investment income or loss as a single amount in its income statement, including the impact of any basis differences. In addition, any investor-level impairment would generally be included in the same line item as equity method income or loss. Multiple investments may be aggregated into a single line item; however, additional disclosure may be necessary for material investments, as further discussed in Sections 6.3 and 6.5. While this presentation is relatively simple, the location of this line item in the income statement may vary depending on facts and circumstances.

- **SEC registrants** — SEC Regulation S-X, Rule 5-03(b)(12), indicates that the investor’s equity in earnings of an unconsolidated subsidiary or a “50 percent or less owned [person]” (i.e., an equity method investee) should be shown after the investor’s income tax provision and before income or loss from continuing operations. However, SEC Regulation S-X, Rule 5-03(b)(12), also states that “[i]f justified by the circumstances, this item may be presented in a different position and a

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1 SEC Regulation S-X, Article 5, applies to financial statements filed for all entities except (1) registered investment companies; (2) employee stock purchase, savings, and similar plans; (3) insurance companies; (4) bank holding companies and banks; and (5) brokers and dealers when filing Form X-17A-5.
different manner.” As a result, questions often arise over the appropriate presentation of equity method earnings.

- **Classification within revenues** — The SEC staff has publicly stated that it is never appropriate to classify earnings of an equity method investee within any revenue amount or revenue caption of the investor.

- **Classification as a component of income from operations** — The staff does not object to classification of equity in earnings of an equity method investee as a component of income from operations (i.e., before nonoperating income and expenses) if the equity method investee’s operations are “integral” to the investor’s business. In this context, the staff’s definition of “integral” indicates more than the fact that the investor and investee operate in the same line of business (see the highlights of the March 2003 AICPA SEC Regulations Committee joint meeting with the SEC staff). The registrant should consider the following questions when determining whether the investee is integral to the investor’s business:
  - Are intercompany transactions between the investor and the investee significant?
  - Is the investee a vital part of the investor’s procurement, production, or distribution functions?
  - Is the registrant’s management of the investee (e.g., through a management contract that does not provide control) similar to its management of its consolidated subsidiaries?
  - Are the investee’s operations an extension of the investor’s operations, providing additional capacity or critical functions?

If an equity method investee’s earnings are classified within income from operations, such amounts, if material, should be shown as a separate line item within operations and should be clearly disclosed as the investor’s share of equity earnings.

- **Classification as a component of nonoperating income or a similar pretax item** — The SEC staff has not provided guidance on the appropriate justification for classification of equity method earnings as other pretax income. Therefore, the staff may challenge registrants that have classified equity method earnings as a component of other income or a similar pretax item. These registrants may be able to use the SEC Regulation S-X, Rule 5-03(b)(12), exception or materiality to justify their classification.

Some registrants have proposed that equity method earnings from pass-through entities such as LLCs and partnerships, when material, may be shown as a separate line item in nonoperating income (pretax) through use of the SEC Regulation S-X, Rule 5-03(b)(12), exception. They argue that classification of these amounts after income tax expense distorts the investor’s effective income tax rate since income taxes on the investor’s share of the equity method investee’s earnings must appear in the investor’s income tax provision and must not be shown net of equity method earnings. However, the SEC staff has neither accepted nor objected to classification of equity method earnings as a nonoperating (pretax) item solely on the basis of this potential distortion. Therefore, registrants classifying equity method earnings on this basis should be prepared to provide additional support for their position and consider further consultation with their advisers.

- **Other entities** — Entities other than SEC registrants may consider the guidance in SEC Regulation S-X, Rule 5-03(b)(12), by analogy but would not be required to do so.
6.2.2.1  **Tax Effects**

An investee’s income tax expense (benefit) is included as part of an investor’s share of equity method earnings. However, the tax consequences of the investor’s equity in earnings and basis differences attributable to its investment in the investee should be recognized within the investor’s income tax provision and not as part of the investor’s equity in the investee’s earnings.

In a manner similar to business combinations, basis differences may give rise to deferred tax effects (additional inside basis differences — see Section 4.5). To accurately account for its equity method investment, an investor would consider these inside basis differences in addition to any outside basis difference in its investment. Since equity method investments are presented as a single consolidated amount, tax effects attributable to the investor basis differences become a component of this single consolidated amount and are not presented separately in the investor’s financial statements as individual current assets and liabilities or DTAs and DTLs. In addition, to accurately measure those tax assets and liabilities, the investor should use ASC 740 to analyze the investee’s uncertain tax positions. The investor’s share of investee income or loss may ultimately need to be adjusted for investor basis differences, including those for income taxes.

For further information on income taxes, see Sections 8.08 through 8.18 of Deloitte’s *A Roadmap to Accounting for Income Taxes*.

### 6.2.2.2  **Disposal Transactions**

<table>
<thead>
<tr>
<th>ASC 205-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-1B</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

| **45-1C** | Examples of a strategic shift that has (or will have) a major effect on an entity’s operations and financial results could include a disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of an entity (see paragraphs 205-20-55-83 through 55-101 for Examples). |

If an equity method investee reports discontinued operations, the amounts are nonetheless included in the line item in which the investor reports equity method investment earnings, even though this line item may be included in income from continuing operations. The investor should not report the equity method investee’s discontinued operations as such unless the entire equity method investment earnings amount is presented in discontinued operations as discussed below.

ASU 2014-08 modified the scope of ASC 205-20 to explicitly include the disposal of equity method investments (for further information on discontinued operations reporting, see Section 1.2 of Deloitte’s *A Roadmap to Reporting Discontinued Operations*). However, the ASU did not expand the scope of ASC 360-10; therefore, an equity method investment that does not qualify as a discontinued operation under ASC 205-20 cannot be reported, and accounted for, as held for sale. Because the measurement guidance in ASC 360-10 (i.e., on impairment considerations) does not pertain to equity method investments, an entity would continue to apply the measurement guidance in ASC 323. See Section 5.5 for a discussion of OTTIs.
If an equity method investment qualifies for discontinued operations reporting, an entity must reclassify the equity method income or loss to income from discontinued operations for all periods presented. Further, the entity must present the equity method investment as assets held for sale on the balance sheet for all periods presented and must disclose the information required by ASC 205-20-50.

For disposal transactions that do not qualify for discontinued operations reporting, a gain or loss on disposal would generally be classified either (1) in the same line item as equity method earnings or (2) as a separate line item in nonoperating income, gross of tax, before the income tax provision. This classification would be applicable when an entity disposes of its interest in an equity method investment or when an investor's ownership interest in an investee is diluted (i.e., an investee issues additional equity interests and the investor does not maintain its proportionate ownership interest in the investee). An investor should disclose its presentation policy.

### 6.2.3 Other Comprehensive Income

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-3</strong> 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.</td>
</tr>
</tbody>
</table>

An investor must report its proportionate share of an equity method investee’s OCI, which may include, among other things, foreign currency translation adjustments, actuarial gains or losses, and gains and losses on AFS securities. The investor has the option to present a separate section within its statement of OCI to separately report its own comprehensive income line items and those of its equity method investee. This option further requires that the investor include additional disclosure of amounts recognized before reclassifications and amounts reclassified to earnings in a manner consistent with ASC 220, as depicted below.

#### Statement of Comprehensive Income

<table>
<thead>
<tr>
<th>Year Ended December 31, 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income: $1,500</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
</tr>
<tr>
<td>Change in foreign currency translation adjustment, net of tax 50</td>
</tr>
<tr>
<td>Change in unrealized gain (loss) on derivative instruments, net of tax:</td>
</tr>
<tr>
<td>Unrealized gain arising during period, net of tax 25</td>
</tr>
<tr>
<td>Reclassification adjustment for gain included in net earnings, net of tax (5)</td>
</tr>
<tr>
<td>Total unrealized gain/(loss) on derivative instruments, net of tax 20</td>
</tr>
<tr>
<td>Share of equity method investment other comprehensive income:</td>
</tr>
<tr>
<td>Amount arising during the period 10</td>
</tr>
<tr>
<td>Amount reclassified to earnings during the period (2)</td>
</tr>
<tr>
<td>Total share of equity method investment other comprehensive income 8</td>
</tr>
<tr>
<td>Other comprehensive income 78</td>
</tr>
<tr>
<td>Comprehensive income $1,578</td>
</tr>
</tbody>
</table>
Alternatively, the investor has the option to combine its share of the investee’s OCI with its own, which results in a presentation that does not separately identify amounts related to OCI for either the investor or the investee, as shown below.

<table>
<thead>
<tr>
<th>Statement of Comprehensive Income</th>
<th>Year Ended December 31, 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income:</td>
<td>$ 1,500</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
</tr>
<tr>
<td>Change in foreign currency translation adjustment, net of tax</td>
<td>55</td>
</tr>
<tr>
<td>Change in unrealized gain (loss) on derivative instruments, net of tax:</td>
<td></td>
</tr>
<tr>
<td>Unrealized gain arising during period, net of tax</td>
<td>30</td>
</tr>
<tr>
<td>Reclassification adjustment for gain included in net earnings, net of tax</td>
<td>(7)</td>
</tr>
<tr>
<td>Total unrealized gain/(loss) on derivative instruments, net of tax</td>
<td>23</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>78</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$ 1,578</td>
</tr>
</tbody>
</table>

6.2.4 Cash Flows

An equity method investor will reflect equity method investment activity only if it results in cash transfers, such as incremental investments, receipt of dividends, or other similar transactions. Capital transactions, such as an initial investment or incremental investment, would generally be recognized as investing activities. However, the classification in the statement of cash flows for cash received from equity method investees is less clear.

In August 2016, the FASB issued ASU 2016-15, which, among other things, provides guidance on the classification of distributions from equity method investments. This ASU is effective for PBEs for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted for all entities. Entities must apply the guidance retrospectively to all periods presented.

6.2.4.1 Before the Adoption of ASU 2016-15

ASC 230 distinguishes between returns of investment, which should be classified as cash inflows from investing activities, and returns on investment, which should be classified as cash inflows from operating activities. Accordingly, to make the appropriate classification in the statement of cash flows, entities must determine whether distributions received from an equity method investee represent a return on or a return of the related investment. ASC 325-20-35-1 states that dividends received from a cost method investee “in excess of earnings subsequent to the date of investment are considered a return of investment.” Entities may also apply this guidance when evaluating returns received from equity method investees.

One acceptable method for distinguishing between a return on or a return of investment is to compare cumulative (i.e., since inception) dividends received by the investor with the investor’s cumulative equity in earnings. Under this approach, cumulative dividends received that do not exceed cumulative equity in earnings represent returns on investment that would be classified as cash inflows from operating activities; cumulative dividends received that exceed the investor’s cumulative equity in earnings represent liquidating dividends or returns of investment that would be classified as cash inflows from investing activities.
Entities may also classify distributions from investees in the statement of cash flows by evaluating the facts and circumstances of each distribution to determine its nature. Examples of distributions that represent returns of investment include, but are not limited to, liquidating dividends and dividends representing proceeds from the sale of property, plant, and equipment (PP&E). Under this approach, such distributions would be classified as cash inflows from investing activities. In the absence of facts and circumstances to the contrary, dividends would be presumed to be returns on investment and be classified as cash inflows from operating activities.

### 6.2.4.2 After the Adoption of ASU 2016-15

An entity must make an accounting policy election to classify distributions received from equity method investees under either of the following methods:

- **Cumulative-earnings approach** — Under this approach, distributions are presumed to be returns on investment and classified as operating cash inflows. However, if the cumulative distributions received, less distributions received in prior periods that were determined to be returns of investment, exceed the entity's cumulative equity in earnings, such excess is a return of capital and should be classified as cash inflows from investing activities.

- **Nature of the distribution approach** — Under this approach, each distribution is evaluated on the basis of the source of the payment and classified as either operating cash inflows or investing cash inflows. If an entity that generally applies this approach does not have enough information to determine the appropriate classification (i.e., the source of the distribution), the entity must apply the cumulative-earnings approach and report a change in accounting principle on a retrospective basis. The entity is required to disclose that a change in accounting principle has occurred as a result of the lack of available information as well as the information required under ASC 250-10-50-2, as applicable.

### 6.2.5 Earnings per Share

**ASC 323-10**

**60-1** For guidance on the computation of consolidated earnings per share (EPS) if equity method investees or corporate joint ventures have issued options, warrants, and convertible securities, see paragraph 260-10-55-20.

**ASC 260-10**

**55-20** The effect on consolidated EPS of options, warrants, and convertible securities issued by a subsidiary depends on whether the securities issued by the subsidiary enable their holders to obtain common stock of the subsidiary or common stock of the parent entity. The following general guidelines shall be used for computing consolidated diluted EPS by entities with subsidiaries that have issued common stock or potential common shares to parties other than the parent entity:

- **a.** Securities issued by a subsidiary that enable their holders to obtain the subsidiary's common stock shall be included in computing the subsidiary's EPS data. Those per-share earnings of the subsidiary shall then be included in the consolidated EPS computations based on the consolidated group's holding of the subsidiary's securities. Example 7 (see paragraph 260-10-55-64) illustrates that provision.

- **b.** Securities of a subsidiary that are convertible into its parent entity's common stock shall be considered among the potential common shares of the parent entity for the purpose of computing consolidated diluted EPS. Likewise, a subsidiary's options or warrants to purchase common stock of the parent entity shall be considered among the potential common shares of the parent entity in computing consolidated diluted EPS. Example 7 (see paragraph 260-10-55-64) illustrates that provision.
Chapter 6 — Presentation and Disclosure

ASC 260-10 (continued)

**55-21** The preceding provisions also apply to investments in common stock of corporate joint ventures and investee companies accounted for under the equity method.

**55-22** The if-converted method shall be used in determining the EPS impact of securities issued by a parent entity that are convertible into common stock of a subsidiary or an investee entity accounted for under the equity method. That is, the securities shall be assumed to be converted and the numerator (income available to common stockholders) adjusted as necessary in accordance with the provisions in paragraph 260-10-45-40(a) through (b). In addition to those adjustments, the numerator shall be adjusted appropriately for any change in the income recorded by the parent (such as dividend income or equity method income) due to the increase in the number of common shares of the subsidiary or equity method investee outstanding as a result of the assumed conversion. The denominator of the diluted EPS computation would not be affected because the number of shares of parent entity common stock outstanding would not change upon assumed conversion.

While the guidance above refers to a “subsidiary,” it is equally applicable to equity method investments. Therefore, an equity method investor must evaluate the terms of any securities issued by its equity method investees to determine whether the securities are convertible into shares of either the investee or the investor.

Although the guidance generally does not affect basic earnings per share (EPS), it may affect diluted EPS. If the securities issued are convertible into common stock of the equity method investor, they would be treated as securities of the equity method investor, and the treasury stock or if-converted method would be used to calculate the dilutive impact. If the securities issued are convertible into common stock of the equity method investee, they would be considered in the determination of the equity method investee’s diluted EPS as illustrated in the example below.

**Example 6-1**

Entity A holds a 40 percent interest in the common stock of Entity B that it accounts for under the equity method. Entity A reported net income of $100,000 (before consideration of its equity in the earnings of B) and has outstanding common stock of 5,000 shares. Entity A has not issued any other securities. Entity B has issued 1,000 shares of common stock and warrants exercisable to purchase up to 50 shares of its common stock at $5 each. Entity B reported net income of $3,000. The average market price for B’s common stock was $10.

Entity B’s basic EPS would be $3 ($3,000 net income ÷ 1,000 shares). Entity B's diluted EPS would be $2.93 ($3,000 net income ÷ 1,025 shares).²

Entity A would then determine its diluted EPS by adding its earnings from the 40 percent interest in B of $1,172¹ to its net income of $100,000, yielding a numerator of $101,172 and diluted EPS of $20.23 ($101,172 ÷ A's 5,000 common shares).

Since the warrants are exercisable into B's shares, the denominator for B must be adjusted. However, since there were no instruments that would affect A's common shares, the denominator for A's diluted EPS calculation does not require adjustment.

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² Calculated as 1,000 Entity B common shares + ([(($10 average share price − $5 warrant conversion price) ÷ $10 average share price) × 50 common shares acquired upon conversion of warrant] × 500 common shares acquired upon conversion of warrant).

³ Calculated as Entity B’s diluted EPS of $2.93 × Entity A’s 400-share interest in B.
6.3 Disclosures

6.3.1 Equity Method Investment Disclosures

**ASC 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).

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.

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.

**ASC 825-10**

50-28 As of each date for which a statement of financial position is presented, entities shall disclose all of the following: . . .

f. For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option, the information required by paragraph 323-10-50-3 (excluding the disclosures in paragraph 323-10-50-3(a)(3); (b); and (d)) . . .
Chapter 6 — Presentation and Disclosure

SEC Rules, Regulations, and Interpretations

Regulation S-X, Rule 5-03(b)(12)

Equity in earnings of unconsolidated subsidiaries and 50 percent or less owned persons. State, parenthetically or in a note, the amount of dividends received from such persons. If justified by the circumstances, this item may be presented in a different position and a different manner (see § 210.4-01(a)).

Investors with investments under the equity method of accounting are subject to specific disclosure requirements. As with most elements of disclosure, investors should consider the materiality of the investment(s) when determining the level of disclosure. When an investor has multiple equity method investments, it may be appropriate for the investor to combine some, or all, of the disclosures depending on the similarity of the investments, similarity of the operations, or materiality of the individual investments. In summary, the disclosure requirements can be classified as those relating to the investor's accounting for its investment and those relating to the investee's financial activity:

- **Disclosures related to the investor's accounting for its investment** — The investor should disclose the investee's name and the investor's percentage ownership of the investee's common stock. As discussed in Section 3.2, there is a presumption under U.S. GAAP that an ownership interest of 20 percent or more (or 3 percent to 5 percent for investments in limited partnerships, LLCs, trusts, and similar entities) provides the investor with significant influence and, conversely, that an ownership interest of less than 20 percent (or 3 percent to 5 percent for investments in limited partnerships, LLCs, trusts, and similar entities) does not provide the investor with significant influence. Accordingly, the investor should disclose:
  - Why the equity method of accounting is not applied when the investor has an interest that would presumptively indicate significant influence does exist.
  - Why the equity method of accounting is applied when the investor has an interest that would presumptively indicate significant influence does not exist.

  The investor should also disclose any differences that exist between the investment balance and the investor's share in the investee's underlying earnings and how the investor is accounting for such differences. This may include basis differences (see Section 4.4). For example, if a basis difference related to tangible assets (e.g., PP&E whose fair value exceeded the investee's carrying value), the investor would need to disclose that the basis difference is being amortized over the remaining useful life of such assets. Differences could also arise from the suspension of the equity method of investment (see Section 5.2), the disproportionate allocation of earnings (see Section 5.1.2), or a bargain purchase (see Section 4.5.1). As a result, investors should consider providing appropriate disclosure to describe these differences and the related accounting policy in a manner consistent with how basis differences would be described.

  Further, when the quoted market price of the investee's common stock is available, the investor should also disclose that investment's fair value on the basis of the quoted market price.

- **Disclosures related to the investee's financial activity** — If the investor's equity method investments are material to the investor, for either an individual investee or all investees in the aggregate, the investor should consider disclosure of summarized information regarding the assets, liabilities, and results of operations of the investees, either in the notes to the financial statements or in separate statements. This information may be presented individually (i.e., on an investee-by-investee basis) or in groups as appropriate for the circumstances depending on the similarity of the investments, similarity of the operations, or materiality of the individual investments. While ASC 323 does not specify thresholds for when this information should be provided or any format for these disclosures, SEC registrants must adhere to specific requirements (see
Section 6.5). Other entities may find the SEC guidance useful as well in evaluating when it would be appropriate to provide these disclosures and determining their format. This information is intended to provide the users of the financial statements with further insight into the investee's operations that could not otherwise be inferred from the amounts recorded in the investor's financial statements.

If the investee has issued securities that may materially affect the investor's share of the investee's reported earnings or losses (e.g., convertible debt, options, warrants, or other securities with similar features), the investor must disclose the effect of the possible conversion, exercise, or issuance of such securities on the investor's share of the investee's earnings or losses. For example, if an investor holds a 25 percent interest in an equity method investee and that investee has issued warrants that, if exercised, could double the number of investee common shares outstanding, the investor should disclose the existence of such instruments and the potential effect, if exercised.

The example below illustrates disclosures by an investor with two individually material investments and numerous immaterial investments.

### Example 6-2

**Note X: Company G’s Equity Method Investments**

<table>
<thead>
<tr>
<th>Investment</th>
<th>Ownership Percentage as of December 31, 20X7</th>
<th>Carrying Value as of December 31, 20X7</th>
<th>Carrying Value as of December 31, 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investee A*</td>
<td>19%</td>
<td>$ 500</td>
<td>$ 450</td>
</tr>
<tr>
<td>Investee B**, ***</td>
<td>27%</td>
<td>400</td>
<td>425</td>
</tr>
<tr>
<td>Other investees</td>
<td></td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$ 925†</td>
<td>$ 895</td>
</tr>
</tbody>
</table>

* Company G owns 19 percent of Investee A’s common stock and holds two of the nine seats on A’s governing board, which allows G to exercise significant influence over A.

** As of December 31, 20X7, the aggregate value of G’s investment in B was $475 based on quoted market prices for B’s common stock.

*** Investee B has issued warrants that, if exercised, will reduce G’s ownership percentage to 22 percent. Had such warrants been exercised on January 1, 20X7, G’s share of earnings in B would have been $4 million less.

† As of December 31, 20X7, the carrying value of G’s equity method investments was approximately $150 million higher than its interest in the investees’ underlying net assets. Of this basis difference, $100 million relates to tangible assets and will be amortized over the tangible assets’ remaining useful life. The remaining amount relates to goodwill recognized upon acquisition of G’s interest in the investees; this goodwill is not amortized.
Example 6-2 (continued)

**Summarized Financial Information**

<table>
<thead>
<tr>
<th>Summarized Balance Sheet</th>
<th>December 31, 20X7</th>
<th>December 31, 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$2,000</td>
<td>$2,250</td>
</tr>
<tr>
<td>Noncurrent assets</td>
<td>4,000</td>
<td>3,900</td>
</tr>
<tr>
<td>Total assets</td>
<td>6,000</td>
<td>6,150</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>1,000</td>
<td>950</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td>1,500</td>
<td>1,700</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>2,500</td>
<td>2,650</td>
</tr>
<tr>
<td>Noncontrolling interests</td>
<td>300</td>
<td>250</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Summarized Income Statement</th>
<th>December 31, 20X7</th>
<th>December 31, 20X6</th>
<th>December 31, 20X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,500</td>
<td>$1,250</td>
<td>$1,300</td>
</tr>
<tr>
<td>Gross profit</td>
<td>150</td>
<td>125</td>
<td>130</td>
</tr>
<tr>
<td>Net income</td>
<td>100</td>
<td>75</td>
<td>70</td>
</tr>
</tbody>
</table>

6.3.1.1 Other Disclosure Considerations

While the guidance above outlines the requirements of ASC 323, equity method investments may necessitate disclosure under other areas of the Codification, including those that address the following circumstances:

- **Disclosures for investments accounted for under the fair value option** — Investors that apply the fair value option to an investment that would otherwise be accounted for under the equity method of accounting must provide the disclosures outlined in ASC 323 with certain exceptions. Investors need not disclose:
  - Information regarding basis differences (since none would exist under the fair value option).
  - The aggregate value of the investments based on quoted market price (since the amount recorded in the financial statements would presumably be based on this amount and subject to fair value disclosures in accordance with ASC 820).
  - Information regarding the investee’s convertible or contingent securities that may materially affect the share of earnings or losses recorded by the investor (since the amount recorded by the investor is based on the fair value of the interests rather than the earnings or losses reported by the investee).

- **Disclosures for investments in VIEs accounted for under the equity method** — Investors may use the equity method to account for investees that are VIEs as defined in ASC 810 but whose primary beneficiaries are not the investors. In such cases, investors must comply with the disclosure requirements of ASC 323 (as outlined above) and of ASC 810. These requirements are discussed further in Section 11.2 of Deloitte’s A Roadmap to Consolidation—Identifying a Controlling Financial Interest.
• *Disclosures for changes in reporting lag* — As described in Section 5.1.4, an investor may report the results of its investments on a lag. If the investor changes the period of the lag, that would generally be considered a change in accounting principle and require disclosures in accordance with ASC 250. These disclosures include the nature of and reason for the change, the method of applying the change, and any indirect effects of the change.

• *Disclosures related to guarantees* — Investors may guarantee investees’ obligations. Such guarantees would usually require disclosure in accordance with ASC 460, including, but not limited to, the nature of the guarantee, the circumstances that would require performance, the guarantee’s term and status, and the maximum potential payable under the guarantee.

• *Disclosures related to income taxes* — SEC registrants must provide specific tax disclosures, including a rate reconciliation as well as a discussion of tax holidays. These disclosure requirements are also relevant to equity method investments if the tax effects are material to the registrant.

### 6.3.2 Related-Party Disclosure Requirements

<table>
<thead>
<tr>
<th>ASC 850-10</th>
</tr>
</thead>
</table>
| **50-1** Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:
|   | a. The nature of the relationship(s) involved |
|   | b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements |
|   | c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period |
|   | d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement |
|   | e. The information required by paragraph 740-10-50-17. |

Related parties include “[e]ntities 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.” Therefore, an investor must provide appropriate disclosure for material transactions with an equity method investee. These disclosures include a description of the transaction, the amounts reflected in the financial statement for each period presented, and the impact of any change in the method of establishing the terms of the transactions. An investor must also disclose the amount due to or from an equity method investee as of each balance sheet date.

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4 See ASC 850-10-20.
6.3.3 Nonmonetary Transaction Disclosure Requirements

**ASC 845-10**

50-1 An entity that engages in one or more nonmonetary transactions during a period shall disclose in financial statements for the period all of the following:
   a. The nature of the transactions
   b. The basis of accounting for the assets transferred
   c. Gains or losses recognized on transfers.

50-2 In accordance with paragraph 845-10-50-1, entities shall disclose, in each period's financial statements, the amount of gross operating revenue recognized as a result of nonmonetary transactions. See Subtopic 505-50.

Nonmonetary transactions may include situations in which, for example, an investor contributes assets to an equity method investee in exchange for initial or additional interests. Therefore, an investor must consider the relevant nonmonetary transaction disclosure requirements, including the basis of accounting applied to the assets transferred, in addition to disclosures required under ASC 323 and other relevant guidance.

6.3.4 Discontinued Operation Disclosure Requirements

**ASC 205-20**

50-1 The following shall be disclosed in the notes to financial statements that cover the period in which a discontinued operation either has been disposed of or is classified as held for sale under the requirements of paragraph 205-20-45-1E:
   a. A description of both of the following:
      1. The facts and circumstances leading to the disposal or expected disposal
      2. The expected manner and timing of that disposal.
   b. If not separately presented on the face of the statement where net income is reported (or statement of activities for a not-for-profit entity) as part of discontinued operations (see paragraph 205-20-45-3B), the gain or loss recognized in accordance with paragraph 205-20-45-3C.
   c. Subparagraph superseded by Accounting Standards Update No. 2014-08
   d. If applicable, the segment(s) in which the discontinued operation is reported under Topic 280 on segment reporting.

An equity method investment accounted for as a discontinued operation continues to remain subject to the equity method investment disclosures of ASC 323-10-50-3(c) (see Section 6.3.1).

6.4 QAHP Investments — Presentation and Disclosure

**ASC 323-740**

50-1 A reporting entity that invests in a qualified affordable housing project shall disclose information that enables users of its financial statements to understand the following:
   a. The nature of its investments in qualified affordable housing projects
   b. The effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations.
ASC 323-740 (continued)

50-2 To meet the objectives in the preceding paragraph, a reporting entity may consider disclosing the following:

a. The amount of affordable housing tax credits and other tax benefits recognized during the year
b. The balance of the investment recognized in the statement of financial position
c. For qualified affordable housing project investments accounted for using the proportional amortization method, the amount recognized as a component of income tax expense (benefit)
d. For qualified affordable housing project investments accounted for using the equity method, the amount of investment income or loss included in pretax income
e. Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of equity contributions that are contingent commitments related to qualified affordable housing project investments and the year or years in which contingent commitments are expected to be paid
f. The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of tax credits or other circumstances. For example, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues.

If an investor has an investment in a QAHP (see Section 2.4.3), certain additional disclosures may be necessary owing to the unique nature of the investment. The guidance above is applicable regardless of whether the proportional amortization method is applied.

6.5 Reporting Considerations for Domestic SEC Registrants

This section outlines some general considerations used to determine the SEC reporting requirements for SEC registrants that (1) have an investment in a 50 percent or less owned entity that is accounted for under the equity method or (2) own more than 50 percent of the voting shares of an entity and use the equity method to account for such an investment (i.e., an equity method investee). The SEC has indicated that the term “50 percent or less owned persons” refers to all investments accounted for under the equity method even if the voting ownership exceeds this percentage. The applicable SEC disclosure requirements are primarily in SEC Regulation S-X, Rules 3-09, 4-08(g), and 10-01(b)(1), and in Section 2400 of the SEC Division of Corporation Finance’s Financial Reporting Manual (FRM). Also see Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for additional information. Registrants should review the applicable guidance as well as consider consulting with their audit and legal professionals to determine the appropriate SEC reporting requirements.

An SEC registrant that has an equity method investee must consider whether financial information about the investee should be provided in any reports filed with the SEC that include the registrant’s financial statements. This is to ensure that investors receive relevant financial information about the registrant’s significant activities. If the equity method investee is considered significant to the registrant, the registrant may be required to provide separate financial statements of the investee in certain filings with the SEC, summarized financial information of the investee in the footnotes to its financial statements, or both. Such filings may include Forms 10-K or 10-Q, registration statements, and proxy statements.

5 When preparing annual and interim financial statements, registrants should also consider ASC 323 and ASC 270, as applicable, in determining the appropriate disclosure requirements for significant equity method investees.
6 See Section 2405 of the FRM and Section 1.1.1 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for discussions of certain filings that require such information.
As discussed further in Section 6.5.1, the amount of information a registrant must present depends on the level of significance, which is determined by the registrant’s performing the significant subsidiary tests in Rule 1-02(w), as applicable:

- Investment in and advances to the equity method investee (investment test).
- Income from continuing operations before income taxes, extraordinary items, and the cumulative effect of a change in accounting principle exclusive of amounts attributable to any noncontrolling interest (income test).
- Proportionate share of total assets of the investee (asset test).

To determine whether separate annual financial statements are required, the registrant must apply the investment and income tests to each equity method investee. All three significance tests must be applied to determine whether annual summarized financial information is required, whereas only the investment and income tests are applied to determine whether summarized information is needed for interim periods. The test that results in the highest significance level will be used to determine the following financial statement reporting requirements:

- **Separate financial statements — annual requirements (Rule 3-09).** If the significance of an equity method investee is greater than 20 percent, the registrant must provide the equity method investee’s financial statements. These financial statements are not required for interim periods.

- **Summarized financial information — annual requirements (Rule 4-08(g)).** If the significance of an equity method investee, individually or as part of an aggregated group, is greater than 10 percent, the registrant’s annual financial statements must include summarized financial information for all equity method investees.

- **Summarized income statement information — interim requirements (Rule 10-01(b)(1)).** If the significance of an equity method investee is greater than 20 percent during the interim period, the registrant’s interim financial statements must include the equity method investee’s summarized income statement information.

The following table summarizes the above requirements:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rule 3-09</td>
<td>Annual</td>
<td>X</td>
<td></td>
<td>Investment, Income</td>
<td>&gt;20%</td>
<td>Historical financial statements</td>
</tr>
<tr>
<td>Rule 4-08(g)</td>
<td>Annual</td>
<td>X</td>
<td>X</td>
<td>Investment, Income, Asset</td>
<td>&gt;10%</td>
<td>Summarized financial statement information</td>
</tr>
<tr>
<td>Rule 10-01(b)(1)</td>
<td>Interim</td>
<td>X</td>
<td></td>
<td>Investment, Income</td>
<td>&gt;20%</td>
<td>Summarized income statement information</td>
</tr>
</tbody>
</table>
The sections below provide a high-level overview of certain SEC rules regarding equity method investees. Section 2400 of the FRM and Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees contain additional interpretive guidance on many of the items below and other requirements not covered herein, including, but not limited to, the following:

- Information regarding the calculations of the significance tests, including the registrant’s use of average income when performing the income test and applying the income test when either the registrant or the equity method investee has a loss.
- Changes in a registrant’s method of accounting for an equity method investment, such as a change from the equity method to the cost method of accounting.
- Interaction of Rule 3-09 with other Regulation S-X requirements, including Rule 3-05, Rule 3-10, and Rule 3-16.

Note that there may be situations in which registrants may wish to seek relief from complying with the various reporting requirements under Regulation S-X, including the omission of an equity method investee’s financial statements under Rule 3-09. Regulation S-X, Rule 3-13, has historically given the SEC staff the authority to permit the omission or substitution of certain financial statements otherwise required under Regulation S-X “where consistent with the protection of investors.” In recent remarks, SEC leadership has encouraged registrants to seek modifications to their financial reporting requirements under Rule 3-13, particularly when the requirements are burdensome but may not be material to the total mix of information available to investors. When assessing a waiver request, the staff may consider, for example, whether the income significance test under Rule 3-09 may be anomalous for a registrant in a break-even position. In such a situation, the staff may consider other metrics when assessing the overall significance of the investment. Because a registrant must continue to assess the significance of an equity method investee in each reporting period, it is permissible for the registrant to request in its Rule 3-09 waiver letter that the SEC extend any relief it grants to current and future filings for which the same type of Rule 3-09 financial statements would be required, provided that the facts have not changed and the investment continues to be insignificant.

For additional guidance on Rule 3-13 waivers and prefiling letter requests, see Appendix B in Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights.

### 6.5.1 Measuring Significance

A registrant must use the applicable significant-subsidiary tests in Rule 1-02(w), as summarized below, to determine whether its interest in an equity method investee is significant and, if so, how much information to present. The three significance tests in Rule 1-02(w) are the investment test, the income test, and the asset test. Under Rule 4-08(g), the significance tests are performed both individually for each equity method investee and in the aggregate for all equity method investees, whereas under Rules 3-09 and 10-01(b)(1), the tests are performed for each equity method investee. See Section 6.5 for a table that summarizes the requirements under Rules 3-09, 4-08(g), and 10-01(b)(1).

Significance testing should be based on the accounting used by the registrant. For example, a domestic registrant must measure significance on the basis of an investee’s U.S. GAAP results even if the investee is a foreign business.7

Note that the discussion below is a high-level summary of the significance tests. Given the complexity of these tests, readers may wish to consult Chapter 2 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees and Section 2400 of the FRM for detailed guidance on performing them.

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7 See paragraph 6350.2 of the FRM.
6.5.1.1 **Investment Test**

Rule 1-02(w)(3) indicates that a subsidiary is significant when “[t]he registrant’s and its other subsidiaries’ investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year” (emphasis added). The numerator is generally composed of the carrying value of the investment recorded by the registrant as well as any receivables or other advances. The amounts used are based on the amount recorded by the registrant, inclusive of any impairments or other basis differences recognized. The denominator is the total assets of the registrant, inclusive of the equity method investment balance included in the numerator. The 10 percent threshold is applicable for consideration of summarized financial information in accordance with Rule 4-08(g). Further, Rule 3-09(a) requires separate financial statements when the result of this test exceeds 20 percent for an equity method investee. The 20 percent threshold is also applicable for the determination of whether interim summarized information is required under Rule 10-01(b)(1).

Note that on the basis of informal discussions with the SEC staff, we understand that if the registrant’s investment balance in an equity method investee is a negative amount, the investment’s absolute value should be used to calculate significance under the investment test.

**Example 6-3**

Registrant A is filing its Form 10-K for December 31, 20X7. Registrant A owns a 40 percent equity method investment in Company B. As of December 31, 20X7, A had recorded $150 million related to its investment in B as well as a receivable from B of $20 million. Registrant A had total assets, on a consolidated basis, of $1.3 billion as of December 31, 20X7. The numerator for the investment test is $170 million ($150 million + $20 million) because it would include both investments in and advances to the investee. This amount is then compared with the registrant’s $1.3 billion in total assets, yielding a significance level of 13 percent. Although B’s individual financial statements are not required under Rule 3-09, summarized financial information would be required in the Form 10-K since significance exceeds 10 percent under Rule 4-08(g).

6.5.1.2 **Income Test**

Rule 1-02(w)(3) indicates that a subsidiary is significant when “[t]he registrant’s and its other subsidiaries’ equity in the income from continuing operations before income taxes . . . and cumulative effect of a change in accounting principle of the subsidiary exclusive of amounts attributable to any noncontrolling interests exceeds 10 percent of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year” (emphasis added). Rule 3-09(a) requires separate financial statements when the result of this test exceeds 20 percent for an equity method investee. The 10 percent and 20 percent thresholds are also applicable for the determination of whether summarized annual and interim information is required under Rules 4-08(g) and 10-01(b)(1), respectively.

When determining the numerator of the income test, the registrant must consider paragraph 2410.3 of the FRM, which states, in part:

The numerator is calculated based on the registrant’s proportionate share of the pre-tax income from continuing operations reflected in the separate financial statements of the investee prepared in accordance with U.S. GAAP for the period in which the registrant recognizes income or loss from the investee under the equity method adjusted for any basis differences. In determining the basis differences that should be included for this test, the registrant should consider ASC 323-10-35-34 and ASC 323-10-35-32A.

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As indicated in Section 6.5, under Rule 4-08(g), the investment test is performed both individually for each equity method investee and in the aggregate for all equity method investees.
Upon initial acquisition of an equity method investment or when additional interests in an equity method investee have been acquired, a registrant may determine that basis differences and equity method goodwill exist. (See Section 4.5 for further discussion.) While the numerator (i.e., the registrant’s share of the investee's income) should be adjusted for basis differences, it should not be adjusted for other items (e.g., impairment charges recorded by the investor, gains/losses on stock sales by the registrant, or gains/losses on dilution from stock sales by the investee).\(^9\)

In addition, a registrant should not eliminate intercompany transactions when determining the significance of an equity method investee since the equity method investee is not consolidated.\(^10\)

### Example 6-4

Registrant A is filing its Form 10-K for December 31, 20X7. Registrant A owns one equity method investment, a 40 percent investment in Company B. For its fiscal year ended December 31, 20X7, B had $20 million in pretax income from continuing operations. Registrant A's proportionate share of B's pretax income from continuing operations is $8 million ($20 million × 40%). In addition, A recognized the following during the year ended December 31, 20X7, related to its investment in B:

- $1 million basis adjustment related to additional depreciation of tangible assets.
- $2 million gain related to the issuance of additional shares by B (i.e., dilution gain).

For the fiscal year ended December 31, 20X7, A's income from continuing operations before taxes presented in its income statement was $100 million.

The numerator for the income test is $7 million ($20 million × 40% – $1 million basis adjustment related to additional depreciation of tangible assets); the dilution gain is excluded. This amount is then compared with A's $100 million in pretax income from continuing operations, yielding a significance level of 7 percent. Therefore, neither summarized financial information under Rule 4-08(g) nor B's financial statements under Rule 3-09 are required in A's Form 10-K.

For more information regarding the calculation of the income test, including the calculation of the denominator, see Chapter 2 of Deloitte's *A Roadmap to SEC Reporting Considerations for Equity Method Investees* and Section 2410 of the FRM.

### 6.5.1.2.1 Fair Value Option

If a registrant applies the fair value option to an investment that would otherwise have been accounted for under the equity method of accounting, the numerator for the income test should be based on the change in fair value reflected in the registrant's income statement rather than the equity in the investee's earnings.\(^11\)

### 6.5.1.2.2 Multiple Equity Method Investees

Under Rule 4-08(g), a registrant must apply the income test both individually and in the aggregate. In some cases, certain equity method investees may report income while others report losses. In accordance with the third computational note to Rule 1-02(w), a registrant must separately combine the pretax income from continuing operations of all equity method investees reporting income and the pretax loss from continuing operations of all equity method investees reporting losses. See Sections 2.1.4 and 2.1.5 of Deloitte's *A Roadmap to SEC Reporting Considerations for Equity Method Investees* for more information.

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\(^9\) See paragraph 2410.3 of the FRM.

\(^10\) See paragraph 2410.6 of the FRM.

\(^11\) See Section 2435 of the FRM.
6.5.1.2.3 Different Fiscal Year-Ends

In certain cases, the periods included in the investee’s financial statements required to be filed under Rule 3-09, may differ from the financial results a registrant uses to record its share of equity method income. This may occur if the investee and registrant have different year-ends or if the registrant records its share of the investee’s income on a lag. In such cases, the significance tests should be based on the financial information of the investee used by the registrant to apply the equity method of accounting in its financial statements related to the equity method investee.\(^\text{12}\)

6.5.1.3 Asset Test

The asset test is used solely to assess the need for summarized financial information in accordance with Rule 4-08(g). Rule 1-02(w)(2) states that an equity method investee is significant when “[t]he registrant’s and its other subsidiaries’ proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year” (emphasis added). The numerator is generally composed of the investor’s proportionate share of the assets of the investee(s); the denominator is the total assets of the registrant, inclusive of the equity method investment balance(s).

If the result of any of the significant-subsidiary tests applied to an equity method investee exceeds 10 percent, a registrant must provide summarized financial information in accordance with Rule 4-08(g). As discussed in Section 6.5, under Rule 4-08(g), the asset test must be performed both individually for each equity method investee and in the aggregate for all equity method investees.

See Section 2.3.1 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for more information.

**Example 6-5**

Registrant A is filing its Form 10-K for December 31, 20X7. Registrant A owns a 40 percent equity method investment in Company B and a 30 percent equity method investment in Company C. As of December 31, 20X7, A’s proportionate share of the total assets of B and C was $60 million and $90 million, respectively. Registrant A had total assets, on a consolidated basis, of $1.3 billion as of December 31, 20X7. Although individually B and C are not significant to A at the 10 percent level, in the aggregate, the numerator for the asset test is $150 million. This amount is then compared with the $1.3 billion of A’s total assets, yielding a significance level of 12 percent. Therefore, A must provide summarized financial information for B and C under Rule 4-08(g).

6.5.1.4 Impact of Retrospective Changes

Under Rules 3-09 and 4-08(g), the significance tests are performed annually in connection with the filing of a Form 10-K (i.e., at the end of the registrant’s fiscal year). Accordingly, significance is not remeasured if updated financial statements that reflect retrospective adjustments are filed in a Form 8-K (or are included in or incorporated into a registration statement).\(^\text{13}\) However, when a registrant files its next Form 10-K reflecting a retrospective change, it must consider whether it should update its prior significance calculations on the basis of the retrospectively adjusted financial statements.\(^\text{14}\) As a result

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12 See paragraph 2410.7 of the FRM.
13 ASC 250 may require that certain changes (e.g., a change in accounting principle or the reporting of a discontinued operation under ASC 205-20) be effected by retrospective application. As indicated in Topic 13 of the FRM, in certain circumstances (e.g., when filing a new registration statement or proxy statement), a registrant may be required to file updated financial statements that reflect retrospective adjustments for periods before the change’s adoption. Such updated financial statements may be filed in a Form 8-K or included or incorporated by reference into the registration or proxy statement.
14 Note that a correction of an error requires the filing of a Form 10-K/A. In such an instance, a registrant should evaluate the requirements under Rules 3-09 and 4-08(g) on the basis of the corrected information in the Form 10-K/A.
of retrospective adjustments, a previously insignificant equity method investee may become significant, and the registrant may be required to file the investee’s financial statements or disclose summarized information of the investee, or both, in the registrant’s Form 10-K, even if the registrant was not required to file such financial information in a prior Form 10-K. See paragraph 2410.8 of the FRM for additional guidance (e.g., how to measure significance when a registrant disposes of an equity method investment). Also see Section 2.1.6 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees.

6.5.1.4.1 Change in Accounting Principle

When a change in accounting is retrospectively applied in financial statements included in a registrant’s Form 10-K, the registrant is not required to recalculate the significance of the equity method investee under Rules 3-09 and 4-08(g) for periods earlier than the one during which the change occurred. Therefore, for periods before the date of initial adoption of a new accounting principle, the registrant is allowed to continue to measure the significance of its equity method investee by using results from its preadoption financial statements.15

6.5.1.4.2 Discontinued Operations

If a registrant reports a discontinued operation retrospectively in financial statements included in its next Form 10-K, the registrant should be mindful that significance under Rules 3-09 and 4-08(g) should be measured for each annual period presented in the financial statements on the basis of amounts that were retrospectively adjusted for the discontinued operation. As a result of retrospective adjustments for a discontinued operation, a previously insignificant equity method investee may become significant, and the registrant may be required to file the investee’s financial statements, summarized financial information, or both in the registrant’s next Form 10-K even if the registrant was not required to file such financial information in a prior Form 10-K.16

6.5.2 Overview of Rule 3-09

6.5.2.1 Form and Content

If an equity method investee and a registrant have the same fiscal year-end, Rule 3-09(b) requires that the dates and periods covered by the separate financial statements be the same as those of the registrant’s audited consolidated financial statements required by SEC Regulation S-X, Rules 3-01 and 3-02 (e.g., two years of balance sheets and three years of statements of operations, statements of comprehensive income, statements of changes in stockholders’ equity, and cash flow statements for a registrant that is not an emerging growth company (EGC)).17 The investee must present the same periods as the registrant for every period in which the equity method of accounting was used, even if the applicable significance tests are not met in all periods. The registrant may, however, provide unaudited financial statements for years in which the significance test is not met. If the registrant has not used the equity method to account for the equity method investee for all periods reflected in its historical financial statements, the equity method investee’s financial statements should be provided only for the period in which the equity method of accounting was used.18

15 See paragraph 2410.8 and Topic 11 of the FRM.
16 See paragraph 2410.8 of the FRM.
17 The JOBS Act created a category of issuers called EGCs whose requirements related to certain areas differ from those of other categories of issuers. For example, EGCs are permitted to file only two years of balance sheets and statements of operations, comprehensive income, and changes in stockholders’ equity in a Securities Act registration statement for an IPO of common equity securities. See Section 6.5.5 for a discussion of EGCs.
18 As discussed in paragraph 2405.4 of the FRM, the Office of Chief Accountant in the SEC’s Division of Corporation Finance will consider written requests to use financial statements for complete years (not only the portion of the year for which the equity method of accounting was applied) “if the registrant demonstrates that it is an undue hardship to obtain investee’s financial statements” for only the portion of the year in which the equity method of accounting was applied.
If the equity method investee and the registrant have different fiscal year-ends, the equity method investee’s separate financial statements may be as of its year-end. See Rule 3-09(b)(2).

At the April 2004 AICPA SEC Regulations Committee joint meeting with the SEC staff, the staff indicated that if the equity method investee is a public company, its financial statements should comply with U.S. GAAP and all provisions of SEC Regulation S-X, including the schedule requirements of Article 12. If the equity method investee is a nonpublic company, it is not required to comply with U.S. GAAP that apply only to public companies, such as the requirements related to EPS (i.e., ASC 260) and segments (i.e., ASC 280), but the form and content of the financial statements, including the schedule requirements, must comply with SEC Regulation S-X.

Equity method investees whose financial statements are included in a registrant’s filing under Rule 3-09 because the equity method investee is significant to the registrant are considered PBEs under U.S. GAAP. As a result, such equity method investees would generally be expected to use PBE adoption dates when preparing their financial statements or financial information to be included in an SEC filing. However, as discussed in Section 5.1.3.4, at the July 2017 EITF meeting, the SEC made a staff announcement indicating that it will not object to a PBE’s using the non-PBE adoption dates for ASC 606 and ASC 842 as long as the PBE is defined as such only because it is among “other entities whose financial statements or financial information are required to be or are included in a filing” (codified in ASC 606-10-S65-1 and ASC 842-10-S65-1, respectively).

Under Rule 3-09(c), if financial statements are required for two or more equity method investees, a registrant may present (1) consolidated financial statements of the group when appropriate under U.S. GAAP (e.g., when one equity method investee should consolidate another equity method investee) or (2) combined financial statements, if such presentation clearly exhibits the financial position, results of operations, and cash flows of the consolidated or combined group. Combined financial statements should be presented only for entities under common control or common management, and only for those periods in which that condition existed.

In general, the investee’s financial statements should be presented in accordance with U.S. GAAP; however, for investees that meet the definition of a foreign business, registrants may instead file the investee’s financial statements in accordance with IFRS Standards as issued by the International Accounting Standards Board (IASB®) or home country GAAP with a reconciliation to U.S. GAAP. Also note that by definition, a 50:50 joint venture accounted for under the equity method would not be a foreign business if a domestic company holds either interest given that a 50 percent interest held by a domestic company would preclude the entity from being “majority owned by persons who are not citizens or residents of the United States.”

See Section 1.1.2 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for further information.

### 6.5.2.2 Lower-Tier Equity Method Investees (i.e., Equity Method Investments of an Equity Method Investee)

Rule 3-09 applies when a registrant owns an equity method investment in an entity that, in turn, holds an equity method investment in another entity, referred to as a lower-tier equity method investee. Rule 3-09 applies to all equity method investees that are significant to the registrant’s financial statements, regardless of whether these investees are directly or indirectly owned by the registrant.

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19 See Section 6.5.3.1 for a similar discussion regarding Rule 4-08(g).
20 See paragraph 2415 of the FRM.
21 See Rule 1-02(l) and paragraph 2425 of the FRM.
22 This topic was discussed at the November 2014 meeting of the International Practices Task Force.
23 See paragraph 2405.6 of the FRM and SAB Topic 6.K.4(a).
Significance should be computed on the basis of the materiality of the lower-tier investee to the registrant on a consolidated basis. Separate financial statements of the lower-tier investee should be provided when the significance level exceeds the 20 percent threshold. For further information and an example, see Section 1.1.3 of Deloitte’s *A Roadmap to SEC Reporting Considerations for Equity Method Investees*.

### 6.5.2.3 Due Date of Financial Statements for Equity Method Investees

A registrant must consider the requirements in Rule 3-09 when filing its annual report on Form 10-K or a registration statement or proxy statement.

**Paragraph 2405.7** of the FRM discusses the due date for filing the financial statements of an equity method investee in a Form 10-K. The equity method investee's financial statements may be due when the registrant initially files its Form 10-K; however, depending on various factors, including the equity method investee's year-end and filing status and whether the equity method investee is a foreign business, the financial statements may be filed later as an amendment to Form 10-K. See Section 2405 of the FRM for more information on the types of filings for which Rule 3-09 financial statements should be included and the appropriate filing deadlines.

The table below shows the effect of the equity method investee's filing status on the filing deadline. This table applies when (1) the equity method investee is not a foreign business and (2) the registrant and the equity method investee have the same fiscal year-end. Equity method investees that are not SEC registrants would be considered nonaccelerated filers in this table.24

<table>
<thead>
<tr>
<th>Equity Method Investee</th>
<th>Registrant</th>
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<tr>
<td></td>
<td>Large Accelerated Filer</td>
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<tr>
<td>Large accelerated filer</td>
<td>No accommodation</td>
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<tr>
<td>Accelerated filer</td>
<td>75 days</td>
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<tr>
<td>Nonaccelerated filer</td>
<td>90 days</td>
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*No accommodation* — Registrant must file the equity method investee's financial statements by the due date of the registrant's Form 10-K.

*75 days* — Registrant must file the equity method investee's financial statements within 75 days of the equity method investee's year-end (i.e., March 16, 20X7, for a December 31, 20X6, year-end).

*90 days* — Registrant must file the equity method investee's financial statements within 90 days of the equity method investee's year-end (i.e., March 31, 20X7, for a December 31, 20X6, year-end).

If the registrant does not file the equity method investee's financial statements in its Form 10-K, they must be filed by amendment before the appropriate due date noted above. See also paragraph 2405.8 of the FRM. As indicated in Note 2 to paragraph 2405.11 of the FRM, this accommodation applies only to annual reports.

Note that if the registrant files a registration statement or proxy statement, it may need to update the equity method investee's financial statements before it amends its annual report (and therefore before the filing dates noted above). See paragraph 2405.11 of the FRM.

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24 This topic was discussed at the April 2006 AICPA SEC Regulations Committee joint meeting with the SEC staff.
Example 6-6

Registrant A and Equity Method Investee B both have a December 31 fiscal year-end. Registrant A is a large accelerated filer. Equity Method Investee B is not an SEC registrant and does not meet the definition of a foreign business.

Because B is not a foreign business and A and B have the same fiscal year-end, A must consider its own filing status and that of B in determining the due date for A to file B's financial statements in its Form 10-K. Because B is a nonaccelerated filer, A must file B's financial statements within 90 days of B's year-end, or by March 31.

See also Section 1.5.1 in Deloitte's A Roadmap to SEC Reporting Considerations for Equity Method Investees for further information.

6.5.2.4 Audit Requirements for Financial Statements

An equity method investee's separate financial statements must be audited only for periods in which the results of the applicable significance tests in Rule 1-02(w) exceed 20 percent. If the equity method investee becomes significant at the greater than 20 percent level in the current year, the registrant must present two years of balance sheets and three years of statements of operations, comprehensive income, stockholders' equity, and cash flows for the equity method investee even if it was not significant in the earliest two years. However, in this case, Rule 3-09(b) does not require that the periods in which the equity method investee was not significant be audited. If the equity method investee was significant in the previous years but becomes insignificant (below the 20 percent level) during the current year, the registrant would still need to present two years of balance sheets and three years of statements of operations, comprehensive income, stockholder's equity, and cash flows; however, the current-year financial statements may be unaudited.

For the independent auditor requirements related to equity method investees, see Section 1.2 of Deloitte's A Roadmap to SEC Reporting Considerations for Equity Method Investees.

6.5.3 Overview of Rule 4-08(g)

6.5.3.1 Form and Content

If the significance test is met in any year, the summarized financial information under Rule 4-08(g) should be presented as of and for the same periods as the registrant's financial statements (i.e., two years of balance sheet information and three years of statements of operations, comprehensive income, changes in stockholders' equity, and cash flow information), even if the significance level is not met in all periods. Further, the disclosure should include all equity method investees, not just those that are significant. The notes to paragraph 2420.3 of the FRM indicate that the SEC staff has acknowledged that in some circumstances, such as when it is impracticable to accumulate such information and the information to be excluded is de minimis, summarized information may be excluded for a specific entity.

Under Rule 1-02(bb), the following financial statement line items are required in the summarized financial information:

- Current and noncurrent assets.
- Current and noncurrent liabilities.
- Redeemable stock.
- Noncontrolling interests.

25 See paragraph 2420.4 of the FRM.
• Revenues.
• Gross profit.
• Income (loss) from continuing operations.
• Net income (loss).
• Net income (loss) attributable to the entity.

Summarized financial information must be presented in the notes to the annual financial statements and should be presented in accordance with U.S. GAAP. Summarized financial information should not be labeled “unaudited.”

If investees do not present classified balance sheets, the registrant should provide other information about the nature and amount of the major components of assets and liabilities. If necessary, equity method investees in specialized industries may also substitute other information for sales and related costs and expenses for a more meaningful presentation. SEC Accounting Series Release No. 302 (FRR Section 213.03.c) provides the following examples:

• “A bank . . . could present total interest income, total interest expense, provision for loan losses, and security gains or losses in lieu of sales and related costs and expenses.”
• “[A]n insurance company could present information as to net premiums earned, net investment income, underwriting costs and expenses, and realized gains or losses or investments.”
• “A finance company . . . should disclose the portion of its total assets represented by net loan receivables when that item represents one of that company’s largest assets.”
• “Long-term liabilities and redeemable preferred stock should be disclosed regardless of the type of balance sheet presented.”

In addition, if an equity method investee’s financial information is included in an SEC filing as a result of Rule 4-08(g), that investee would be considered a PBE and generally would be expected to apply the requirements specific to PBEs. Therefore, a registrant should determine, subject to materiality considerations, whether to use PBE adoption dates when it is preparing the summarized financial information of equity method investees that is required by Rule 4-08(g). As discussed in Section 5.1.3.4, because of the complexities involved in adopting ASC 606 and ASC 842, the SEC has provided relief by allowing equity method investees to use non-PBE adoption dates. However, this exception applies solely to the adoption of ASC 606 and ASC 842.

The summarized financial information may be presented for each equity method investee individually or on a combined basis with the information of other equity method investees. While aggregation is acceptable in most circumstances, it can sometimes be misleading or result in the suppression of important information. The SEC staff may, for example, request that investees in different businesses be aggregated separately, or it may request separate presentation for investees that are quantitatively or qualitatively significant.

See Section 1.1.4 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for further information.

26 See paragraph 3240.4 of the FRM.
27 See Section 6.5.2.1 for similar discussion regarding Rule 3-09.
6.5.3.2 Interaction of Rules 4-08(g) and 3-09

In limited circumstances, a registrant may be able to exclude the summarized financial information for an equity method investee that is significant under Rule 3-09, and for which the registrant has included the equity method investee’s separate financial statements in its Form 10-K. However, to use this accommodation, the registrant must file the investee’s separate financial statements at the same time it files its Form 10-K. For more information, see ASC 323-10-S99-2, paragraph 2420.5 of the FRM, and Section 1.3.3 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees.

6.5.4 Overview of Rule 10-01(b)(1)

6.5.4.1 Form and Content

If Rule 10-01(b)(1) requires that summarized financial information be included in interim financial statements, registrants must disclose the following income statement line items specified in Rule 1-02(bb)(ii):

- Revenues.
- Gross profit.
- Income (loss) from continuing operations.
- Net income (loss).
- Net income (loss) attributable to the entity.

If summarized financial information is required, a registrant should provide year-to-date information for both the current interim period and the comparative prior-year interim period.

6.5.4.2 Determining Whether Summarized Interim Information Is Required

A registrant’s interim financial statements must include an equity method investee’s summarized income statement information if both (1) the significance of the equity method investee exceeds 20 percent under either the income test or the investment test as prescribed in Rule 1-02(w) and (2) interim financial information would be required if the equity method investee were a registrant.

With respect to (2) in the paragraph above, certain entities, such as “foreign private issuers, asset-backed issuers, mutual life insurance companies and certain mining companies,” are not required to file financial information on Form 10-Q. Therefore, summarized income statement information for equity method investees is not required for such entities.

In performing the income test, the registrant should use the year-to-date interim period income statement for the current year rather than the financial information from either the current quarterly period or the most recently completed fiscal year. The investment test should be based on (1) the most recent interim balance sheet included in the filing (which should correspond to the end of the year-to-date period used in the income test) and (2) the balance sheet as of the end of the most recently completed fiscal year (the comparative balance sheet provided in the interim report). If the result of either the income test or the investment test exceeds the 20 percent significance level, the summarized...
income statement information for both the current and prior-year comparative year-to-date periods should be presented for investees that are significant.

See Section 2.1.3 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for further information.

### 6.5.5 Considerations for EGCs

A registrant may qualify as an EGC and therefore for certain accommodations, including the requirement to present only two years of audited financial statements in its IPO of common equity securities. If an operating company EGC has a significant equity method investee, it may present only two years of the investee’s financial statements in the IPO of common equity securities. This accommodation is available even if the EGC presents a third year of its own financial statements, though this is not required. However, the presentation of three years of financial statements is required for EGCs in an IPO of debt securities or an Exchange Act registration statement (i.e., Form 10).

See Topic 10 of the FRM for eligibility requirements for an EGC and the reporting requirements related to EGCs.

### 6.5.6 Considerations for Acquisitions and Dispositions

SEC registrants are required to periodically file current reports on Form 8-K to inform investors of certain events. When a registrant acquires or disposes of an interest in an equity method investee, it must assess the significance of the acquisition or disposition and should consider whether a Form 8-K should be filed. Form 8-K, Item 2.01, requires a registrant to file a Form 8-K if either a business or asset acquisition or disposition is significant. Item 2.01, Instruction 4, states, in part:

> An acquisition or disposition shall be deemed to involve a significant amount of assets:
> (i) if the registrant’s and its other subsidiaries’ equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or
> (ii) if it involved a business (see 17 CFR 210.11-01(d)) that is significant (see 17 CFR 210.11-01(b)).

Registrants should consider the guidance in Topics 2 and 3 of the FRM and may want to consult with their legal advisers and independent accountants regarding these requirements. Further, see the discussions of SEC reporting in Chapter 7 of Deloitte’s A Roadmap to Reporting Discontinued Operations and Section AA.5 of Deloitte’s A Roadmap to Accounting for Asset Acquisitions.

#### 6.5.6.1 Acquisition of an Equity Method Investee

According to Rule 3-05(a)(1)(i) and paragraph 2010.3 of the FRM, a business acquisition for SEC reporting purposes includes “the acquisition of an interest in a business accounted for by the equity method.” Therefore, when a registrant acquires an interest in an equity method investee, it must assess the acquisition’s significance and determine whether separate historical preacquisition financial statements of the investee and pro forma financial information must be filed.

The registrant’s Form 8-K must be filed within four business days of the acquisition’s completion. The registrant must describe the acquisition and provide the required historical financial statements and pro forma financial information in accordance with SEC Regulation S-X, Article 11, giving effect to the acquisition. If the historical financial statements and pro forma financial information are not available at

33 See paragraph 10220.5 of the FRM.
34 See Section 1.1.1 of Deloitte’s A Roadmap to SEC Reporting Considerations for Equity Method Investees for information regarding certain registration statements.
35 For the requirements of Regulation S-X related to pro forma information, see Article 11.
the time of the initial filing, the registrant has 71 days from the filing of the initial Form 8-K to amend it with the required information.

For further information on the reporting requirements for the acquisition of a business, see the guidance referred to in Section 6.5.6.

6.5.6.2 Disposition of an Equity Method Investee
A registrant may be required to file a Form 8-K for the disposition of an equity method investee. For additional guidance, see Section 2100 of the FRM and Chapter 7 of Deloitte’s A Roadmap to Reporting Discontinued Operations.

6.5.6.3 Contribution of a Business or Assets to an Equity Method Investee
A registrant may contribute a business or other assets to an equity method investee either at formation or during the investee’s operation in an exchange transaction.36 These transactions may represent (1) the disposal of assets or a business or (2) the acquisition of an interest in the equity method investee.

36 See paragraph 2025.4 of the FRM.
Chapter 7 — Identification of a Joint Venture

7.1 Overview

Corporate and unincorporated joint venture entities ("joint ventures") are a common form of business enterprise. For a number of reasons, investors ("venturers") establish joint ventures rather than undertaking business activities on their own. Venturers may use joint ventures to enter new markets, finance major projects that are beyond each venturer's financial capabilities, or share expertise or risks. Joint ventures also allow venturers to partially exit a business or enterprise as an alternative to a complete disposition. Joint ventures can take a variety of forms, including corporations, partnerships, and LLCs.

Generally, a venturer accounts for its investment in a joint venture the same way it would for any other equity method investment under ASC 323. However, determining whether a legal entity is in fact a joint venture is necessary because such a determination may affect the basis of accounting for both the venturer and the financial statements of the joint venture upon the venture's initial formation. For instance, if an entity is a joint venture, the venture may measure the initial net assets received at historical cost or at fair value, depending on facts and circumstances. From a venturer's perspective, the accounting for its initial contribution could be affected by the legal entity's classification as a joint venture.

In other circumstances, if a venturer determines that a legal entity does not meet the definition of a joint venture, the venturer may be required to account for the venture's initial formation as a business combination in accordance with ASC 805. In addition, whether a legal entity is a VIE may affect the venturer's evaluation of whether it has a controlling financial interest in the venture in accordance with ASC 810.

There is diversity in practice in the identification of whether an enterprise is a joint venture owing to a lack of prescriptive guidance in U.S. GAAP beyond the term's definition in the ASC master glossary, which originated in APB Opinion 18, in 1971. In practice, "joint venture" is commonly used for ventures that do not meet the definition of a joint venture in accordance with U.S. GAAP because:

- Many use the phrase generously in the titles of legal/organizational documents.
- Some use the phrase to describe all investments with only two investors.
- Others mischaracterize investments as joint ventures because of the lack of comprehensive guidance related to what constitutes a joint venture.

Consequently, many investments that are called joint ventures do not meet the accounting definition of a joint venture.

1 We use the term "venturer" when referring to the members of or investors in a legal entity that meets the definition of a joint venture. Should the legal entity not meet, or it is unknown whether it meets, the definition of a joint venture, we will interchangeably use the terms "member" or "investor."
7.2 Definition of a Joint Venture

ASC 323-10 — Glossary

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.

ASC 805-10 — SEC Materials — SEC Staff Guidance

SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation
S99-8 The following is the text of SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation.

The SEC staff will object to a conclusion that did not result in the application of Topic 805 to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.

ASC 845-10 — SEC Materials — SEC Staff Guidance

SEC Observer Comment: Accounting by a Joint Venture For Businesses Received at Its Formation
S99-2 The following is the text of SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation.

The SEC staff will object to a conclusion that did not result in the application of Topic 805 to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.

The ASC master glossary defines “corporate joint venture” and provides specific characteristics of a joint venture within that definition. In addition to those characteristics, there is a consensus that venturers must have joint control over an entity for it to be considered a joint venture, as evidenced by the codified comments from the SEC staff observer captured originally in EITF Issue 98-4. Further, the Accounting Standards Executive Committee (AcSEC) indicated in the advisory conclusion of its AICPA Issues Paper, “Joint Venture Accounting,” issued July 17, 1979, that the element of “joint control” of major decisions should be the central distinguishing characteristic of a joint venture. The AcSEC recommended that the definition in Section 3055 of the Canadian Institute of Chartered Accountants Handbook (subsequently

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2 We have used the terms “corporate joint venture” and “joint venture” interchangeably in this publication.
amended) be adopted in substance as the definition of a joint venture. The Handbook defines a joint venture as:

An arrangement whereby two or more parties (the venturers) jointly control a specific business undertaking and contribute resources towards its accomplishment. The life of the joint venture is limited to that of the undertaking which may be of short or long-term duration depending on the circumstances. A distinctive feature of a joint venture is that the relationship between the venturers is governed by an agreement (usually in writing) which establishes joint control. Decisions in all areas essential to the accomplishment of a joint venture require the consent of the venturers, as provided by the agreement; none of the individual venturers is in a position to unilaterally control the venture. This feature of joint control distinguishes investments in joint ventures from investments in other enterprises where control of decisions is related to the proportion of voting interest held.

Although joint control is a joint venture’s most distinguishing feature, it is not the only characteristic of a joint venture, and as described in ASC 805-10-S99-8 and ASC 845-10-S99-2, the SEC staff “would object to a conclusion that joint control is the only defining characteristic of a joint venture.”

On the basis of the definition of a joint venture in ASC 323-10-20, we believe that a joint venture has all the following characteristics:

- It is a separate legal entity (see Section 7.2.1).
- It is owned by a small group of entities (see Section 7.2.2).
- Its operations are for the mutual benefit of the venturers (see Section 7.2.3).
- Its purpose 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 (see Section 7.2.4).
- It allows each venturer to participate, directly or indirectly, in the overall management. The members have an interest or relationship other than that of passive investors (see Section 7.2.5).
- It is not a subsidiary of one of the members (commonly referred to as the “joint control” provision) (see Section 7.2.6).

The decision tree below illustrates how an investor should determine whether an entity is a joint venture.

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3 The requirement that all the conditions must be met is consistent with the views expressed by SEC Professional Accounting Fellow Chris Rogers at the 2014 AICPA Conference on Current SEC and PCAOB Developments. See Section 7.2.4 for excerpts from the remarks.
Is the entity a separate entity?
Yes

Is the entity owned by a small group of entities?
Yes

Are the operations of the entity for the mutual benefit of the members?
Yes

Is the purpose to share risks and rewards, combine technology, or pool resources?
Yes

Can each venturer participate in the entity’s management?
Yes

Is the entity jointly controlled by the venturers (not a subsidiary of a venturer)?
Yes

Apply joint venture accounting.

No

Do not apply joint venture accounting.

No

No

No

No

No
7.2.1 Separate Legal Entity

ASC 323-30

15-3 Although Subtopic 323-10 applies only to investments in common stock of corporations and does not cover investments in partnerships and unincorporated joint ventures (also called undivided interests in ventures), many of the provisions of that Subtopic would be appropriate in accounting for investments in these unincorporated entities as discussed within this Subtopic.

ASC 810-10 — Glossary

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.

One of the characteristics in the definition of a joint venture is that the venture must be a separate entity. Further, we believe that the joint venture must be a separate legal entity because it is important that the entity have a separate legal identity from that of its venturers. This is the foundation for the ability of all venturers to participate in the entity’s decision making. See Section 3.2 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest for further information regarding the evaluation of legal entities. If the venture is not formed as a separate legal entity, it may be a collaborative arrangement as defined by ASC 808.

Even though ASC 323-10-20 defines a corporate joint venture, other unincorporated legal entities (e.g., partnerships) may also be joint ventures. As described in ASC 323-30-15-3, many of the same principles used in the evaluation of a corporate joint venture would apply to the evaluations of these other unincorporated entities.

7.2.2 Small Group of Entities

While ASC 323-10-20 prescribes that a joint venture must be owned by a small group of entities, there is no indication in U.S. GAAP of the maximum number of entities that may own a joint venture. We believe that in practical terms, the greater the number of investors, the less likely it is for an entity to be jointly controlled by its venturers. We also believe that the greater the number of investors, the less likely it is that the entity may meet the condition of being owned by a small group of entities and therefore, the less likely it is to qualify as a joint venture.

ASC 323-10-20 does allow a joint venture to have a noncontrolling interest held by public investors (both public entities and individual shareholders). It is not uncommon, nor is it prohibited by U.S. GAAP, for public entities to be venturers in a joint venture. It is less common for numerous individual shareholders to hold interests in the joint venture. Typically, when individual shareholders have an interest in a joint venture, these interests are not significant to those of the other venturers, and the individual shareholders cannot substantively participate in the financial and operating decisions made in the ordinary course of business for the joint venture. In these circumstances, a legal entity is not precluded from meeting the definition of a joint venture should the remaining venturers jointly control the legal entity.

7.2.3 Mutual Benefit of Members (Venturers)

The joint venture’s operations must be for the mutual benefit of its members. The members, however, do not need to benefit equally for the entity to be a joint venture. In fact, one venturer may receive substantially all of the benefit and the entity may still be a joint venture.
7.2.4 Purpose

The definition of a joint venture in ASC 323-10-20 describes its purpose:

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.

At the 2014 AICPA Conference, Mr. Rogers commented on the evaluating the purpose of a joint venture and stated, in part:

In evaluating joint venture formation transactions, the staff continues to believe that joint control is not the only defining characteristic of a joint venture. Rather, each of the characteristics in the definition of a joint venture in Topic 323 should be met for an entity to be a joint venture, including that the “purpose” of the entity is consistent with that of a joint venture. . . .

The staff has seen recent fact patterns where the primary purpose of a transaction is to combine two or more existing operating businesses in an effort to generate synergies such as economies of scale or cost reductions and/or to generate future growth opportunities. In these fact patterns, determining whether the purpose of the transaction is consistent with the definition of a joint venture as described in Topic 323 or whether the substance of the formation transaction is a merger or put together transaction that should be accounted for as a business combination under Topic 805 requires a significant amount of judgment. [Footnotes omitted]

As emphasized by Mr. Rogers, the “purpose” criterion is one of the defining characteristics of a joint venture. Many transactions that may be viewed as potential joint ventures do not meet the definition of a joint venture because the purpose of the venture is only to generate synergies, such as economies of scale or cost reductions, or to generate future growth opportunities of two merged companies. This does not mean that a venture that will create synergies is precluded from meeting the definition of a joint venture but that a venture that is created solely to combine existing businesses or to function as an extension of the investors’ ongoing operations would not meet the purpose criterion. Instead, a venture must focus on the development of something new and different to satisfy the purpose criterion (e.g., the combination of technological knowledge to achieve a new commercial purpose or business objective).

Example 7-1

Company A has a subsidiary, Entity C, that sells outdoor equipment. Entity C meets the definition of a business. Company A approached a private equity firm, Company B, to invest in C. To effect the transaction, A formed a new entity, NewCo, and contributed C. Company B contributed its cash investment in exchange for an ownership interest of 50 percent in NewCo.

NewCo is not a joint venture because it does not meet the purpose criterion in the term’s definition. That is, NewCo is not developing a new market, product, or technology; combining complementary technological knowledge; or pooling resources in developing production or other facilities.

Example 7-2

Company A has developed a new product, SW. To expand its manufacturing capabilities for this new product, A and a private equity firm, PE 1, form a legal entity (NewCo) whereby A will contribute its intellectual property for SW as well as facilities in which SW will be manufactured, and A will transfer employees to manufacture SW. PE 1 will contribute cash that NewCo will use to expand its manufacturing capacity. Company A and PE 1 jointly control all decisions that affect NewCo’s economic performance and share equally in its profits and losses. Company A will distribute SW within its distribution channels.

NewCo is not a joint venture because it does not meet the purpose criterion in the term’s definition. While NewCo is manufacturing a new product, A (instead of NewCo) developed it. Further, NewCo is not developing a new market but will employ A’s distribution channels. PE 1 is not combining complementary technological knowledge; nor will its contributed cash be used to develop new technology, production, or facilities.
**Example 7-3**

Company X is a business that explores for, develops, and drills for oil and natural gas assets in Alaska. Company X is highly leveraged and is not cash flow positive and therefore desires to more readily access the capital markets. Company Y is a multinational conglomerate that owns a diverse portfolio of businesses, including drilling equipment. Company Y's drilling business is cash flow positive. Both companies contribute their respective businesses into a new legal entity, Entity OG, resulting in operational synergies. Companies X and Y jointly control all decisions that affect OG's economic performance of OG and share equally in its profits and losses.

While the resulting operational synergies do not preclude OG from meeting the definition of a joint venture, it is not a joint venture because it does not meet the purpose criterion in the term's definition. Companies X and Y are combining their businesses with the purpose of more readily accessing capital markets and will not be developing a new market, product, or technology; combining complementary technological knowledge; or pooling resources in developing production or other facilities.

### 7.2.5 Management of the Entity

Venturers in a joint venture must be able to participate in its management. The term's definition allows for this participation to be direct or indirect. That is, each venturer could but is not required to serve as a member of management and carry out the day-to-day operations. If venturers instead appoint a management team, they should be able to substantively participate in the appointment, oversight, and termination of team members, in addition to the setting and adjustment of their compensation as well as other financial and operating decisions made in the joint venture's ordinary course of business. Further, the venturers must not convey to management any power to make significant decisions that affect the venture. See Section 7.2.6.2 for an evaluation of management teams.

To participate indirectly in the joint venture's management, the venturers should make its significant financial and operating decisions (e.g., approving operating and capital budgets as well as selecting, terminating, and setting the compensation of management team members) that occur in the ordinary course of business, and management should be able to only carry out these decisions (e.g., implementing the venturer-approved operating and capital budgets) and not significantly deviate from them.

### 7.2.6 Joint Control

Joint control is the most distinguishing characteristic of a joint venture. Even though the definition of a joint venture in ASC 323-10-20 specifies only that it cannot be a subsidiary of one of the venturers (see the discussion in Section 7.2.6.1 regarding considerations of whether an investor would consolidate a VIE and voting interest entity, respectively), on the basis of guidance from the SEC, a joint venture must be jointly controlled by its venturers. This distinction is significant since it may be possible for the investors to be precluded from consolidating a legal entity without jointly controlling it.

The ASC master glossary defines “joint control” as “decisions regarding the financing, development, sale, or operations [that] require the approval of two or more of the owners.” Likewise, the G4+1 Organization Special Report Reporting Interests in Joint Ventures and Similar Arrangements may be helpful in the determination of the presence of joint control. Paragraph 2.14 of the Special Report states, in part:

> Joint control over an enterprise exists when no one party alone has the power to control its strategic operating, investing, and financing decisions, but two or more parties together can do so, and each of the parties sharing control (joint venturers) must consent.
Example 7-4

Investor A, Investor B, and Investor C form a venture, Entity Z. All decisions that significantly affect Z are made by a simple majority vote of Z’s board of directors. All three investors may appoint one director. Entity Z is not jointly controlled by the three investors because each decision does not require the consent of all the investors. That is, a decision may be made with the vote of two of the investors.

Connecting the Dots

An investor evaluating whether there is joint control over an entity must consider each investor’s rights in case the investors cannot reach a unanimous decision (i.e., a deadlock). These tiebreaker terms and conditions and an understanding of who has the authority to make decisions if there is a deadlock may prove critical in the determination of whether the investors jointly control the venture. For the venture to be jointly controlled, no investor can have the unilateral ability to cast a deciding vote in the event of deadlock. Consider the following example:

Investor RK and Investor JK form Company PN. All decisions that significantly affect the company require unanimous consent from both investors. In case of a deadlock, the matter is taken to an arbitration court in which each investor may elect one arbiter, and those two arbiters will elect the third. The arbitration court will rule on the matter with a simple majority, and the ruling will be accepted by both RK and JK.

In this example, neither investor has the unilateral ability to break the deadlock, and therefore, PN is jointly controlled.

7.2.6.1 Variable Interest Entity and Voting Interest Entity Models

In determining whether a reporting entity and other investors jointly control a legal entity, the reporting entity must first consider which consolidation model — the voting interest entity model (“voting model”) or variable interest entity model (“VIE model”) — is applicable. ASC 810-10 requires the reporting entity to first determine whether the legal entity is a VIE. Should the reporting entity determine that the legal entity is a VIE, it would apply the VIE model to determine whether the reporting entity has a controlling financial interest. Conversely, should the reporting entity determine that the legal entity is not a VIE, it would apply the voting model to ensure that the reporting entity does not have a controlling financial interest.

As discussed in further detail below, there are some significant differences in the analysis of control under these respective models (see Section 1.4 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest for a more complete comparison).

7.2.6.1.1 VIE Model

In accordance with ASC 810-10-25-38A, a reporting entity has control over a VIE if it has “[t]he power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.” To determine whether the investors jointly control the VIE, the reporting entity would perform the following steps:

- **Step 1** — Evaluate the purpose and design of the VIE and the risks the VIE was designed to create and pass along to its variable interest holders.
- **Step 2** — Identify the significant decisions related to the risks identified in step 1 and the activities associated with those risks.
- **Step 3** — Identify the party that makes the significant decisions or controls the activity or activities that most significantly affect the VIE’s economic performance.
If each of the investors shares in making all decisions over the activities that most significantly affect the VIE’s economic performance, the investors would jointly control the VIE.

For more information on the power to direct the most significant activities and the VIE model, see Chapter 7 of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

### 7.2.6.1.2 Voting Model

ASC 810-10-15-8 and 15-8A indicate that an investor with a majority voting interest or a limited partner with a majority of kick-out rights through voting interests will generally control a legal entity. However, ASC 810-10-15-8 and 15-8A also provide exceptions to this guidance and indicate that the power to control may also exist with a lesser percentage of ownership (e.g., by contract, lease, agreement with other owners of voting interests, or court decree). Therefore, conclusions about control should be based on an evaluation of the specific facts and circumstances. In some situations, an investor with less than a majority voting interest or a limited partner with less than a majority of kick-out rights can control a legal entity. In other situations, the power of a stockholder with a majority voting interest or of a limited partner with a majority of kick-out rights to control a legal entity does not exist with the majority owner because of noncontrolling rights or as a result of other factors. The majority investor may be precluded from controlling the legal entity when another investor has the ability to veto or substantively participate in the legal entity's significant decisions.

We believe that for the legal entity to qualify as a joint venture, each venturer should substantively participate in all the legal entity's significant decisions. If one or more, but not all, of the investors have the ability to unilaterally perform the following actions, the investors do not jointly control the legal entity:

- Set or significantly change the legal entity's operating and capital policies, including budgets, in the ordinary course of business.
- Select, terminate, and set the compensation of investee management responsible for implementing the investee's policies.

The following conditions may indicate that the investors do not jointly control the legal entity should one or more, but not all, of the investors:

- Hold the majority of total equity or otherwise provide additional financial support to the legal entity (e.g., one investor guarantees the legal entity's debt), thereby resulting in potential influence beyond voting share percentage.
- Have the ability to unilaterally sell, lease, or otherwise dispose of the legal entity's assets or to unilaterally enter into contracts or commitments on the legal entity's behalf.

In summary, we believe that to jointly control a legal entity, all investors must participate in the legal entity's significant decisions. To the extent that an investor has little or no influence, the investors would not jointly control the legal entity.

For more information on the voting model, see Appendix D of Deloitte's *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*. 
Company A and Company B form a venture, Entity Z, that is a voting interest entity under ASC 810. Entity Z’s significant operating and capital decisions are made by a simple majority vote of its board of directors. Company A may appoint three directors, while B may appoint only two. However, B has a consent right for the appointment, termination, and determination of the compensation of Z’s management. Company B’s consent right for Z’s management is a substantive participating right and would preclude A from consolidating Z. However, B does not have the ability to jointly participate in the remaining operating and capital decisions that are significant to Z, and therefore Z is not jointly controlled by A and B.

**Example 7-6**

Investor A and Investor B form a joint venture and each own equity and voting interests of 50 percent. All decisions that most significantly affect the venture are made by a unanimous vote of the shareholders. Investor A has the ability to call 10 percent of B’s ownership interests for a fixed price. Even though the call option would convey an additional 10 percent voting interest to A, the legal entity’s governance still requires the unanimous vote of both investors to make the joint venture’s significant decisions. Therefore, the venture would be under joint control regardless of the substance of the call option, which would change only the economic ownership percentage rather than the governance to control.

However, if the decisions that most significantly affect the venture were made by a simple majority vote of shareholders, careful consideration should be given to the evaluation of the call option. If the fixed-price call option is exercisable by A at little or no economic cost, there would not be a significant barrier to A’s exercising the option, and therefore A and B would not jointly control the venture.

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7.2.6.1.3 Other Differences Between the VIE and Voting Models

7.2.6.1.3.1 Forward Starting Rights and Potential Voting Rights and Contingencies

Future decision making and control can be conveyed to a venture through potential voting rights, in some cases referred to as forward starting rights (such as call options and put options conveyed in accordance with contracts in existence as of the balance sheet date), or through the occurrence of a contingent event.

In the VIE model, while the existence of such rights, in isolation, may not be determinative in the identification of the party (or parties) with power over the activities that most significantly affect the VIE’s economic performance, such rights often help a reporting entity understand the purpose and design of a legal entity. Therefore, potential voting rights are considered in the determination of whether the reporting entity and other investors jointly control the VIE. In addition, forward starting rights as a result of a contingent event should be evaluated in the determination of whether the contingency initiates or results in a change in power and, for the latter, whether the contingency is substantive. For example, a venture may be created to construct a power plant (i.e., the construction phase) and to subsequently provide power to customers (i.e., the operations phase). Sometimes venturers will create these multiphased ventures with different parties governing and making decisions for each phase. We believe that the venturers must jointly control the joint venture during each of these phases.

In the voting model, potential voting rights, whether forward starting or conveyed upon the resolution of contingency, are not considered in the analysis of which entity has a controlling financial interest unless they are deemed to be held because of a nonsubstantive exercise or purchase price (i.e., a reporting entity can obtain these voting rights at little or no economic cost) and there are no significant decisions in the ordinary course of business that will be made before the potential voting rights are exercisable. A reporting entity must use significant judgment and evaluate all relevant facts and circumstances to determine whether the purchase price is nonsubstantive.
7.2.6.1.3.2 Related Parties

In the VIE model, a reporting entity should take care in evaluating which entity has control of a legal entity when the reporting entity’s related parties are involved with the VIE. If investors are related parties and share power over a VIE, one of the investors must consolidate the VIE. Because a legal entity cannot meet the definition of a joint venture if one party consolidates the legal entity, neither investor would be able to conclude that the legal entity is a joint venture despite the fact that there is joint control over the most significant activities.

ASC 850-10-20 defines “related parties,” and the VIE model expands the population of entities that are considered related parties for VIE analysis purposes. Specifically, ASC 810 identified certain relationships that may indicate that one party (the “de facto agent”) may be acting on behalf of another (the “de facto principal”).

In practice, joint venture arrangements frequently have transfer restrictions on when each venturer can sell its investment. A potential de facto agency relationship may exist when the transfer restrictions are not mutual (e.g., when one venturer can sell its interest whereas the other venturer must receive approval from the other venturer to sell its interest). However, the existence of transfer restrictions does not always result in a de facto agency relationship as indicated in ASC 810-10-25-43(d), which states that “a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.”

See ASC 810-10-25-43 for the various de facto agents identified by the FASB and Section 8.2.3 in Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest for more information.

In the voting model, related parties — both related parties defined in ASC 850-10-20 and de facto agents — are not considered.

7.2.6.2 Decisions Made by Different Governing Parties

Assessing whether the power criterion has been met can be more complex when decisions are made by different parties and at different governance levels. In some arrangements, certain decisions could be made directly by the investors, a board of directors established for the venture, or the venture’s management. It is important for an entity to identify which party or parties make the venture's significant decisions and whether one or more, but not all, of the investors may unilaterally make those decisions when the entity is determining whether the investors jointly control the venture. Each venturer may or may not appoint an equal number of directors to the board or members of management. However, the venturers may jointly control the venture as long as each venturer equally participates in the venture's significant decisions through the venturer's representation on the board or in management. That is, significant decisions must require the consent of each of the venturers (or their delegates on the management team) for the venture to qualify as a joint venture. See Section 7.2.6.1 on the evaluation of control in both the VIE and voting models.
Example 7-7
Two unrelated investors, Company R and Company S, form an LLC by contributing equal amounts of cash for equity ownership interest of 50 percent each. Profits and losses are shared equally. The investors have delegated the LLC’s management to a four-member management committee to which each investor appoints two representatives.

Decisions regarding the LLC’s ongoing operations require a majority vote of the management committee. The venturers can remove a member of the management committee only for cause. The LLC’s governing documents state that there must always be equal representation of both venturers on the management committee.

While the right to make day-to-day decisions has been assigned to a management committee, the LLC is still governed and jointly controlled by the venturers because decisions made in the ordinary course of business require the consent of at least one representative from each of the venturers. That is, the representatives from R are required to obtain at least one vote from the representatives from S, and vice versa, to move forward with a decision that affects the LLC’s ongoing operations.

7.2.6.3 Unequal Ownership
In both the VIE and voting models, a reporting entity that has a majority ownership interest in a legal entity may not have a controlling financial interest in that entity. Similarly, venturers may have varying degrees of ownership interests in the joint venture and are not required to have equal ownership interests to jointly control the legal entity.

Example 7-8
Company B and Company C enter into a joint venture arrangement (forming Entity D) that enables B to gain access to C’s technology and enables C to gain access to B’s production and distribution network. The equity interests and profit/loss allocation under the arrangement is 60:40 to B and C, respectively. While B has majority ownership, the joint venture agreement provides that all significant decisions involving the joint venture’s activities require unanimous approval of both B and C.

The ownership interests do not have to be split equally among the venturers for joint control to exist. Because the joint venture agreement provides that all significant decisions involving D’s activities require unanimous approval of both venturers, neither one is able to unilaterally control D. As long as no conditions exist that indicate substantive control of D by either B or C, joint control would exist between the venturers. While C is in a position to veto actions proposed by B only by exercising its participating rights, in substance, this is equivalent to equal ownership between the venturers, a situation that would also require unanimous approval of both venturers.

7.2.7 Reassessment of the Joint Venture Determination
The determination of whether a reporting entity should consolidate a legal entity is a continual process. That is, as facts and circumstances change, a reporting entity may obtain (or lose) a controlling financial interest in a legal entity. As a result, a previous conclusion that a legal entity is a joint venture may change. Accordingly, upon a change in facts and circumstances, a venturer should determine whether its previous conclusions regarding the characteristics of a joint venture have changed. For example, a change in the venturer’s participation in the joint venture’s significant decisions may indicate that the venturer’s conclusion regarding this characteristic of a joint venture is no longer appropriate. In addition, if the joint venture has been determined to be a VIE, a change in this determination or change in the reporting entity’s related parties may require the venturer to reevaluate its conclusion that the legal entity is a joint venture.
Chapter 8 — Accounting by the Joint Venture

8.1 Overview

ASC 805-10

15-4 The guidance in the Business Combinations Topic does not apply to any of the following:
   a. The formation of a joint venture...

ASC 845-10

15-20 The guidance in these Subsections does not apply to the following types of transfers:
   a. Transfers between a joint venture and its owners...

Pending Content (Transition Guidance: ASC 606-10-65-1)

15-20 Paragraph superseded by Accounting Standards Update No. 2017-05.

The accounting by legal entities that meet the definition of a joint venture for noncash assets contributed by venturers upon the initial formation of a joint venture is not addressed by U.S. GAAP. The EITF evaluated the accounting by joint ventures for businesses received at formation but did not reach a consensus on this issue (Issue 98-4). In addition, ASC 805 and ASC 845 expressly exclude from their scope the formation of a joint venture and transfers between joint ventures and their owners, respectively.

In the absence of FASB guidance, the SEC has periodically provided guidance on joint ventures that has influenced the accounting by both private and public entities. At the 1992 AICPA Conference on Current SEC Developments, Professional Accounting Fellow Steve Blowers stated that the SEC staff would continue to scrutinize any step-up in basis for nonmonetary assets contributed to a joint venture and that it would permit a full step-up only if the following criteria were met:

- Contribution of the asset or business was to a new entity.
- The fair value was objectively determinable and supported by an equal contribution of monetary assets by the other investor(s).
- The monetary assets must have stayed in the new venture or been used for transactions with parties other than the venturers.
- There was an equal allocation of equity and profits or losses between the venturers.
- The new entity was clearly a joint venture; control was shared in meaningful respects (board of directors, shareholder interests, and so forth).
Because it is difficult to meet these criteria, joint ventures would historically typically recognize contributions of nonmonetary assets upon the venture's initial formation by using the venturers' carrying value (historical cost basis).

The SEC staff has asked the FASB to address the absence of prescriptive guidance for the accounting by joint ventures. In remarks made at the 2014 AICPA Conference, SEC Professional Accounting Fellow Chris Rogers asked the Board to “consider providing clarity on the definition of a joint venture in Topic 323, and to provide guidance on the appropriate accounting in the stand-alone financial statements of a joint venture for assets and businesses contributed to the joint venture.” As of the date of this Roadmap’s publication, there was no related FASB project on its agenda.

8.2 Initial Contribution of Nonmonetary Assets That Meet the Definition of a Business

8.2.1 Impact of Fair-Value-Based Measurement and Pushdown Accounting on Joint Venture Formation Measurement

Before we discuss the views that may be applied in practice for the contribution of nonmonetary assets that meet the definition of a business, it is important to understand the following developments in fair-value-based measurement and the requirements necessary to apply that measurement:

- **Fair value measurement proliferation in accounting standards** — Since the remarks made by Mr. Blowers in 1992, the use and requirement of fair-value-based measurement have significantly increased in U.S. GAAP. For example, FAS 141(R), issued in 2007, generally required acquired assets and liabilities to be fair valued in a business combination. In addition, FAS 160 was issued in 2007 and required entities to measure retained equity interests at fair value when deconsolidating a subsidiary that meets the definition of a business. FAS 157, issued the same year, defined “fair value” and established a framework for measuring it in U.S. GAAP.

- **Evolution of guidance on when to apply pushdown accounting** — The application of pushdown accounting establishes a “new basis.” Specifically, an entity that was acquired by a buyer adjusts its stand-alone financial statements to reflect the buyer’s new basis of accounting by remeasuring its assets and liabilities on the date of acquisition. Since the issuance of the 1979 AICPA Issues Paper on joint venture accounting, some have argued that the establishment of a joint venture should reflect the new basis for businesses contributed. While the accounting in the stand-alone financial statements of a business that has been acquired is not the same as that for the formation of a joint venture, some believe that both are instances in which a new basis of accounting should be reflected. Therefore, we believe that there is some background from pushdown accounting that is informative for the evaluation of the basis of accounting for joint ventures.

In 1983, the SEC issued SAB Topic 5.J, which provided an option in certain cases and a requirement in others for the application of fair-value-based measurement for transactions that were not business combinations. However, the SEC’s views evolved, and the Commission expanded the number of situations in which this guidance was required to be applied, including when a group of investors rather than a single investor consummates a transaction. Consequently, in 2001, additional pushdown accounting guidance was provided in EITF Topic D-97 and in comments made by the SEC observer at EITF meetings (all of which was previously included in ASC 805-50-S99-1 through S99-3).

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1 Paragraph 53a of the 1979 AICPA Issues Paper, “Joint Venture Accounting.”
Despite this guidance, in practice, there were many challenges in the determination of when pushdown accounting should be applied. As a result, in 2014, the FASB issued ASU 2014-17, which made it optional for an entity to apply pushdown accounting in its separate financial statements when an acquirer obtains control of it. In response to the issuance of ASU 2014-17, the SEC staff issued SAB 115 to rescind the guidance in SAB Topic 5J, and the FASB issued ASU 2015-08 to rescind the remaining guidance on pushdown accounting and collaborative groups in ASC 805-50-S99.

- **SEC remarks in 2009** — At the 2009 AICPA Conference on Current SEC and PCAOB Developments, Joshua Forgione, associate chief accountant in the OCA, stated:

Now, as it relates to the accounting for the joint venture itself, Statement 141(R) excludes from its scope the accounting for the formation of a joint venture. The staff has historically conveyed strong views when considering the use of fair value in recording noncash assets contributed to a joint venture. More specifically, many believe that the staff would only support step-up to fair value when certain conditions are met, including where the asset or business is contributed to a new entity and fair value is supported by an equal amount of monetary assets that either remains in the entity or used by the new entity in transactions with parties other than investors in the venture.

There may be questions developing on the topic of new basis for joint venture formation transactions as a result of these recent changes. The good news or, depending on your perspective, the bad news is that I'm not going to roll out a new model for new basis in joint venture formation transactions. There are certainly a number of good questions surrounding new basis accounting in general. In the absence of additional standard setting, there may be more circumstances where it may be appropriate to record the contributed business at fair value. This is an area that requires a significant amount of analysis and you should carefully evaluate the facts and circumstances surrounding the transaction and determine whether you believe new basis of accounting will result in decision-useful information to investors.

Possibly in response to the proliferation of fair-value-based measurement accounting guidance from the FASB, the SEC staff has recently been more receptive to considering the recognition of the initial contributions of businesses received by a joint venture at fair value. Perhaps because of the increasing prevalence of fair value measurement and the issuance of FAS 160 (codified in ASC 810), which requires investors to recognize their retained noncontrolling interest in a business (i.e., contributions of businesses in exchange for a noncontrolling interest) at fair value, the SEC staff acknowledged in Mr. Forgione's 2009 speech that there “may be more circumstances” in which “it may be appropriate” to recognize contributed businesses at fair value. While neither the SEC nor the FASB subsequently issued further guidance as to which circumstances give rise to the application of fair value, we observe that paragraph B55 of the Background Information and Basis for Conclusions in FAS 160 stated, in part, that the derecognition of a subsidiary that is a business is a significant economic event as follows:

Measuring the retained investment to fair value reflects the Board's view that a decrease in a parent's ownership interest in a subsidiary to the point that the parent no longer has a controlling financial interest in that subsidiary is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins, and that relationship differs significantly from the former parent-subsidiary relationship. Recognizing the retained investment at fair value is more representationally faithful and provides users of financial statements with more relevant information about the value of the retained investment.

Note that for entities that have adopted ASU 2017-05, contributions that are conveyances of oil and gas mineral rights or transfers of goods or services in a contract with a customer that are within the scope of ASC 606 are not within the scope of ASC 810. For entities that have not adopted ASU 2017-05, contributions that are in-substance real estate or conveyances of oil and gas mineral rights are not within the scope of ASC 810.
8.2.2 Measurement for Initial Contribution of Nonmonetary Assets That Meet the Definition of a Business

We observe that the loss of a controlling financial interest by a parent in a business, as opposed to a new entity's obtaining a controlling financial interest in that business, requires an investor to measure its retained noncontrolling interest in that business at fair value. Therefore, a venturer contributing a business to a joint venture will record its investment in the joint venture at fair value, and should the joint venture record its venturers' contributions at their historical cost, there will be a basis difference. Conversely, if the joint venture records its venturers' contribution at fair value and both venturers contribute a business, there will not be a basis difference. Some advocate that this is a reason to record the venturers' contribution at fair value, so that there is no basis difference between the venturers' investments and the venture's financial statements. Others observe that because the application of pushdown accounting is optional, there should not be a mandate to record the venturers' contribution at fair value to prevent basis differences.

What is clear is that there is no prescriptive framework in U.S. GAAP regarding the recognition and measurement in the joint venture's financial statements for net assets received from its venturers. The landscape in accounting has evolved since Mr. Blowers's 1992 speech; today, the application of fair-value-based measurement has increased. However, fair-value-based measurement is still not required, and the optionality of the application of pushdown accounting allowed by ASU 2014-07 for the initial measurement of net assets of an entity that has not been acquired in a business combination provides evidence of the lack of consensus. Similarly, we believe that there is diversity in preference for measurement in a joint venture's financial statements.

In summary, we believe that it remains acceptable for a joint venture to recognize a business or businesses contributed to it at the venturer's historical basis. As observed above, there are some who believe that fair value recognition is also acceptable. Should an entity believe that fair value recognition and measurement for the joint venture is appropriate, we would encourage the entity to consult with its accounting advisers and, if applicable, the OCA.

8.3 Measurement for Initial Contribution of Nonmonetary Assets That Do Not Meet the Definition of a Business

<table>
<thead>
<tr>
<th>ASC 323-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-2</strong> 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, 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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 606-10-65-1)</th>
</tr>
</thead>
</table>
| **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. |
SAB Topic 5.G, Transfers of Nonmonetary Assets by Promoters or Shareholders

The following is the text of SAB Topic 5.G, Transfers of Nonmonetary Assets by Promoters or Shareholders.

Facts: Nonmonetary assets are exchanged by promoters or shareholders for all or part of a company's common stock just prior to or contemporaneously with a first-time public offering.

Question: Since FASB ASC paragraph 845-10-15-4 (Nonmonetary Transactions Topic) states that the guidance in this Topic is not applicable to transactions involving the acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise, what value should be ascribed to the acquired assets by the company?

Interpretive Response: The staff believes that transfers of nonmonetary assets to a company by its promoters or shareholders in exchange for stock prior to or at the time of the company's initial public offering normally should be recorded at the transferors' historical cost basis determined under GAAP.

The staff will not always require that predecessor cost be used to value nonmonetary assets received from an enterprise's promoters or shareholders. However, deviations from this policy have been rare applying generally to situations where the fair value of either the stock issued or assets acquired is objectively measurable and the transferor's stock ownership following the transaction was not so significant that the transferor had retained a substantial indirect interest in the assets as a result of stock ownership in the company.

FN1 Estimating the fair value of the common stock issued, however, is not appropriate when the stock is closely held and/or seldom or ever traded.

ASC 810-10

40-5 If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in Subtopic 845-10 applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

a. The aggregate of all of the following:
   1. The fair value of any consideration received
   2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized
   3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.

b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.
An investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at the investor’s cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. An investor shall not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. Some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph 360-20-40-49 on accounting for sales of real estate to a venture by an investor apply to those transactions. An example of such a transaction is one in which investor A contributes to a venture real estate with a fair value of $2,000 and investor B contributes cash in the amount of $1,000 which is immediately withdrawn by investor A, 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 is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor A of a one-half interest in the real estate in exchange for cash.

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.

There is no guidance under U.S. GAAP on the accounting by the joint venture when receiving contributions of assets that do not meet the definition of a business. While the SEC staff has indicated that there may be more circumstances in which the recording of the contribution of a business at fair value is appropriate, the staff has not provided recent remarks or guidance for contributions of assets that do not meet the definition of a business. Therefore, the above codified guidance written for the venturer’s accounting is frequently referenced by analogy to support the accounting by the joint venture itself. In the absence of guidance from the FASB or SEC, these various analogies have been used to justify the recognition and measurement methods shown in the chart below for contributions received by the joint venture. The chart below is followed by a detailed explanation of each method.
<table>
<thead>
<tr>
<th>Basis of Presentation</th>
<th>Applicability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical cost</td>
<td>Always acceptable.</td>
</tr>
<tr>
<td>Fair value (full step-up)</td>
<td>If a venture would like to apply fair value measurement, we would encourage the entity to consult with its accounting advisers and, if applicable, the OCA.</td>
</tr>
<tr>
<td>Partial step-up</td>
<td>If a venture would like to apply partial step-up to fair value when monetary assets are withdrawn before the adoption of ASU 2017-05, we would encourage the entity to consult with its accounting advisers and, if applicable, the OCA. After the adoption of ASU 2017-05, we believe that partial step-up would be prohibited when monetary assets are withdrawn.</td>
</tr>
</tbody>
</table>

- **Historical cost** — Proponents of the view that joint ventures should record contributions of nonmonetary assets that do not meet the definition of a business at historical cost may support this determination by analogizing to ASC 323-10-30-2. ASC 323 requires investors to initially recognize their equity method investments at cost unless this initial recognition is the result of the deconsolidation of a subsidiary (see Section 8.2.2). The use of historical cost is also consistent with the use of the cost accumulation model for the initial measurement of assets acquired that do not meet the definition of a business in ASC 805-50-30. In addition, proponents have also analogized to ASC 970-323-30-3, which states that “[a]n investor shall not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process.” Finally, we also observe that some have also analogized to SAB Topic 5.G (codified in ASC 845-10-S99-1), in which the nonmonetary assets are “normally” recorded at historical cost.

- **Fair value (full step-up)** — As discussed in Section 8.2.2, in accordance with ASC 810-10-40-5, retained interests in a business that is deconsolidated are initially measured at fair value. ASC 810-10-40 provided guidance only for assets that met the definition of a business. In part to align the accounting for the measurement upon derecognition of assets and businesses, the FASB issued ASU 2017-05, which also requires retained interests in a previously consolidated subsidiary that does not meet the definition of a business to be initially measured at fair value. Even though the guidance is for investors, proponents of the view that joint ventures should record contributions of nonmonetary assets that do not meet the definition of a business at fair value analogize to ASU 2017-05. In accordance with the proponents of fair value accounting for businesses contributed to a joint venture, they advocate that this is a reason to record the venturers’ contribution at fair value, so that there is no basis difference between the venturers’ investments and the joint venture’s financial statements.

- **Partial step-up** — Some believe that the substance of some transactions in which monetary assets are withdrawn may be a partial sale of nonmonetary assets that do not meet the definition of a business and therefore that the joint venture should partially step up the contributed assets. Proponents of the view that the asset value should be partially stepped up analogize to ASC 970-323-30-3 (formerly SOP 78-9), which provides the following example of an in-substance partial sale:

  [I]nvestor A contributes to a venture real estate with a fair value of $2,000 and investor B contributes cash in the amount of $1,000 which is immediately withdrawn by investor A, 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 is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor A of a one-half interest in the real estate in exchange for cash.
The guidance above in ASC 970-323 has been amended to require the entity that has lost control to recognize and measure its retained interest at fair value upon the adoption of ASU 2017-05. We believe that upon adoption of ASU 2017-05, in instances whereby nonmonetary assets are contributed to a joint venture and monetary assets are withdrawn, the joint venture would not be permitted to partially step up the fair value of the assets contributed to it.

8.3.1 Summary of Views for Measurement for Initial Contribution of Nonmonetary Assets That Do Not Meet the Definition of a Business

We believe that it remains acceptable for a joint venture to recognize nonmonetary assets contributed to it at the venturer's historical cost basis when the nonmonetary assets do not meet the definition of a business. As observed above, there are some who believe that fair value recognition is also acceptable. Should an entity believe that fair value recognition is appropriate, we would encourage the entity to consult with its accounting advisers and, if applicable, the OCA.

8.4 Other Matters

8.4.1 Contribution of Nonmonetary Assets After Formation

Nonmonetary assets or businesses contributed to a joint venture in a separate and distinct transaction after the joint venture's formation date are generally recorded at fair value. However, if the post-formation contribution is, in substance, an extension of the original formation of the joint venture, it may be appropriate to record it at historical cost when the initial formation transaction was accounted for at historical cost.

The existence of one or more of the following criteria may indicate that the subsequent contribution is an extension of the joint venture's original formation and that it thus may be appropriate to record the subsequent contribution at historical cost (but only if the initial contribution was recorded at historical cost):

- The subsequent contribution is required under the original terms of the joint venture agreement.
- The venturers consider the subsequent contribution to be part of the original formation of the joint venture.
- The activities of the original joint venture (before the post-formation contribution) are considered insignificant or inconsequential.
- The time from the original formation to the post-formation contribution is relatively short.

The preceding list is not intended to be all-inclusive, and entities should carefully consider their facts and circumstances.

Example 8-1

On January 1, 20X7, two venturers form a limited liability partnership (LLP) by contributing $100 each. As of the formation date, the LLP is considered a joint venture in accordance with ASC 323. During the first year, the joint venture's only transaction is to enter into an office space lease, an activity considered insignificant to the LLP's planned business activities. On January 1, 20X8 (the contribution date), each venturer contributes an existing business to the joint venture. The estimated fair value of each of the contributed businesses is $100 million. While the legal formation date of the joint venture was January 1, 20X7, the venturers used the LLP to facilitate the formation of a new joint venture one year later. In other words, the contribution date is, in substance, the formation date. As a result, the venturers should treat the contribution date as if it were the formation date and evaluate whether their contributions should be recognized at the venturers' historical costs or at fair value (see Section 8.2.2) as of January 1, 20X8.
Example 8-2

Venturer X and Venturer Y each contribute a fully occupied commercial building to a newly formed entity that meets the definition of a joint venture in accordance with ASC 323. Voting rights, as well as profits and losses, are shared equally between X and Y. Several years later, Venturer Z, an unrelated party, contributes another commercial building to the joint venture. When Z makes its contribution, the joint venture is restructured so that X, Y, and Z share equally in profits and losses. All decisions regarding the joint venture require the unanimous consent of all three owners. Venturer Z's admission was not contemplated at the joint venture's formation. Therefore, the joint venture should account for the building contributed by Z at fair value.

8.4.2 Differences in Accounting Policies

Upon formation of a joint venture, the venture selects accounting policies. Although a joint venture has the option of conforming its accounting policies to those of the venturers, it is not required to do so. Should the joint venture select accounting policies that are different than those of the venturers, it is not a change in accounting principle under ASC 250. See Section 5.1.3 for further discussion of differences in accounting policies between equity method investees and investors.

Example 8-3

Venturer X and Venturer Y are unrelated parties that form a joint venture that is an SEC registrant. In exchange for equal ownership interests, X and Y contribute nonmonetary assets to the joint venture. Specifically, X contributes deferred advertising costs with a carrying value of $50. As permitted by ASC 720-35-25-1, X's accounting policy is to expense advertising costs when incurred, which is an acceptable alternative under ASC 720-35-25-1. On the formation date, the joint venture decides to adopt an accounting policy for expensing advertising costs in its separate financial statements, which is consistent with Y's accounting policy.

While it is acceptable for the joint venture to record the asset at its carrying value ($50) as of the formation date, it should immediately record an adjustment in which it reduces the asset to zero to comply with its own accounting policy. The joint venture's resulting asset balance, which is different from X's carrying value before its contribution, is based on an acceptable alternative accounting policy. The debit of $50 should be recorded in the joint venture's equity rather than in its income or loss, because the transaction is a result of neither operations nor the completion of any other earnings process. While the joint venture's initial adoption of an accounting policy is not a change in accounting principle, ASC 250-10-45-5 requires that a new accounting policy be applied retrospectively, with an adjustment to "the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period." Because the joint venture's opening balance sheet is prepared at the beginning of the first period presented, its beginning equity will reflect the impact of the accounting principle selected. This results in an adjustment to the joint venture's opening equity balance.

As a result of the transaction described above, there will be a difference between the amount of X's investment in the joint venture and the proportionate amount of X's equity in the joint venture. Because the difference can be attributed to the deferred advertising costs, X should amortize the difference over the period from the formation date to the first time the advertising takes place.

8.4.3 Joint Venture’s Investment in the Stock of a Venturer

A joint venture may purchase the stock of one of its venturers for various reasons, including to (1) provide share-based compensation to the joint venture's employees, (2) hedge the cost and cash requirements of stock appreciation rights, or (3) hold the stock as an investment.
We believe that the joint venture should follow the tentative conclusion reached by the EITF in Issue 98-2, which states:

[A]ssuming the joint venture partner has substantive operations apart from its investment in the joint venture, a joint venture should account for an investment in the stock of its joint venture partner as an asset in its separate financial statements. That asset should be accounted for using the equity method of accounting, with an elimination of the reciprocal ownership investments.

While no final consensus was reached by the EITF, we support its tentative conclusion in Issue 98-2 and believe that it should be applied by all joint ventures.

### 8.4.4 Start-Up Costs Incurred by the Joint Venture

<table>
<thead>
<tr>
<th>ASC 720-15 — Glossary</th>
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<tbody>
<tr>
<td><strong>Start-Up Activities</strong></td>
</tr>
<tr>
<td>Defined broadly as those one-time activities related to any of the following:</td>
</tr>
<tr>
<td>a. Opening a new facility</td>
</tr>
<tr>
<td>b. Introducing a new product or service</td>
</tr>
<tr>
<td>c. Conducting business in a new territory</td>
</tr>
<tr>
<td>d. Conducting business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the public) or beneficiary</td>
</tr>
<tr>
<td>e. Initiating a new process in an existing facility</td>
</tr>
<tr>
<td>f. Commencing some new operation.</td>
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<table>
<thead>
<tr>
<th>ASC 720-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1 Costs of start-up activities, including organization costs, shall be expensed as incurred.</strong></td>
</tr>
</tbody>
</table>

A joint venture may incur certain costs associated with start-up activities. The definition of “start-up activities” in ASC 720-15-20 is broad and may include the start-up activities of a joint venture. Because the purpose of a corporate joint venture in accordance with ASC 323-10-20 includes the development of a new market, product, technology, or production or other facilities (as discussed in Section 7.2), costs associated with these start-up activities should be expensed as incurred under ASC 720-15-25-1.
Chapter 9 — Accounting by the Venturer

9.1  Initial Contribution of Nonmonetary Assets That Meet the Definition of a Business

The deconsolidation and initial measurement of retained noncontrolling interest in a business are governed by ASC 810-10-40, and its requirements are the same for investors and venturers (see Section 4.3.1).

9.2  Initial Contribution of Nonmonetary Assets That Do Not Meet the Definition of a Business

9.2.1  Framework Before the Adoption of ASU 2017-05

**ASC 323-10**

30-2  Except as provided in the following sentence, an investor shall measure an investment in the common stock of an investee (including a joint venture) initially at cost in accordance with the guidance in Section 805-50-30. An investor shall initially measure, at fair value, 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.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

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.
SAB Topic 5.G, Transfers of Nonmonetary Assets by Promoters or Shareholders

**Facts:** Nonmonetary assets are exchanged by promoters or shareholders for all or part of a company's common stock just prior to or contemporaneously with a first-time public offering.

**Question:** Since FASB ASC paragraph 845-10-15-4 (Nonmonetary Transactions Topic) states that the guidance in this Topic is not applicable to transactions involving the acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise, what value should be ascribed to the acquired assets by the company?

**Interpretive Response:** The staff believes that transfers of nonmonetary assets to a company by its promoters or shareholders in exchange for stock prior to or at the time of the company's initial public offering normally should be recorded at the transferors' historical cost basis determined under GAAP. The staff will not always require that predecessor cost be used to value nonmonetary assets received from an enterprise's promoters or shareholders. However, deviations from this policy have been rare applying generally to situations where the fair value of either the stock issued or assets acquired is objectively measurable and the transferor's stock ownership following the transaction was not so significant that the transferor had retained a substantial indirect interest in the assets as a result of stock ownership in the company.

FN1 Estimating the fair value of the common stock issued, however, is not appropriate when the stock is closely held and/or seldom or ever traded.

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**ASC 810-10**

**40-5** If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in Subtopic 845-10 applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

a. The aggregate of all of the following:
   1. The fair value of any consideration received
   2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized
   3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.
   b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.
ASC 970-323

Contribution of Real Estate

**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 the investor’s cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. An investor shall not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process. Some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph 360-20-40-49 on accounting for sales of real estate to a venture by an investor apply to those transactions. An example of such a transaction is one in which investor A contributes to a venture real estate with a fair value of $2,000 and investor B contributes cash in the amount of $1,000 which is immediately withdrawn by investor A, 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 is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor A of a one-half interest in the real estate in exchange for cash.

Pending Content (Transition Guidance: ASC 606-10-65-1)

**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.

For entities that have yet to adopt ASU 2017-05, in the absence of guidance from the FASB or SEC, there is diversity in practice for the accounting by venturers when initially recognizing contributions of nonmonetary assets that do not meet the definition of a business. We observe that the views shown in the chart below may be applied in practice for the recognition and measurement by the joint venture. The chart is followed by a detailed explanation of each view.

<table>
<thead>
<tr>
<th>Basis of Presentation</th>
<th>Applicability Before the Adoption of ASU 2017-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical cost (no gain or loss recognized)</td>
<td>Always acceptable.</td>
</tr>
<tr>
<td>Fair value (gain or loss recognized)</td>
<td>Prohibited.¹</td>
</tr>
<tr>
<td>Partial step-up (partial gain or loss recognized)</td>
<td>If a venturer would like to apply partial step-up to fair value and recognize a partial gain or loss, it may do so in certain circumstances. Specifically, we believe that gain recognition that is limited to the lesser of the computed gain or the amount of cash received would be allowed, provided the recipient has no refund or continuing support obligation, in accordance with the SEC staff’s remarks below.</td>
</tr>
</tbody>
</table>

¹ Prohibited on the basis of the SEC staff’s historical views that the formation of a joint venture does not result in the culmination of an earnings process, as described in the Historical Cost (No Gain or Loss Recognized) section.
9.2.1.1  **Historical Cost (No Gain or Loss Recognized)**

Proponents of the view that venturers should record retained noncontrolling interests in nonmonetary assets that do not meet the definition of a business at historical cost without any gain or loss recognition may support this determination by analogizing to ASC 323-10-30-2. ASC 323 requires investors to initially recognize their equity method investments at cost unless this initial recognition is the result of the deconsolidation of a subsidiary (see Section 9.1). In addition, proponents have also analogized to ASC 970-323-30-3, which states that “[a]n investor shall not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process.”

Further, proponents look to remarks made at the 1993 AICPA Conference on Current SEC Developments by SEC staff member Jan Book, who stated, in part:

> Another aspect of accounting by the investor involves the propriety of gain recognition upon the contribution of assets to a joint venture. The staff's position has been, and continues to be, that contributing assets to a joint venture is not the culmination of the earnings process — it is an exchange of a portion of operating assets for a 50% interest in a larger pool of operating assets.

The SEC staff's position, Ms. Book said, is that “contributing assets to a joint venture is not the culmination of the earnings process.” Before the adoption of ASU 2017-05, we believe that the application of fair value measurement to a retained equity method investment in a joint venture would be prohibited.

Upon adoption of ASU 2017-05, venturers will be required to record retained noncontrolling interests in nonmonetary assets that do not meet the definition of a business at fair value with any gain or loss recognized upon contribution of the nonmonetary assets to the venture.

9.2.1.2  **Partial Step-Up (Partial Gain or Loss Recognized)**

Some believe that before the adoption of ASU 2017-05, the substance of some transactions in which monetary assets are withdrawn may be a partial sale of nonmonetary assets that do not meet the definition of a business and therefore that the venturer should recognize a gain or loss with the partial sale. Proponents of the view that the asset value should be partially stepped up analogize to ASC 970-323-30-3 (formerly SOP 78-9), which provides the following example of an in-substance partial sale:

[I]nvestor A contributes to a venture real estate with a fair value of $2,000 and investor B contributes cash in the amount of $1,000 which is immediately withdrawn by investor A, 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 is not committed to reinvest the $1,000 in the venture, the substance of this transaction is a sale by investor A of a one-half interest in the real estate in exchange for cash.

Ms. Book stated further:

> The staff has modified its position when cash is received for the contribution of assets and certain other conditions are met. This is similar to the guidance provided in SOP 78-9, Accounting for Investments in Real Estate Ventures. Sometimes, cash is paid to balance the fair market values of the contributed assets.

For example, Company A contributes a business with a book value of $30 and a fair value of $100. Company B contributes a business with a book value of $20 and a fair value of $70, plus cash of $30. The joint venture then pays the $30 to Company A. The staff would not object to recognition of up to 50% of the indicated gain by Company A, limited to the amount of cash received. (Thus the calculated $35 gain would be limited to $30).

This assumes that Company A has no obligation to refund the cash to the joint venture or to Company B. The staff has also allowed gain recognition to the extent that other near-cash, monetary assets or traded, marketable securities are part of the settlement.
The SEC staff has taken a position similar to the guidance in ASC 970-323 when cash is paid to one of the joint venturers to balance the fair market value of assets contributed by each venturer. In such cases, the staff has allowed gain recognition that is limited to the lesser of the computed gain or the amount of cash received, provided the recipient has no refund or continuing support obligation.

The guidance above in ASC 970-323 has been amended to require the entity that has lost control to recognize and measure its retained interest at fair value upon adoption of ASU 2017-05. Upon adoption of ASU 2017-05, venturers will be required to record retained noncontrolling interests in nonmonetary assets that do not meet the definition of a business at fair value with any gain or loss recognized upon contribution of the nonmonetary assets to the venture.

For an explanation of the transition impact of ASU 2017-05 (ASC 610-20), see Section 9.2.2.1.

9.2.2 Framework Upon Adoption of ASU 2017-05

The deconsolidation and initial measurement of retained noncontrolling interest in an asset that does not meet the definition of a business were affected by the issuance of ASU 2017-05. The accounting for investors and that for venturers is now aligned (see Section 4.3.2).

Venturers who formed a joint venture and contributed nonmonetary assets that do not meet the definition of a business before the adoption of ASU 2017-05 may still retain their accounting for the initial contribution of nonmonetary assets after the adoption of ASU 2017-05; however, entities need to consider the transition method upon their adoption of this ASU to determine whether their initial accounting application remains appropriate (or is affected by the adoption of ASU 2017-05). See Section 9.2.2.1 below for details.

9.2.2.1 Summary of Transition Impact for Measurement for Initial Contribution of Nonmonetary Assets That Do Not Meet the Definition of a Business

The table below lists the transition approaches a joint venture may take upon adoption of ASU 2017-05 for the recognition and measurement for the initial contribution of nonmonetary assets that do not meet the definition of a business.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Transition Approach</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formation of joint venture at historical cost by the venturer (no gain or loss recognized)</td>
<td>Full retrospective</td>
<td>Reevaluate. If ASC 610-20 (i.e., ASC 606) indicates control does transfer, a gain or loss would be recognized. We expect that ASC 610-20 (i.e., ASC 606) would indicate that control has transferred since one of the requirements to be a joint venture is that the venturers have joint control over the joint venture.</td>
</tr>
<tr>
<td>Modified retrospective to all contracts</td>
<td>Reevaluate. See the “full retrospective” recommendation (the only difference is that the equity impact is recognized as of the effective date of ASC 610-20).</td>
<td></td>
</tr>
<tr>
<td>Modified retrospective only to contracts that are not complete</td>
<td>Generally, do not reevaluate. If the accounting for the initial contribution of nonmonetary assets would have resulted in recognition of all (or substantially all) of the gain or loss, reevaluation may not be necessary because the contract meets the definition of a completed contract.²</td>
<td></td>
</tr>
</tbody>
</table>

² This accounting outcome assumes that (1) there are no other contractual obligations that have been allocated consideration that have yet to be fulfilled and (2) there is no contingent consideration that has not yet been recognized (i.e., “substantially all” of the consideration has been recognized).
(Table continued)

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Transition Approach</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formation of joint venture with partial step-up (partial gain or loss recognized) by the venturer</td>
<td>Full retrospective</td>
<td>Reevaluate. If ASC 610-20 (i.e., ASC 606) indicates control does transfer, a gain or loss would be recognized. We expect that ASC 610-20 (i.e., ASC 606) would indicate that control has transferred since one of the requirements to be a joint venture is that the venturers have joint control over the joint venture.</td>
</tr>
<tr>
<td>Modified retrospective to all contracts</td>
<td>Reevaluate. See the “full retrospective” recommendation (the only difference is that the equity impact is recognized as of the effective date of ASC 610-20).</td>
<td></td>
</tr>
<tr>
<td>Modified retrospective only to contracts that are not complete</td>
<td>Generally, do not reevaluate. If the accounting for the initial contribution of nonmonetary assets would have resulted in recognition of all (or substantially all) of the gain or loss, reevaluation may not be necessary because the contract meets the definition of a completed contract.(^3)</td>
<td></td>
</tr>
</tbody>
</table>

\(^3\) See footnote 2.
Appendix A — Glossary of Terms

This appendix includes defined terms from the glossaries of ASC 323-10-20, ASC 970-323-20, and ASC 974-323-20.

**ASC 323-10 — Glossary**

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Common Stock</strong></td>
<td>A stock that is subordinate to all other stock of the issuer. Also called common shares.</td>
</tr>
<tr>
<td><strong>Corporate Joint Venture</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>Dividends paid or payable in cash, other assets, or another class of stock and does not include stock dividends or stock splits.</td>
</tr>
<tr>
<td><strong>Earnings or Losses of an Investee</strong></td>
<td>Net income (or net loss) of an investee determined in accordance with U.S. generally accepted accounting principles (GAAP).</td>
</tr>
<tr>
<td><strong>In-Substance Common Stock</strong></td>
<td>An investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock.</td>
</tr>
<tr>
<td><strong>Investee</strong></td>
<td>An entity that issued an equity instrument that is held by an investor.</td>
</tr>
<tr>
<td><strong>Investor</strong></td>
<td>A business entity that holds an investment in voting stock of another entity.</td>
</tr>
<tr>
<td><strong>Noncontrolling Interest</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>
Not-for-Profit Entity
An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

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.)

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.
ASC 323-10 — Glossary (continued)

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.

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.)

ASC 970-323 — Glossary

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.

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.

General Partnership
An association in which each partner has unlimited liability.

Joint Control
Occurs if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners.
### ASC 970-323 — Glossary (continued)

**Kick-Out Rights (Voting Interest Entity Definition)**
The rights underlying the limited partner’s or partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

**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.

**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.

**Real Estate Venture**
Any of the following: a joint venture, a general partnership, a limited partnership, and an undivided interest.

**Syndication Activities**
Efforts to directly or indirectly sponsor the formation of entities that acquire interests in real estate by raising funds from investors. As consideration for their investments, the investors receive ownership or other financial interests in the sponsored entities. All general partners in syndicated partnerships are deemed to perform syndication activities.

**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.

### ASC 974-323 — Glossary

**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.
Appendix B — Comparison of U.S. GAAP and IFRS Standards

Under IFRS Standards, the source of guidance on determining whether and how to apply the equity method of accounting is IAS 28. Both U.S. GAAP and IFRS Standards require the application of the equity method to certain investments. However, the FASB has not converged its guidance on equity method investments or on joint ventures with the IASB's, and there is no project to consider such convergence. Therefore, while both sets of standards require the use of the equity method or joint venture accounting in certain instances, they differ in several respects in the determination of when and how it should be applied.

The table below summarizes the key differences between U.S. GAAP and IFRS Standards in the determination of when and how the equity method of accounting or joint venture accounting should be applied. The table is presented in two parts, one for each accounting approach. For detailed interpretive guidance under IAS 28 and IFRS 11, see Chapter A26, “Investments in Associates and Joint Ventures,” and Chapter A27, “Joint Arrangements,” respectively, in Deloitte’s iGAAP publication.

### Equity Method of Accounting

**Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards**

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminology</td>
<td>When an investor has an investment that is accounted for under the equity method (generally because the investor exercises significant influence over another entity), that entity is referred to as an investee.</td>
<td>When an investor has an investment in, and exercises significant influence over, an entity, that entity is referred to as an associate.</td>
</tr>
</tbody>
</table>
Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
</table>
| Scope: General        | As described in Section 2.3, an investor must apply the equity method of accounting when it has significant influence over an investee unless (1) it has elected the fair value option or (2) it carries its investment at fair value under specialized industry accounting guidance applicable to investment companies. In these cases, the investor would record its interest at fair value. In addition, an investment in a partnership or certain LLCs requires the use of the equity method of accounting with as little as 3 percent to 5 percent ownership even if significant influence does not clearly exist. | An investor must apply the equity method of accounting when it has significant influence over an investee unless:
• The investment is in a venture capital organization, mutual fund, unit trust, or similar entity (including an investment-linked insurance fund) (collectively referred to as “investment entities”). For these entities, an investor may account for investments that would otherwise be accounted for under the equity method by using fair value through profit or loss (FVTPL) in accordance with IFRS 9.¹ Further, if an investor holds a portion of its investment in an investee indirectly through investment entities, the investor may account for that portion of the investment at FVTPL. This election can be applied even in circumstances in which the direct investor does not have significant influence. If the investor makes this election, however, it still must apply the equity method of accounting to any portion of the investment not held through investment entities.
• The investor is not providing consolidated financial statements (i.e., certain parent-only and subsidiary financial statements).

For further information, see Chapter A26, Section 4.2, of Deloitte’s iGAAP publication.

Because IFRS Standards do not include a fair value option for equity method investments, the application of fair value rather than the equity method of accounting is more limited under IFRS Standards than it is under U.S. GAAP. For example, assume a manufacturing company reports under U.S. GAAP and has elected to apply the fair value option to its investments that would otherwise be accounted for in accordance with the equity method. In preparing IFRS financial statements, the company would be required to apply the equity method of accounting.

¹ See paragraphs 18 and 19 of IAS 28.
Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope: Investments in instruments other than common equity</td>
<td>As described in Section 2.5, an investor would apply the equity method of accounting for an investment in a corporation when it has significant influence over an investee and it holds an investment in common stock or in-substance common stock. In-substance common stock includes instruments that are substantially similar to common stock based on subordination, risks and rewards of ownership, and an obligation to transfer value. In addition, there are unique rules under U.S. GAAP for a partnership and certain LLCs that maintain specific ownership accounts. These rules can result in application of the equity method of accounting with as little as 3 percent to 5 percent of the ownership interests in the investee.</td>
<td>The evaluation of significant influence is framed in reference to “voting rights,” which can arise from instruments other than ordinary common shares. For example, when 50 percent of the voting rights in an entity are held by the ordinary shareholders and the other 50 percent of the voting rights are attached to voting preferred shares, an investment in 4 percent of the ordinary shares and 36 percent of the voting preferred shares will result in a presumption that the 4 percent ordinary share ownership will be accounted for under the equity method, provided that the voting preferred share investment is substantively the same as the investment in ordinary shares. Factors that either individually or collectively may indicate that a preferred share investment is substantively the same as an ordinary share investment include:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The investee has little or no significant ordinary shares or other equity, on a fair value basis, that is subordinate to the preferred shares.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The investor, regardless of ownership percentage, has demonstrated the power to exercise significant influence over the investee's operating and financial decisions. The power to participate actively is an important factor in the determination of whether an equity interest exists by virtue of preferred shareholdings.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The investee's preferred shares have essentially the same rights and characteristics as the investee's ordinary shares in regard to voting rights, board representation, and participation in — or rate of return approximating — the ordinary share dividend.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The preferred shares have a conversion feature (with significant value in relation to the total value of the shares) to convert the preferred shares to ordinary shares.</td>
</tr>
</tbody>
</table>

Therefore, while IFRS Standards do not specifically refer to “in-substance common stock,” the fact that significant influence is determined on the basis of “voting rights” results in similar application to investments in instruments other than common stock. For further information, see Chapter A26, Sections 3.3.3 and 4.4.3.3, of Deloitte’s iGAAP publication.
Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applying the equity method of accounting: significant influence</td>
<td>As described in ASC 323-10-15-6 (see Section 3.3), significant influence *may be indicated in several ways, including the following:</td>
<td>IAS 28 provides considerations similar to those in U.S. GAAP for the evaluation of whether an investor holds significant influence over an investee:</td>
</tr>
<tr>
<td></td>
<td>a. Representation on the board of directors</td>
<td>“a. representation on the board of directors or equivalent governing body of the investee;</td>
</tr>
<tr>
<td></td>
<td>b. Participation in policy-making processes</td>
<td>b. participation in policy-making processes, including participation in decisions about dividends or other distributions;</td>
</tr>
<tr>
<td></td>
<td>c. Material intra-entity transactions</td>
<td>c. material transactions between the entity and its investee;</td>
</tr>
<tr>
<td></td>
<td>d. Interchange of managerial personnel</td>
<td>d. interchange of managerial personnel; or</td>
</tr>
<tr>
<td></td>
<td>e. Technological dependency</td>
<td>e. provision of essential technical information.</td>
</tr>
<tr>
<td></td>
<td>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).</td>
<td>This list is not all-inclusive, and all relevant facts and circumstances should be considered.</td>
</tr>
</tbody>
</table>

However, this list is not all-inclusive, and all relevant facts and circumstances should be considered.

Further, an investment of 20 percent or more in a corporation is presumed to provide significant influence. In addition, an investment greater than 3 percent to 5 percent in a partnership or LLC that maintains specific ownership accounts is generally considered an indication that the equity method of accounting should be applied.

For example, assume a company owns a 10 percent LP interest in an investment partnership. The company does not have any participation in the investment partnership’s governance, investment decisions, or other significant activities and does not have any involvement with the investment partnership other than receiving distributions. Under U.S. GAAP, the company would apply the equity method of accounting to its interest in the investment partnership. But under IFRS Standards, the company may conclude that it does not have significant influence over the investment partnership.

For further information, see Chapter A26, Sections 3.2 and 3.4, of Deloitte’s iGAAP publication.

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See paragraph 6 of IAS 28.
### Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

<table>
<thead>
<tr>
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<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applying the equity method of accounting: potential interests</td>
<td>As described in ASC 323-10-15-9 (see Section 3.2.6), an investor would consider only “present voting privileges.” Therefore, potential voting privileges are generally disregarded.</td>
<td>An investor should consider “potential voting rights that are currently exercisable or convertible.” Additional instruments contingent on future events or the passage of time would not be considered until the contingent event occurs or the specified time frame passes.</td>
</tr>
</tbody>
</table>

For example, an investor may conclude that although its present voting interest is less than 20 percent, it has significant influence as a result of “potential voting rights” it holds through a currently exercisable option agreement. This concept also applies to warrants, options, or other instruments held by other investors. That is, an investor with greater than 20 percent of present voting interest may conclude that it does not have significant influence as a result of “potential voting rights” held by a third party through a currently exercisable option agreement that would preclude significant influence. This may lead to differences between U.S. GAAP and IFRS Standards regarding the existence of significant influence and thus the application of the equity method of accounting.

In another example, assume Investor A holds a 25 percent interest in Investee B. Investor C holds the remaining 75 percent in B. Investee B has also issued debt to C that is convertible at any time, at C’s option, to additional shares of B. If C elects to convert the debt, A’s ownership interest would be diluted to 10 percent. Under U.S. GAAP, A would be likely to conclude that it has significant influence over B since potential voting rights are disregarded. However, under IFRS Standards, A may conclude that it does not have significant influence over B because of the currently exercisable additional interests of C.

For further information, see Chapter A26, Section 4.4.3.2, of Deloitte’s iGAAP publication.

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3 See paragraphs 7 through 9 of IAS 28.
Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<th>Subject</th>
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<tbody>
<tr>
<td>Initial measurement: contingent consideration</td>
<td>As discussed in Section 4.4, contingent consideration may be recognized in two scenarios:</td>
<td>While IFRS Standards do not provide explicit guidance, IAS 28 indicates that “the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.” Therefore, contingent consideration is generally recognized at its fair value on the acquisition date in accordance with IFRS 3. Subsequently, the liability is recognized at fair value with any changes in value recognized in the income statement. Therefore, any investment with contingent consideration may result in an initial cost basis that is greater under IFRS Standards than under U.S. GAAP. For example, assume Investor A acquires a 25 percent interest in Investee B for $100 million in cash and contingent consideration due in one year (and based on the earnings of B) ranging from $5 million to $50 million. The share of net assets A acquired is $120 million, and the fair value of the contingent consideration is $25 million. In accordance with U.S. GAAP, A would recognize the cash consideration of $100 million and contingent consideration of $20 million (since the initial cost is less than the share of net assets acquired) for a total of $120 million. In accordance with IFRS Standards, A would recognize an initial cost of $125 million since the contingent consideration would be recognized at fair value under IFRS 3. For further information, see Chapter A26, Section 4.4.9, of Deloitte’s iGAAP publication.</td>
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<td>• When the contingent consideration meets the recognition criteria of U.S. GAAP (other than ASC 805), such as if the contingent consideration meets the definition of a derivative.</td>
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<td>• When the noncontingent consideration offered is less than the interest in the investee’s underlying net assets.</td>
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</table>

4 Quoted from paragraph 26 of IAS 28.
Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

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<th>Subject</th>
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<th>IFRS Standards</th>
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<tr>
<td>Initial measurement: nonmonetary contributions</td>
<td>As described in Section 4.3, the recognition of nonmonetary contributions to an equity method investee depends on whether the assets contributed are a business. If they are, ASC 810 would indicate that full gain or loss recognition is required (except if the transaction is the sale of in-substance real estate or a conveyance of oil and gas mineral rights). If they are not, the gain recognized would generally be limited to the portion of the assets effectively sold to the other investors in the equity method investment (“partial gain recognition”).</td>
<td>IFRS Standards contain conflicting guidance, which the IASB attempted to resolve through a narrow scope amendment. IAS 28 indicates that nonmonetary contributions should be recognized with partial gain recognition. This, however, conflicts with IFRS 10, which indicates that upon loss of control of a subsidiary, a parent should recognize full gain or loss. Therefore, when an entity contributes shares of a subsidiary in exchange for an equity method investment, the entity in effect has an accounting policy choice between applying the approach in IFRS 10 (“full gain recognition”) or IAS 28 (partial gain recognition) since both IAS 28 and IFRS 10 have equal standing under IFRS Standards. The IASB issued Sale or Contribution of Assets Between an Investor and Its Associate or Joint Venture (Amendments to IFRS 10 and IAS 28) in September 2014 to resolve this conflict. The amendments would require an investor to determine whether the assets contributed represented a business. If they did, IFRS 10 would apply, and full gain recognition would be appropriate. If they did not, IAS 28 would apply, and partial gain recognition would be appropriate. However, the effective date of the amendments has been deferred indefinitely because several practical implementation issues were identified. The amendments will be considered as part of the IASB’s larger research project on the equity method of accounting. Therefore, until further guidance is issued, entities may continue to make an accounting policy choice between partial gain recognition and full gain recognition when applying IFRS Standards, whereas U.S. GAAP provides more specific requirements on the basis of whether the assets contributed constitute a business. For further information, see Chapter A26, Section 4.4.15, of Deloitte’s iGAAP publication.</td>
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### Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
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<tr>
<td><strong>Subsequent measurement: step acquisitions</strong></td>
<td>As described in Section 5.6.2, when an additional interest in an entity is acquired that results in a change in the accounting for the investment to the equity method, the investor should apply the equity method of accounting on a prospective basis from the date it obtains significant influence over the investee.</td>
<td>IFRS Standards do not provide explicit guidance regarding the transition to the equity method of accounting. We believe that two approaches are acceptable. First, by analogy to business combination guidance (IFRS 3), a transaction resulting in significant influence could be viewed as a disposal of an existing interest and the acquisition of an interest that conveys significant influence. Second, the fair value of the existing interest may be considered the &quot;deemed cost&quot; of that portion of the interest on the date significant influence is obtained. Regardless of the approach used, the equity method of accounting would be applied only from the date significant influence was obtained forward. Thus, the entity would be required under both U.S. GAAP and IFRS Standards to apply the equity method prospectively. However, differences may continue to exist regarding the determination of the initial basis in the equity method investee and the recognition of any related gain or loss. For further information, see Chapter A26, Section 4.4.8, of Deloitte’s iGAAP publication.</td>
</tr>
<tr>
<td><strong>Subsequent measurement: losses that exceed interests</strong></td>
<td>As described in Section 5.2, an investor generally discontinues use of the equity method of accounting when the value of an investment reaches zero unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support to the investee. However, an investor should continue to recognize additional losses if the imminent return to profitable operations appears to be assured.</td>
<td>IFRS Standards typically require an investor to discontinue use of the equity method of accounting when the value of an investment reaches zero unless the investor has incurred legal or constructive obligations or made payments on behalf of the associate. However, unlike the requirements under U.S. GAAP, those under IFRS Standards do not permit an investor to continue to provide for additional losses if an imminent return to profitable operations by an associate appears to be assured. For example, assume Investor A has a 25 percent interest in Investee B. Investor A’s carrying value is $50 million, and its share of B’s losses for the current year is $75 million. Investee B has recently refocused its product line and has sufficient sales contracts for the following year to ensure profitability. In accordance with U.S. GAAP, A would reduce its investment balance to zero and record a liability for $25 million, representing the excess of its share of losses over the existing carrying value. In accordance with IFRS Standards, A would reduce its investment balance to zero but would not record any further losses or liability. For further information, see Chapter A26, Section 4.4.16, of Deloitte’s iGAAP publication.</td>
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<td>Subject</td>
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<td>IFRS Standards</td>
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<td>Subsequent measurement:</td>
<td>As described in Section 5.5, an investor must determine whether its</td>
<td>An investor first looks for any indicators of impairment as described in either</td>
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<td>impairment</td>
<td>equity method investment has a loss in value and, if so, whether that</td>
<td>(1) paragraphs 58 through 62 of IAS 39 (before the adoption of IFRS 9) or (2)</td>
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<td>loss is other than temporary. If an impairment is determined to be</td>
<td>paragraphs 41A through 41C of IAS 28 (after the adoption of IFRS 9). Under both</td>
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<td>appropriate, investments with other-than-temporary losses must be</td>
<td>standards, the impairment indicators focus on identifiable loss events that</td>
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<td>written down to fair value. Impairment losses cannot be reversed in</td>
<td>will affect future cash flows. Loss events can arise only from past events.</td>
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<td>subsequent periods.</td>
<td>If an impairment indicator exists, the investor must then measure any</td>
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<td>impairment as described in IAS 28. Impairments are measured in accordance</td>
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<td>with IAS 36 as the excess of the investment's carrying value over its</td>
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<td>recoverable amount. The recoverable amount is calculated as the higher of</td>
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<td>the investment's (1) fair value less cost to sell or (2) value in use. The</td>
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<td>investor can calculate the value in use by using either (1) the present</td>
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<td>value of the investor's share of estimated future cash flows from the</td>
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<td>associate's operations, including proceeds from the investment's disposal, or</td>
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<td>(2) the present value of the investor's estimated future dividends from the</td>
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<td>associate and estimated proceeds from the investment's disposal. Under IAS</td>
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<td>28, the investor should reverse previously recorded impairment losses to the</td>
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<td>extent that the recoverable amount of the investment subsequently increases.</td>
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<td>However, the investment can be written up no higher than its original cost</td>
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<td>basis.</td>
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<td>Since IFRS Standards do not contemplate the concept of other-than-temporary</td>
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<td>losses but do allow reversals of impairments and use different measurement</td>
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<td>methods than do U.S. GAAP, significant differences may arise between IFRS</td>
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<td>Standards and U.S. GAAP when an entity is accounting for impairments of equity</td>
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<td>method investments.</td>
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<td>For further information, see Chapter A26, Section 4.4.19, of Deloitte’s iGAAP</td>
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<td>publication.</td>
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<tr>
<td>Subsequent</td>
<td>As described in Section 5.1.3.3, an investor is not required to conform</td>
<td>IFRS Standards specifically require an investor to conform an investee's</td>
</tr>
<tr>
<td>measurement: investee</td>
<td>an investee's accounting policies to its own as long as the investee's</td>
<td>accounting policies to its own when applying the equity method of accounting.3</td>
</tr>
<tr>
<td>accounting policies</td>
<td>accounting policies are an acceptable alternative under U.S. GAAP. The</td>
<td>This may result in differences in accounting for equity method investments</td>
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<td>investor may elect to conform the investee's accounting policies to its</td>
<td>between U.S. GAAP and IFRS Standards.</td>
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<td>own when applying the equity method of accounting.</td>
<td>For further information, see Chapter A26, Section 4.4.13, of Deloitte’s iGAAP</td>
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<td>publication.</td>
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</table>

3 See paragraphs 35 and 36 of IAS 28.
### Determining Whether to Apply the Equity Method of Accounting — Differences Between U.S. GAAP and IFRS Standards

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<th>IFRS Standards</th>
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</thead>
<tbody>
<tr>
<td>Subsequent measurement: investee fiscal year-end</td>
<td>As described in Section 5.1.4, an investor must record equity earnings or losses on the basis of the investee’s “most recent available financial statements.” It is usually acceptable for the investor to apply the equity method of accounting by using the equity method investee’s financial statements with a different reporting date as long as the reporting dates of the investor and investee are no greater than three months apart. In addition, the difference between the investor’s and investee’s reporting dates should be consistent in each reporting period. Finally, the investor is generally not required to record its share of the associate’s significant transactions or events occurring during the lag period. However, recognition should be given by disclosure or otherwise for intervening events that materially affect the investor’s financial position or results of operations.</td>
<td>The investor’s and investee’s reporting dates must be the same unless it is impracticable for them to be the same. When it is impracticable, the dates must be no more than three months apart, and the lag period should be consistent. In addition, as of the investor’s reporting date, the investor must record its share of the associate’s significant transactions or events that have occurred during the lag period. Therefore, differences may arise between U.S. GAAP and IFRS Standards, because IFRS Standards require recognition if such intervening transactions are significant, whereas U.S. GAAP do not. For further information, see Chapter A26, Section 4.4.12, of Deloitte’s iGAAP publication.</td>
</tr>
<tr>
<td>Subsequent measurement: loss of significant influence</td>
<td>As discussed in Section 5.6.5, when an investor loses significant influence over an investee, it recognizes any retained investment on the basis of historical cost and thus recognizes no gain or loss solely because of the loss of significant influence (and thus the discontinuance of the equity method of accounting).</td>
<td>An investor would recognize any retained interest at fair value, with any difference between the fair value of the retained interest and the carrying value of the equity method investment recognized in the income statement. As a result, under IFRS Standards, an entity will recognize a gain or loss as a result of losing significant influence, whereas under U.S. GAAP, the entity will record the interest at historical cost. Note, however, that depending on the classification of the retained interest (e.g., a trading security under ASC 320 or, after the adoption of ASU 2016-01, any equity security that is measured at fair value), changes in fair value may be immediately recognized under other U.S. GAAP. In those instances, the impact to the income statement of losing significant influence may be the same under U.S. GAAP and IFRS Standards. For further information, see Chapter A26, Section 4.4.17, of Deloitte’s iGAAP publication.</td>
</tr>
<tr>
<td>Subject</td>
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<td>IFRS Standards</td>
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<tr>
<td><strong>Presentation: general and</strong></td>
<td>As discussed in <strong>Section 6.1</strong>, an equity method investment is presented as a single line item on the balance sheet and in the income statement. In addition, basis differences and investor-level impairments are typically recognized in the same line in the income statement as the equity in the investee's earnings or losses.</td>
<td>An equity method investment is presented as a separate line item on the balance sheet and in the income statement. However, we generally believe that under IFRS Standards, investor-level impairments should not be offset against the share of profit or loss from an associate because this would conflict with the requirement to show that share of profit or loss as a separate line item. Therefore, differences may arise between IFRS Standards and U.S. GAAP regarding the classification of investor-level impairment charges in the income statement. For further information, see Chapter A26, Section 6.1, of Deloitte’s iGAAP publication.</td>
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<tr>
<td><strong>improvement</strong></td>
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<tr>
<td><strong>Presentation: proportionate</strong></td>
<td>As discussed in <strong>Section 2.4.4</strong>, under U.S. GAAP, proportionate consolidation may be used to account for undivided interests in assets and liabilities as well as investments in unincorporated legal entities, such as partnerships, in certain industries (i.e., construction and extractive).</td>
<td>The use of proportionate consolidation is appropriate only to account for a joint operation. A joint operation is defined in Appendix A of IFRS 11 as a “joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.” Since IFRS Standards focus more on the nature and characteristics of the investments, without regard to industry, differences between IFRS Standards and U.S. GAAP may arise in the application of proportionate consolidation.</td>
</tr>
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</table>
| **classification**            | As described in **Section 6.2.2.2**, an equity method investment that does not qualify for discontinued operations reporting would not qualify for held-for-sale classification. An equity method investment that does qualify for discontinued operations would qualify for held-for-sale classification. However, equity method investments are not within the scope of the measurement guidance in ASC 360; rather, they must be assessed for impairment in accordance with ASC 323 even while classified as held for sale. In addition, ASC 323 does not provide specific guidance on disposals. Therefore, an investor should apply the equity method of accounting until the date on which significant influence is lost, which will usually not be before the date of disposal. | An equity method investment may be eligible for held-for-sale accounting if it satisfies certain criteria in paragraphs 6 through 12 of IFRS 5, including:  
  - The investment will be sold in a sale transaction.  
  - The investment is available for immediate sale.  
  - The sale is highly probable.  
  - The sale is expected to take place within one year.  
If the held-for-sale criteria are met, an investor should record the equity method investment at the lower of its (1) fair value less cost to sell or (2) carrying value on the date when the held-for-sale criteria are met. The investor would no longer apply the equity method of accounting and would instead remeasure the held-for-sale investment as of each subsequent reporting date. In addition, the investment may qualify for separate presentation in the investor's discontinued operations if it qualifies as a component of the entity and meets certain other criteria under paragraphs 31 and 32 of IFRS 5. Therefore, differences may arise between IFRS Standards and U.S. GAAP related to when the equity method of accounting will no longer apply and the measurement of the held-for-sale equity method investment. |

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<tbody>
<tr>
<td>Disclosures</td>
<td>As described in Chapter 6, an investor's disclosure of its equity method investments should include the following:</td>
<td>Under IFRS 12, an investor must disclose information largely similar to that required to be disclosed under U.S. GAAP (excluding the required disclosure under U.S. GAAP for possible conversions of convertible securities and exercise of options and warrants). In addition, an investor must disclose:</td>
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<td>• The investee's name.</td>
<td>• The investee's principal place of business.</td>
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<td>• The investor's percentage ownership of the investee's common stock.</td>
<td>• The reporting dates of investments recorded on a lag and the reasons the dates are different.</td>
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<td>• Basis differences.</td>
<td>• Any restrictions on the associate to pay dividends or repay loans to the investor.</td>
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<td>• The aggregate value of that investment based on the quoted market price, if available.</td>
<td>• The investor's share of the associate's contingent liabilities.</td>
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<td>• Summarized information regarding the assets, liabilities, and results of operations of investees, either individually or in the aggregate, for material investments.</td>
<td>• The unrecognized share of losses if the equity method of accounting has been suspended.</td>
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<td>• The factors leading to an accounting conclusion that either (1) a 20 percent or greater interest does not provide significant influence or (2) a less than 20 percent interest does provide significant influence.</td>
<td>In addition, the summarized financial information must be provided separately for each material investment (whereas U.S. GAAP indicates the information should be provided individually or in the aggregate as appropriate). IFRS 12 also provides more prescriptive guidance regarding what specific information should be disclosed, including:</td>
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<td>• Information regarding material impacts of any potential conversion of outstanding convertible securities, exercise of outstanding options and warrants, and other contingent issuances on the investor's share of reported earnings or losses.</td>
<td>• Current assets.</td>
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<td>• Noncurrent assets.</td>
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<td></td>
<td>• Current liabilities.</td>
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<td>• Noncurrent liabilities.</td>
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<td></td>
<td>• Revenue.</td>
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<td>• Profit or loss from continuing operations.</td>
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<td>• Post-tax profit or loss from discontinued operations.</td>
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<td></td>
<td>• Other comprehensive income.</td>
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<td>• Total comprehensive income.</td>
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</table>

The only incremental disclosure required under U.S. GAAP, as compared with IFRS 12, is the last bullet above.

Therefore, IFRS Standards require additional disclosures beyond those required under U.S. GAAP.
Joint Venture Accounting

Determining Whether to Apply Joint Venture Accounting — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<th>Subject</th>
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</thead>
<tbody>
<tr>
<td>Definition, scope, and type of joint venture</td>
<td>As discussed in Section 7.2, in accordance with the definition of a joint venture in ASC 323-10-20, a joint venture has all of the following characteristics:</td>
<td>A joint arrangement is an arrangement in which two or more parties have joint control.</td>
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<td>• It is a separate legal entity.</td>
<td>IFRS 11 requires an investor to follow the three-step process below when classifying a joint arrangement as either a joint operation (controlled by joint operators) or a joint venture (controlled by joint venturers).</td>
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<td>• It is owned by a small group of entities.</td>
<td>• Step 1 — If the joint arrangement is not structured through a legal vehicle, it should always be classified as a joint operation.</td>
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<td>• The operations are for the mutual benefit of the venturers.</td>
<td>• Step 2 — If the parties have rights to the assets and obligations for the liabilities either through legal form of the entity or by contract (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the parties), the joint arrangement should be classified as a joint operation. Conversely, if the parties have rights to the net assets of the arrangement, step 3 should be considered.</td>
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<td>• The purpose 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.”</td>
<td>• Step 3 — Despite the parties having only rights to the net assets of the arrangement, if the parties have designed the arrangement in such a way that (1) its activities provide the parties with the output (i.e., the parties receive substantially all of the economic benefit of the assets in the vehicle) and (2) the vehicle relies on the parties for settling the liabilities, the arrangement is a joint operation. Otherwise, the arrangement is a joint venture.</td>
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<td>• Each venturer can participate, directly or indirectly, in the overall management. The members have an interest or relationship other than passive investors.</td>
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<td>• It is not a subsidiary of one of the members.</td>
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<tr>
<td>Accounting for jointly controlled entities</td>
<td>Generally, the venturer should apply the equity method of accounting, except in certain industries (i.e., the construction and extractive industries), in which proportionate consolidation is permitted.</td>
<td>A joint venturer should recognize its interest in a joint venture as an investment and should account for that investment by using the equity method in accordance with IAS 28 unless the venturer is exempted from applying the equity method as specified in that standard.</td>
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## Determining Whether to Apply Joint Venture Accounting — Differences Between U.S. GAAP and IFRS Standards

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<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
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</thead>
</table>
| Accounting for jointly controlled operations | ASC 323 does not address jointly controlled operations (since a jointly controlled operation does not have a legal entity). However, ASC 808-10 addresses the accounting for collaborative arrangements, which are jointly controlled operations that are not primarily conducted through a legal entity. To be within the scope of ASC 808-10, a participant must be (1) an active participant in the joint operations conducted primarily outside of a legal entity and (2) exposed to significant risks and rewards that depend on the joint activity's success. As in IFRS 11, under ASC 808-10, a participant recognizes its share of costs incurred and revenue generated from transactions with third parties (i.e., nonparticipants) in its income statement. However, ASC 808-10 also requires a participant to record such amounts on a gross or net basis in its income statement in accordance with either ASC 605-45-45 (if the participant has not adopted ASC 606) or with ASC 606-10-55-36 through 55-40 (if the participant has adopted ASC 606). That is, a participant would record the amounts gross if it was the principal on the sales transaction with the third party or net if it was an agent to the transaction with the third party. | IFRS 11 states that a joint operation “is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.” A joint operator recognizes the following attributes “in relation to its interest in a joint operation:

- its assets, including its share of any assets held jointly;
- its liabilities, including its share of any liabilities incurred jointly;
- its revenue from the sale of its share of the output of the joint operation;
- its share of the revenue from the sale of the output by the joint operation; and
- its expenses, including its share of any expenses incurred jointly.” |
(Table continued)

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<tr>
<th>Subject</th>
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</table>
| Initial contribution of nonmonetary assets that meet the definition of a business to a joint venture or joint operation | A gain or loss is recognized as the difference between the following:  
- The sum of the fair value of any consideration received, the fair value of any retained noncontrolling investment in the net assets as of the date of contribution (the date control is lost), and the carrying amount of any noncontrolling interest in the net assets as of the date of contribution (the date control is lost).  
- The carrying amount of the net assets contributed as of the date of contribution (the date control is lost). | An accounting policy election among the following three approaches may be taken (unless a venturer adopted the amendments proposed by the IASB in September 2014 before it indefinitely deferred them in December 2015):  
- **Approach A (based on the September 2014 amendments to IFRS 10 and IAS 28)** — In a transaction involving a joint venture, the extent of gain or loss recognition by the venturer depends on whether the assets sold or contributed constitute a business. When an entity (1) sells or contributes assets that constitute a business to a joint venture or (2) loses control of a subsidiary that contains a business but retains joint control, the gain or loss resulting from that transaction is recognized in full.  
- **Approach B (based on the guidance in IAS 28 before the adoption of the September 2014 amendments)** — Paragraph 28 of IAS 28 states that any gain or loss is recognized by the venturer “only to the extent of unrelated investors’ interests in the . . . joint venture.”  
- **Approach C (based on the guidance in IFRS 10 before the adoption of the September 2014 amendments)** — IFRS 10 states that the venturer derecognizes all the net assets of the former subsidiary and recognizes at fair value any consideration received and any retained interest in the former subsidiary. |
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<tr>
<th>Subject</th>
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<tr>
<td>Initial contribution of nonmonetary assets that do not meet the definition of a business to a joint venture or joint operation</td>
<td>Before the Adoption of ASU 2017-05</td>
<td>An accounting policy election among the following three approaches may be taken (unless a venturer adopted the amendments proposed by the IASB in September 2014 before it indefinitely deferred them in December 2015):</td>
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<td>As discussed in Section 9.2.1, there is no prescriptive guidance on how venturers may determine whether they can recognize a gain upon contributing nonmonetary assets that do not meet the definition of a business. In certain circumstances, venturers may recognize a partial gain. Under no circumstances should they recognize a full gain.</td>
<td>• Approach A (based on the September 2014 amendments to IFRS 10 and IAS 28) — In a transaction involving a joint venture, when the venturer (1) sells or contributes assets that do not constitute a business to a joint venture or (2) loses control of a subsidiary that does not contain a business but retains joint control in a transaction involving a joint venture, the gain or loss resulting from that transaction is recognized only to the extent of the unrelated investors’ interests in the joint venture (i.e., the entity’s share of the gain or loss is eliminated). A new example added to IFRS 10 (see Appendix B, Example 17) illustrates the appropriate accounting in such circumstances.</td>
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<td>After the Adoption of ASU 2017-05</td>
<td>• Approach B (based on the guidance in IAS 28 before the adoption of the September 2014 amendments) — Paragraph 28 of IAS 28 states that a gain or loss is recognized by the venturer “only to the extent of unrelated investors’ interests in the . . . joint venture.”</td>
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<td>As discussed in Section 9.2.3, generally, venturers recognize the initial contributions of nonmonetary assets that do not meet the definition of a business at fair value and may recognize a gain if applicable.</td>
<td>• Approach C (based on the guidance in IFRS 10 before the adoption of the September 2014 amendments) — IFRS 10 states that the venturer derecognizes all the net assets of the former subsidiary and recognizes at fair value any consideration received and any retained interest in the former subsidiary.</td>
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Differences Between U.S. GAAP and IFRS Standards

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<tr>
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<tr>
<td>Initial contribution of nonmonetary assets that do not meet the definition of a business to a joint venture or joint operation (continued)</td>
<td>Note that entities that cannot formally adopt the September 2014 amendments (e.g., because of a requirement for endorsement of changes to IFRS Standards in their jurisdiction) may adopt an accounting policy consistent with those amendments (i.e., distinguishing between transactions on the basis of whether the subsidiary being sold or contributed constitutes a business) provided that the requirements of paragraph 14(b) of IAS 8 are met (i.e., the change in policy results in the financial statements' providing reliable and more relevant information). However, such a “voluntary” change in policy would have to be applied retrospectively in accordance with IAS 8; the transition provisions of the September 2014 amendments (which allow for prospective application to transactions occurring after a specified date) would not be available.</td>
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</table>
Appendix C — Titles of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

**AICPA Statement of Position**
78-9, “Accounting for Investments in Real Estate Ventures”

**FASB Accounting Standards Codification (ASC) Topics**
ASC 205, *Presentation of Financial Statements*
ASC 210, *Balance Sheet*
ASC 220, *Income Statement — Reporting Comprehensive Income*
ASC 230, *Statement of Cash Flows*
ASC 250, *Accounting Changes and Error Corrections*
ASC 260, *Earnings per Share*
ASC 270, *Interim Reporting*
ASC 272, *Limited Liability Entities*
ASC 280, *Segment Reporting*
ASC 310, *Receivables*
ASC 320, *Investments — Debt and Equity Securities*
ASC 321, *Investments — Equity Securities*
ASC 323, *Investments — Equity Method and Joint Ventures*
ASC 325, *Investments — Other*
ASC 326, *Financial Instruments — Credit Losses*
ASC 350, *Intangibles — Goodwill and Other*
ASC 360, *Property, Plant, and Equipment*
ASC 405, *Liabilities*
ASC 450, *Contingencies*
ASC 460, *Guarantees*
ASC 480, Distinguishing Liabilities From Equity
ASC 505, Equity
ASC 605, Revenue Recognition
ASC 606, Revenue From Contracts With Customers
ASC 610, Other Income
ASC 718, Compensation — Stock Compensation
ASC 720, Other Expenses
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 808, Collaborative Arrangements
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 840, Leases
ASC 842, Leases
ASC 845, Nonmonetary Transactions
ASC 850, Related Party Disclosures
ASC 860, Transfers and Servicing
ASC 932, Extractive Activities — Oil and Gas
ASC 946, Financial Services — Investment Companies
ASC 954, Health Care Entities
ASC 958, Not-for-Profit Entities
ASC 960, Plan Accounting — Defined Benefit Pension Plans
ASC 965, Plan Accounting — Health and Welfare Benefit Plans
ASC 970, Real Estate — General
ASC 974, Real Estate — Real Estate Investment Trusts

**FASB Accounting Standards Updates (ASUs)**

ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

ASU 2017-13, Revenue Recognition (Topic 605), Revenue From Contracts With Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments

ASU 2017-05, 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


ASU 2016-13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

ASU 2016-09, Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

ASU 2016-02, Leases (Topic 842)


ASU 2015-08, Business Combinations (Topic 805): Pushdown Accounting — Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115

ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis

ASU 2014-17, Business Combinations (Topic 805): Pushdown Accounting — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, Revenue From Contracts With Customers (Topic 606)

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity

ASU 2014-01, Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects — a consensus of the FASB Emerging Issues Task Force

ASU 2012-04, Technical Corrections and Improvements

**FASB Statements (Pre-Codification Literature)**

Statement 160, Noncontrolling Interests in Consolidated Financial Statements

Statement 157, Fair Value Measurements

Statement 144, Accounting for the Impairment or Disposal of Long-Lived Assets

Statement 141(R), Business Combinations

Statement 133, Implementation (Derivatives)

Statement 123(R), Share-Based Payment

**FASB APB Opinions**

No. 29, "Accounting for Nonmonetary Transactions"

No. 18, “The Equity Method of Accounting for Investments in Common Stock"
**EITF Issues (Pre-Codification Literature)**

08-6, “Equity Method Investment Accounting Considerations”

03-16, “Accounting for Investments in Limited Liability Companies”

03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”

02-14, “Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock”

01-2, “Interpretations of APB Opinion No. 29”

00-12, “Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee”

99-10, “Percentage Used to Determine the Amount of Equity Method Losses”

98-4, “Accounting by a Joint Venture for Businesses Received at Its Formation”

98-2, “Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner”

**EITF Topics**

D-97, “Push-Down Accounting”

D-96, “Accounting for Management Fees Based on a Formula”

D-46, “Accounting for Limited Partnership Investments”

**G4+1 Organization Special Report**

*Reporting Interests in Joint Ventures and Similar Arrangements*

**SEC Regulation S-X**

Rule 1-02, “Definitions of Terms Used in Regulation S-X (17 CFR part 210)”

- Rule 1-02(l), “Foreign Business”
- Rule 1-02(w), “Significant Subsidiary”
- Rule 1-02(bb), “Summarized Financial Information”

Rule 3-01, “Consolidated Balance Sheets”

Rule 3-02, “Consolidated Statements of Income and Changes in Financial Positions”

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 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”

- Rule 3-10(g), “Recently Acquired Subsidiary Issuers or Subsidiary Guarantors”

Rule 3-13, “Filing of Other Financial Statements in Certain Cases”

Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired”

Rule 3-16, “Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered”
Rule 3A-02(b), “Consolidated Financial Statements of the Registrant and Its Subsidiaries; Different Fiscal Periods”

Rule 3A-05, “Special Requirements as to Public Utility Holding Companies”

Rule 4-02, “Items Not Material”

Rule 4-08(g), “General Notes to Financial Statements; Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Article 5, “Commercial and Industrial Companies”

Rule 5-02, “Balance Sheets”
  • Rule 5-02(12), “Other Investments”

Rule 5-03, “Income Statements”
  • Rule 5-03(b)(12), “Equity in Earnings of Unconsolidated Subsidiaries and 50 Percent or Less Owned Persons”

Rule 10-01(b), “Interim Financial Statements; Other Instructions as to Content”

Article 11, “Pro Forma Financial Information”

Article 12, “Form and Content of Schedules”

**SEC Staff Accounting Bulletin (SAB) Topics**

SAB Topic 5.G, “Transfers of Nonmonetary Assets by Promoters or Shareholders”

SAB Topic 5.J (rescinded by SAB 115)


SAB Topic 6, “Interpretations of Accounting Series Releases and Financial Reporting Releases”

SEC Staff Accounting Bulletin No. 115

SEC Staff Accounting Bulletin No. 117

**SEC Final Rule**

33-9273, *Rescission of Outdated Rules and Forms, and Amendments to Correct References*

**SEC Division of Corporation Finance’s Financial Reporting Manual (FRM) Topics**

Topic 2, “Other Financial Statements Required”

Topic 3, “Pro Forma Financial Information”

Topic 6, “Foreign Private Issuers & Foreign Businesses”

Topic 10, “Emerging Growth Companies”

Topic 11, “Reporting Issues Related to Adoption of New Accounting Standards”

Topic 13, “Effects of Subsequent Events on Financial Statements Required in Filings”
**International Standards**

IFRS 12, *Disclosure of Interests in Other Entities*

IFRS 11, *Joint Arrangements*

IFRS 10, *Consolidated Financial Statements*

IFRS 9, *Financial Instruments*

IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*

IFRS 3, *Business Combinations*

IAS 39, *Financial Instruments: Recognition and Measurement*

IAS 36, *Impairment of Assets*

IAS 28 (Revised 2011), *Investments in Associates and Joint Ventures*

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*
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<td>AcSEC</td>
<td>Accounting Standards Executive Committee</td>
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<tr>
<td>AFS</td>
<td>available for sale</td>
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<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<td>AOCI</td>
<td>accumulated other comprehensive income</td>
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<td>APB</td>
<td>Accounting Principles Board Opinion</td>
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<td>APIC</td>
<td>additional paid-in capital</td>
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<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<td>CECL</td>
<td>current expected credit loss</td>
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<td>CEO</td>
<td>chief executive officer</td>
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<td>CFO</td>
<td>chief financial officer</td>
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<tr>
<td>CFR</td>
<td>U.S. Code of Federal Regulations</td>
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<tr>
<td>COO</td>
<td>chief operating officer</td>
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<td>CTA</td>
<td>cumulative translation adjustment</td>
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<td>DTA</td>
<td>deferred tax asset</td>
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<td>EGC</td>
<td>emerging growth company</td>
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<td>EPS</td>
<td>earnings per share</td>
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<td>FAS</td>
<td>FASB Statement of Financial Accounting Standards</td>
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<td>SEC Division of Corporation Finance's Financial Reporting Manual</td>
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<td>FRR</td>
<td>SEC Financial Reporting Release</td>
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<td>FVTPL</td>
<td>fair value through profit or loss</td>
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<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<td>GP</td>
<td>general partner</td>
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<td>HLBV</td>
<td>hypothetical liquidation at book value</td>
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<td>IAS</td>
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<td>International Financial Reporting Standard</td>
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<td>IPO</td>
<td>initial public offering</td>
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<td>IPR&amp;D</td>
<td>in-process research and development</td>
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<td>IRR</td>
<td>internal rate of return</td>
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<td>ITC</td>
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<td>LLC</td>
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<td>line of credit</td>
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<td>limited partnership</td>
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<td>NFP</td>
<td>not-for-profit entity</td>
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<td>OCA</td>
<td>SEC's Office of the Chief Accountant</td>
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<td>OCI</td>
<td>other comprehensive income</td>
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<td>OTTI</td>
<td>other-than-temporary impairment</td>
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<td>PBE</td>
<td>public business entity</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>PCC</td>
<td>Private Company Council</td>
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<td>PP&amp;E</td>
<td>property, plant, and equipment</td>
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<td>QAHP</td>
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<td>Statement of Position</td>
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<td>VIE</td>
<td>variable interest entity</td>
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The following is a list of short references for the Acts mentioned in this publication:

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<th>Abbreviation</th>
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<tbody>
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<td>Jumpstart Our Business Startups Act</td>
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