



# Equity method

## Handbook

**US GAAP**

November 2023

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# Still standing

The FASB has made sweeping changes in the last two decades to the accounting for investments in consolidated subsidiaries and equity securities. However, it has left the accounting for equity method investments largely unchanged since the Accounting Principles Board released APB 18 in 1971.

The Accounting Principles Board developed the equity method with the view that its one-line consolidation premise would “best [enable] investors...to reflect the underlying nature of their investment[s].”

Notwithstanding that some have advocated eliminating the equity method of accounting, its principles have remained intact – often bending, but not yet breaking – as the capital markets evolve. New and unique investment structures often challenge those principles and push the profession to make critical judgments about their application in today’s financial reporting environment.

Our objective with this publication is to help you make those critical judgments. We provide you with equity method basics and expand on those basics with insights, examples and perspectives based on our years of experience in this area. We navigate scope, deconstruct initial measurement, and examine subsequent measurement – including how to analyze complex capital structures, demystify dilution transactions and outline presentation, disclosure and reporting considerations.

We hope you will find this Handbook to be a useful tool in applying the equity method of accounting.

Matt Drucker and Nick Burgmeier  
**Department of Professional Practice, KPMG LLP**

# About this publication

The purpose of this Handbook is to assist you in applying the standard on the equity method of accounting, Topic 323, and the requirements of other standards that affect the accounting for equity method investments.

## Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

- 323-10-35-13 is paragraph 35-13 of ASC Subtopic 323-10.
- S-X Rule 4-08 is Rule 4-08 of SEC Regulation S-X.
- SAB Topic 12.C is SEC Staff Accounting Bulletin Topic 12.C.
- TQA 7100.08 is section 7100.08 of the AICPA's Technical Questions and Answers.
- FAS 141.24 is paragraph 24 of Statement of Financial Accounting Standards No. 141.
- 2016 AICPA Conf is the 2016 AICPA National Conference on Current SEC and PCAOB Developments. These references are hyperlinked to the source material on the SEC's website.
- CAQ 03-14 is the March 2014 meeting of the Center for Audit Quality's SEC Regulations Committee. These references are hyperlinked to the source material on the CAQ's website.

## Pending content

Some paragraphs reproduced in this Handbook from Topic 323 were amended by the following Accounting Standards Updates. These amendments are labeled as Pending Content in the excerpts from the Codification. Our interpretive guidance presumes that they have **not** been adopted.

- ASU 2016-13, Financial Instruments—Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments
- ASU 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

When an excerpt from the Codification is affected by pending content, the pending content marked for changes from the original wording follows at the end of the excerpt.

## November 2023 edition

This edition of our Handbook includes new and updated interpretations based on our experience with companies applying Topic 323. New Questions and Examples are identified with \*\* and items that have been significantly updated or revised are identified with #. The [Index of changes](#) identifies all significant changes.

## Recent ASUs

The FASB has issued a number of recent updates that modify the guidance on the equity method of accounting or our interpretation of that guidance.

### ASU 2016-13: Credit losses

#### Overview

In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments. The ASU added Topic 326 (financial instruments – credit losses), which requires an investor in financial assets that are held at amortized cost to reflect in its allowance for credit losses its current estimate of all expected credit losses.

The change in how to compute the allowance for credit losses may affect the amortized cost basis of an equity method investor's other investments issued by an equity method investee – e.g. loans. Those changes may affect how much of the investee's losses the investor recognizes in earnings.

[Section 4.4](#) discusses the accounting for equity method losses when the equity method investment is reduced to zero.

For an in-depth understanding of ASU 2016-13, see KPMG Handbook, [Credit impairment](#), and our financial instruments resource page on [Financial Reporting View](#).

#### Effective dates

Entity type	Effective dates for calendar year-end entities <sup>2,3</sup>
SEC filers not eligible to be SRCs <sup>1</sup>	January 1, 2020
SEC filers eligible to be SRCs	January 1, 2023
Public business entities that are not SEC filers	January 1, 2023
All other entities, including not-for-profits and employee benefit plans	January 1, 2023
Notes:	
1. The SEC defines a smaller reporting company (SRC) based on these initial qualification thresholds:	

- public float of less than \$250 million; or
  - annual revenues of less than \$100 million as of the most recent fiscal year, and either no public float or a public float of less than \$700 million.
2. Effective dates revised by ASU 2019-10, Effective Dates.
  3. The Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Consolidated Appropriations (CAA) Act permit insured depository institutions, bank holding companies or any affiliate to temporarily defer applying ASU 2016-13. Under the CARES Act and the CAA, an eligible filer may defer adoption to the earlier of:
    - the beginning of the fiscal year that begins after the date the COVID-19 national emergency comes to an end; or
    - January 1, 2022.
- The SEC’s Chief Accountant stated that the SEC staff would not object to the conclusion that financial statements prepared subject to one or both of these elections for the periods for which such elections are available are in accordance with GAAP. Further, the SEC staff has clarified several matters about applying the deferred effective date. See KPMG Hot Topic, [Accounting and reporting impacts of the CARES Act](#), for additional guidance.

## ASU 2023-02: Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

### Overview

In March 2023, the FASB issued ASU 2023-02, which expands the population of investments for which an investor may elect to apply the proportional amortization method (PAM). Expanding the availability of the PAM may simplify an investor’s accounting for a more diverse population of tax equity investments.

PAM accounting has been available for qualifying investments in Qualified Affordable Housing Projects (e.g. low income housing tax credit or LIHTC investments) as an alternative to either the cost or equity method of accounting since 2014. Under the ASU, an investor in a tax equity investment may elect the PAM for qualifying investments on a tax credit program-by-program basis. To qualify for the PAM, an investment must meet the criteria previously applicable only to LIHTC investments, as clarified by the ASU. Disclosures are required on an interim and annual basis for tax equity investments in tax credit programs for which the PAM is elected, regardless of whether the PAM is applied.

The ASU also eliminates certain guidance previously provided for LIHTC investments related to the cost method, equity method impairment and delayed equity contributions.

For the PAM-related scope expansion and clarifications, an investor can choose to apply the ASU using a modified retrospective or retrospective transition method at the beginning of the annual period that includes the adoption date. Prospective application is also available for the non-PAM changes in ASU 2023-02.

## Effective dates

Public business entities	Other entities
Annual and interim periods in fiscal years beginning after December 15, 2023.	Annual and interim periods in fiscal years beginning after December 15, 2024.

Early adoption is permitted. Section 6 of KPMG Handbook, [Tax credits](#), provides additional guidance on the PAM.

## Abbreviations

We use the following abbreviations in this Handbook:

AOCI	Accumulated other comprehensive income
CTA	Cumulative translation adjustment
EBP	Employee benefit plan
GP	General partner
HLBV	Hypothetical liquidation at book value
IPR&D	In-process research and development
JV	Joint venture
LIHTC	Low Income Housing Tax Credits
LLC	Limited liability company
LP	Limited partner
NFP	Not-for-profit entity
NCI	Noncontrolling interest
OCI	Other comprehensive income
OTTI	Other than temporary impairment
PAM	Proportional amortization method
PBE	Public business entity
PP&E	Property, plant and equipment
SAB	SEC Staff Accounting Bulletin
SOP	Statement of position
VIE	Variable interest entity

# 1. Executive summary

## Scope

An investor generally applies the equity method of accounting to its investment when it has the ability to exercise significant influence over the operating and financial decisions of that investee. While significant influence can be conveyed through a variety of different investment vehicles, an investor applies the equity method only when it has made a:

- capital investment in a partnership or partnership-like LLC; or
- common stock (or in-substance common stock) investment in a corporation, corporate joint venture or corporate-like LLC.

An investor's degree of influence tends to increase as its relative ownership in the investee's voting stock increases.

- Topic 323 establishes a presumption that an investor has the ability to exercise significant influence if its direct or indirect investment in a corporation, corporate JV or corporate-like LLC is 20% or more of the investee's voting stock. Conversely, it is presumed not to have that ability when its investment is less than 20%.
- An investor in a partnership or partnership-like LLC generally applies the equity method unless its interest is so minor that it has virtually no influence. As such, investments of 3 to 5% (or more) in these entities are typically accounted for under the equity method.

Determining whether an investor has the ability to exercise significant influence is not always clear and requires an investor to evaluate the individual facts and circumstances related to each investment.

An investor that obtains the requisite degree of influence begins applying the equity method on that date – even if that influence is expected to be temporary.

Read more: [chapter 2](#)

## Initial recognition and measurement

An investor initially recognizes its equity method investment at cost and presents it as a single amount on its balance sheet. Once the investor has measured the cost of the investment, it prepares its memo purchase price allocation as follows.

**Step 1:** Allocate cost to share of investee's underlying assets and liabilities.

**Step 2:** Determine whether equity method goodwill exists.

**Step 3:** Identify basis differences.

The investor's execution of the first two steps generally depends on whether or not the investee is a business.



Excess cost	Cost shortage
<ul style="list-style-type: none"> <li>— If the investee is a business, the investor applies the acquisition method principles of Topic 805 on business combinations – including determining whether equity method goodwill exists.</li> <li>— If the investee is not a business, the investor generally allocates excess cost to its share of the investee’s noncurrent nonfinancial assets based on relative fair values.</li> </ul>	<ul style="list-style-type: none"> <li>— An investor generally allocates a cost shortage to its share of the investee’s noncurrent nonfinancial assets based on relative fair values – regardless of whether or not the investee is a business.</li> </ul>

Read more: [chapter 3](#)

## Applying the equity method

Each reporting period, the investor adjusts the investment account for its share of the investee’s financial activity and certain investor-level activity, such as intra-entity eliminations and basis difference amortization.

## *Recognizing investee activity*

The investor periodically adjusts the carrying amount of its investment for its share of the investee’s earnings and losses, other comprehensive income (OCI) and capital transactions. The investor generally recognizes each component in the same way it would if the investee were a consolidated subsidiary. The investor’s share of the investee’s earnings is the foundation of the investor’s equity in earnings of the investee.

An investor typically recognizes its share of the investee’s activity based on the proportion of the investee’s common stock that it owns. An investor uses US GAAP to measure its share of the investee’s activity and generally recognizes that share in the period in which the investee recognizes it.

An investor generally stops applying the equity method when its share of the investee’s net losses has reduced its investment to zero unless it has additional investments in the investee or has committed financial support to the investee.

In complex capital structures, the allocation of earnings may differ from the distributions of cash from operations (or on liquidation). In these situations, how the investor determines its share of the investee’s earnings requires careful consideration of the substance of the arrangement.

An investor recognizes in its OCI its share of an investee’s OCI with a corresponding increase or decrease to its investment account.

Investee’s capital activity can result in the investor:

- increasing or decreasing its ownership interest, which results in acquisition or sale accounting;

- increasing or decreasing its claim on the investee’s net assets, which may result in adjustment to its equity in earnings at a point in time or over time; or
- receiving cash, which generally results in a reduction to the investment balance.

Read more: [chapter 4](#)

## Recognizing investor-level adjustments

The investor periodically adjusts the carrying amount of its investment for the following investor-level adjustments.

Investor-level adjustment	Investor accounting
<b>Intra-entity eliminations</b>	Investor generally eliminates some or all intra-entity profits and losses until realized by the investor or investee in transactions with third parties.
<b>Basis differences</b>	Investor adjusts equity in earnings for changes in the basis differences identified in its memo purchase price allocation completed on acquisition.  Typical adjustments include depreciation, depletion, amortization, and accretion for differences between the investor’s share of the fair value of the investee’s identifiable assets and assumed liabilities and their carrying amounts in the investee’s US GAAP financial statements.
<b>Equity method goodwill</b>	Investor does not amortize equity method goodwill unless it applies the accounting alternative for private companies and not-for-profit entities, which generally requires a 10-year amortization period.
<b>Other-than-temporary impairment</b>	If investor determines that the fair value of an equity method investment is less than its carrying amount at the reporting date and the impairment is other-than-temporary, it reduces the carrying amount of the investment to its fair value. The charge to the income statement is recognized through equity in earnings of the investee.

The investor generally recognizes each component in the same way it would if the investee were a consolidated subsidiary.

Read more: [chapter 5](#)

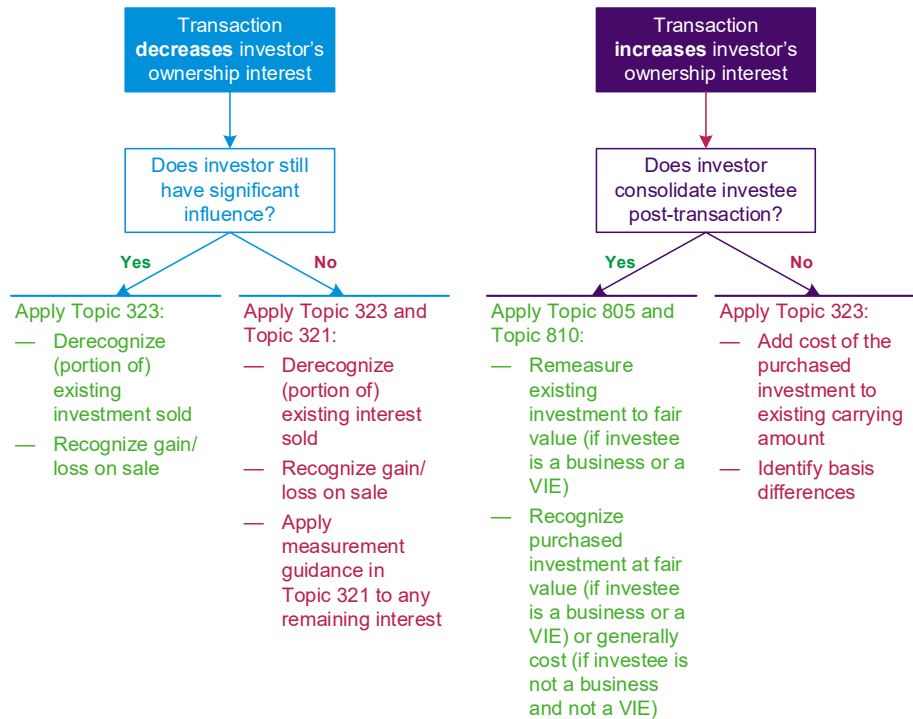
## Changes in ownership and degree of influence

An investor’s ownership percentage or degree of influence may change for many reasons. A purchase or sale of equity ownership interests by the investor or the investee is the most common.

The investor’s accounting for the transaction and measurement of any retained interest in the investee depends on whether the change results in a change in

the accounting method – i.e. from equity method to consolidation under Topic 810 or fair value measurement under Topic 321.

The following diagram summarizes the investor’s accounting when there are increases or decreases in its ownership or degree of influence in an existing equity method investee.



Read more: [chapter 6](#)

## Presentation and disclosure

An investor generally presents an equity method investment in one line on the balance sheet and its related earnings effect in one line in the income statement. The investor generally presents its share of an investee’s OCI in its OCI.

Topic 323 includes a list of disclosures, which generally focus on:

- the investor’s ownership interest, potential changes to it and its relation to the 20% significance presumption;
- basis differences; and
- the investee’s financial results (when material to the investor).

The SEC also requires an investor to file separately investee financial statements or provide investee summary financial data when certain conditions exist and provides guidance on other disclosure matters related to related party transactions.

Read more: [chapter 7](#)

# 2. Scope

## Detailed contents

### Item significantly updated in this edition: #

#### 2.1 How the standard works

#### 2.2 Objective

#### 2.3 Scope

- 2.3.10 Overview
- 2.3.20 Investments in the common stock of corporations, corporate JVs and corporate-like LLCs
- 2.3.30 Investments in the in-substance common stock of corporations, corporate JVs and corporate-like LLCs
- 2.3.40 Investments in partnerships, unincorporated JVs and partnership-like LLCs #
- 2.3.50 Undivided interests

#### Questions

- 2.3.10 Does the equity method apply to a common stock investment with a readily determinable fair value?
- 2.3.20 How does a would-be equity method investor apply the fair value option when it has other interests in the investee? #
- 2.3.30 What are the identifying characteristics of a corporate JV?
- 2.3.40 When does an investment company apply the equity method?
- 2.3.50 Does an NFP apply the equity method to investments in for-profit entities?
- 2.3.60 When does an investor analyze an LLC equity interest like common stock?
- 2.3.70 What are the characteristics of in-substance common stock?
- 2.3.80 How does an investor evaluate the subordination characteristic when its investment has a liquidation preference?
- 2.3.90 Is a variable interest other than common stock in the scope of Topic 323?
- 2.3.100 Does the in-substance common stock guidance apply to all kinds of equity investments?
- 2.3.110 Is an investment manager's carried interest in the scope of Topic 323 or Topic 606?

- 2.3.120 If an investor accounts for a carried interest under Topic 323, may it elect the fair value option?
- 2.3.125 Can an investor with a carried interest elect the fair value option for other would-be equity method investments in the same investee?
- 2.3.130 When does an investor analyze an LLC equity interest like a capital investment?
- 2.3.140 Does an investor apply the equity method to a collaborative arrangement?
- 2.3.150 How does an investor account for an undivided interest held through an interest in a legal entity? #
- 2.3.160 How does an investor account for ownership of an undivided interest in a specified asset? #

## 2.4 Significant influence

- 2.4.10 Overview
- 2.4.20 Corporations, corporate JVs and corporate-like LLCs
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### Questions

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- 2.4.100 Can lending funds to the investee provide the investor with significant influence?
- 2.4.110 May an investor account for a majority owned investee under the equity method?

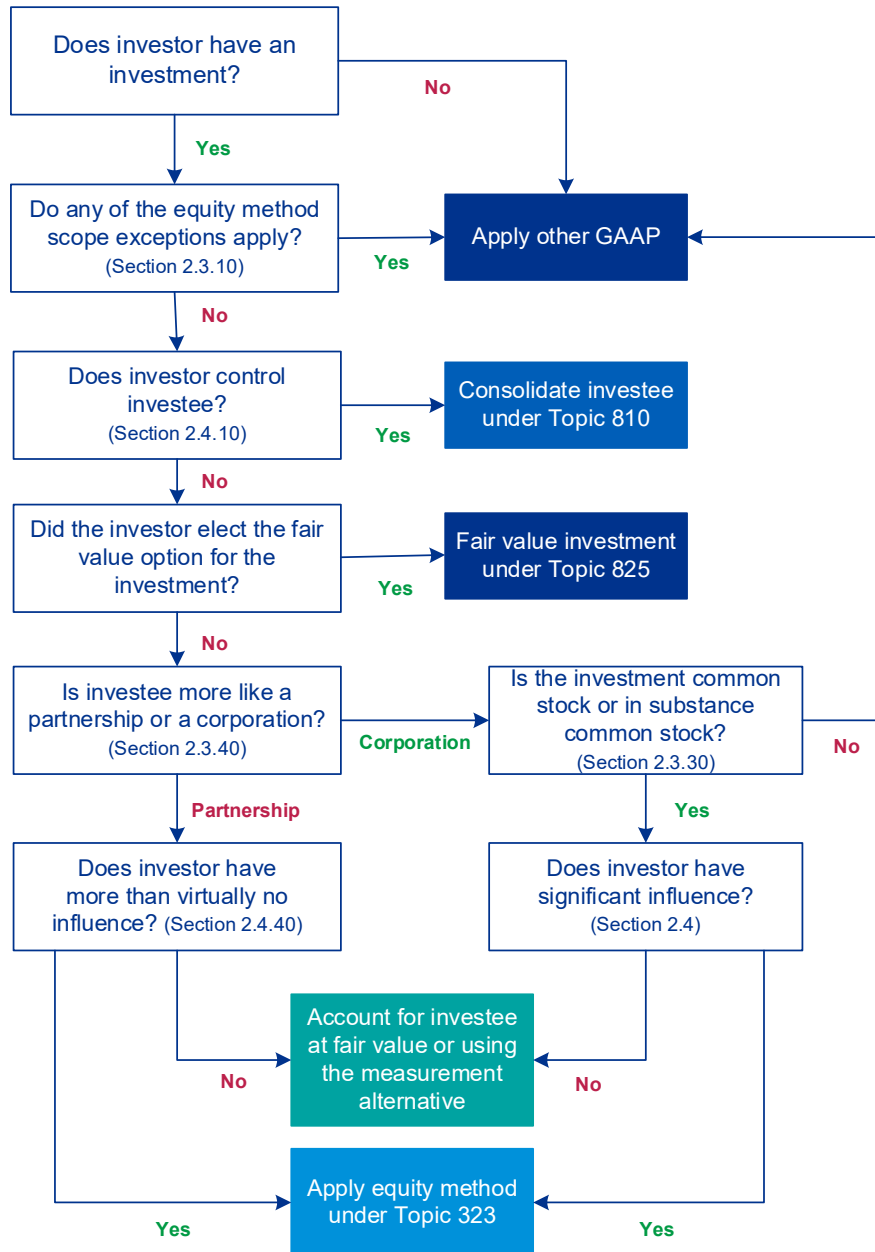
- 2.4.120 How does an investor consider a put/call arrangement on an investee's equity?
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- 2.4.150 What guidance on evaluating significant influence for corporate investments may be useful for partners?

**Examples**

- 2.4.10 Significant influence with less than 20% stock ownership
- 2.4.15 Significant influence with less than 20% stock ownership with a group voting agreement
- 2.4.20 Significant influence with less than 20% stock ownership plus board representation

## 2.1 How the standard works

The following diagram illustrates the scope of Topic 323.



In this chapter, we refer to the following additional Topics and Subtopics only by their Codification reference.

- Topic 250, Accounting Changes and Error Corrections
- Topic 321, Investments—Equity Securities
- Topic 323, Investments—Equity Method and Joint Ventures

- Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall
- Subtopic 323-30, Investments—Equity Method and Joint Ventures—Partnerships, Joint Ventures, and Limited Liability Entities
- Subtopic 323-740, Investments—Equity Method and Joint Ventures—Income Taxes
- Topic 606, Revenue from Contracts with Customers
- Topic 805, Business Combinations
- Topic 808, Collaborative Arrangements
- Topic 810, Consolidation
- Topic 815, Derivatives and Hedging
- Subtopic 825-10, Financial Instruments—Overall
- Topic 860, Transfers and Servicing
- Subtopic 958-325, Not-for-Profit Entities—Investments—Other
- Subtopic 970-323, Real Estate—General—Investments—Equity Method and Joint Ventures



## 2.2 Objective



### Excerpt from ASC 323-10

> Overview and Background

**05-4** Investments held in stock of entities other than **subsidiaries**, namely **corporate joint ventures** and other noncontrolled 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 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.

**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.

A defining characteristic of an investment in the scope of Topic 323 is an investor's ability to exercise significant influence over the operating and financial decisions of the investee.

This characteristic differentiates an equity method investor from:

- a controlling investor, which consolidates the operations of an investee; and
- a passive equity investor, which generally recognizes its investment at fair value.

In recognizing that differentiating factor, the equity method of accounting was developed with the view that its one-line consolidation premise would "best [enable] investors ... to reflect the underlying nature of their investment[s]." [\[323-10-05-4\]](#)

## 2.3 Scope

### 2.3.10 Overview

An investor applies one of three methods when accounting for an equity investment.

Method	When applied	What is presented
<b>Consolidation (Topic 810)</b>	Investor has a controlling financial interest in the investee.	Financial statements that consolidate the assets, liabilities, operations and cash flows of the investee (a subsidiary) with those of the investor.
<b>Equity method, the subject of this Handbook</b>	<ul style="list-style-type: none"> <li>— Investor has an investment in a corporate-like investee and can exercise significant influence over the operating and financial decisions of that investee.</li> <li>— Investor has an investment in a partnership-like investee and has more than virtually no influence over the investee.</li> </ul>	The investment is presented on the balance sheet as a single amount, and the investor's share of the investee's earnings or losses is presented in the income statement as a single amount.
<b>Fair value measurement (Topic 321 for equity securities)</b>	Investor neither consolidates nor applies the equity method to its investment.	The investment is presented on the balance sheet as a single amount and the investor recognizes in the income statement the changes in fair value of the investment.

The following table summarizes when an investor generally applies the equity method of accounting. The guidance in Topic 323 applies equally to foreign and domestic investments. [323-10-15-3, 15-5, 323-30-15-2 – 15-3, 970-323-25-12, 970-810-45-1]

Investee structure	Investment type	Degree of influence
<ul style="list-style-type: none"> <li>— Corporation</li> <li>— Corporate JV</li> <li>— LLC that does not maintain separate ownership accounts (a corporate-like LLC)</li> </ul>	<ul style="list-style-type: none"> <li>— Common stock</li> <li>— In-substance common stock</li> </ul>	<ul style="list-style-type: none"> <li>— Has the ability to exercise significant influence</li> </ul>
<ul style="list-style-type: none"> <li>— Partnership</li> <li>— Unincorporated JV</li> <li>— LLC that maintains separate ownership accounts (a partnership-like LLC)</li> </ul>	<ul style="list-style-type: none"> <li>— Capital investment</li> </ul>	<ul style="list-style-type: none"> <li>— Any influence, except when it has virtually no influence</li> </ul>
<ul style="list-style-type: none"> <li>— Direct ownership interest in real property assets</li> </ul>	<ul style="list-style-type: none"> <li>— Undivided interest</li> </ul>	<ul style="list-style-type: none"> <li>— Assets are under joint control or criteria for proportionate</li> </ul>

Investee structure	Investment type	Degree of influence
		consolidation are not met

Topic 323 cites some specific exceptions. An investor does not apply the equity method to: [323-10-15-4, 323-30-15-4, 323-740-25-1]

- derivative instruments;
- investments held by nonbusiness entities;
- controlling financial interests;
- most investments held by investment companies;
- investments in limited liability companies that are accounted for as debt securities under Topic 860; and
- certain qualified affordable housing investments.

In applying Topic 323, there are exceptions to one-line presentation. This presentation is often referred to as ‘proportionate consolidation’.

- Investors in the construction and extractive industries that must apply the equity method to their investees operating in those same industries may present their proportionate share of the investee’s individual assets, liabilities and components of comprehensive income in their financial statements. [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1]
- An investor also may present undivided interests in real property using proportionate consolidation presentation if certain conditions are met (see section 2.3.50). [970-810-45-1]

## 2.3.20 Investments in the common stock of corporations, corporate JVs and corporate-like LLCs



### Excerpt from ASC 323-10

#### Scope and Scope Exceptions

> Instruments

**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).

**15-4** The guidance in this Topic does not apply to any of the following:

- a. An investment accounted for in accordance with Subtopic 815-10
- b. An investment in common stock held by a nonbusiness entity, such as an estate, trust, or individual
  1. [Subparagraph superseded by Accounting Standards Update No. 2012-04].
  2. [Subparagraph superseded by Accounting Standards Update No. 2012-04].
  3. [Subparagraph superseded by Accounting Standards Update No. 2012-04].
- 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.

**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.



## Excerpt from ASC 958-810

> Other Considerations

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

- a. An NFP with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a **limited partnership** or similar **legal entity** shall apply the guidance in the General Subsections of Subtopic 810-10. However, in accordance with paragraph 810-10-15-17, NFPs are not subject to the Variable Interest Entities Subsections of that Subtopic.
- b. An NFP that is a general partner or a limited partner of a for-profit limited partnership or a similar legal entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I. However, the guidance in those paragraphs does not apply to the following:
  1. A general partner or a limited partner that reports its partnership interest at **fair value** in accordance with (e).
  2. Entities in industries, such as the construction or extractive industries, in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).
- 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, with changes in fair value reported in the statement of activities, provided that all such investments are measured at fair value.

Unless excluded from the scope of Subtopic 323-10, an investor generally applies the equity method when its investment in common stock gives it the ability to exercise significant influence over the operating and financial policies of a corporation, corporate JV or LLC that does not maintain separate ownership accounts (a corporate-like LLC). This includes investors that are NFPs with common stock investments in for-profit companies. [323-10-15-3 –15-5]

Common stock investments not eligible for the equity method include those held by: [323-10-15-4]

- nonbusiness entities; and
- investment companies – unless the investment is in an operating company that provides services to the investment company (see [Question 2.3.40](#)).



### Question 2.3.10

**Does the equity method apply to a common stock investment with a readily determinable fair value?**

**Background:** An investment with a readily determinable fair value is measured at fair value through net income if the investor neither controls, nor has the ability to exercise significant influence over, the investee. [321-10-35-1]

An equity security has a readily determinable fair value if it meets any of the following conditions. [321-20 Glossary]

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

**Interpretive response:** Yes. Unless there is a scope exception, an investor applies the equity method to a common stock investment that gives it the ability to exercise significant influence over the operating and financial policies of the investee. This applies regardless of whether the investment has a readily determinable fair value.

However, an investor that would otherwise apply the equity method may elect to apply the fair value option under Subtopic 825-10 on a contract-by-contract basis (see [Question 2.3.20](#)). [323-10-15-3, 825-10-15-4]



### Question 2.3.20#

**How does a would-be equity method investor apply the fair value option when it has other interests in the investee?**

**Interpretive response:** Subtopic 825-10 permits an investor to elect fair value measurement for an investment that would otherwise be accounted for under the equity method.

However, while an investor generally may elect the fair value option on a contract-by-contract basis, if it has elected fair value measurement for a would-be equity method investment, it must: [825-10-25-7(b)]

- measure at fair value
  - its entire equity method interest (including additional interests purchased in the future); and
  - other financial interests in the investee that are eligible to be measured at fair value under Subtopic 825-10 – e.g. other equity investments, debt investments and guarantees.

- record investee distributions (e.g., dividends) as income similar to an investment accounted for at fair value under Topic 321. See section 5.5 of KPMG Handbook, [Investments](#), for further guidance.

A separate service arrangement with an investee (e.g. to provide payroll or other administrative services) generally does not meet the definition of a financial asset or liability. As a result, the investor does not consider that arrangement an attribute of its ownership interest and does not include it when remeasuring to fair value its equity interest. Further, it does not apply fair value measurement to carried interests, even if those interests are accounted for under Topic 323 (see [Questions 2.3.120](#) and [2.3.125](#)).

See [Question 2.3.120](#) for additional discussion about the effects of embedded service agreements on the fair value option election.



### Question 2.3.30

#### What are the identifying characteristics of a corporate JV?



### Excerpt from ASC 323-10

#### 20-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.

**Interpretive response:** A corporate JV has two identifying characteristics: governance, and risks and rewards.

#### Governance

The Topic 323 definition of 'corporate JV' does not include joint decision-making as a distinguishing feature of the arrangement.

Consequently, we believe that a corporate JV differs from an operating JV, as that term is used when evaluating the scope of the VIE subsections of

Topic 810. We believe that while an operating JV establishes joint decision-making over all key decisions, the governance of a corporate JV must provide its venturers only the ability to participate, directly or indirectly, in the overall management of the venture. Section 2.4 of KPMG Handbook, [Consolidation](#), discusses operating JVs.

### Risks and rewards

We believe the risks and rewards of a corporate JV include the ability to participate in both earnings (losses) and capital appreciation (depreciation). [Section 2.3.30](#) provides additional information about determining whether an investor participates in the risks and rewards of ownership in the context of identifying in-substance common stock.

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### Question 2.3.40

#### When does an investment company apply the equity method?

**Interpretive response:** An investment company generally measures its investments in debt and equity securities at fair value instead of applying the equity method.

However, an exception exists when an investment company has invested in an operating company from which it obtains services (e.g. investment advisory or transfer agent services). In those cases, the investor's purpose for investing is to obtain services rather than to realize a gain on sale of the investment. Therefore, the equity method applies to an investment company's ownership interest in such an operating company if that interest otherwise qualifies for equity method accounting. [323-10-15-4(d), 946-320-35-1, 946-323-45-2]

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### Question 2.3.50

#### Does an NFP apply the equity method to investments in for-profit entities?

**Interpretive response:** Yes. Unless the NFP elects fair value measurement under Subtopic 958-325, it should apply the equity method to a noncontrolling investment in the common stock of a for-profit entity (i.e. corporation, corporate JV or corporate-like LLC) if it has the ability to exercise significant influence. [958-810-15-4(c)]

Likewise, unless it elects fair value measurement, an NFP should apply the equity method to a noncontrolling investment in a for-profit partnership, unincorporated JV or partnership-like LLC, unless it has virtually no influence. [958-810-15-4(d)]

If the NFP applies the equity method, it also should provide the disclosures required by Topic 323 (see [chapter 7](#)).

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### Question 2.3.60

#### When does an investor analyze an LLC equity interest like common stock?

**Interpretive response:** An LLC investor analyzes its equity interest in the same way as *common stock* when the LLC does *not* maintain a specific ownership account for each investor – i.e. it is a corporate-like LLC. [323-10-15-5(b), 323-30-15-2(c), 35-3]

In contrast, an LLC investor analyzes its equity interest in the same way as a *capital investment* in a partnership when the LLC maintains a specific ownership account for each investor – i.e. it is a partnership-like LLC (see [Question 2.3.130](#)).

How an LLC is taxed typically drives whether it maintains specific ownership accounts. When an LLC is taxed like a partnership, it often establishes and maintains specific ownership accounts because those accounts function like partners' capital accounts. When taxed like a corporation, it often unitizes its equity – i.e. divides its equity into individual units that are interchangeable and indistinguishable from each other. A members' interest in a unitized LLC is similar to a common shareholder's interest in a corporation.

Determining whether an LLC (or similar entity) maintains specific ownership accounts largely depends on the legal documents governing the entity and the laws of the jurisdiction in which it is domiciled. In some cases, an investor may need to consult its legal advisors to make this determination.

## 2.3.30 Investments in the in-substance common stock of corporations, corporate JVs and corporate-like LLCs



### Excerpt from ASC 323-10

#### • > In-Substance Common Stock

**15-13** For purposes of this Topic, in-substance common stock is an investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock. An investor shall consider all of the following characteristics when determining whether an investment in an entity is substantially similar to an investment in that entity's common stock:

- a. Subordination. An investor shall determine whether the investment has subordination characteristics that are substantially similar to that entity's common stock. If an investment has a substantive liquidation preference over common stock, it is not substantially similar to the common stock. However, certain liquidation preferences are not substantive. An investor shall determine whether a liquidation preference is substantive. For example, if the investment has a stated liquidation preference that is not significant in relation to the purchase price of the investment, the liquidation preference is not substantive. Further, a stated liquidation preference is not substantive if the investee has little or no subordinated

equity (for example, common stock) from a fair value perspective. A liquidation preference in an investee that has little or no subordinated equity from a fair value perspective is nonsubstantive because, in the event of liquidation, the investment will participate in substantially all of the investee's losses.

- b. Risks and rewards of ownership. An investor shall determine whether the investment has risks and rewards of ownership that are substantially similar to an investment in that entity's common stock. If an investment is not expected to participate in the earnings (and losses) and capital appreciation (and depreciation) in a manner that is substantially similar to common stock, the investment is not substantially similar to common stock. If the investee pays **dividends** on its common stock and the investment participates currently in those dividends in a manner that is substantially similar to common stock, then that is an indicator that the investment is substantially similar to common stock. Likewise, if the investor has the ability to convert the investment into that entity's common stock without any significant restrictions or contingencies that prohibit the investor from participating in the capital appreciation of the investee in a manner that is substantially similar to that entity's common stock, the conversion feature is an indicator that the investment is substantially similar to the common stock. The right to convert certain investments to common stock (such as the exercise of deep-in-the-money warrants) enables the interest to participate in the investee's earnings (and losses) and capital appreciation (and depreciation) on a substantially similar basis to common stock.
- c. Obligation to transfer value. An investment is not substantially similar to common stock if the investee is expected to transfer substantive value to the investor and the common shareholders do not participate in a similar manner. For example, if the investment has a substantive redemption provision (for example, a mandatory redemption provision or a non-fair-value put option) that is not available to common shareholders, the investment is not substantially similar to common stock. An obligation to transfer value at a specious future date, such as preferred stock with a mandatory redemption in 100 years, shall not be considered an obligation to transfer substantive value.

**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.

**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.

**15-19** Example 1 (see paragraph 323-10-55-1) illustrates the application of the guidance in paragraphs 323-10-15-13 and 323-10-15-15.



## Excerpt from ASC 323-10

- > Example 1: In-Substance Common Stock

**55-1** The following Cases illustrate the application of the characteristics described in paragraphs 323-10-15-13 and 323-10-15-15 to various investments:

- a. Subordination substantially similar to **common stock** (Case A)
- b. Subordination not substantially similar to common stock (Case B)

- c. Investment expected to participate in risks and rewards of ownership (Case C)
- d. Investment not expected to participate in risks and rewards of ownership (Case D)
- e. **Investee** not obligated to transfer substantive value (Case E)
- f. Investee obligated to transfer substantive value (Case F).

**55-2** Each Case provides sufficient information to reach a conclusion about whether the investment contemplated in the Case has the characteristic of **in-substance common stock** being demonstrated in the Case. In each Case, assume that the **investor** is performing the analysis because it has determined that it is not required to consolidate the investee under Subtopic 810-10, that it has the ability to exercise **significant influence** over the operating and financial policies of the investee, and that its investment does not meet the definition of a derivative instrument under Subtopic 815-10.

•• > Case A: Subordination Substantially Similar to Common Stock

**55-3** Investor organized Investee and acquired all of the common stock of Investee on January 1, 2003. On January 1, 2004, Investee sells 100,000 shares of preferred stock to a group of investors in exchange for \$10,000,000 (\$100 par value; liquidation preference of \$100 per share). The fair value of the entity's common stock is approximately \$100,000 on January 1, 2004.

**55-4** In this Case, the stated liquidation preference is equal to the fair value of the preferred stock. However, the fair value of the common stock (\$100,000), if compared with the fair value of the preferred stock, indicates that Investee has little or no common stock from a fair value perspective. An investor should therefore conclude that the liquidation preference is not substantive and that the subordination characteristics of its preferred stock investment are substantially similar to the subordination characteristics of Investee's common stock. The investor should also evaluate whether the preferred stock has the characteristics in paragraph 323-10-15-13(b) through 15-13(c), and paragraphs 323-10-15-14 through 15-15 (if necessary) to reach a conclusion about whether the preferred stock is in-substance common stock.

•• > Case B: Subordination Not Substantially Similar to Common Stock

**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.

• • > 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.

**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.

•• > 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.

An investor generally applies the equity method to its investment when the investment enables the investor to exercise significant influence over the operating and financial decisions of the investee. While significant influence (see [section 2.4](#)) can be conveyed through a variety of different investment vehicles, the equity method is applied only when the investor has invested in either the common stock or the in-substance common stock of the investee.

The investor initially determines whether an investment is in-substance common stock when it obtains the ability to exercise significant influence. It reassesses its conclusion if there is a change in:

- the investment's contractual terms that affects its analysis of the characteristics; or

- the investee’s capital structure, including the investee’s receipt of additional subordinated financing.

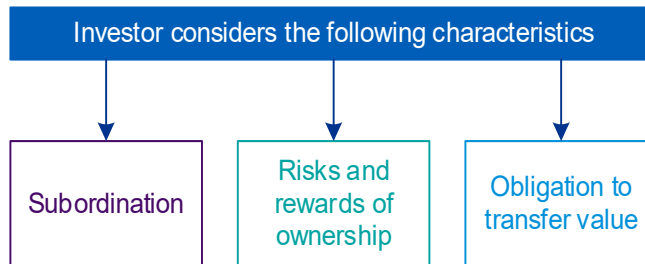
An investor also reevaluates whether its investment is in-substance common stock if it acquires additional interests.



### Question 2.3.70

#### What are the characteristics of in-substance common stock?

**Interpretive response:** In-substance common stock has characteristics that are substantially similar to the investee’s common stock. Topic 323 includes the specific characteristics to consider when determining whether an investment is in-substance common stock.



An investor concludes its investment is in-substance common stock only if all of the characteristics are substantially similar to common stock. [323-10-15-13]

- **Subordination.** The investor evaluates whether the investment has subordination characteristics that are substantially similar to common stock. If the investment has a liquidation preference over the common stock, the investor evaluates whether that liquidation preference is substantive. If it is, the investment is not substantially similar to common stock and is not in-substance common stock.
- **Risks and rewards of ownership.** The investor evaluates whether the risks and rewards of owning the investment are substantially similar to common stock. Risks and rewards of ownership include the ability to participate in earnings, losses, capital appreciation and depreciation in a manner that is substantially similar to common stock. Participation in common dividends and the ability to convert to common stock are indicators that an investment shares in the risks and rewards of ownership in a manner substantially similar to common stock.
- **Obligation to transfer value.** If the investment’s terms obligate the investee to transfer to the investor substantive value that is not available to common shareholders, that investment generally is not in-substance common stock. An investment with substantive redemption features generally obligates the investee to transfer value not available to common shareholders. However, a nonsubstantive redemption feature (e.g. one with mandatory redemption in 100 years) is not an obligation to transfer value.



Sometimes the investor's analysis of these characteristics will be inconclusive – e.g. two of the three criteria are met, but the third is unclear. In that situation, the investor should analyze whether changes in the investment's fair value are expected to vary directly with the changes in the fair value of the common stock. If the changes in fair value do not vary directly, the investment is not in-substance common stock.

If an investee has more than one class of common stock, the investor performs the analysis by comparing its investment to all the classes.

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### Question 2.3.80

**How does an investor evaluate the subordination characteristic when its investment has a liquidation preference?**

**Interpretive response:** An investment with a liquidation preference is substantially similar to common stock if the liquidation preference is not substantive.

Cases A and B in FASB Example 1 illustrate how to evaluate the subordination characteristic. In both cases, the preferred stock investor considers whether: [\[323-10-15-13\(a\)\]](#)

- the liquidation preference is insignificant relative to the purchase price of the investment; or
- the investee has little to no subordinated (e.g. common) equity from a fair value perspective.

If either of these conditions is met, the liquidation preference is not substantive. In both of the FASB Cases, the liquidation preference equals the cash paid for (and the fair value of) the preferred stock; therefore, the first condition is not met. Consequently, these cases are useful for evaluating how to interpret the second condition (little to no subordinated equity).

In Case A, the fair value of the investee's common equity (\$100,000) is 1% of the \$10,000,000 fair value of the preferred stock. The investor concludes that the liquidation preference is not substantive because the investee has little or no subordinated equity. As a result, the investor concludes that the preferred stock has subordination characteristics that are substantially similar to common stock. Next, the investor evaluates the remaining characteristics: risks and rewards of ownership, and obligation to transfer value. [\[323-10-55-3 – 55-4\]](#)

In Case B, the fair value of the investee's common equity (\$15,000,000) is greater than the \$10,000,000 fair value of the preferred stock. The investor concludes that the liquidation preference is substantive because the investee has adequate subordinated equity. As a result, the investor concludes that the preferred stock does not have subordination characteristics that are substantially similar to common stock and is not in-substance common stock. [\[323-10-55-5 – 55-6\]](#)

Based on these illustrations, we believe that an investee has little to no subordinated equity when the fair value of its common stock is 1% or less of the fair value of the preferred stock. In that situation, a liquidation preference

associated with an other-than-common-stock investment is non-substantive – even when the liquidation preference itself is significant relative to the purchase price of the investment.

However, we do not believe the fair value of the common stock must exceed the fair value of the preferred stock to conclude that the investee’s equity is adequate. We believe investors should consider the facts and circumstances in making this determination.

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### Question 2.3.90

#### Is a variable interest other than common stock in the scope of Topic 323?

**Background:** Topic 810 addresses when a reporting entity should consolidate a legal entity in which it has an economic interest if the traditional voting interest approach would be ineffective in identifying the holder of a controlling financial interest. Topic 810 does not address accounting for a variable interest that is not a controlling financial interest. [810-10-15-4 – 15-5]

**Interpretive response:** It depends. An investor with a variable interest in a VIE other than common stock applies the equity method if the variable interest: [323-10-15-3 – 15-11]

- is not a controlling financial interest in the VIE under Topic 810;
- qualifies as in-substance common stock (see [Question 2.3.100](#)); and
- conveys the ability to exercise significant influence over the VIE’s operating and financial policies.

Chapter 6 of KPMG Handbook, [Consolidation](#), provides additional guidance about identifying the primary beneficiary of a VIE.

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### Question 2.3.100

#### Does the in-substance common stock guidance apply to all kinds of equity investments?

**Interpretive response:** No. We believe that the in-substance common stock guidance does not apply to investments:

- accounted for under Topic 815;
- in a partnership;
- in an LLC that maintains specific ownership accounts;
- in a trust; or
- in other unincorporated entities that maintain specific ownership accounts and do not have the same capital structure as a corporation.

We believe the in-substance common stock guidance applies to an LLC that does not maintain specific ownership accounts – i.e. a corporate-like LLC for Topic 323 purposes. See [Question 2.3.60](#) and [section 2.4.40](#) for additional discussion.

While these exceptions are not included in Topic 323, they were included in EITF 02-14, Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock, the original source of the guidance on in-substance common stock. Paragraph 5 of EITF 02-14 stated:

This Issue does not apply to investments accounted for under Statement 133, non-corporate entities accounted for under SOP 78-9, or to limited liability companies that maintain "specific ownership accounts" for each investor as discussed in Issue No. 03-16, "Accounting for Investments in Limited Liability Companies."

### 2.3.40 Investments in partnerships, unincorporated JVs and partnership-like LLCs#



#### Excerpt from 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.



#### Excerpt from ASC 323-30

> Transactions

**15-2** This Subtopic provides guidance on applying the criteria for equity method accounting to investments in all of the following entities:

- a. Partnerships
- b. Unincorporated joint ventures
- c. Limited liability companies.

**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.

**15-4** This Subtopic does not provide guidance for investments in limited liability companies that are required to be accounted for as debt securities pursuant to paragraph 860-20-35-2.

> Terminology

**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**.

> Investment in a Limited Liability Company

**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.



### Excerpt from ASC 970-323

> General Partnerships

**25-3** Many provisions of Topic 323 are appropriate in accounting for investments in certain unincorporated entities. The principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The equity method, however, enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, investments in noncontrolled real estate general partnerships shall be accounted for and reported under the equity method.

**25-4** An entity shall apply the one-line equity method of presentation in both the balance sheet and the statement of income. Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph 810-10-45-14. Topic 323 shall be used as a guide in applying the equity method.

> Limited Partnerships

**25-5** For guidance on determining whether a general partner or a limited partner shall consolidate a limited partnership or apply the equity method of accounting to its interests in the limited partnership, see paragraph 970-810-25-3.

**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.

Unless excluded from the scope of Subtopic 323-30, an investor generally applies the equity method to a capital investment in a partnership, an unincorporated JV, a partnership-like LLC (i.e. an LLC that maintains specific ownership accounts) or other investment structures such as trusts that

maintain specific ownership accounts, unless its investment is so minor that it has virtually no influence over the investee. [323-30-15-2, 323-10-15-5, 970-323-25-2 – 25-6]

The ‘virtually-no-influence’ threshold is addressed in Subtopic 970-323. Although the guidance specifically applies to real estate partnerships, it is generally applied by analogy in practice to all entities in the scope of Subtopic 323-30 (see [Question 2.4.140](#)). [970-323-25-2 – 25-6]

The only exceptions to this guidance are investments in partnerships, unincorporated JVs or LLCs that are investments in: [323-10-15-5(b), 323-30-15-4, 323-740-15-3]

- corporate-like LLCs – i.e. LLCs that do not maintain specific ownership accounts (see [Question 2.3.60](#));
- LLCs that are accounted for as debt securities under Topic 860; and
- the following tax credit structures:
  - before adoption of ASU 2023-02, investments in qualified affordable housing projects (LIHTC investments) for which the PAM has been elected and applied. If the PAM has not been elected and applied, the investor applies the equity method of accounting under Topic 323, or a modified cost method illustrated in Subtopic 323-740.
  - after adoption of ASU 2023-02, tax equity investments for which the PAM has been elected and applied. If the PAM has not been elected and applied, the investor applies the equity method of accounting under Topic 323.

ASU 2023-02 expands the population of investments for which an investor may elect to apply the PAM. Subtopic 323-740 addresses when election and application of the PAM is appropriate. Appendix B of KPMG Handbook, [Accounting for income taxes](#), provides additional information about when an investor may elect and apply the PAM before the adoption of ASU 2023-02, and Chapter 6 of KPMG Handbook, [Tax credits](#), provides that information for after the adoption of ASU 2023-02.

The ASU also eliminates certain guidance previously provided for LIHTC investments, including the guidance stating it may be appropriate to apply the cost method to an LIHTC investment. When transitioning out of the cost method guidance, an investor determines whether it must account for the investment at fair value under Topic 321 and, if not, whether it elects to account for the investment at fair value or using the Topic 321 measurement alternative. Section 6 of KPMG Handbook, [Tax credits](#), provides additional guidance on the PAM.



### Question 2.3.110

**Is an investment manager’s carried interest in the scope of Topic 323 or Topic 606?**

**Interpretive response:** It depends.

Investment managers are compensated in different ways for providing asset management services including a base management fee, an incentive-based

fee or an incentive-based capital allocation in the form of a carried interest in a partnership or similar structure. Incentives are earned based on the performance of the assets under management.

Before adopting Topic 606, if a GP (investment manager) did not consolidate the limited partnership, it generally accounted for its fee (including its performance fee in the form of a carried interest) based on the guidance in paragraph 605-20-S99-1 (previously EITF Topic D-96), which provided two acceptable methods for income recognition. Topic D-96 also included guidance that permitted entities that previously applied the equity method to continue to do so. Because the SEC withdrew this guidance on the effective date of Topic 606, stakeholders raised questions about whether carried interest arrangements are in the scope of Topic 606 or, because generally they are in the legal form of equity, they should be accounted for as an ownership interest in the investee.

The IASB and the FASB's Joint Transition Resource Group for Revenue Recognition discussed this issue at its April 2016 meeting. FASB members present indicated that the FASB discussed performance fees in asset management contracts when developing Topic 606. All FASB members expressed the view that performance fees in the form of carried interest arrangements were intended to be in the scope of Topic 606. [\[TRG 04-16.50\]](#)

The SEC Observer at the meeting indicated that the SEC staff would accept an application of Topic 606 for these arrangements. However, he also noted that applying an ownership model to these arrangements, rather than Topic 606, may be acceptable based on the specific facts and circumstances. If an entity were to apply an ownership model, the SEC staff would expect full application of the ownership model, including an analysis of the consolidation guidance in Topic 810, the equity method under Topic 323 or other relevant guidance. We understand that the SEC staff would not object to an entity evaluating the carried interest as a *performance fee* rather than an interest in the fund itself when assessing whether it is a variable interest under Topic 810.

The SEC Observer did not elaborate on the nature of the facts and circumstances that in the SEC staff's view would require applying Topic 606 to these arrangements. We are not aware of any scenarios in which the SEC staff believe applying an ownership model would be unacceptable when the performance fee is in the form of equity (i.e. carried interest).

Based on our understanding of the SEC staff's views, we believe both private and public companies may elect as an accounting policy when they adopt Topic 606 to account for performance-based fees in the form of a capital allocation by applying either:

- the revenue recognition guidance in Topic 606; or
- an equity ownership model using the guidance in Topic 323, Topic 810 or other relevant guidance.

Either accounting policy selected should be consistently applied. Based on our current understanding of the views of the FASB and SEC staffs, if an entity elects to initially apply Topic 606 to these arrangements, we believe it will generally be difficult to support a conclusion that it is preferable to change to an ownership model at a future date. Our current understanding may be affected

by future standard setting or regulatory developments that may cause our views to change.

If an entity determines it is appropriate to apply an ownership model (e.g. Topic 323), it applies the guidance in Topic 250 for a change in accounting and not the transition guidance in Topic 606. In that situation, the entity would separate the presentation and disclosure of the equity income from these arrangements from revenue derived from arrangements that are accounted for under Topic 606.

Chapter 2 of KPMG Handbook, [Revenue recognition](#), provides additional guidance on evaluating the scope of Topic 606. Chapter 3 of KPMG Handbook, [Accounting changes and error corrections](#), provides guidance on accounting changes.

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### Question 2.3.120

#### If an investor accounts for a carried interest under Topic 323, may it elect the fair value option?

**Background:** As discussed in [Question 2.3.110](#), an investor may elect to apply Topic 606 or Topic 323 to a noncontrolling carried interest in an investee.

**Interpretive response:** It depends. While an investor generally may elect to apply the Subtopic 825-10 fair value option to an equity method investment, the SEC staff has indicated that it may not be appropriate to apply Subtopic 825-10 to certain equity method investments that have embedded nonfinancial performance obligations, such as carried interests. The staff indicated that careful consideration is required to determine whether these arrangements are eligible for the fair value option. [[323-10-15-3](#), [825-10-15-4](#), [2007 AICPA Conf](#)]

See [Question 2.3.20](#) for additional discussion on applying the fair value option when the investor has a separate services agreement with the investee.

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### Question 2.3.125

#### Can an investor with a carried interest elect the fair value option for other would-be equity method investments in the same investee?

**Background:** As discussed in [Question 2.3.110](#), an investor may elect to apply Topic 606 or Topic 323 to a noncontrolling carried interest in an investee.

An investor with a carried interest is generally unable to elect the fair value option for that interest.

- If the investor accounts for the carried interest under Topic 323, it is generally unable to elect the fair value option for that interest because the interest has an embedded nonfinancial performance obligation (see [Question 2.3.120](#)).

- If the investor accounts for the carried interest under Topic 606, it is unable to elect the fair value option for that interest because it represents consideration from a customer and not a financial instrument. [606-10-15, 825-10-15]

However, an investor with a carried interest often also has an equity interest in the investee that would be in the scope of Topic 323 – e.g. a limited partner (LP) interest.

**Interpretive response:** Yes. When an investor has both a noncontrolling carried interest and an LP interest in an investee, we believe it may elect the fair value option for the LP interest. Although the noncontrolling carried interest may be accounted for under Topic 323, it is ineligible for the fair value option under Subtopic 825-10. We do not believe that ineligibility precludes use of the fair value option for the LP investment.

When measuring the fair value of the LP investment, the investor does not consider the carried interest an attribute of the LP interest – i.e. the carried interest is a separate unit of account. The investor separately accounts for the noncontrolling carried interest under Topic 606 or Topic 323, based on the accounting policy originally elected.



### Question 2.3.130

#### When does an investor analyze an LLC equity interest like a capital investment?

**Interpretive response:** An LLC investor analyzes its equity interest in the same way as a *capital investment* in a partnership when the LLC maintains a specific ownership account for each investor – i.e. it is a partnership-like LLC. [323-30-15-2(c), 35-3, 323-10-15-5(b)]

In contrast, an LLC investor analyzes its equity interest in the same way as *common stock* when the LLC does *not* maintain a specific ownership account for each investor – i.e. it is a corporate-like LLC.

As discussed in [Question 2.3.60](#), how an LLC is taxed typically drives whether the LLC maintains specific ownership accounts. When an LLC is taxed like a partnership, it often establishes and maintains specific ownership accounts because those accounts function like partners' capital accounts. When taxed like a corporation, it often unitizes its equity. A member's interest in a unitized LLC is similar to a common shareholder's interest in a corporation.

Determining whether an LLC (or similar entity) maintains specific ownership accounts largely depends on the legal documents governing the entity and the laws of the jurisdiction in which it is domiciled. In some cases, an investor may need to consult its legal advisors.

Specific ownership account structures also may be present in entities that have a different legal form than an LLC. It may be appropriate to analogize to the partnership equity method guidance for other entities with specific ownership account structures.





### Question 2.3.140

#### Does an investor apply the equity method to a collaborative arrangement?

**Background:** A collaborative arrangement is a contractual arrangement involving a joint operating activity in which the parties are active participants and are exposed to its risks and rewards. [808-10-20]

**Interpretive response:** No. Topic 323 applies only to (1) an investment in the common stock or in-substance common stock of a **legal entity** or (2) an **undivided interest** in real property subject to joint control (see [Question 2.3.150](#)).

An investor generally applies Topic 606 or Topic 808 when accounting for a collaborative arrangement that does not involve a legal entity. Which guidance applies depends on the nature of the arrangement and the relationship between the parties.

ASU 2018-18, Clarifying the Interaction between Topic 808 and Topic 606, clarifies that transactions between collaborative partners should be accounted for as revenue transactions under Topic 606 if one of the parties is a customer with respect to that transaction. Other transactions between collaborative partners are generally accounted for under Topic 808.

Section 2.2.20 of KPMG Handbook, [Revenue Recognition](#), provides additional guidance on determining whether a collaboration partner is a customer in the scope of Topic 606.

## 2.3.50 Undivided interests



### Excerpt from ASC 910-81

**45-1** Paragraph 810-10-45-14 explains that 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 (as discussed in this Topic) or an extractive industry (see paragraphs 930-810-45-1 and 932-810-45-1).



### Excerpt from ASC 930-810

> Proportionate Consolidation

**45-1** Paragraph 810-10-45-14 explains that 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 (as discussed in this Topic and paragraph

932-810-45-1). As indicated in that paragraph, 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.



### Excerpt from ASC 932-810

> Proportionate Consolidation

**45-1** Paragraph 810-10-45-14 explains that 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 or an extractive industry (as discussed in this Topic and paragraph 930-810-45-1). As indicated in that paragraph, 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.



### Excerpt from ASC 810-10

> Proportionate Consolidation

**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.



### Excerpt from ASC 970-323

> Undivided Interests

**25-12** If real property owned by undivided interests is subject to **joint control** by the owners, the investor-venturers shall not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Most real estate ventures with ownership in the

form of undivided interests are subject to some level of joint control. Accordingly, such investments shall be presented in the same manner as investments in noncontrolled partnerships.

**20 Glossary**

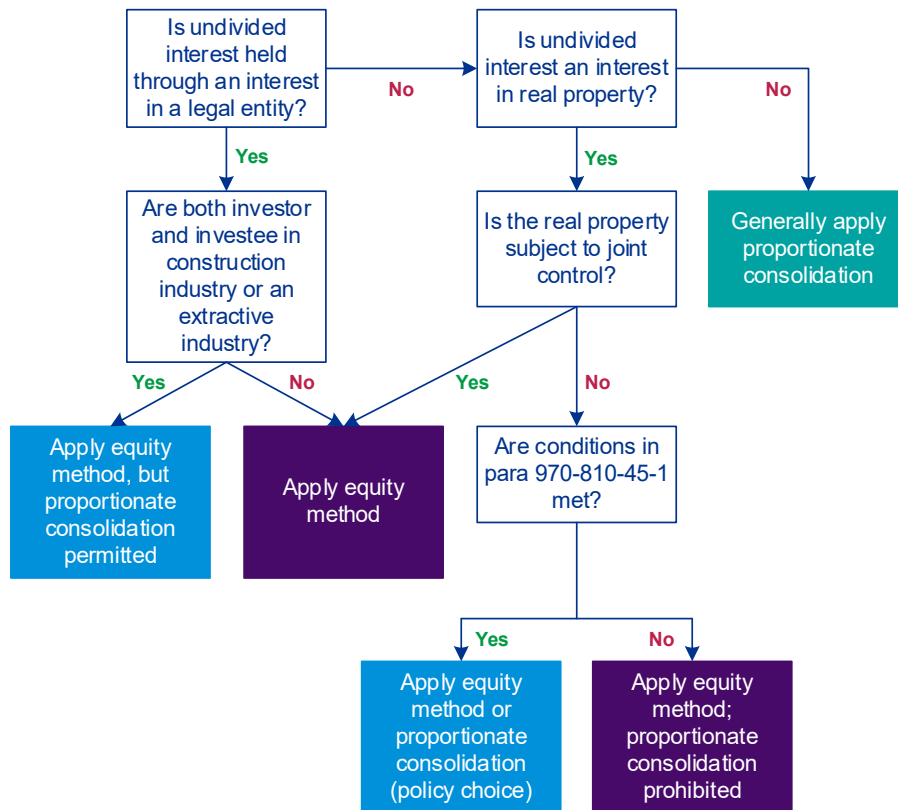
**Joint control**

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

**Undivided Interest**

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

The following decision tree highlights the key considerations when determining which accounting method to apply to an undivided interest.



**Question 2.3.150#**  
**How does an investor account for an undivided interest held through an interest in a legal entity?**

**Interpretive response:** An investor may have an investment in a legal entity such as a partnership or unincorporated joint venture (also called an undivided

interest in an entity) in which it has undivided interests in each asset and is proportionately liable for each liability. An investor generally applies the equity method to an undivided interest that is held through an ownership interest in a legal entity in the following circumstances:

- if the venture is a partnership or a partnership-like LLC, unless the investor has virtually no influence (see [sections 2.3.40](#) and [2.4.40](#)); or
- if the venture is a corporation or a corporate-like LLC and the investor has the ability to exercise significant influence (see [sections 2.3.20](#) and [2.4.20](#)).

However, there is an exception if an investor has an interest in an investee and both entities operate in the construction or extractive industries. While the investor applies the recognition and measurement principles in Topic 323, it may present its proportionate share of the investee's individual assets, liabilities, and components of comprehensive income in its financial statements rather than presenting its share on one line as required by Topic 323. This presentation is often referred to as proportionate consolidation. [[810-10-45-14](#), [910-810-45-1](#), [930-810-45-1](#), [932-810-45-1](#), [970-810-45-1](#), [323-10-45-1](#)]

While an investor with an investment that qualifies for proportionate consolidation may elect to apply that presentation, it is not required to do so. Instead, the investor may elect to use the one-line presentation required by Topic 323. Furthermore, an investor is not precluded from proportionately consolidating a qualifying investment if another investor consolidates the investee.

Combinations of these methods are used in the construction industry. For example, it is common for a construction industry investor to present its investment on one line on the balance sheet but present its proportionate share of the investee's components of comprehensive income in the income statement.

For guidance on conforming accounting policies for proportionately consolidated entities, see [Question 4.2.20](#).



### Question 2.3.160#

#### How does an investor account for ownership of an undivided interest in a specified asset?

**Background:** An undivided interest in an asset is an ownership arrangement in which two or more parties jointly own the asset, and title is held individually to the extent of each party's interest.

**Interpretive response:** US GAAP does not specifically address how to account for an undivided interest in non-real estate assets. However, in our experience, such an investor generally accounts for and presents an undivided interest in a specified non-real asset as its proportionate share of the underlying asset. The investor classifies its share of the asset on its balance sheet based on the nature of the asset (e.g. property) and recognizes in the income statement the individual components of its results of operations (e.g. depreciation).

An undivided interest in a specified asset generally is outside the scope of Topic 323 because it represents a direct ownership of that individual asset – it

is not an interest in an entity that holds the asset. A holder of an undivided interest in a specified asset has proportional ownership of that asset.

However, an investor applies the equity method to an undivided interest in real property if that property is subject to joint control. Joint control exists when the approval of two or more of the venturers is required for decisions about the financing, development, sale and operations of the real property. [970-323-25-12]

If the undivided interest in real property is not subject to joint control, the investor may elect as an accounting policy to account for its proportionate share if each investor is: [970-810-45-1]

- entitled to only its pro rata share of income;
- responsible to pay only its pro rata share of expenses; and
- severally liable only for indebtedness it incurs in connection with its interest in the property.

The investor must apply its accounting policy consistently for all undivided interests that meet these criteria.

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## 2.4 Significant influence

### 2.4.10 Overview

An investor generally should apply the equity method when its investment in common stock (or in-substance common stock) enables it to exercise significant influence over the operating and financial policies of a corporation, corporate JV or corporate-like LLC (i.e. an LLC that does not maintain separate ownership accounts). This includes investors that are NFPs with common stock investments in for-profit companies. [323-10-15-6 – 15-11]

An investor generally applies the equity method to a capital investment in a partnership, unincorporated JV or partnership-like LLC (i.e. an LLC that maintains specific ownership accounts) unless its investment is so minor that it has virtually no influence over the investee. [323-30-15-2, 323-10-15-5, 970-323-25-2 – 25-6]

An investor that obtains the requisite degree of influence begins applying the equity method on that date, even if that influence is expected to be temporary (see [Questions 2.4.30](#) and [6.2.10](#)). [323-10-15-12]

### 2.4.20 Corporations, corporate JVs and corporate-like LLCs



#### Excerpt from ASC 323-10

> Other Considerations

• > Significant Influence

**15-6** Ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

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

**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.

**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**.

**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 generally applies the equity method to a common stock or in-substance common stock investment when it has the ability to exercise significant influence over the operating and financial decisions of the investee. The investor's investment might be direct or indirect (e.g. through a consolidated subsidiary). An investor's voting stock interest in an investee is based on the investee's currently outstanding securities with present voting privileges.

An investor's degree of influence tends to increase as its relative ownership in the investee's voting stock increases. Topic 323 establishes a presumption that an investor has the ability to exercise significant influence if its direct or indirect investment is 20% or more of the investee's voting stock. Conversely, it presumably does not have that ability when its investment is less than 20%. However, determining whether an investor has the ability to exercise significant influence is not always clear and requires an investor to evaluate the individual facts and circumstances related to each investment. [323-10-05-5, 15-7 – 15-8]

An investor's ability to exercise significant influence over the operating and financial policies of an investee may also be indicated by any of the following: [323-10-15-6]

- representation on the board of directors;
- participation in policy-making processes;
- material intra-entity transactions;

- interchange of managerial personnel; and
- technological dependency.

 **Question 2.4.10**  
**What are indicators of significant influence?**

**Interpretive response:** The following table includes examples of the indicators of significant influence (not exhaustive) and additional detail about why they indicate significant influence. [Question 2.4.40](#) discusses the SEC staff’s views on evaluating the indicators. [323-10-15-6]

Board representation	Participation in policy making	Intra-entity transactions	Technological dependency
<ul style="list-style-type: none"> <li>— Voting rights</li> <li>— Veto or approval power over management decisions</li> </ul>	<ul style="list-style-type: none"> <li>— Shared management personnel</li> <li>— Specific approval requirements for operating decisions (e.g. policy, budgets, management selection and compensation)</li> </ul>	<ul style="list-style-type: none"> <li>— Significant intra-entity transactions including administrative support (e.g. human resources, business development or finance)</li> <li>— Significant source of customers or suppliers</li> <li>— Economic dependence</li> </ul>	<ul style="list-style-type: none"> <li>— Sole source of technology that is significant to the investor or investee’s success</li> <li>— Significant reliance on investor for critical items based on lack of market availability</li> </ul>

The ability to exert significant influence is not a controlling financial interest. If the investor has a controlling financial interest in an investee (including when the investor is the investee’s primary beneficiary), the investor must consolidate the investee under Topic 810. As a result, to apply the equity method, an investor must first conclude that it is not required to consolidate the investee. Because significant influence does not provide the investor the ability to control the investee, to establish that the investor has significant influence there is no requirement or expectation that the investee will carry out the investor’s wishes or directives.

KPMG Handbook, [Consolidation](#), provides additional guidance about accounting for controlling financial interests.



### Question 2.4.20

#### Can the 20% presumption of significant influence be overcome?

**Interpretive response:** Yes. In addition to the 20% presumption, Topic 323 also states that an investor with: [\[323-10-15-8 – 15-19\]](#)

- more than a 20% voting interest may not have the ability to exercise significant influence if there is 'predominant evidence' to the contrary; and
- less than 20% voting interest may have that ability if such ability can be demonstrated.

Determining whether an investor has the ability to exercise significant influence is not always clear and requires the investor to evaluate the individual facts and circumstances of each investment. For example, there may be contractual or other limitations on a greater-than-20% investor's ability to exercise significant influence (see [section 2.4.30](#)).

Likewise, certain contracts or other investments may give a less-than-20% investor the ability to exercise significant influence. When evaluating whether it has the ability to exercise significant influence, the investor considers not only its direct voting interests, but also: [\[323-10-15-8\]](#)

- indirect ownership interests (see [Question 2.4.80](#));
- debt arrangements with the investee, including convertible debt (see [Question 2.4.100](#));
- other operational arrangements, such as licensing agreements, management agreements, supply agreements and employee secondment arrangements (see [Example 2.4.10](#) and [Question 2.4.60](#));
- preferred equity investments; and
- outstanding options, warrants and other financial instruments.

These arrangements may give the investor the ability to exercise significant influence by combining rights, privileges or preferences that are stated in the individual contracts, the investee's articles of incorporation or by-laws, the investment contract or other means. For example, a less-than-20% investor would have significant influence over the investee if substantive participating rights were conveyed through a contract or series of contracts.

We believe an investor also should consider whether the following rights, privileges or preferences (each on its own or in combination) give it the ability to exercise significant influence:

- the right to vote with common shareholders;
- the right to appoint members of the board of directors (see [Question 2.4.70](#));
- cumulative and participating dividends; and
- liquidation preferences.

For example, assume that the investor holds 19% of an investee's stock, has an outstanding loan to the investee (convertible into common stock), options to purchase additional shares of the investee, and several seats on the investee's



board. In this example, the investor should apply the equity method because the combination of its interests demonstrate that the investor has the ability to exercise significant influence. [TQA 2220.01]

However, an investor must have a direct or indirect investment in the investee's common stock or in-substance common stock to apply the equity method. The investor's voting common stock interest includes only those shares with current voting privileges. If an investor holds only potential voting privileges (e.g. through a call option on the investee's common stock) and has no other arrangements that collectively provide it significant influence over the investee, it does not apply the equity method. [Question 2.4.120](#) provides additional guidance on how to consider put/call arrangements. [323-10-15-9]



### Question 2.4.30

#### Does an investor apply the equity method when significant influence is temporary?

**Interpretive response:** Yes. Unless a scope exception applies, an investor applies the equity method to a corporate-like investment that gives it the ability to exercise significant influence over the operating and financial policies of the investee. This applies regardless of whether or not the significant influence is temporary.



### Question 2.4.40

#### What are the SEC's views on what may cause a less-than-20% investor to apply the equity method?

**Interpretive response:** Paul R. Kepple addressed this topic at the 1999 AICPA National Conference on Current SEC Developments. Mr. Kepple addressed many of the same indicators discussed in [Question 2.4.10](#) and stated:

- When considering whether the application of the equity method of accounting is required for an investment in common stock, the staff has evaluated:
- The nature and significance of the investments, in any form, made in the investee. The staff does not consider the difference between a 20 percent common stock investment versus a 19.9 percent investment to be substantive, as some have asserted in applying [ASC 323]. In addition, the staff will consider whether the investor has other forms of investments or advances, such as preferred or debt securities, in the investee in determining whether significant influence results.
  - The capitalization structure of the investee. The analysis would consider whether the investee effectively is being funded by common or non-common stock investments and how critical the investments made by the investor are to the investee's capitalization structure (e.g., is the investor the sole funding source).

- Voting rights, veto rights, and other protective and participating rights held by the investor. The greater the ability of the investor to participate in the financial, operating, or governance decisions made by the investee, via any form of governance rights, the greater the likelihood that significant influence exists.
- Participation on the investee's board of directors (or equivalent), whether through contractual agreement or not. The staff will consider, in particular, whether any representation is disproportionate to the investment held. For example, an investor that is contractually granted 2 of 5 board seats, coupled with a 15 percent common stock investment, will likely be viewed to have significant influence over the investee.
- Other factors as described in full in paragraph 323-10-15-10.

In summary, evaluating the existence of significant influence is often a judgment call. While the starting point in any evaluation of significant influence is the investor's common stock ownership level in the investee, the staff does not believe that a "bright line" approach is appropriate and will consider and weigh all of the factors noted above in concluding on any given set of facts and circumstances. [\[1999 AICPA Conf\]](#)

The SEC staff also addressed in a speech a situation in which an investor held less than a 20% stock ownership interest and had a voting arrangement with other investors as it relates to the investee's board of directors (see [Example 2.4.15](#)). [\[2020 AICPA Conf\]](#)

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### Example 2.4.10

#### Significant influence with less than 20% stock ownership

Investor owns 15% of Investee's voting common stock. Investee's remaining outstanding common stock is not heavily concentrated in a single investor or related group of investors.

Investor has 25% (two of eight) of Investee's board seats. Investee's board is not actively involved in Investee's daily operations but has veto rights with respect to decisions that investee's management makes about its operational and financial policies.

Investee is a manufacturing company and purchases from Investor approximately 25% of the parts necessary to manufacture its product.

Although Investor owns less than 20% of Investee's common stock, it concludes that it has the ability to exercise significant influence because:

- Investee's other outstanding common stock is not heavily concentrated in a single investor or related investors;
- it engages with Investee in a significant volume of intra-entity transactions in the ordinary course of business;

- it holds 25% of the seats on Investee’s board, allowing it to influence Investee’s operational and financial policies through its veto power; and
- it provides Investee with a significant portion of Investee’s product parts.

As a result, Investor concludes that it should apply the equity method to its investment in Investee.

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### Example 2.4.15

#### Significant influence with less than 20% stock ownership with a group voting agreement

Investor owns 15% of Investee’s voting stock common stock. Investor enters into a contractual agreement with a group of other investors to vote in concert when electing Investee’s board members. The members of the Group (the parties subject to the voting agreement) are not related parties.

The Group can appoint individuals comprising a majority of the board of directors based on its aggregate stock ownership. Investor has significant input into those appointments because without Investor, the aggregate ownership of the rest of the group would not allow it to appoint a majority of the board members. The individuals currently appointed by Group include representatives from Investor.

Investor also:

- shares managerial personnel with Investee under separate employment agreements; and
- has access to certain confidential information under informal agreements.

Although Investor owns less than 20% of the Investee’s voting common stock, it concludes that it has the ability to exercise significant influence and should apply the equity method to its investment in Investee.

**Note:** This Example was addressed by the SEC staff in a speech (see [Question 2.4.40](#)).

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### Question 2.4.50

#### Must an investor actively exercise its significant influence to apply the equity method?

**Interpretive response:** No. An investor applies the equity method when it has the *ability to exercise* significant influence over the operating and financial decisions of the investee – even if it does not actively exercise that ability. [323-10-15-6]

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### Question 2.4.60

#### How does an investor account for multiple transactions in which significant influence is gained or lost?

**Interpretive response:** Topic 323 requires an investor to start applying the equity method when it obtains the ability to exercise significant influence and to stop applying it when that ability is lost. Often significant influence is gained in a purchase of common stock or in-substance common stock and lost in a sale or dilution transaction. However, in some cases, an investor may gain or lose significant influence through a combination of equity transactions and contractual arrangements.

Topic 323 does not address when an investor should combine arrangements and account for them together as a transition to or from the equity method.

However, Topic 810 provides indicators for an investor (parent) to consider when determining whether multiple transactions that cause it to lose its controlling financial interest should be accounted for as a single deconsolidation transaction. Any of the following conditions may indicate that an investor (parent) should account for multiple transactions as a single transaction: [810-10-40-6]

- the transactions are entered into at the same time or in contemplation of one another;
- the transactions form a single transaction designed to achieve an overall commercial effect;
- the occurrence of one arrangement is dependent on the occurrence of at least one other arrangement; or
- one arrangement considered on its own is not economically justified, but when considered together they are economically justified.

We believe these indicators may be useful to an investor's evaluation of whether multiple transactions that result in the gain or loss of significant influence should be accounted for together.

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### Question 2.4.70

#### Does an investor with less than 20% of the board seats presume it does not have significant influence?

**Interpretive response:** No. We believe that an investor with more than a nominal percentage of voting securities and board representation generally has the ability to exercise significant influence over the investee. [323-10-15-6]

We believe board representation is a strong indicator of the ability to exercise significant influence because it typically allows the investor to vote for or veto management's decisions related to the operating and financial decisions of the investee.

However, the investor should consider all relevant facts and circumstances. For example, if the investor can observe but not vote or otherwise participate in the board meetings then board representation may not give the investor the ability to exercise significant influence over the investee. Furthermore, an investor's failed attempt to obtain board representation may indicate that it does not have significant influence over the investee. [323-10-15-10]

[Questions 2.4.10, 2.4.20 and 2.4.40](#), and [Examples 2.4.10, 2.4.15 and 2.4.20](#), provide additional guidance and illustrations.

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### Example 2.4.20

#### Significant influence with less than 20% stock ownership plus board representation

Investor owns 17% of Investee's voting common stock. Investor also has 17% (one of six) of Investee's board seats. Investee's board is ultimately responsible for Investee's operating and financial decisions and there are no other relationships, transactions, agreements or dependences between Investor and Investee. Investor concludes that it should apply the equity method to its investment in Investee.

Assuming there are no additional countervailing factors, we believe Investor's representation on Investee's board of directors, together with its ownership in Investee's voting shares, indicates that Investor has significant influence over the operating and financial decisions of Investee.

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### Question 2.4.80

#### Can an indirect investment give an investor the ability to exercise significant influence?

**Interpretive response:** Yes. If an investor can exercise significant influence over the investee when considering its indirect investment, it should account for its investment under the equity method. The following are common examples, which are further illustrated in [Examples 4.2.20 to 4.2.40](#). [323-10-15-8]

#### Scenario 1: Investments through consolidated subsidiaries

Investor has three consolidated subsidiaries: Sub1, Sub2 and Sub3.

Each subsidiary purchases 10% of the outstanding voting common stock in Investee. If Sub1, Sub2 and Sub3 were unrelated parties, their direct 10% investments would not provide them individually with the ability to exercise significant influence over Investee.

Investor is presumed to have significant influence over Investee through its indirect interests held by its consolidated subsidiaries. This assumes that Investor has not identified predominant evidence to the contrary (see [Question 2.4.20](#) and [section 2.4.30](#)).

Because Investor controls Sub1, Sub2 and Sub3, it has the ability to exercise its significant influence through those subsidiaries. However, Topic 323 does not

address whether Sub1, Sub2 and Sub3 must apply the equity method as a result. We believe that while Sub1, Sub2 and Sub3 often do apply the equity method in their separate financial statements, it may be acceptable not to depending on the how their related party relationships affect whether they can individually significantly influence the investee.

### Scenario 2: Investments in an investee's subsidiary

Investor has an equity method investment in Investee. Investee has a consolidated subsidiary, Sub.

Investor directly purchases a nominal percentage of Sub's voting common stock. The direct investment does not give Investor the ability to exercise significant influence over Sub. However, Investor applies the equity method to its direct investment in Sub because it can indirectly exercise significant influence over Sub through its significant influence over Sub's parent, Investee.

Investor should adjust Investee's earnings for the NCI in Sub before it computes its share of those earnings to ensure it does not double count its share of Sub's earnings when applying the equity method to both investments (see [section 4.2](#)).

### Scenario 3: Investments in an investee's investee

Investor has an equity method investment in Investee1. Investee1 has an equity method investment in Investee2.

Investor directly purchases a nominal percentage of the voting common stock of Investee2. The direct investment does not provide Investor with the ability to exercise significant influence over Investee2.

In contrast to Scenario 2, Investor should *not* apply the equity method to its direct investment in Investee2, because it cannot exercise significant influence over Investee2. Investor's significant influence over Investee1 extends downstream only to Investee1's subsidiaries. It does not extend to Investee1's investments in NCIs.

However, if Investor's direct investment over Investee2 provided Investor with significant influence, it would account for its direct investment in Investee2 under the equity method.



#### Question 2.4.90

**Does an investor include investee shares held in trust when measuring its ownership interest?**

**Interpretive response:** No. An investor that holds shares in a fiduciary capacity should not include those shares when measuring its equity interest.

This situation occurs most often with bank investors and their trust departments. For example, a bank holds a 15% interest in an investee's voting common stock and its trust department holds 30%. The bank does not add the trust department's 30% interest to its 15% when evaluating whether it is presumed to have significant influence. This is because the trust department is

legally required to vote its shares in the best interests of the trust's beneficiaries, which may not be in the investor's best interest.

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### Question 2.4.100

#### Can lending funds to the investee provide the investor with significant influence?

**Interpretive response:** Yes. If the investor has a common stock (or in-substance common stock) investment, it should determine whether the terms of the lending arrangement provide it with the ability to exercise significant influence over the investee.

We believe that one or more of the following conditions may suggest that the investor/lender has the ability to exercise significant influence over the investee (not exhaustive).

- The financing was extended to the investee at off-market terms.
- The investee was unable to obtain financing from a third party at similar terms or could only obtain financing at significantly disadvantageous terms.
- The financing is noncollateralized or payable on demand.
- The loan provides the investor with voting rights.

Determining whether a lending arrangement provides the investor with the ability to exercise significant influence depends on the facts and circumstances.

For example, an investor owns 17% of the voting common stock of an investee and its investment does not provide it with the ability to exercise significant influence over the investee. In addition, the investor extends to the investee financing that:

- accrues at a market rate of interest;
- is secured by specific collateral;
- does not include a subjective acceleration clause;
- has a term of five years and requires periodic principal and interest payments; and
- does not provide the investor with any voting rights.

If there are no other relationships, transactions, agreements or dependencies between the investor and the investee, we believe the lending arrangement does not provide the investor with the ability to exercise significant influence over the investee.

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### Question 2.4.110

#### May an investor account for a majority owned investee under the equity method?

**Background:** Topic 810 addresses when a reporting entity should consolidate a legal entity. In some situations, the majority shareholder does not consolidate the legal entity. This may occur when the legal entity is: [810-10-15-8, 15-10]

- a VIE and the majority shareholder is not the primary beneficiary;
- a voting interest entity but the minority interest holders have substantive participating rights that overcome the presumption that the majority shareholder controls the entity; or
- operating under legal or governmental restrictions, such as bankruptcy, legal reorganization or foreign exchange restrictions.

**Interpretive response:** Yes. When a majority shareholder does not consolidate a legal entity under Topic 810, it applies the equity method to that investment if it has significant influence.

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### Question 2.4.120

#### How does an investor consider a put/call arrangement on an investee's equity?

**Background:** An investor may purchase an equity interest in an investee with the understanding that it will purchase additional equity interests at a future date for a fixed price.

These arrangements are often executed using a put/call instrument where in conjunction with buying a small equity interest, the investor (1) purchases a call option that allows it to buy additional voting common stock in the investee and (2) writes a put option that allows the seller to sell to the investor the additional voting common stock.

**Interpretive response:** The existence of the put/call instrument does not necessarily provide the investor with the ability to exercise significant influence over the investee. An investor's voting stock interest in an investee is based on the investee's currently outstanding securities that have present voting privileges (see [Question 2.4.20](#)). As a result, an investor applies the equity method to the investment before the put/call exercise date only if before that date it has (1) a common (or in-substance common) equity interest and (2) the ability to exercise significant influence.

#### **Able to exercise significant influence before exercise**

The investor may conclude that it is able to exercise significant influence over the investee before exercise based on the common stock it currently holds and its present voting privileges. In that situation, the investor applies the equity method to its current investment in the investee's voting common stock (or in-substance common stock) and applies other applicable US GAAP to the put/call arrangement.

#### **Not able to exercise significant influence before exercise**

If the investor concludes it does not have the ability to exercise significant influence over the investee before exercise, it applies Topic 321 to its current investment in the investee's common stock (or in-substance common stock) and applies other applicable US GAAP to the put/call arrangement.



### Applying other GAAP to the put/call

An investor may need to address whether the put and call are considered separate option contracts or a single forward contract. If the options do not meet the criteria for combining, they are accounted for separately. The following paragraph is applied to each instrument/unit of account identified.

If the instrument meets the definition of a derivative and does not meet a scope exception, the investor accounts for it as a freestanding derivative measured at fair value. If the instrument is not in the scope of the general subsection of Topic 815, the investor determines if it is in the scope of the 'certain contracts on debt and equity securities' subsections of Topic 815. If it is in the scope of that guidance, the investor accounts for it similar to an equity security under Topic 321. Question 2.2.30 in KPMG Handbook, [Investments](#), provides additional guidance on the scope of and interaction between Topic 815 and Topic 321.

[Questions 3.2.35](#) and [3.2.36](#) provide additional guidance on how an investor accounts for a purchased call option or a forward contract to purchase an ownership interest in an equity method investee.

### Exercise of the put/call

When the put/call feature is exercised and the investor purchases the additional voting securities, it determines whether the increase triggers a change in accounting method.

Effect of purchase of additional voting common stock	Accounting by investor
No increase in investor's influence over the investee; investor is a passive investor before and after exercise.	Recognize the additional purchase and continue to apply Topic 321.
No increase in investor's influence over the investee; investor has significant influence before and after exercise.	Recognize the increase in ownership and continue to apply Topic 323 (see <a href="#">section 6.2</a> ).
Increase in investor's influence over the investee – from less than significant influence to significant influence.	Recognize the increase in ownership and transition from Topic 321 to the equity method under Topic 323 (see <a href="#">Question 6.2.20</a> ).
Increase in investor's influence over the investee – from significant influence to a controlling financial interest.	Recognize the increase in ownership and transition from equity method to consolidation under Topic 810 (see <a href="#">Question 6.2.60</a> ).

For additional guidance on accounting for increases in ownership or influence, see [section 6.2](#).

## 2.4.30 Limitations to applying the equity method



### Excerpt from 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.

> The Equity Method—Overall Guidance

**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.

As discussed in [Question 2.4.20](#), an investor that has 20% or more of the voting securities of a corporation, corporate JV or corporate-like LLC, is presumed to have the ability to exercise significant influence over the investee. However, there may be situations in which that presumption is overcome.

A greater-than-20% investor should consider circumstances that may prevent it from being able to exercise significant influence before determining how to account for its investment. However, as the investor's ownership percentage in the investee's voting interests increases, it becomes more difficult to overcome the presumption of significant influence.

Topic 323 provides the following indicators that a greater-than-20% investor may not have the ability to exercise significant influence. [\[323-10-15-10\]](#)

- There is litigation or other challenges by the investee calling into question the investor's influence.
- The investor and investee have executed a standstill agreement under which the investor surrenders significant rights as a shareholder.
- Majority ownership is concentrated in a small group of shareholders who autonomously operate the investee.
- The investor needs more financial information to apply the equity method than is available to the investee's shareholders (e.g. quarterly financial information) and fails to obtain that information.
- The investor tries and fails to obtain representation on the investee's board of directors.



### Excerpt from ASC 810-10

**15-8** For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

**15-8A** Given the purpose and design of limited partnerships, **kick-out rights** through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

**15-9** A majority-owned **subsidiary** is an entity separate from its parent and may be a **variable interest entity** (VIE) that is subject to consolidation in

accordance with the Variable Interest Entities Subsections of this Subtopic. Therefore, a reporting entity with an explicit or implicit interest in a legal entity within the scope of the Variable Interest Entities Subsections shall follow the guidance in the Variable Interest Entities Subsections.

**15-10** A reporting entity shall apply consolidation guidance for entities that are not in the scope of the Variable Interest Entities Subsections (see the Variable Interest Entities Subsection of this Section) as follows:

- a. All majority-owned subsidiaries—all entities in which a parent has a controlling financial interest—shall be consolidated. However, there are exceptions to this general rule.
  1. A majority-owned subsidiary shall not be consolidated if control does not rest with the majority **owner**—for instance, if any of the following are present:
    - i. The subsidiary is in legal reorganization
    - ii. The subsidiary is in bankruptcy
    - iii. The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the subsidiary.
    - iv. In some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (hereafter referred to as noncontrolling rights). In paragraphs 810-10-25-2 through 25-14, the term *noncontrolling shareholder* refers to one or more noncontrolling shareholders and the terms *limited partner* and *general partner* refer to one or more limited or general partners. Those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee’s operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.
    - v. Control exists through means other than through ownership of a majority voting interest or a majority of kick-out rights through voting interests, for example as described in (c) through (e).
  2. A majority-owned subsidiary in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of Topic 940 and control is likely to be temporary.
  3. [Subparagraph superseded by Accounting Standards Update No. 2013-08]
- b. [Subparagraph superseded by Accounting Standards Update No. 2015-02].
- c. Subtopic 810-30 shall be applied to determine the consolidation status of a research and development arrangement.
- d. The Consolidation of Entities Controlled by Contract Subsections of this Subtopic shall be applied to determine whether a contractual management relationship represents a controlling financial interest.

- e. Paragraph 710-10-45-1 addresses the circumstances in which the accounts of a rabbi trust that is not a VIE (see the Variable Interest Entities Subsections for guidance on VIEs) shall be consolidated with the accounts of the employer in the financial statements of the employer.

In addition, Topic 323 states that the limitations under which a majority-owned subsidiary should not be consolidated should also be applied as limitations to using the equity method. Those limitations preclude a greater-than-20% investor from applying the equity method when: [323-10-25-2, 810-10-15-8 – 15-10]

- the investee is in legal reorganization or bankruptcy;
- the foreign investee operates under foreign exchange restrictions, controls or other governmentally imposed uncertainties so severe that they cast significant doubt on the investor’s ability to exert significant influence over the investee; or
- the investor has contractually afforded certain rights to other investors in the investee.



### Question 2.4.130

#### What changes may affect whether an investor has significant influence?

**Interpretive response:** Changes in the following could affect the investor’s ability to exercise significant influence:

- capital structure of the investee;
- overall operational management of the investee;
- investor’s ownership interest in the investee, whether due to sales and/or purchases of the investee’s equity by the investor or investee; and
- organization of the investee.

An investor must continually monitor its relationship with the investee for changes that could affect whether it has the ability to exercise significant influence.

Once the situation limiting the investor’s ability to exercise significant influence has been resolved, the investor should apply the equity method of accounting. [Chapter 6](#) provides additional guidance on transitioning to and from the equity method.

## 2.4.40 Partnerships, unincorporated JVs and partnership-like LLCs



### Excerpt from 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**.

> Accounting for Limited Partnership Investments

**S55-1** See paragraph 323-30-S99-1, SEC Staff Announcement: Accounting for Limited Partnership Investments, for SEC Staff views on when a limited partner may have “so minor” an interest that the equity method would not be required.

> SEC Staff Guidance

- > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

- • > 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.



## Excerpt from ASC 970-323

> General Partnerships

**25-2** Paragraph 970-810-25-2 states that a noncontrolling investor in a **general partnership** shall account for its investment by the equity method and should be guided by the provisions of Topic 323.

**25-3** Many provisions of Topic 323 are appropriate in accounting for investments in certain unincorporated entities. The principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The equity method, however, enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, investments in noncontrolled real estate general partnerships shall be accounted for and reported under the equity method.

**25-4** An entity shall apply the one-line equity method of presentation in both the balance sheet and the statement of income. Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph 810-10-45-14. Topic 323 shall be used as a guide in applying the equity method.

> Limited Partnerships

**25-5** For guidance on determining whether a general partner or a limited partner shall consolidate a limited partnership or apply the equity method of accounting to its interests in the **limited partnership**, see paragraph 970-810-25-3.

**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.

### **General partnerships and similar entities**

A GP in a general partnership (or limited partnership) assumes joint and several (or sole) liability for the partnership's obligations. If the GP does not have a controlling financial interest, it applies the equity method to those investments. [323-30-25-1, 970-323-25-2 – 25-4]

### **Limited partnerships and similar entities**

An LP does not assume liability for the partnership's obligations, but the legal nature of a partnership implies an inherent right to influence the operating and financial policies of the partnership. A noncontrolling LP also should apply the equity method unless its interest is so minor that it has virtually no influence. Limited partnership investments of 3 to 5% (or more), are typically accounted for under the equity method. An investor also may apply the equity method to interests of less than 3%, depending on the facts and circumstances. [323-30-25-1, 970-323-25-6, 323-10-S99-1]

An LP in a limited partnership could have a controlling financial interest in the partnership – e.g. if the limited partnership is a voting interest entity under Topic 810 and the LP has more than 50% of the voting rights to remove the GP. An LP with a controlling financial interest should consolidate the partnership under Topic 810. [970-323-25-8]



#### Question 2.4.140

**How does an investor evaluate the 'virtually no' threshold when the investee is not a real estate venture?**

**Background:** Subtopic 970-323 indicates that a noncontrolling LP should apply the equity method unless its interest is so minor that it has virtually no influence over the partnership's operating and financial policies. Limited partnership investments of 3 to 5% (or more) are typically accounted for under the equity method. Subtopic 970-323 applies only to investments in real estate ventures. [970-323-05-1, 25-6, 323-10-S99-1]

**Interpretive response:** Although the ‘virtually no’ threshold specifically applies to real estate ventures, it generally is applied by analogy in practice to all investees in the scope of Subtopic 323-30, which includes all partnerships, unincorporated JVs and partnership-like LLCs (see [section 2.3.40](#)).

The SEC staff has reiterated that while the ‘virtually no’ guidance was originally written in the context of investments in real estate companies, investors in all limited partnerships should apply the equity method unless they have virtually no influence over the investee. [\[2019 AICPA Conf\]](#)

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### Question 2.4.150

#### What guidance on evaluating significant influence for corporate investments may be useful for partners?

**Interpretive response:** [Sections 2.4.20](#) and [2.4.30](#) provide guidance on how to evaluate significant influence for investments in corporations, corporate JVs and corporate-like LLCs. Some of that guidance also may be relevant for investments in partnerships, unincorporated JVs and partnership-like LLCs, including the following.

- [Question 2.4.30](#) on applying the equity method when significant influence is temporary.
  - [Question 2.4.50](#) on whether an investor must actively exercise its influence to apply the equity method.
  - [Question 2.4.60](#) on how an investor should account for multiple transactions in which influence is gained or lost.
  - [Question 2.4.80](#) (and related examples) on how to consider the effects of indirect investments.
  - [Question 2.4.110](#) on whether a majority interest holder can apply the equity method.
  - [Question 2.4.120](#) on how an investor should consider a put/call arrangement.
  - [Section 2.4.30](#) on the limitations to applying the equity method.
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# 3. Initial recognition and measurement

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**New item added in this edition: \*\***  
**Item significantly updated in this edition: #**

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- 3.3.30 Amounts allocated to IPR&D on acquisition of an equity method investee that is not a business
- 3.3.40 Accounting for deferred taxes on the excess purchase price

### 3.1 How the standard works

An investor initially recognizes its equity method investment at cost and presents it as a single amount on its balance sheet. Each reporting period, the investor adjusts the investment account for its share of the investee’s financial activity and certain investor-level activity, such as intra-entity eliminations and basis difference amortization.

The following table shows what types of investor expenditures are included and excluded from the cost of an equity method investment at initial measurement.

Included in initial measurement	Excluded from initial measurement
<ul style="list-style-type: none"> <li>— Consideration paid to acquire the investment</li> <li>— Transaction costs</li> <li>— Previously held interests</li> <li>— In some cases, contingent consideration</li> </ul>	<ul style="list-style-type: none"> <li>— Internal costs</li> <li>— Costs to raise equity or debt for the acquisition</li> </ul>

Once the investor has measured the cost of the equity method investment, it prepares its memo purchase price allocation as follows.

Step	Investee is a business	Investee not a business
<b>1. Allocate cost to share of investee’s underlying assets and liabilities</b>	Apply the acquisition method principles in Topic 805.	Allocation generally based on fair values. Excess cost generally is allocated to the investee’s noncurrent nonfinancial assets based on relative fair values.
<b>2. Determine whether equity method goodwill exists</b>	Equity method goodwill is the excess of the investor’s cost over its share of the fair value of the investee’s underlying net assets.	None.
<b>3. Identify basis differences</b>	<ul style="list-style-type: none"> <li>— Basis differences are the differences between the amounts the investor allocated to its share of each of the investee’s assets and liabilities and its share of the carrying amount of each of the investee’s underlying assets and liabilities as reported under US GAAP.</li> <li>— The total difference between the investor’s carrying amount and its share of the investee’s net assets is sometimes referred to as the ‘aggregate’ or ‘overall’ basis difference.</li> </ul>	

KPMG Handbook, [Business combinations](#), provides additional guidance on applying the acquisition method when the investee is a business. And KPMG Handbook, [Asset acquisitions](#), discusses measuring cost and allocating consideration paid when the investee is not a business.

In this chapter, we refer to the following additional Topics and Subtopics only by their Codification reference.

- Topic 321, Investments—Equity Securities
- Topic 323, Investments—Equity Method and Joint Ventures
- Topic 360, Property, Plant, and Equipment
- Topic 450, Contingencies
- Topic 606, Revenue from Contracts with Customers
- Subtopic 610-20, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets
- Topic 740, Income Taxes
- Topic 805, Business Combinations
- Subtopic 805-10, Business Combinations—Overall
- Subtopic 805-50, Business Combinations—Related Issues
- Topic 815, Derivatives and Hedging
- Topic 820, Fair Value Measurement
- Topic 845, Nonmonetary Transactions

## 3.2 Measuring the cost basis



### Excerpt from ASC 323-10

> The Equity Method—Overall Guidance

**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.



### Excerpt from ASC 323-10

• > Contingent Consideration

**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.

**30-2B** A liability recognized under paragraph 323-10-25-2A shall be measured initially at an amount equal to the lesser of the following:

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

> Terminology

**35-1** 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% or less of the common stock or in-substance common stock (or both common stock or in-substance common stock).

> The Equity Method—Overall Guidance

**35-2** Paragraph 323-10-25-2 states that the equity method is not a valid substitute for consolidation. That paragraph also explains that 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.

> Change in Level of Ownership or Degree of Influence

• > Increase in Level of Ownership or Degree of Influence

**35-33** Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. The current basis of the investor's previously held interest in the investee shall be remeasured in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable, immediately before adopting the equity method of accounting. For purposes of applying paragraph 321-10-35-2 to the investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or a similar investment of the same issuer that results in it applying Topic 323, the entity shall remeasure its previously held interest at fair value immediately before applying Topic 323.

The investor's first step in applying the equity method is to measure and recognize the investment at cost. The investor's cost basis includes transaction costs that are directly related to the acquisition.

Measuring cost generally is straightforward when an equity method investment is acquired for cash. However, it may be more complicated when the investor does not pay cash, but instead transfers assets or issues equity. In some cases, the investor measures its newly acquired equity method investment at the previous carrying amount of the asset transferred – e.g. if it is required to do so under the guidance in Topic 845 on nonmonetary exchanges. In other cases, the investor measures the equity method investment at its fair value – e.g. if it transfers a nonfinancial asset under Subtopic 610-20.

Topic 805 provides guidance on how to account for contingent consideration in a business combination. However, Topic 805 does not apply to the acquisition of an equity method investment. Under Topic 323, an investor includes contingent consideration in its cost for an equity method investment only if: [\[323-10-25-2A, 30-2A\]](#)

- the fair value of the investor's share of the investee's net assets exceeds the investor's initial cost; or
- the contingent consideration arrangement must be recognized under other US GAAP.



### Question 3.2.10

#### On what date does an investor measure its cost and start applying the equity method?

**Interpretive response:** An investor measures its cost and begins applying the equity method to an investment in a corporation, corporate JV or corporate-like LLC on the date that it has: [323-10-15-3]

- acquired a common stock (or in-substance common stock) investment; and
- the ability to exercise significant influence over the financial and operating policies of the investee (see [section 2.4.20](#)).

An investor measures its cost and begins applying the equity method to an investment in a partnership, unincorporated JV or a partnership-like LLC on the date it acquires a capital investment, unless it has virtually no influence over the operating and financial policies of the partnership or LLC (see [section 2.4.40](#)).  
[323-30-25-1, 970-323-25-6]



### Question 3.2.15

#### How does an investor measure its cost when it acquires an equity method investment in a business combination?

**Interpretive response:** Under the measurement principles of Topic 805, an investor initially measures an acquired equity method investment at fair value as of the acquisition date.

See [Question 3.3.20](#) for further considerations around the application of Topic 820 in determining the fair value of an equity method investment and allocating that fair value to the individual net assets of the investee.



### Question 3.2.20

#### What types of costs are 'transaction costs'?

**Interpretive response:** US GAAP does not define transaction costs. We believe transaction costs include direct costs to acquire the assets. These might include, for example, fees paid to external advisors, brokers, attorneys and accountants.

Indirect costs, such as general and administrative expenses, salaries and benefits of employees, are not directly attributable to acquiring the assets and should not be included in the overall cost measurement of the assets acquired.  
[FAS 141.24]

Further, an investor accounts for costs related to raising equity or debt to fund the acquisition of the investment under other applicable guidance.

Question 3.2.20 of KPMG Handbook, [Asset acquisitions](#), provides additional guidance.

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### Question 3.2.25

#### Is a guarantee issued by the investor included in the cost of the investee?

**Interpretive response:** An investor may issue a guarantee to a third party (e.g. a bank) on behalf of an investee, or to the investee itself, in connection with acquiring its investment. If the guarantee is in the scope of Topic 460, the investor recognizes a guarantee liability at fair value with a corresponding amount in the initial cost of the equity method investment. Subsequently, the guarantee is accounted for separately from the equity method investment under Topic 460. [460-10-15-7, 55-23(c)]

For example, Investor acquires a 40% ownership interest in Investee for \$200 and issues a guarantee to Bank for Investee's outstanding loan balance with Bank. Investor determines that the guarantee is in the scope of Topic 460 and recognizes a guarantee liability of \$50. Therefore, Investor initially measures its equity method investment at \$250. Investor subsequently accounts for the guarantee in accordance with Topic 460 and any changes in the liability do not affect the equity method investment.

In contrast, if the guarantee issued in connection with the initial investment is not in the scope of Topic 460, the investor is only required to recognize a liability in connection with the investment if required by other GAAP. [Section 4.4](#) discusses an investor's guarantee of an investee's losses when the investment is reduced to zero.

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### Question 3.2.26\*\*

#### How does an investor account for funding commitments or delayed contributions?

**Interpretive response:** An investor may have a commitment to make future contributions to an investee. The commitment is generally not included in the initial measurement of the investment unless required by other GAAP (e.g. Topic 815 or 460). When recognition of an upfront liability is not required under other GAAP, the contribution is included in the cost basis of the investment when made.

Before the adoption of ASU 2023-02, some entities analogized to the guidance in Subtopic 323-740 on delayed contributions and recognized a liability for unconditional and legally binding obligations or contingent obligations probable of occurring. After adoption of ASU 2023-02, we believe this analogy is no longer appropriate. [ASU 2023-02.BC25]

See [Question 3.2.35](#) for additional discussion about accounting for commitments or options to purchase additional equity interests in an investee.

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### Question 3.2.30#

#### How does an investor measure its cost basis when an additional purchase of investee stock triggers the equity method?

**Interpretive response:** When an investor increases its ownership and triggers the requirement to use the equity method, it does so prospectively by adding the cost of acquiring the additional interest in the investee to the 'current basis' of the investor's previously held interest. [323-10-35-33]

If the investor measured its previously held interest at fair value under Topic 321, we believe the current basis of its previously held interest on transition to the equity method is its fair value at the date the equity method must be applied. If the investor measured its previously held interest using the measurement alternative under Topic 321, the current basis of that interest on transition to the equity method depends on whether the investor acquired additional identical or similar investments of the same issuer in an orderly transaction. [321-10-30-1, 321-10-35-1 – 35-2]

- If so, the current basis is remeasured to fair value immediately before applying the equity method (see [Question 6.2.20](#)).
- If not, the cost of the additional interest is added to the basis under the measurement alternative to arrive at the current basis.



### Question 3.2.35#

#### How does an investor account for a commitment (or option) to purchase an ownership interest in an equity method investee?

**Background:** An investor may purchase an equity interest in an investee with a commitment to purchase additional equity interests at a future date for a fixed price. These arrangements may be a purchased call option or a forward agreement and may be embedded in the investor's existing equity interest or freestanding.

**Interpretive response:** An investor first applies Topic 815 to determine if the instrument is freestanding or an embedded feature in the existing shares.

#### **Freestanding instruments**

An investor generally accounts for freestanding commitments or options to purchase equity in either a new or existing investee in one of three ways.

#### **Derivative instruments**

If the instrument is in the scope of the general subsections of Topic 815, the investor accounts for it as a freestanding derivative and measures it at fair value during the forward or option period. The fair value of the derivative plus the consideration paid at the settlement date is added to the cost basis of the new investment. [815-10-15-83, 30-1, 35-1]

### **Other freestanding instruments**

For forward contracts and purchase options, an entity does not consider whether the underlying equity securities to be purchased on settlement of the forward contract or exercise of the purchased option (either individually or together with existing investments) would be accounted for under the equity method or using the fair value option. [815-10-15-141A]

As a result, an entity applies the guidance in the 'certain contracts on debt and equity securities' subsections of Subtopic 815-10 if the instrument: [815-10-15-141]

- requires physical settlement of the contract by delivery of the securities;
- is not a derivative instrument otherwise subject to Topic 815; and
- has no intrinsic value at acquisition, if it is a purchased option.

Under this guidance, the investor remeasures the instrument at fair value each reporting period during the forward or option period unless the measurement alternative is applied. If the investor applies the measurement alternative, it initially measures the instrument at cost (which may be zero) minus impairment and adjusts the measurement to fair value during the forward or option period if an observable transaction in the same or similar security occurs. [815-10-25-18, 30-6]

Further, if there is an observable price change or an impairment of *the securities subject to the forward or option*, the investor remeasures the forward or option to its fair value as of the date that the observable price change or impairment occurs.

Under either the fair value model or measurement alternative model, the fair value of the equity securities purchased at the settlement date becomes the cost basis of the new investment. [815-10-35-6]

### **Instruments to purchase a controlling financial interest**

If an instrument is in the scope of the 'certain contracts on debt and equity securities' subsections of Subtopic 815-10, the investor accounts for it similar to an equity security under Topic 321. [815-10-15-141 – 15-142]

However, Topic 815 does not specifically address whether forward contracts and purchase options that on settlement would result in consolidation are in or out of the scope of the 'certain contracts on debt and equity securities' subsections of Subtopic 815-10. As a result, investors with such freestanding instruments generally measure them at cost during the forward or option period.

Further, freestanding instruments to purchase a controlling financial interest are generally not accounted for as derivatives because the contract: [815-10-15-74(c), 15-59, 15-83(c)]

- when settled results in a business combination;
- meets the scope exception in Topic 815 for contracts that are not traded on an exchange; or
- cannot be settled net.

### **Embedded features**

An investor with a commitment or option to purchase equity that is embedded in its existing shares evaluates the feature under Topic 815 to determine whether it must account for the feature separately as a derivative. If the

investor must account for the feature separately as a derivative, it measures the derivative at fair value during the forward or option period. The fair value of the derivative plus the consideration paid at the settlement date becomes the cost basis of the new investment. [815-15-25-1, 30-2, 35-2A]

If the investor does not account for the feature separately under Topic 815 during the forward or option period, we believe it generally accounts for the feature when (or if) settled. The consideration paid at the settlement date becomes the cost basis of the new investment. [323-10-30-2]

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### Question 3.2.36

#### Is a contract a 'commitment to purchase' when settlement is subject to one or more contingencies?

**Background:** As discussed in [Question 3.2.35](#), an investor may enter into a commitment to purchase equity interests that it expects to account for as an equity method investment when it settles the contract at a future date. In some cases, settlement is contingent on the occurrence or nonoccurrence of an event – i.e. shareholder or regulatory approval of the purchase.

**Interpretive response:** Generally, yes. We believe that a forward (or option) contract to purchase equity securities is subject to the guidance in [Question 3.2.35](#) even if it includes one or more contingencies.

However, there may be contracts with terms that call into question whether the agreement in its totality creates enforceable rights and obligations. In that case, the investor needs to analyze whether the agreement is more appropriately accounted for as an executory contract.

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### Question 3.2.40

#### How does an investor transition to the equity method when it loses a controlling financial interest in its consolidated subsidiary?

**Interpretive response:** When an investor loses its controlling financial interest in a consolidated subsidiary, it deconsolidates the subsidiary and begins applying the equity method if it retains the ability to exercise significant influence over the investee. If not, the investor accounts for the investment under other applicable US GAAP – e.g. Topic 321 or Topic 320.

The investor generally measures its retained ownership interest in the investee at its fair value at the point in time that control ends and the equity method begins (see [Question 6.3.80](#)). This fair value measurement becomes the investor's cost basis in its equity method investment, which is allocated to the acquired assets and liabilities so the investor can identify and account for its basis differences. [810-10-40-3A, 323-10-30-2, 35-5, 35-13]

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Question 3.2.50

**Can an investor hedge the forecasted purchase of an equity method investment?**

**Interpretive response:** No. Topic 815 prohibits an investor from hedging the forecasted purchase or sale of an equity method investment. This restriction also applies to firm commitments. [815-20-25-43b(1), 25-43c(5), 25-15h(1)]



Question 3.2.60

**How does an investor measure its cost basis when it pays with noncash consideration?**

**Interpretive response:** It depends. The investor’s measurement of its cost basis depends on the nature of the noncash consideration transferred, although fair value is the typical measurement attribute. However, the basis in US GAAP for using fair value differs depending on the nature of the outbound asset.

Outbound noncash consideration	Measurement of inbound equity method investment
Controlling financial interest in a business	Fair value [810-10-40-5]
Financial asset (including an equity method investment)	Fair value [860-20-30-1]
Nonfinancial asset (or in-substance nonfinancial asset) transferred to a noncustomer	Fair value (or stand-alone selling price if fair value cannot be reasonably estimated) <sup>1, 2</sup> [610-20-32-2 – 32-5]
Nonfinancial asset transferred to a customer	Fair value (or stand-alone selling price if fair value cannot be reasonably estimated) <sup>3</sup> [606-10-32-2 – 32-27]

Notes:

1. This measurement applies even if the equity method investee holds the outbound nonfinancial asset after the transfer – e.g. the investor transfers a nonfinancial asset into a newly formed partnership in exchange for an equity method investment in that newly formed partnership. [610-20-32-4]
2. Sections A, D and F of KPMG Handbook, [Revenue: real estate](#), provide additional guidance and examples of how to account for a transfer of a nonfinancial asset in exchange for an equity method investment.
3. This measurement does not apply if the equity method investee holds the outbound nonfinancial asset after the transfer — e.g. the investor transfers a nonfinancial asset into a partnership that is a customer in exchange for an equity method investment in that partnership (see [Question 5.2.100](#)). In that situation, the investor eliminates the intra-entity profit and recognizes it when the asset is sold to a third party. [323-10-35-7]

If not in the scope of any of the above guidance, the transaction may be in the scope of Topic 845 (nonmonetary assets). Under Topic 845, an investor generally measures the cost basis of its equity method investment at fair value

unless carryover basis is required. Topic 845 requires carryover basis if the nonmonetary exchange: [845-10-30-3 – 30-8]

- involves assets whose fair values are not determinable within reasonable limits;
- is between entities in the same line of business to facilitate sales to customers or potential customers; or
- lacks commercial substance.



### Question 3.2.70

#### How does an investor measure its cost basis when it contributes a nonfinancial asset to the investee?

**Interpretive response:** As discussed in [Question 3.2.60](#), if the investor's outbound consideration is a nonfinancial asset (or in-substance nonfinancial asset), it measures the inbound equity method investment at fair value (or stand-alone selling price if fair value cannot be reasonably estimated), unless the investee is a customer. If the investee is a customer, the investor eliminates the intra-entity profit and recognizes it when the nonfinancial asset is sold to a third party. [610-20-32-2 – 32-5, 606-10-32-2 – 32-27, 323-10-35-7]

This guidance applies to sales, exchanges and contributions of nonfinancial assets to new and existing equity method investees. [610-20-05-2]

[Questions 5.2.100](#) and [5.2.130](#) provide additional guidance on how an investor accounts for a transfer of a nonfinancial asset to an existing equity method investee.



### Question 3.2.80

#### Does an investor include in its initial cost basis contingent consideration that is a derivative?

**Interpretive response:** Yes. An investor includes a contingent consideration arrangement in its initial cost of an equity method investment if US GAAP other than Topic 805 requires recognition. [323-10-30-2A]

As a result, if the contingent consideration arrangement meets the requirements in Topic 815 to be accounted for as a derivative, the investor includes its fair value in the initial cost of the equity method investment. However, the investor does not adjust the cost basis of the investment for subsequent changes in the fair value of the derivative. Instead, it accounts for subsequent fair value changes under Topic 815. [815-10-15-83, 30-1, 35-1]

For example, an investor acquires (for \$100 in cash) a 25% ownership interest in the voting stock of an investee over which it has the ability to exercise significant influence. It also enters into a contingent consideration arrangement that meets the requirements in Topic 815 to be accounted for as a derivative and has a fair value of \$5. The investor:

- measures the initial cost of its equity method investment at \$105; and
- accounts for subsequent changes in the fair value of the derivative under Topic 815. It does not report those changes as equity in earnings, or otherwise adjust the cost basis of its equity method investment.



### Question 3.2.90

**Does an investor include in its initial cost basis contingent consideration when the acquisition is a bargain purchase?**

**Interpretive response:** Yes. An investor includes contingent consideration in its initial cost of an equity method investment when the investor’s share of the fair value of the investee’s net assets exceeds the investor’s initial cost – i.e. the acquisition is a bargain purchase. This guidance applies even if other US GAAP does not require recognition of the contingent consideration (see [Question 3.2.80](#)).

The amount the investor accrues as a liability for contingent consideration is the lesser of: [\[323-10-25-2A, 30-2A – 30-2B, 55-2B\]](#)

- the maximum amount of contingent consideration; or
- the excess of the investor’s share of the fair value of the investee’s underlying net assets over the initial cost measurement excluding the contingent consideration – i.e. the bargain purchase amount.

This liability reduces or eliminates the bargain purchase amount that the investor will generally allocate to the noncurrent nonfinancial assets acquired but cannot result in the creation of equity method goodwill. [Question 3.3.80](#) discusses how to account for a bargain purchase.

## 3.3 Allocating the cost of an equity method investment



### Question 3.3.10

**How does the investor allocate the cost of an equity method investment?**

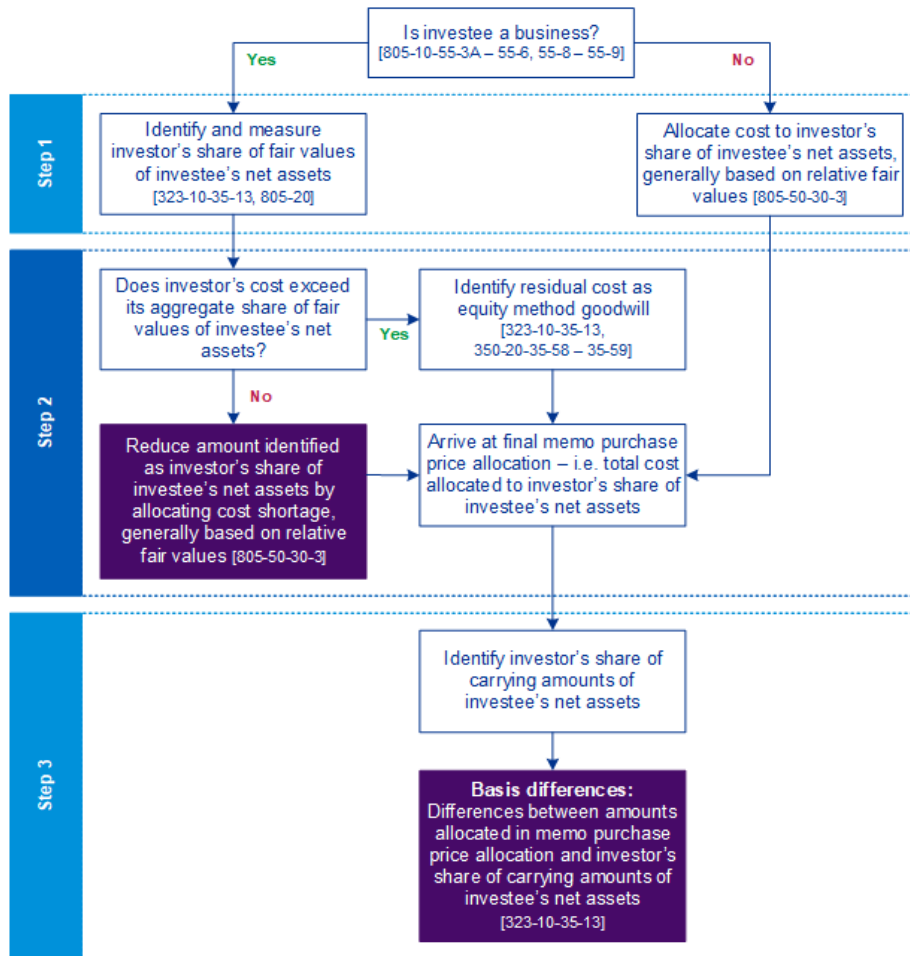
**Interpretive response:** Once the investor has measured the cost of its equity method investment (see [section 3.1](#)), it prepares its memo purchase price allocation. It does so in three basic steps.

**Step 1:** The investor allocates its cost to its share of the investee’s assets and liabilities, which may include assets and liabilities not recognized by the investee. See [Question 3.3.60](#) for discussion about allocating cost when the investee is and is not a business.

**Step 2:** The investor determines whether equity method goodwill exists.

**Step 3:** The investor identifies its basis differences.

The following flowchart addresses each step in more detail.



### Financial statement presentation

While an investor allocates its cost on purchase of an equity method investment in a manner similar to the process the acquirer uses in a business combination, it does not separately recognize on its balance sheet its share of the investee’s individual assets and liabilities or any equity method goodwill. Instead, the investor reports its investment in one line on its balance sheet but makes memo entries to track the results of its memo purchase price allocation.

### Subsequent accounting for basis differences

The investor subsequently accounts for basis differences as if the investee were a consolidated subsidiary. For example, if the investor identifies a basis difference because its share of the fair value of an investee’s office building exceeds its share of the investee’s carrying amount, each reporting period the investor: [323-10-35-13]

- recognizes its share of depreciation expense, as reported by the investee; and
- recognizes amortization of its basis difference related to the office building based on the building’s remaining useful life from the acquisition date.

While the investor accounts for the basis differences as if the investee were a consolidated subsidiary, it recognizes the amortization and accretion of basis differences in the same line item in which it recognizes its share of the investee's earnings and losses – i.e. in equity in earnings.

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### Question 3.3.20

#### Must an investor obtain a third-party valuation when it purchases an equity method investment?

**Interpretive response:** It depends.

An investor allocates its cost to its share of the investee's underlying assets and liabilities based on their fair values if the investee is a business; and generally based on their relative fair values if the investee is not a business (see [Question 3.3.60](#)). [805-20, 805-50-30-3]

An investor applies Topic 820 when measuring fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It also requires the investor to maximize the use of relevant observable inputs and minimize the use of unobservable inputs. [820-10-35-2, 35-16AA]

Estimating fair value will likely be straightforward for some of the investee's assets and liabilities (e.g. working capital accounts, Level 1 securities) and complex for others (e.g. intangible assets, long-lived tangible assets). When estimating fair value involves a high degree of estimation uncertainty, an investor may need to engage a third-party specialist.

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### Question 3.3.30

#### Should an investor adjust the investee's underlying financial information for material differences from US GAAP?

**Interpretive response:** Yes. When the investor computes the difference between the cost of its investment and its share of the investee's underlying net assets, it should ensure that those underlying net assets are recognized and measured in conformity with US GAAP. [Questions 4.2.10](#) and [4.2.50](#) discuss how to consider investee amounts resulting from rate-making activities and nonconforming accounting policies.

If the investee's underlying financial statements include material variances from US GAAP (e.g. the investee applies IFRS® Accounting Standards, regulatory accounting principles or tax basis), the investor should adjust those financial statements to conform with US GAAP. The investor then uses the adjusted financial statements to calculate the differences between its allocated cost and its share of the investee's underlying net assets. [323-10-35-13]

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**Example 3.3.10**  
**Process of allocating the cost of an equity method investment (1)**

Investor purchases a 25% equity method investment in Investee for \$1,000,000 in cash. Investee is a manufacturing company with one factory and no other significant assets or liabilities.

Investor’s share of the carrying amount of Investee’s underlying net assets under US GAAP is \$700,000.

To assist in performing its memo purchase price allocation, Investor engages an independent appraiser to estimate the fair values of Investee’s recognized and unrecognized assets (including intangible assets) and liabilities. After completing its analysis, the independent appraiser reports that the fair value of Investee’s net assets is attributable entirely to the factory, which has a fair value of \$4,000,000. Investor’s 25% share of that fair value is \$1,000,000.

Based on the appraiser’s work, Investor concludes that its \$1,000,000 cost should be allocated entirely to its share of Investee’s factory.

Investor then computes the difference between its allocated cost and its share of the carrying amount of the factory (as reported by Investee).

Cost allocated to factory	\$1,000,000
Investor’s share of factory’s carrying amount	700,000
<b>Investor’s basis difference in factory</b>	<b>\$ 300,000</b>

Each period, Investor will recognize in equity in earnings:

- its share of depreciation expense as reported by Investee (based on Investee’s historical carrying amount); and
- amortization of its \$300,000 basis difference (based on the factory’s remaining useful life on acquisition).



**Question 3.3.40**  
**How does an investor consider an investee’s NCI when identifying its share of the underlying net assets?**

**Interpretive response:** We believe the investor should use the investee’s total equity minus the carrying amount of NCI in the investee’s consolidated subsidiaries, if any, to determine its share of the investee’s underlying net assets. This is because the investee’s investors can lay claim only to those amounts the investee reports as attributable to the controlling interest.



**Example 3.3.20**  
**Process of allocating the cost of an equity method investment (2)**

Investor purchases 200 shares of common stock in Investee, a 20% interest. Investee owns 90% of its consolidated Subsidiary, which has total equity of \$1,000,000.

Investee’s equity at the time of Investor’s investment is reported as follows.

	<b>Investee equity</b>
Equity attributable to controlling interest	\$5,900,000
Equity attributable to NCI	100,000
<b>Investee’s total equity</b>	<b>\$6,000,000</b>

Investor’s share of the carrying amount of Investee’s underlying net assets is \$1,180,000 (\$5,900,000 × 20%).



**Question 3.3.50**  
**May an investor apply the alternative to not separately identify certain intangible assets in its memo purchase price allocation?**

**Interpretive response:** Yes. A private company or NFP can elect to classify certain intangible assets, such as customer-related intangible assets that cannot be sold or licensed independently from other assets, as part of goodwill. [805-20-15-2, 25-1]

A private company or NFP equity method investor that elects this policy does not separately identify those intangible assets in its memo purchase price allocation. The fair value of those intangible assets is instead captured in equity method goodwill. If the investor elects this policy, it must also elect to amortize its equity method goodwill (see section 5.3). [323-10-35-13]

A private company or NFP that elects to use the alternative must apply it when allocating consideration to assets and liabilities acquired in all business combinations and all purchases of equity method investments. [805-20-15-3]

Section 5.3 discusses the investor’s accounting for equity method goodwill.



**Question 3.3.60**  
**How does an equity method investor’s cost allocation change if the investee is not a business?**

**Interpretive response:** If an investee is a business, an equity method investor generally applies the principles in Subtopic 805-10 on business combinations.

If the investee is not a business, the investor applies the principles in Subtopic 805-50 on asset acquisitions.

There are several differences in the investor's accounting depending on whether the investee is a business.

### Identification of equity method goodwill

If the investee is a business, the investor allocates its cost based on its share of the fair value of each of the investee's assets and liabilities. If there is excess cost that remains unallocated, the investor identifies that excess as equity method goodwill in its memo purchase price allocation. [Section 5.3](#) provides additional guidance on how the investor subsequently accounts for equity method goodwill. [\[323-10-35-13, Subtopic 805-20\]](#)

If the investee is not a business, the investor does not recognize equity method goodwill. If the investor's cost is greater than its share of the fair value of the investee's net assets, the excess cost generally is allocated to the nonfinancial assets acquired. We do not believe that excess cost should be allocated to financial assets or indefinite-lived intangible assets because that could result in an immediate recognition of an impairment loss related to those assets. This would be inconsistent with the general principle in Subtopic 805-50 that there should be no immediate gain or loss recognized as part of an asset acquisition. [\[805-50-30-3\]](#)

In addition to financial assets (other than the investee's equity method investments) and indefinite-lived intangible assets, we do not expect an investor to allocate excess cost to assets acquired that are held-for-sale under Topic 360, deferred tax assets, postretirement benefit plan assets, current assets (including inventory), contract assets recorded under Topic 606 and indemnification assets.

### Identification of intangible assets

The recognition threshold that must be met for an investor to identify an intangible asset in its memo purchase price allocation differs depending on whether or not the investee is a business.

For an intangible asset to be recognized in a business combination, it must meet one of two criteria in the definition of 'identifiable': [\[805-20 Glossary\]](#)

- it is separable – e.g. capable of being separated from the entity and sold or otherwise disposed of; or
- it arises from contractual or other legal rights – regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible assets acquired in an asset acquisition do not need to meet the identifiable criteria. They are recognized if they meet the asset recognition criteria in FASB Concepts Statement No. 5. [\[350-30-25-4, CON 5.63-77, CON 6.25-33\]](#)

This lower intangible asset recognition threshold for an asset acquisition may result in the investor recognizing more intangible assets when the investee is not a business than when it is. For example, if the investee is a business, the investor does not identify an assembled workforce as an intangible asset in its memo purchase price allocation, but it does if the investee is not a business.

### Measurement period

If an investor acquires an investee that is a business, it may identify provisional amounts in its memo purchase price allocation. The measurement period ends at the earlier of (1) one year from the acquisition date, and (2) when the investor has obtained all relevant information about facts that existed at the acquisition date (or learns that more information is not obtainable). [805-10-25-12 – 25-14]

There is no concept of a measurement period when the investor acquires an investee that is not a business. The investor should finalize its memo purchase price allocation before its next reporting date.

### Acquired contingencies

An investor that acquires an investee that is a business should measure in its memo purchase price allocation its share of the investee's contingencies using Topic 805. That guidance requires the investor to use fair value measurement at the acquisition date (or during the measurement period) if fair value is determinable. If not, the investor should identify and measure in its memo purchase price allocation its share of the investee's contingencies in a manner similar to Topic 450. [805-20-25-18A – 25-20B]

An investor that acquires an investee that is not a business should identify and measure in its memo purchase price allocation its share of the investee's contingencies using Topic 450. Under Topic 450, an investor would identify in its memo purchase price allocation its share of an investee's contingent liability if it is both probable and reasonably estimable. It does not account for its share of a gain contingency until the investee realizes that gain. [450-20-25-2, 450-30-25-1]

### Other differences

Other aspects of the investor's accounting that differ depending on whether the investee is a business include how to account for deferred taxes (see [Question 3.3.90](#)) and IPR&D (see [Question 3.3.70](#)).

Section 2 of KPMG Handbook, [Business combinations](#), and KPMG Handbook, [Asset acquisitions](#), provide additional guidance on identifying the differences between acquiring a business and a group of assets.

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### Question 3.3.70

#### Does an equity method investor allocate cost to IPR&D?

**Interpretive response:** Yes, but the investor's subsequent accounting depends on whether the investee is a business.

If the investee is a business, the investor allocates cost to IPR&D in its memo purchase price allocation under the acquisition method principles of Subtopic 805-20 and accounts for the basis difference as if the investee were a consolidated subsidiary. Acquired IPR&D is considered indefinite-lived until research and development is complete or abandoned. At that time, the investor determines the asset's useful life and amortizes it under Subtopic 350-30. [350-30-35-17A]

If the investee is not a business, the investor allocates cost to IPR&D under the asset acquisition principles of Subtopic 805-50, but immediately expenses that amount at acquisition if the IPR&D has no alternative future use. We believe this guidance applies regardless of whether the investor reports its share of the investee's earnings or losses (and its basis difference amortization) on a lag basis. See [section 4.7](#) and [Question 4.7.70](#) for additional information about lag reporting. [730-10-25-2]

Section 2 of KPMG Handbook, [Business combinations](#), and chapter 4 of KPMG Handbook, [Asset acquisitions](#), provide additional guidance on accounting for IPR&D.



### Example 3.3.30

#### Amounts allocated to IPR&D on acquisition of an equity method investee that is not a business

Investor acquires a 25% voting interest in Investee for \$2.5 million in cash. Investor accounts for its investment under the equity method and determines that Investee does not meet the definition of a business.

Before Investor's acquisition, Investee incurred significant R&D costs related to developing a potential new product. Investee expensed these costs as incurred and has little or no equity at the date of acquisition. Investee plans to continue these R&D efforts hoping to commercialize the product in the future.

Investor estimates the fair value of the acquired IPR&D to be \$10 million at the date of acquisition, of which \$2.5 million represents Investor's share.

In its memo purchase price allocation, Investor allocates its \$2.5 million (\$10 million × 25% ownership) cost entirely to intangible assets associated with Investee's R&D activities.

Because Investee is not a business, Investor immediately expenses the \$2.5 million, unless the intangible assets have alternative future uses. If they do have alternative future uses, Investor identifies them in its memo purchase price allocation as basis differences in intangible assets.

If Investee were a business, Investor would identify the entire \$2.5 million as a basis difference in the intangible assets; this is because the assets have no carrying amount on Investee's US GAAP financial statements. Investor would not initially amortize the basis difference because IPR&D is considered indefinite-lived. Once the research and development activities are complete or abandoned, Investor would amortize the basis difference over the useful life of the intangible asset(s).



### Question 3.3.80

#### How does an investor account for an equity method investment that results in a bargain purchase?

**Interpretive response:** Topic 323 provides no guidance on accounting for a bargain purchase. However, because an investor initially measures its equity method investment at cost, we believe the investor should analogize to the guidance in Subtopic 805-50 on accounting for asset acquisitions when determining how it should account for a bargain purchase.

Subtopic 805-50 prohibits recognizing a gain or loss on acquisition unless the fair value of noncash consideration transferred differs from its carrying amount. It also requires allocating the cost to the individual assets acquired based on their relative fair values. [805-50-30-1 – 30-3]

As a result, we believe an equity method investor generally should allocate the bargain purchase amount – i.e. the difference between the investor’s share of the fair value of the investee’s net assets and its cost – in its memo purchase price allocation in the same manner as excess cost (see [Question 3.3.60](#)), with one exception. We believe it is appropriate to allocate a bargain purchase amount to the investor’s share of indefinite-lived intangible assets; this is because the allocation of the bargain purchase amount would reduce the amount allocated to that asset and would not increase it above the investor’s share of its fair value.

In some situations, a bargain purchase amount remains after allocating the initial amount to eligible assets (including indefinite-lived intangible assets) in the memo purchase price allocation. In that case, we believe an investor should allocate the remainder to the rest of the investee’s underlying assets to avoid recognizing a bargain purchase gain – unless other relevant US GAAP requires the underlying assets to be subsequently measured at fair value. We believe not adjusting the amount allocated to assets subsequently measured at fair value (and therefore recognizing some bargain purchase gain at acquisition) is appropriate, because if an investor were to allocate a bargain purchase gain to an underlying asset measured at fair value in its memo purchase price allocation, it would ultimately recognize that allocated amount in the subsequent period when the investee recognizes its fair value adjustment.

Liabilities accrued for contingent consideration will decrease the bargain purchase amount. [Questions 3.2.80](#) and [3.2.90](#) provide additional discussion on how an investor accounts for contingent consideration.

Accounting for income taxes in a bargain purchase can be challenging. When an investor allocates its bargain purchase amount to its share of the investee’s noncurrent nonfinancial assets, it changes the basis differences related to those assets. Those changes in the basis differences result in changes to the related deferred taxes. The investor needs to account for those deferred tax changes by again adjusting its share of the investee’s noncurrent nonfinancial assets, which starts the cycle again. Topic 740 requires the investor to use a ‘simultaneous equation’ to solve for this circularity (see [Question 3.3.90](#)). [740-10-25-50 – 25-52]

Chapter 4 of KPMG Handbook, [Asset acquisitions](#), provides additional guidance and illustrations of bargain asset purchases.



### Question 3.3.90

#### How does an investor account for deferred taxes on its equity method basis differences?

**Interpretive response:** The investor generally identifies in its memo purchase price allocation deferred taxes for its basis differences related to individual investee assets and liabilities. [805-740-25-2 – 25-5, 740-10-25-50 – 25-52]

While the investor has already identified in its memo purchase price its share of the investee's underlying deferred taxes, its basis differences represent incremental temporary differences for which it should identify deferred taxes unless Topic 740 provides an exception. For example, an investor does not identify as a temporary difference the amount of equity method goodwill because it is generally not deductible. [805-740-25-8 – 25-9]

When the investee is a business, an investor offsets the amount that it identifies as deferred taxes on its basis differences with an increase or decrease to equity method goodwill in its final memo purchase price allocation.

When the investee is not a business, there is no equity method goodwill. In this situation, an investor generally offsets the amount that it identifies as deferred taxes on its basis differences with an increase or decrease to the amounts it initially allocated to its share of the investee's noncurrent nonfinancial assets (see [Question 3.3.60](#)). The investor allocates those amounts based on the relative fair value of those assets.

This calculation then becomes circular. When the investor adjusts the amounts it has allocated to its share of the investee's noncurrent nonfinancial assets, it changes the basis differences related to those assets. Those changes in the basis differences result in changes to the related deferred taxes. The investor needs to account for those deferred tax changes by again adjusting its share of the investee's noncurrent nonfinancial assets, which starts the cycle again.

Topic 740 requires the investor to use a 'simultaneous equation' to solve for this circularity. An investor using a simultaneous equation solves for the deferred taxes related to its share of the investee's noncurrent nonfinancial assets by multiplying the simultaneous equation factor (i.e. the tax rate ÷ (1-tax rate)) by the basis differences (after the initial deferred tax amount has been allocated).

The result is the amount that the investor should identify in its memo purchase allocation as: [740-10-25-50 – 25-52]

- deferred taxes related to its share of the investee's noncurrent nonfinancial assets; and
- the final adjustment to the amount allocated to its share of the investee's noncurrent nonfinancial assets.

Section 10 of KPMG Handbook, [Accounting for income taxes](#), provides additional guidance on and illustrations of identifying temporary differences on the acquisition of an equity method investment and how to apply a simultaneous equation when the investee is not a business.



**Example 3.3.40**  
**Accounting for deferred taxes on the excess purchase price**

Investor purchases a 40% equity method interest in the common stock of Investee for \$10 million in cash. The fair value of Investee’s net assets is \$25 million.

On acquisition, Investee owns one significant asset, a factory, which has a \$14 million carrying amount. It is assumed that Investee meets the definition of a business to provide a simple illustration of the deferred tax accounting on an excess purchase price.

Investee’s tax basis in the factory is \$5 million and its statutory tax rate is 21%. Investee’s financial statements include a \$1.89 million deferred tax liability: \$14 million carrying amount minus \$5 million tax basis × 21%.

In its preliminary memo purchase price allocation, Investor allocates its \$10 million (\$25 million × 40% ownership) cost entirely to Investee’s factory.

Investor then computes the difference between its allocated cost and its share of the carrying amount of the factory (as reported by Investee).

Cost allocated to factory	\$10,000,000
Investor’s share of factory’s carrying amount <sup>1</sup>	(5,600,000)
<b>Investor’s basis difference in factory</b>	<b>\$ 4,400,000</b>
Note:	
1. Investee’s carrying amount of \$14 million × Investor’s 40% interest.	

Investor’s \$4.4 million basis difference in the factory represents an incremental temporary difference for which Investor should identify a \$924,000 deferred tax liability (\$4.4 million × 21%) in its memo purchase price allocation.

The following is Investor’s final memo purchase price allocation.

Investor’s share of Investee’s net assets	\$ 5,600,000
Basis difference in factory	4,400,000
Deferred tax liability related to basis difference	(924,000)
Equity method goodwill	924,000
<b>Investor’s investment in Investee</b>	<b>\$10,000,000</b>



**Question 3.3.100#**  
**How does an investor account for deferred taxes on the outside basis difference in its investment?**

**Background:** Because an investor generally accounts for an equity method investment using the cost method for tax purposes, a temporary difference often arises between the tax basis and the financial statement carrying amount



of the investment. This difference is referred to as the investor's outside basis difference in the investment. The outside basis difference in the investment can change each reporting period because the investor adjusts the financial statement carrying amount of its investment for its equity in earnings or losses from the investee, amortization of its basis differences and translation gains and losses.

**Interpretive response:** The investor recognizes a deferred tax asset or liability on the outside basis difference in its investment unless: [740-30-25-2 – 25-6]

- the investee is a foreign corporate JV and the investor has met the Topic 740 indefinite reversal criterion; or
- the outside basis difference (or a portion of it) represents pre-1993 earnings and the investee is a domestic corporate JV.

The investor measures its deferred tax asset or liability based on its expected manner of recovery – e.g. through dividends, sale or both. For example, if the investor expects to recover a taxable temporary difference through dividends, it considers the effects of dividends received deductions, foreign tax credits and withholding taxes. Alternatively, if it expects to recover a temporary difference through sale, the investor considers whether capital gain rates would apply. [740-10-55-24]

In addition, we believe an equity method investor may exclude certain components from its outside basis difference when measuring the related deferred tax asset or liability if the investee is a partnership. Those components include the items for which Topic 740 provides an exception to recognizing deferred taxes when they are individually recognized assets and liabilities.

For example, Topic 740 provides an exception to recognizing deferred taxes on nondeductible goodwill and certain investments in subsidiaries. If a portion of the equity method investor's outside basis difference is attributable to the partnership investee's inside basis difference for nondeductible goodwill, the investor may exclude that portion from its outside basis difference when computing its related deferred tax asset or liability. [805-740-25-8 – 25-9]

Topic 740 includes other exceptions to recognizing deferred tax assets and liabilities for outside basis differences in consolidated subsidiaries, but those exceptions generally do not apply to equity method investments.

Sections 2 and 10 of KPMG Handbook, [Accounting for income taxes](#), provide additional guidance on identifying and measuring deferred taxes for outside basis differences.

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# 4. Recognizing investee activity

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**New items added in this edition: \*\***  
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## 4.1 How the standard works

Under the equity method, the investor periodically adjusts the carrying amount of its investment for the following.



The investor generally recognizes each component in the same way it would if the investee were a consolidated subsidiary.

This chapter focuses on how the investor recognizes its share of the investee’s underlying financial activity – i.e. earnings and losses, OCI and capital transactions. The investor’s share of the investee’s earnings is the foundation of the investor’s equity in earnings of the investee.

Investee activity	Investor accounting
<b>Earnings and losses – simple allocation structures</b>	An investor typically recognizes its share of the investee’s activity based on the proportion of the investee’s common stock that it owns. An investor uses US GAAP to measure its share of the investee’s activity and generally recognizes that share in the period in which the investee recognizes it.
<b>Earnings and losses – complex allocation structures</b>	In complex allocation structures, the allocation of earnings may differ from the allocation of cash from operations (or on liquidation). In these situations, how the investor determines its share of the investee’s earnings requires careful consideration of the substance of the arrangement.  Investors often use an approach referred to as HLBV. Under HLBV, the investor analyzes how the increase or decrease in the investee’s net assets during the reporting period would affect the cash that it would receive over the investee’s life and on its liquidation.  The change in the investor’s share of the investee’s net assets from the beginning to the end of the reporting period (after adjusting for cash contributions and distributions) represents the investor’s share of the investee’s earnings from its investment.
<b>Losses when the investment has been reduced to zero</b>	An investor generally stops applying the equity method when its share of the investee’s net losses has reduced its investment to zero. However, an investor continues to recognize investee losses in excess of its investment to the extent it has: <ul style="list-style-type: none"> <li>— guaranteed obligations of the investee;</li> <li>— committed to provide further financial support;</li> <li>— accumulated a net other comprehensive loss from recognizing the investee’s other comprehensive losses; or</li> <li>— made additional investments in the investee, including investments in preferred stock or other capital, debt securities, and loans or advances.</li> </ul>

Investee activity	Investor accounting
	<p>Once an investor has reduced its investment, additional investments and commitments to zero, it stops applying the equity method.</p> <p>If the investee subsequently reports net income, the investor resumes applying the equity method when its share of that net income equals the share of the investee's net losses that the investor did not recognize ('suspended losses').</p>
<b>Other comprehensive income</b>	An investor recognizes in its OCI its share of an investee's OCI with a corresponding increase or decrease to the carrying amount of its equity method investment.
<b>Capital activity</b>	<p>An investee's capital activity can result in the investor:</p> <ul style="list-style-type: none"> <li>— increasing or decreasing its ownership interest, which results in acquisition or sale accounting (see <a href="#">chapter 6</a>);</li> <li>— increasing or decreasing its claim on the investee's net assets, which may result in adjustment to its equity in earnings at a point in time or over time; or</li> <li>— receiving cash, which generally results in a reduction to the investment balance.</li> </ul>

[Chapter 5](#) discusses how the investor adjusts its share of the investee's activity to arrive at total equity in earnings of the investee.

In this chapter, we refer to the following additional Topics and Subtopics only by their Codification reference.

- Topic 250, Accounting Changes and Error Corrections
- Topic 310, Receivables
- Subtopic 310-10, Receivables—Overall
- Subtopic 320-10, Investments—Debt and Equity Securities—Overall
- Topic 321, Investments—Equity Securities
- Subtopic 321-10, Investments—Equity Securities—Overall
- Topic 323, Investments—Equity Method and Joint Ventures
- Subtopic 323-740, Investments—Equity Method and Joint Ventures—Income Taxes
- Topic 326, Financial Instruments, Credit Losses
- Topic 480, Distinguishing Liabilities from Equity
- Topic 606, Revenue from Contracts with Customers
- Topic 718, Compensation—Stock Compensation
- Topic 740, Income Taxes
- Topic 810, Consolidation
- Topic 840, Leases
- Topic 842, Leases
- Topic 946, Financial Services—Investment Companies
- Subtopic 970-323, Real Estate—General—Investments—Equity Method and Joint Ventures
- Topic 980, Regulated Operations



## 4.2 Investor's proportionate share of the investee's earnings or losses



### Excerpt from ASC 323-10

#### > The Equity Method—Overall Guidance

**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.

#### > Retention of Industry-Specific Guidance

**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.



### Excerpt from ASC 323-30

#### > Partnership Profits and Losses

**35-1** Partnership profits and losses accrued by investor-partners generally shall be reflected in their financial statements as described in paragraphs 323-10-45-1 through 45-2, respectively.

An investor's share of an investee's earnings or losses (equity in earnings of the investee) is generally calculated by multiplying the investor's proportion of the investee's outstanding common stock (and in-substance common stock) by the investee's US GAAP net income for each interim and annual reporting period. [323-10-35-4]

We believe an investor determines its share of the investee's income/loss (and comprehensive income/loss) after the investee's comprehensive income has been adjusted for amounts attributable to NCI.

Determining the investor's ownership interest in the investee is straightforward when the investor holds only a common stock investment. For example, if an investee has 10,000 issued and outstanding shares of common stock, and an investor holds 3,000 of those shares, the investor has a 30% ownership interest in the investee.

The investor then uses that ownership interest to calculate and recognize its share of the investee's comprehensive income. The investor also uses its ownership percentage to determine its share of the investee's underlying net assets.

Determining the investor's ownership interest in an investee is more complicated when the investor has multiple investments in the investee, or the investee has multiple types of equity instruments.



#### Question 4.2.10

**When computing investee earnings, does an investor adjust for nonconforming accounting policies?**

**Interpretive response:** Generally, no. Topic 323 defines 'earnings or losses of an investee' as the investee's net income determined using US GAAP. As a result, when the investee follows a US GAAP accounting principle that is acceptable, but different from what the investor uses, the investor generally does not adjust the investee's financial statements to conform accounting principles. [323-20 Glossary]

However, there are exceptions when the investor is an SEC registrant and:

- applies proportionate consolidation (see [Question 4.2.20](#));
- invests in a company that applies private company accounting alternatives (see [Question 4.2.30](#)); or
- invests in a company that applies private company effective dates (see [Question 4.2.40](#)).

In some situations, the investee applies industry-specific accounting principles provided for in the industry-specific Topics of US GAAP. Topic 323 requires an investor to retain those principles. For example, a non-investment company investor in an investment company investee recognizes its share of the earnings or losses of that investee based on the investee's reported earnings or losses, measured under Topic 946. [323-10-25-7]



### Question 4.2.20

#### What are the SEC's views on conforming accounting policies when a registrant investor has oil and gas producing activities?

**Interpretive response:** As discussed in [section 2.3.50](#), the construction and extractive industry Topics allow certain investors to apply the equity method, but present their results using proportionate consolidation instead of one-line presentation.

SAB Topic 12.C addresses the SEC staff's views on how an investor should apply the guidance on conforming accounting policies when an investee's operations are presented in one line (traditional equity method) and proportionately consolidated.

SAB Topic 12.C allows, but does not require, an investor with oil and gas producing activities to conform to its own accounting policies the investee's method of accounting for those activities if the investor does not apply proportionate consolidation. [\[932-10-S99-3\]](#)

If a registrant investor with oil and gas producing activities applies proportionate consolidation to its 50% or less owned investee, it must conform the investee's method of accounting to its own accounting policies – e.g. by applying the full cost or successful efforts method of accounting for oil and gas producing activities. [\[932-10-S99-3\]](#)

We also believe the staff would require proportionately consolidated investees to apply the same accounting principles as the registrant investor at the same time. This would result in proportionately consolidated investees needing to adopt new accounting standards at the same date as the registrant investor, regardless of whether the proportionately consolidated investee is a PBE.



### Question 4.2.30

#### When computing investee earnings, does a PBE investor adjust for the investee's use of private company accounting alternatives?



### Excerpt from FASB Master Glossary

#### 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.

**Interpretive response:** US GAAP permits private companies (and NFPs) to elect certain alternative accounting principles and exceptions that are not available to PBEs. Whether the investor picks up the effects of those alternatives in its equity in earnings depends on the characteristics of the investor.

**Investor is a PBE because it meets Criterion (a) of the definition: Yes**

An investor is a Criterion (a) PBE if it is required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC. This includes investors whose financial information or financial statements are required to be or are included in a filing.

To compute its equity in earnings, we believe a Criterion (a) PBE needs to adjust its share of the investee's earnings to remove the effects of any accounting alternative applied by the investee that is not available to the investor.

This conclusion is consistent with the following.

- At the March 2014 Center for Audit Quality SEC Regulations Committee meeting, the SEC staff expressed the view that registrants must use the equity method investee's results prepared on a PBE basis to measure significance when determining its reporting requirements. This was true even if the investee's financial statements were not required to be provided under S-X Rule 3-09 and the investor did not disclose the investee's summarized financial information under S-X Rule 4-08(g). [\[CAQ 03-14\]](#)
- The general position of the SEC staff is that private company exceptions and alternatives are not appropriate for preparing the financial statements of registrants.
- AICPA guidance on applying the definition of a PBE. [\[TQA 7100.08\]](#)

**Investor is not a PBE or is a PBE because it meets Criteria (b)–(e) of the definition: Generally, no**

As discussed in the AICPA guidance, if the investor is not a PBE or is a Criteria (b)–(e) PBE, it generally picks up its share of the investee’s earnings without adjustment. However, if the investee has applied an accounting alternative that is not available to the investor, the investor can elect to conform the investee’s policy to its own. A non-PBE investor or a Criteria (b)–(e) PBE investor might elect to do this if it anticipates becoming a Criterion (a) PBE. [TQA 7100.08]

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**Question 4.2.40****When computing investee earnings, does a PBE investor adjust for the investee’s use of private company effective dates?**

**Interpretive response:** It depends. As discussed by the SEC staff, an equity method investee of a PBE – that is not itself a PBE – may adopt new accounting standards using private company effective dates. This may result in a PBE investor adopting a new accounting standard before its investee. In those cases, the investor need not adjust its equity method pick-up to accelerate the investee’s adoption of the new accounting standard. [\[2016 AICPA Conf\]](#)

An equity method investee itself might meet the definition of a PBE – e.g. because its financial information is included in an SEC filing under S-X Rules 3-09 or 4-08(g) (see [Question 7.3.30](#)). In that case, generally it is required to adopt accounting standards on PBE effective dates.

However, the SEC staff granted limited effective date relief for a PBE that otherwise would not meet the PBE definition except for the requirement to include its financial statements (or financial information) in another entity’s filing. On July 20, 2017, the SEC staff observer at the FASB’s EITF meeting announced that the staff would not object if such a PBE used private company adoption dates for Topic 606 and Topic 842.

The SEC staff’s comments did not extend to other accounting standards. All PBE investees still need to comply with US GAAP and adopt other new accounting standards that have different adoption dates for public and private companies using the public company adoption dates.

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**Example 4.2.10****Recognizing equity in earnings when the investor and investee adopt Topic 842 in different reporting periods**

Investor, a PBE, adopts Topic 842 as of January 1, 2019 for both its interim and annual reporting.

Investee, a private company, adopts Topic 842 as of January 1, 2021 for its annual reporting, and as of January 1, 2022 for its interim reporting. As a result,

Investee will continue to apply Topic 840 for the first, second and third quarters of 2021.

Investor computes its equity in earnings in Investee without adjustment for the difference in effective dates. Therefore, Investor’s share of Investee’s earnings will include lease income and expense based on the following accounting standards.

Investor period	Q1	Q2	Q3	Q4	Annual
2019	Topic 840	Topic 840	Topic 840	Topic 840	Topic 840
2020	Topic 840	Topic 840	Topic 840	Topic 840	Topic 840
2021	Topic 840	Topic 840	Topic 840	Topic 842 <sup>1</sup>	Topic 842
2022	Topic 842	Topic 842	Topic 842	Topic 842	Topic 842

Note:

- Investor’s equity in earnings of Investee for Q4 2021 will include the aggregate adjustment needed to catch up the first three quarters that were prepared using Topic 840.  
 Investor will compute its Q4 equity in earnings of Investee by starting with its share of Investee’s net income for the 2021 annual period and subtracting its share of Investee’s net income for the first three quarters of 2021.  
 In addition, in its fourth quarter retained earnings, Investor will include Investee’s cumulative-effect adjustment from adopting Topic 842.

 **Question 4.2.50**  
**When computing a regulated investee’s earnings, should a nonregulated investor adjust for amounts that result solely from rate-making actions?**

**Background:** Topic 980 provides guidance on how regulated entities account for rate actions by regulators. In some cases, regulators will direct entities to apply an accounting principle that conflicts with principles specified in the non-industry topics of US GAAP. Topic 980 provides a framework for a regulated entity to determine when those regulatory policies should be reflected in its US GAAP financial statements.

For example, a regulator may direct an entity to capitalize and amortize a research and development cost because that cost will provide future benefits to customers. However, US GAAP for nonregulated entities might require that same cost to be expensed as incurred. Topic 980 addresses the conflict by providing criteria that, if met, allow the entity to follow the regulatory directive in its US GAAP financial statements. [\[980-10-15-5\]](#)

**Interpretive response:** No. If the amount results from applying an accounting principle prescribed by a regulatory agency and Topic 980 permits the investee to apply that principle for US GAAP financial statements, the investor does not

adjust the investee's earnings. That principle represents US GAAP for the regulated investee.

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#### Question 4.2.60

#### Does an investor apply its fully-diluted ownership percentage when allocating investee earnings?

**Interpretive response:** No. When an investee has outstanding warrants, options, conversion privileges or other potential shares of common stock, the investor should not assume exercise or conversion of those rights when determining its ownership interest in the investee (see [Question 2.4.120](#)). These rights affect the investor's ownership interest in the investee only when they are exercised or converted. However, the investor should consider disclosing the potential effects on its ownership interest if it ultimately exercises those rights.

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#### Question 4.2.70

#### How does an investor apply the equity method to indirect investments?

**Interpretive response:** If an investor can exercise significant influence over the investee when considering its indirect investment, it should account for its direct and indirect investment under the equity method.

Indirect investments include investments in an investee that are held by the investor's subsidiaries and existing equity method investees (see [Question 2.4.80](#)).

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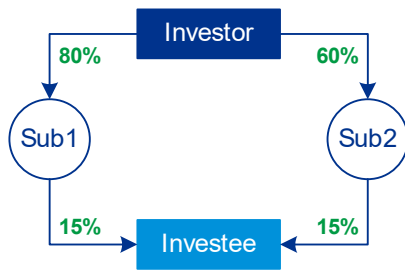
#### Example 4.2.20

#### Investments through consolidated subsidiaries

On December 31, Year 1, Investor owns 80% of Sub1's voting common stock and 60% of Sub2's voting common stock. Investor has a controlling financial interest in Sub1 and Sub2 and consolidates them.

On January 1, Year 2, Sub1 and Sub2 each purchase 15% of Investee's voting common stock. If Sub1 and Sub2 were unrelated parties, their direct 15% investments would not give them individually the ability to exercise significant influence over Investee.

The following diagram illustrates the structure.



Investor is presumed to have significant influence over Investee through its 30% indirect interests held by Sub1 and Sub2, its consolidated subsidiaries, and applies the equity method (see [Question 2.4.80](#)).

The following results are for Year 2.

Sub1's net income attributable to controlling interests, excluding the effects of its investment in Investee	\$1,080
Sub2's net income attributable to controlling interests, excluding the effects of its investment in Investee	\$1,000
Investee's net income	\$ 100

Investor records the following entries in Year 2; income taxes and income attributable to NCI are ignored.

	<i>Debit</i>	<i>Credit</i>
Investment in subsidiary (Sub1)	1,080	
Equity method investment in Investee (via Sub1)	12	
Net income attributable to controlling interest (Sub1)		1,080
Equity in earnings of Investee (via Sub1) <sup>1</sup>		12
<i>To recognize Investor's share of earnings in Sub1 and Investee.</i>		
Investment in subsidiary (Sub2)	1,000	
Equity method investment in Investee (via Sub2)	9	
Net income attributable to controlling interest (Sub2)		1,000
Equity in earnings of Investee (via Sub2) <sup>2</sup>		9
<i>To recognize Investor's share of earnings in Sub2 and Investee.</i>		
Notes:		
1. Investee's \$100 net income × Sub1's 15% ownership interest in Investee × Investor's 80% ownership interest in Sub1.		
2. Investee's \$100 net income × Sub2's 15% ownership interest in Investee × Investor's 60% ownership interest in Sub2.		

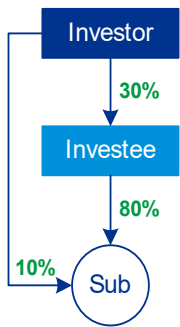


**Example 4.2.30**  
**Investment in an investee's subsidiary**

On December 31, Year 1:

- Investor owns 30% of Investee's voting common stock. Investor has the ability to exercise significant influence over Investee and applies the equity method to its investment.
- Investee has an 80% controlling financial interest in Sub and consolidates it.

On January 1, Year 2, Investor purchases 10% of Sub's outstanding voting common stock. The following diagram illustrates the structure.



Investor's direct 10% investment does not give it the direct ability to exercise significant influence over Sub. However, Investor does apply the equity method to its 10% direct investment in Sub because it can indirectly exercise significant influence over Sub through its significant influence over Sub's parent, Investee (see [Question 2.4.80](#)).

The following results are for Year 2.

Investee's reported net income attributable to controlling interests, including its 80% share of Sub's net income after eliminating intra-entity transactions	\$1,080
Sub's reported net income	\$ 100

Investor records the following entries in Year 2; income taxes and income attributable to NCI are ignored.

	<i>Debit</i>	<i>Credit</i>
Equity method investment in Investee	324	
Equity in earnings of Investee <sup>1</sup> <i>To recognize Investor's share of Investee's earnings.</i>		324
Equity method investment in Sub	10	
Equity in earnings of Sub <sup>2</sup> <i>To recognize Investor's share of Sub's earnings.</i>		10

Notes:

1. Investee's \$1,080 net income × Investor's 30% ownership interest.
2. Sub's \$100 net income × Investor's 10% ownership interest.



### Example 4.2.40 Investment in an investee's investee

On December 31, Year 1:

- Investor owns 40% of Investee1's voting common stock. Investor has the ability to exercise significant influence over Investee1 and applies the equity method to its investment.
- Investor owns 15% of Investee2's voting common stock. Investor's direct investment does not give it the ability to exercise significant influence over Investee2.
- Investee1 owns 22% of Investee2's voting common stock. Investee1 has the ability to exercise significant influence over Investee2 and applies the equity method to its investment.

Investor should not assume that it has the ability to exercise significant influence over Investee2 simply because its direct and indirect interests aggregate to 24%: 8.8% indirect interest through Investee1 (40% × 22%) plus its 15% direct interest.

While Investor's significant influence over Investee1 gives it significant influence over Investee1's consolidated subsidiaries (see [Example 4.2.20](#)), it does not automatically give it significant influence over Investee1's equity method investees or other NCI investments (see [Question 2.4.80](#)). Therefore, Investor applies Topic 321 to its 15% investment in Investee2.

The following results are for Year 2.

Investee1's reported net income attributable to controlling interests, including its 22% share of Investee2's net income after eliminating intra-entity transactions	\$ 1,080
Investee2's reported net income	\$ 100
Increase in the fair value of Investor's investment in Investee2	\$ 5

Investor records the following entries in Year 2; income taxes are ignored.

	<i>Debit</i>	<i>Credit</i>
Equity method investment in Investee1 <sup>1</sup>	432	
Equity in earnings of Investee1 <sup>1</sup>		432
<i>To recognize Investor's share of Investee1's earnings.</i>		

	<i>Debit</i>	<i>Credit</i>
Investment in Investee2	5	
Unrealized gain in Investee2		5
<i>To recognize increase in fair value of Investor's investment in Investee2.</i>		
Note:		
1. Investee1's \$1,080 net income × Investor's 40% ownership interest.		

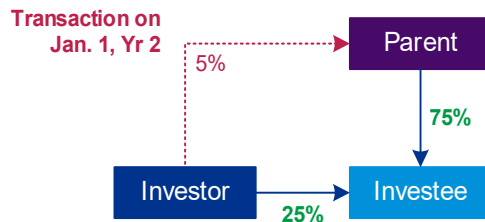


### Example 4.2.50 Investment in an investee's parent

On December 31, Year 1:

- Investor owns 25% of Investee's voting common stock. Investor has the ability to exercise significant influence over Investee and applies the equity method to its investment.
- Parent owns 75% of Investee's voting common stock.

On January 1, Year 2, Investor pays \$10 million for a 5% equity interest in Parent. The following diagram illustrates the structure.



Investor's investment does not give it the ability to exercise significant influence over Parent. Therefore, Investor should not account for its investment in Parent as part of its equity method investment in Investee. Instead, Investor should account for the investment in Parent based on the nature of the investment under applicable US GAAP – e.g. Topic 321.



### Question 4.2.80 Does an investor include investee shares held in trust when measuring its ownership interest?

**Interpretive response:** No. An investor that holds shares in a fiduciary capacity should not include those shares when measuring its equity interest (see [Question 2.4.90](#)).

 **Question 4.2.90**  
**How do acquisitions and sales of a portion of an equity method investment affect the investor's equity in earnings?**

**Interpretive response:** Partial acquisitions and partial sales of an investee's common stock generally result in increases and decreases in the investor's ownership interest. These increases and decreases affect how the investor calculates its share of the investee's earnings and its ownership interest in the investee's assets and liabilities.

If an investor purchases and sells the investee's common stock at various dates during the same reporting period, calculating its percentage ownership interest in the investee over the reporting period can be complex.

The investor needs to recalculate its percentage ownership interest in the investee every time an ownership interest is purchased or sold during a reporting period – and calculate its share of the investee's earnings based on this changing percentage ownership interest.

When an investor purchases or sells investee common stock during a period for which financial statements are not available (e.g. mid-month), it may need to estimate the investee's earnings or losses before and after the purchase or sale to accurately calculate its share of earnings for the reporting period.

 **Example 4.2.60**  
**Determining the investor's ownership interest when partial acquisitions occur during the period**

On January 1, Year 1, Investor owns 20% of the common stock of Investee and accounts for the investment under the equity method. Both Investor and Investee are calendar year-end companies.

- During Year 1, Investor purchases additional ownership interests.
- On February 15, Investor purchases an additional 5% of Investee's common stock, raising its percentage ownership interest to 25%.
  - On August 1, Investor purchases another 10% of Investee's common stock, raising its percentage ownership interest to 35%.

To determine its share of Investee's earnings for Year 1, Investor:

- estimates Investee's earnings for each of the periods in the following table;

Period	Investor's ownership interest
January 1 to February 14, Year 1	20%
February 15 to July 31, Year 1	25%
August 1 to December 31, Year 1	35%

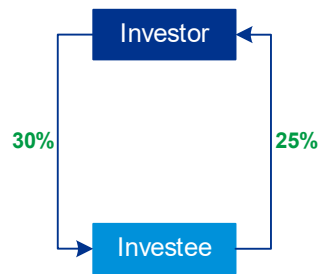
- multiplies those estimates by its percentage ownership interest during each of those periods; and
- adds its share of Investee’s earnings for each period to arrive at the total for Year 1.

**Question 4.2.100**  
**When computing investee earnings, does an investor adjust for the investee’s interest in the investor?**

**Interpretive response:** Yes. We believe an investor generally determines its share of the investee’s comprehensive income or loss **before** the investee recognizes its share of the investor’s income or loss.

**Example 4.2.70**  
**Accounting by an investor when the investee has an equity method investment in the investor**

On January 1, Year 1, Investor acquires a 30% investment in Investee for \$100,000 in cash. On the same day, Investee acquires a 25% investment in Investor. Both companies account for their investments under the equity method.



Assume the following activity in Year 1.

- Investor’s net income is \$50,000 – before its equity method pick-up of Investee’s earnings;
- Investee’s net income is \$80,000 – before its equity method pick-up of Investor’s earnings;
- Investee has substantive operations other than its investment in Investor; and
- the effects of income taxes, basis differences and intra-entity transactions are ignored.

Investor's entries in Year 1 are as follows.

	<i>Debit</i>	<i>Credit</i>
Equity method investment	100,000	
Cash		100,000
<i>To record purchase of equity method investment on January 1.</i>		
Equity method investment	24,000	
Equity in earnings		24,000
<i>To recognize share of Investee's net income (\$80,000 × 30%).</i>		
Notes:		
— Investor's Year 1 net income is \$74,000 (\$50,000 + \$24,000) and its equity method investment in Investee is \$124,000 (\$100,000 + \$24,000).		
— In this example, Investee has substantive operations other than its 25% investment in Investor. If Investee had little or no substantive operations other than its investment in Investor, we believe it may be appropriate for Investor to account for the purchase of Investee's stock as a treasury stock purchase.		

### 4.3 Complex earnings allocation structures



#### Excerpt from ASC 970-323

• > Allocation Ratios

**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.

Investment agreements typically state in advance how earnings, losses and cash will be allocated among the investors over the life of an entity. In some cases, the agreements provide for allocating earnings differently from allocating cash from operations (or on liquidation). Other agreements provide for changes in one or more of the allocations at specified times or when specified events occur.

For example, an investment agreement between two investors allocates depreciation expense entirely to one investor and revenues and other expenses equally to each investor. However, the agreement also provides for equal allocation and distribution of cash to each investor each reporting period. In this situation, each investor would recognize a 50% share of the investee's earnings because that allocation more faithfully reflects the economic substance of the agreement.

How an investor determines its share of the investee's earnings under these agreements requires careful consideration of the substance of the arrangement. [970-323-35-17]



#### Question 4.3.10

**Does an investor consider differing allocation structures when the investee is not a real estate venture?**

**Background:** Subtopic 970-323 indicates that an investor with a venture agreement that designates different allocations of profits, losses, costs, expenses, distributions, etc. does not use specified profit and loss allocation ratios if cash and liquidating distributions are determined on some other basis. Subtopic 970-323 applies only to investments in real estate ventures. [970-323-35-16 – 35-17]

**Interpretive response:** While the guidance about investee earnings allocation for complex capital structures appears in Subtopic 970-323, which applies only to real estate ventures, investors broadly analogize to it when accounting for other investments with complex capital structures.

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### Question 4.3.20#

## How does an investor compute its share of investee earnings when its economic rights differ from its legal ownership interest?

**Background:** Certain investment agreements may designate different allocations among the investors for items including profits and losses, cash, liquidation proceeds, specified costs and expenses, and tax attributes.

For example, some arrangements establish preferential rights to income or residual assets to the different classes of securities (sometimes called a 'distribution waterfall'). Other arrangements may provide tax-equity investors a disproportionate share of income tax credits and depreciation deductions during the early years of the structure but shift allocations as the tax attributes diminish.

Investment arrangements that commonly have complex allocation structures include:

- extractive industry structures in which financial investors fund capital intensive development projects and provide for a disproportionate allocation of cash distributions until a specified internal rate of return is achieved;
- investment vehicles that hold a power plant or renewable energy asset in which bonus tax depreciation and tax credits are distributed to a certain class of investor until the investor achieves a specified rate of return;
- investment funds in which distribution waterfalls or performance fee allocations to the asset manager depend on achieving specified returns; and
- real estate trusts or funds in which certain classes of investors benefit from tax depreciation and tax credits.

Differing allocations among investors typically also exist when the investee issues both common stock and in-substance common stock.

**Interpretive response:** We believe an investor computes its share of the investee's earnings based on its rights to the distributions and residual assets of the investee, including the effects of retroactive or 'claw-back' provisions, if any. The investor should apply its method consistently to similar investments.

If an investment agreement specifies an allocation for earnings that matches the allocation of cash from operations and on liquidation, the investor uses the earnings allocation included in the investment agreement when recognizing its share of the investee's earnings. This includes situations in which the investment agreement includes contractual changes in fixed allocation rates. We believe an investor may not apply a single blended rate over the expected life of the investment, even if its share of the investee's earnings will change based on a contractually specified schedule.

If the specified allocation for earnings differs from the allocation of cash from operations and on liquidation, the investor should not use the specified earnings or loss percentages to determine its share of the investee's earnings. Rather, the investor should analyze the investment agreement to determine how the increase or decrease in the investee's net assets during the reporting period



would affect the cash that the investor would receive over the investee’s life and on its liquidation. [970-323-35-17]

In some cases, the investment agreement is silent (or unclear) about cash distributions and the investor needs to interpret its conditions to determine how cash would be distributed if the investee was hypothetically liquidated at the reporting date. Regardless, the investor’s analysis must be consistent with the contractual provisions of the investment agreement.

Investors often consider the guidance in the AICPA’s Proposed SOP, *Accounting for Investors’ Interests in Unconsolidated Real Estate Investments* (draft SOP). While the draft SOP was never finalized, an investor may find it helpful when evaluating whether its earnings allocation is consistent with the principles of Subtopic 970-323.

Specifically, the draft SOP illustrated an approach referred to as HLBV. Under HLBV, the investor computes at the beginning and end of the reporting period its share of the investee’s net assets assuming the investee (1) liquidated its net assets at their book values and (2) distributed the proceeds to the investors based on the distribution waterfall in the investment agreement. The investor generally considers only its claim on the book-value liquidation proceeds and does not consider costs associated with a hypothetical liquidation event – e.g. debt prepayment penalties that would be assessed on early extinguishment or certain investment tax credit recapture requirements.

Under HLBV, the investor’s share of the investee’s earnings or loss in the current period represents the change in the investor’s share of the investee’s net assets and is calculated using the following four steps based on the investee’s book values.

<b>Step 1</b>		Investor’s capital account (i.e. claim on net assets) at the end of the period assuming Investee was liquidated or sold at book value
<b>Step 2</b>	+	Cash distributions received by Investor during the period
<b>Step 3</b>	–	Investor’s contributions or new investments in Investee made during the period
<b>Step 4</b>	–	Investor’s capital account (i.e. claim on net assets) at the beginning of the period assuming Investee was liquidated or sold at book value
<b>=</b>		<b>Investor’s share of Investee’s current-period earnings or loss</b>

The change is recognized in equity in earnings (losses) each reporting period, along with any investor-level adjustments – e.g. amortization basis differences and elimination of certain intra-entity profits and losses.

If there is uncertainty about how cash would ultimately be distributed – e.g. if the attribution could change based on the resolution of a contingency – an investor needs to consider the facts and circumstances and use judgment when determining what attribution method best reflects the economic substance of the arrangement.

### Basis differences

An investor’s share of the investee’s earnings or loss in the current period also includes any adjustments related to basis differences (see [section 3.3](#)). The

draft SOP describes two approaches to account for basis differences – the recast financial statements approach and the two component approach.

Under the recast financial statements approach, an investor recasts the investee's financial statements to reflect the investor's basis in the investee, thereby eliminating basis differences, and uses the recast financial statements for purposes of applying HLBV. Under the two component approach, the investment is thought of as comprising two components: (1) the investor's claim on the reported book value of the investee and (2) the basis difference. Under either approach, the total amount of equity in earnings is ultimately based on the investor's basis in the investee's net assets (i.e. the fair value of the assets at the time of investment). [Draft SOP, para 29-31, Examples 8-13]

Although the draft SOP describes only two approaches, others may be acceptable as long as they take into account the investor's basis in the investee's net assets in computing the investor's share of the investee's earnings or loss when applying HLBV.

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### Example 4.3.10

#### Allocation of profit and loss equals allocation of distributions of cash from operations and liquidation

Investor owns 40% of Investee's common stock. Investee operates a single power plant in a foreign country. The foreign government owns the remaining 60% of the common stock. The life of the power plant is 20 years.

The investment agreement allocates Investee's earnings as follows.

- For Years 1–10, 30% of Investee's earnings are allocated to the foreign government, and the remaining 70% are split 60/40 in proportion to the investors' ownership interests.
- For Years 11–20, 60% of Investee's earnings are allocated to the foreign government, and the remaining 40% are split 60/40 in proportion to the investors' ownership interest.
- Cash distributions from operations and liquidation are made to the investors based on their earnings/loss allocations.

Investor recognizes its share of Investee's earnings based on the allocation in the investment agreement. This allocation is appropriate because cash will be distributed on the same basis. This means that Investor recognizes 28% ( $70\% \times 40\%$ ) of Investee's earnings in Years 1–10, and 16% ( $40\% \times 40\%$ ) of Investee's earnings in Years 11–20.

Investor does not apply a single blended rate over the 20-year period for recognizing its share of Investee's earnings, even though that share will contractually decrease in 10 years.

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**Example 4.3.15\*\***  
**Application of HLBV**

On January 1, Year 1, Investee was formed as a limited partnership by Investor1 and Investor2. Investor1 owns 100% of the limited partnership interests and 50% of the general partnership interests, and Investor2 owns 50% of the general partnership interests. Investor1 has preferential rights whereby upon liquidation it is entitled to a return of its \$80 million capital investment, plus an annual return of 10% thereon (i.e. \$8 million per year). Any remaining amounts are allocated to the general partnership interests on a pro rata basis using ownership interests. Distributions are allocated consistent with liquidation. Both Investor1 and Investor2 have the ability to exercise significant influence over Investee and apply the equity method.

**Year 1**

During Year 1, the following occurs.

- Investee had net income of \$8 million.
- Investee obtained a loan from a third party of \$12 million.
- Investor1 and Investor2 each contributed \$10 million (\$20 million in total).

Following is the balance sheet of Investee at the beginning and end of Year 1.

<b>Investee's balance sheets</b>		
<i>(in millions)</i>	<b>Beginning of Year 1</b>	<b>End of Year 1</b>
Cash	\$20	\$40
Property	80	100
Loan	-	(12)
Equity	\$100	\$128

Following are the calculations for Investor1's and Investor2's equity in earnings using HLBV.

<i>(in millions)</i>		<b>Investee</b>	<b>Investor1</b>	<b>Investor2</b>
<b>Step 1</b>	Investor's capital account (i.e. claim on net assets) at the end of the period assuming Investee was liquidated or sold at book value	\$128	\$108 <sup>1</sup>	\$20
<b>Step 2</b>	<b>+</b> Cash distributions received by Investor during the period	-	-	-
<b>Step 3</b>	<b>-</b> Investor's contributions or new investments in Investee made during the period	20	10	10

<i>(in millions)</i>		Investee	Investor1	Investor2
<b>Step 4</b>	– Investor’s capital account (i.e. claim on net assets) at the beginning of the period assuming Investee was liquidated or sold at book value	100	90 <sup>2</sup>	10
	<b>= Equity in earnings for the period using HLBV</b>	<b>\$8</b>	<b>\$8</b>	<b>\$0</b>
Notes:				
1. \$108 million = \$80 million (Investor1’s capital investment) + \$8 million (Investor1’s annual return) + \$20 million (Investor1’s 50% interest in remaining net assets × Investee’s \$40 million remaining net assets (\$128 million total net assets – \$88 million preferred return to Investor1))				
2. \$90 million = \$80 million (Investor1’s capital investment) + \$10 million (Investor1’s 50% interest in remaining net assets × Investee’s \$20 million remaining net assets (\$100 million total net assets – \$80 million preferred return to Investor1))				

Investor1 records the following entry in Year 1; income taxes are ignored.

<i>(in millions)</i>	Debit	Credit
Dr. Investment in Investee	8	
Cr. Equity in earnings of Investee		8
<i>To recognize accounting income in Investee for Year 1.</i>		

## Year 2

During Year 2, the following occurs.

- Investee had net income of \$30 million.
- Investor1 received distributions of \$5 million.

Following is the balance sheet of Investee at the beginning and end of Year 2.

<i>(in millions)</i>	End of Year 1	End of Year 2
Cash	\$40	\$73
Property	100	90
Loan	(12)	(10)
Equity	\$128	\$153

Following are the calculations for Investor1’s and Investor2’s equity in earnings using HLBV.

<i>(in millions)</i>		Investee	Investor1	Investor2
<b>Step 1</b>	Investor's capital account (i.e. claim on net assets) at the end of the period assuming Investee was liquidated or sold at book value	\$153	\$122 <sup>1</sup>	\$31
<b>Step 2</b>	<b>+</b> Cash distributions received by Investor during the period	5	5	-
<b>Step 3</b>	<b>-</b> Investor's contributions or new investments in Investee made during the period	-	-	-
<b>Step 4</b>	<b>-</b> Investor's capital account (i.e. claim on net assets) at the beginning of the period assuming Investee was liquidated or sold at book value	128	108	20
<b>=</b>	<b>Equity in earnings for the period using HLBV</b>	<b>\$30</b>	<b>\$19</b>	<b>\$11</b>
Note: 1. \$122 million = \$91 million (Investor1's capital investment of \$80 million + \$16 million annual return – \$5 million of distributions) + \$31 million (Investor1's 50% interest in remaining net assets × Investee's \$62 million remaining net assets (\$153 million total net assets – \$91 million capital investment and annual return to Investor1))				

Investor1 records the following entry in Year 2; income taxes are ignored.

<i>(in millions)</i>	Debit	Credit
Dr. Investment in Investee	19	
Cr. Equity in earnings of Investee		19
<i>To recognize accounting income in Investee for Year 2.</i>		

**Question 4.3.24**  
**How does a tax equity investor account for the tax credit it receives?**

**Background:** Some real estate and renewable energy projects attract tax credits on qualifying expenditures. Sponsors of tax-credit-qualifying assets may seek to monetize these credits by partnering with tax equity investors. The tax equity investor generally makes an investment in a pass-through entity (partnership or LLC) that receives the tax credits and distributes them to the tax equity investor. In exchange, the sponsor of the structure keeps a greater percentage of the pass-through entity's recognized net assets.

**Interpretive response:** We believe a tax equity investor should apply the same method of accounting to tax credits received from an equity method investee that the investor applies to investment tax credits generated by its owned assets – i.e. the deferral or flow-through method under Topic 740. Topic 740 states that the deferral method is preferable, however the flow-through method is also acceptable. [740-10-25-46]

While Topic 740 does not address the accounting for tax credits distributed to equity method investors, we believe it is appropriate to analogize to its guidance on how to recognize investment tax credits arising from direct investments in qualifying assets.

Chapter 5 of KPMG Handbook, [Tax Credits](#), and Section 10 of KPMG Handbook, [Accounting for income taxes](#), provide additional guidance on applying the deferral and flow-through methods to tax credits arising from equity method investments.

### Deferral method

Topic 740 requires an entity that applies the deferral method to recognize the benefit of an investment tax credit over the productive life of the acquired property. [740-10-25-46]

We believe an equity method investor applying the deferral method recognizes the tax credit in earnings over the productive life of the underlying asset giving rise to the tax credit – i.e. the property owned by the investee. We believe the investor may present the benefit as a credit to income tax expense (benefit) or equity in earnings.

We generally do not believe it is appropriate for the investor to recognize the tax benefit over the:

- period the investee must hold the asset to avoid recapture of the tax credit;
- depreciable life of the asset for tax purposes; or
- period the investor expects to hold its equity method investment.

An investor generally presents the deferred benefit – i.e. the portion of the tax benefit not recognized in earnings as of the balance sheet date – as a reduction in the carrying amount of its equity method investment. In some cases, this presentation results in a credit balance in the investment account. We believe this presentation is appropriate even if the investor is not committed to fund investee losses (if any); this is because the credit amount is representative of the investor deferring its income tax credit benefit versus recognizing equity in losses in excess of the investment’s financial statement carrying amount.

When the investor reduces the carrying amount of its investment, it also identifies a book-to-tax basis difference in its investment, which may result in needing to recognize deferred taxes. We believe the investor may recognize the deferred tax asset or liability, if any, as an adjustment to (1) income tax expense or benefit or (2) the financial statement carrying amount of the investment.

If the investor elects to adjust the financial statement carrying amount of the investment, the basis difference will also change, and the calculation becomes circular. As discussed in [Question 3.3.90](#), the investor solves for this circularity by using the simultaneous equation.

### Deferral method and fair value option

We believe an investor applying the fair value option to its equity method investment should present the deferred income tax benefit as a deferred income liability not as a reduction in the carrying amount of its equity method investment.

Further, we believe the investor's remeasurement to fair value of the equity method investment is not affected by the deferred income liability amount. The periodic fair value adjustment is computed and recognized independently of the tax benefit, which is being recognized in earnings over the productive life of the underlying asset giving rise to the tax credit.

### Flow-through method

Under the flow-through method, an investor recognizes the benefit of the tax credit in the year that it reduces income taxes payable or is recognizable as a deferred tax asset. [740-10-25-46]



#### Question 4.3.25

**How does a tax equity investor that applies HLBV account for the decrease in its capital account when the tax credit is distributed?**

**Background:** As discussed in [Question 4.3.24](#), sponsors of tax-credit-qualifying assets may seek to monetize tax credits by partnering with tax equity investors. The tax equity investor generally makes an investment in a pass-through entity (partnership or LLC) that will receive the tax credits and distribute them to the tax equity investors. When the tax credits are distributed, the pass-through entity (i.e. the investee) reallocates its equity capital among its investors to reflect the return provided to the tax equity investor. After the distribution of the tax credits and the reallocation of capital, the tax equity investor's claim to the investee's net assets is less than before.

A tax equity investor typically applies HLBV to measure its share of the investee's profit or loss (see [Question 4.3.20](#) and [Example 4.3.15](#)).

**Interpretive response:** Two approaches that we believe a tax equity investor applying HLBV may use to account for the decrease in its capital account are what we call the point-in-time approach and the basis difference approach.

#### Point-in-time approach

Under the point-in-time approach, when the investee reallocates its equity capital, the tax equity investor recognizes a charge to equity in earnings equal to the decrease in its claim to the investee's net assets. An investor using this approach accounts for the capital reallocation resulting from distribution of the tax credit in the same way that it accounts for other changes to its share of the investee's net assets when applying HLBV (see [Question 4.3.20](#) and [Example 4.3.15](#)).

A tax equity investor generally uses this approach when it applies the flow-through method of accounting for the receipt of the tax credits (see

[Question 4.3.24](#)). This is because the income tax benefit of the tax credit will largely offset the charge to equity in earnings.

#### **Basis difference approach**

Under the basis difference approach, when the investee reallocates its equity capital, the tax equity investor identifies a basis difference related to the investee's qualifying asset – i.e. the asset that gave rise to the tax credit. That basis difference equals the decrease in the investor's share of the investee's net assets resulting from the distribution of the tax credits and is amortized to equity in earnings in the same periods that the investee depreciates the qualifying asset.

A tax equity investor generally uses this approach when it applies the deferral method of accounting for the receipt of the tax credits (see [Question 4.3.24](#)). This is because the income tax benefit of the tax credit recognized over time will largely offset the charge to equity in earnings resulting from the basis difference amortization.

Chapter 5 of KPMG Handbook, [Tax Credits](#), and section 10 of KPMG Handbook, [Accounting for income taxes](#), provide further guidance on applying the point-in-time and basis difference approaches to tax credits.

#### **Other-than-temporary impairment under either approach**

Regardless of which method an investor uses, it must continue to evaluate its investment for impairment (see [section 5.5](#)). An equity method investment is impaired if its fair value under Topic 820 is less than its carrying amount.

When an investor concludes that its investment is impaired at the reporting date, it must determine whether the impairment is temporary or other-than-temporary. If an investor concludes that an impairment is other-than-temporary, it reduces the carrying amount of the investment to its fair value by recognizing a charge to its income statement. The investor generally recognizes the impairment charge in the same line that it presents its equity in earnings of the investee.



#### **Question 4.3.30**

**How does an investor compute its share of investee earnings when it holds common stock and preferred stock that is not in-substance common stock?**

**Interpretive response:** We believe an investor with preferred stock that is not in-substance common stock may apply either of the following approaches to compute its share of investee earnings. These approaches incorporate concepts that are similar to those used in allocating investee losses to common stock and other investments.



### Ownership-level method

If the investor allocates earnings using the ownership-level approach, it:

- allocates total investee earnings between the common and preferred shares based on the distributions in a hypothetical liquidation; and
- recognizes its proportionate share of the amount allocated to each class of stock.

This method results in allocating earnings to both classes of stock on an HLBV basis.

### Common-claim method

If the investor allocates earnings using the common-claim method, it:

- allocates total investee earnings between the common and preferred shares based on the distributions in a hypothetical liquidation;
- recognizes only its share of the amount allocated to the common stock; and
- recognizes amounts attributable to its preferred stock based on other US GAAP.

This method results in allocating earnings based on the contractual distribution provisions of the different classes of stock but keeps the investor from recognizing under the equity method investee earnings attributable to an instrument that is neither common stock nor in-substance common stock.

While both methods generally are acceptable, we believe an equity method investor should apply the common-claim method if it has only a de minimis amount of common and in-substance common stock.

Regardless of which method a preferred stock investor uses to determine its share of the investee's earnings, we believe the investor must continue to apply other applicable GAAP to that investment.

Under Topic 321, an equity investor measures its preferred stock investment at fair value with changes recognized in net income, unless the investment does not have a readily determinable fair value. In that case, the investor may elect to measure the investment using a measurement alternative. The measurement alternative allows an investor to measure the investment at cost minus any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. Topic 321 requires that if an investor identifies such an observable price, it measures its equity security at fair value under Topic 820 as of the date that the observable transaction occurred. [\[321-10-35-2\]](#)

The measurement guidance in Topic 321 does not apply to investments accounted for under the equity method – i.e. investments in common stock and in-substance common stock that allow the investor to exercise significant influence over the investee. However, we believe it does apply to other equity investments in the investee – e.g. preferred stock that is not in-substance common stock.

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### Example 4.3.20

#### Applying the equity method when holding both common stock and preferred stock that is not in-substance common stock

Investor has significant influence over Investee and accounts for its investment under the equity method. Investor holds 30% of Investee's common stock and 100% of its preferred stock. Investor's interest in Investee's preferred stock entitles it to 15% of the votes and cash distributions.

While Investor's preferred stock has voting and dividend rights, it has a substantive liquidation preference and is not in-substance common stock (see [Question 2.3.70](#)).

During Year 1, Investee had \$100 of cash and accrual earnings. Based on the priority of distributions, if it distributed \$100, \$15 would be distributed to Investor as the sole preferred shareholder and the remainder to the common shareholders based on their respective ownership percentages.

#### Ownership-level method

If Investor applies the ownership-level method, it recognizes \$40.50 in equity in earnings.

- Investor first allocates Investee's \$100 earnings between the common and preferred shares based on distributions in a hypothetical liquidation. This results in an allocation of \$15 to preferred stock ( $\$100 \times 15\%$  distribution rate) and \$85 to common stock ( $\$100 - \$15$  attributable to preferred stock).
- Investor then recognizes its proportionate share of the amount allocated to each class of stock. This results in an allocation of:
  - \$15 to Investor's preferred stock:  $\$15 \times$  Investor's 100% preferred stock ownership; and
  - \$25.50 to Investor's common stock:  $\$85 \times$  Investor's 30% common stock ownership percentage.

#### Common-claim method

If Investor applies the common-claim method, it recognizes \$25.50 in equity in earnings.

- Investor first allocates Investee's \$100 earnings between the common and preferred shares based on the distributions in a hypothetical liquidation. This results in an allocation of \$15 to preferred stock ( $\$100 \times 15\%$  distribution rate) and \$85 to common stock ( $\$100 - \$15$  attributable to preferred stock).
- Investor then recognizes its share of the amount allocated to the common stock. This results in an allocation of \$25.50 ( $\$85 \times$  Investor's 30% common stock ownership).

Investor also recognizes dividend income of \$15 for its preferred return if that amount was accruable under other US GAAP.

## 4.4 Accounting for equity method losses when the investment is reduced to zero

### 4.4.10 Overview

An investor generally stops applying the equity method when its share of the investee's net losses has reduced its investment to zero. However, an investor continues to recognize investee losses in excess of its investment to the extent it has done any of the following:

- guaranteed obligations of the investee (see [section 4.4.20](#));
- committed to provide further financial support – e.g. by explicitly or implicitly committing to additional investments in common stock, preferred stock or other capital, debt securities, and loans or advances (see [section 4.4.20](#));
- accumulated a net other comprehensive loss from recognizing the investee's other comprehensive losses (see [section 4.4.20](#)); or
- made additional investments in the investee, including investments in preferred stock or other capital, debt securities, and loans or advances (see [section 4.4.30](#)).

An investor continues to recognize investee losses beyond the carrying amount of its investment ('excess losses') to the extent of its additional investments and commitments. [\[323-10-35-19\]](#)

Once an investor has reduced its investment, commitments and additional investments to zero, it stops applying the equity method.

If the investee subsequently reports net income, the investor resumes applying the equity method when its share of that net income equals the share of the investee's net losses that the investor did not recognize ('suspended losses'). [\[323-10-35-22\]](#)

### 4.4.20 Suspending equity method and the effects of committed funding



#### Excerpt from ASC 323-10

##### > Equity Method Losses

**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.

An investor stops applying the equity method when its share of the investee's net losses have reduced its investment to zero, unless it appears assured that the investee's return to profitability is imminent (see [Question 4.4.20](#)). An investor's 'investment' includes its investment in common equity (or partners' capital) and in-substance common stock.

Even after its investment has been reduced to zero, an investor continues to recognize investee losses to the extent it has accumulated a net other comprehensive loss from recognizing its share of the investee's other comprehensive losses.

If the investee subsequently reports net income, the investor resumes applying the equity method when its share of that net income equals its suspended losses. [[323-10-35-22](#)]

As discussed in [section 4.4.10](#), an investor recognizes losses in excess of its investment when certain conditions apply, including when the investor has committed to provide additional financial support. An investor continues to recognize excess losses to the extent of its commitments and additional investments (see [section 4.4.30](#)). [[323-10-35-19](#)]




### Question 4.4.10


**What conditions may suggest that an investor has committed to provide additional financial support?**

**Interpretive response:** The following circumstances may indicate that the investor has committed to provide additional financial support to the investee.

Investor has a legal obligation as a guarantor or general partner (i.e. an explicit commitment).	Investor has indicated a commitment, based on considerations such as business reputation, intra-entity relationships, or credit standing, to provide additional financial support.	Operating considerations imply it is unlikely investor will abandon investee – e.g. investee provides necessary products or services to investor at less than market prices, or investee licenses technology to investor that is significant to investor’s operations.
Investor makes statements to other investors or third parties indicating an intention to provide support to the investee.	Commitment is implied by previous support the investor has provided.	

 **Question 4.4.20**  
**What conditions may suggest that an investee’s imminent return to profitability appears assured?**

**Interpretive response:** An investee’s imminent return to profitability may appear assured when its excess losses are solely attributable to start-up costs, significant impairments or similar circumstances that are considered temporary or nonrecurring. When the investee’s imminent return to profitability appears assured, the investor continues to recognize its share of excess losses. [323-10-35-21]

 **Question 4.4.30**  
**How does accumulating a net other comprehensive loss from an investee affect when the investor should stop applying the equity method?**

**Background:** As discussed in section 4.5, an investor recognizes in its OCI its share of the investee’s other comprehensive income or loss. The investor records the offset to that amount in its equity method investment account. [323-10-35-18]

**Interpretive response:** We believe an investor continues to recognize its share of the investee’s net losses after its investment account is reduced to zero to the extent it has accumulated net other comprehensive losses by recognizing its share of the investee’s other comprehensive loss. The investor recognizes these losses with a charge to equity in earnings or losses and a credit to AOCI.

When the investor has recognized its share of the investee’s losses equal to the carrying amount of its investment plus its share of the investee’s accumulated other comprehensive losses, it stops applying the equity method if it has not guaranteed the investee’s obligations or otherwise committed to provide additional financial support for the investee. [323-10-35-20]



**Example 4.4.10**  
**Other comprehensive losses exceed investment balance**

On January 1, Year 1, Investor acquired a 40% equity method interest in Investee for \$1,000 in cash. Investor has not guaranteed Investee’s obligations or otherwise committed to provide additional financial support to Investee.

During Years 1–5, Investee incurred \$2,000 in net losses and \$500 in other comprehensive losses. Investor recognized its share of those losses and reduced its investment account to zero by December 31, Year 5:  $\$1,000 = (\text{Investee’s net losses of } \$2,000 + \text{Investee’s other comprehensive losses of } \$500) \times \text{Investor’s 40\% ownership interest}$ .

In Year 6, Investee reports net losses of \$1,500. Investor’s share of those net losses is \$600. Investor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Equity in losses from Investee	200	
AOCI		200
<i>To recognize additional Investee losses equal to Investor’s share of Investee’s accumulated other comprehensive losses.</i>		

Investor recognizes \$200 of its \$600 share of Investee’s losses because it has recognized in its OCI \$200 of Investee’s other comprehensive losses in previous years. Investor does not recognize the additional \$400 of Investee’s losses because it has not guaranteed Investee’s obligations or otherwise committed to provide additional financial support to Investee. Those losses will remain suspended until Investor’s share of Investee’s net income exceeds the amount of suspended losses.



**Question 4.4.40**  
**Does an investor stop amortizing basis differences when it stops recognizing its share of investee losses?**

**Interpretive response:** Yes. An investor stops applying the equity method, including amortizing its basis adjustments, when its share of the investee’s net losses has reduced its investment to zero – unless it is assured that the investee’s return to profitability is imminent. [323-10-35-20 – 35-21]

The investor resumes the equity method when its share of the investee’s subsequent net income equals the share of the investee’s net losses that the investor did not recognize. [323-10-35-22]

As a result, the investor needs to monitor and separately track the following amounts that it has **not** recognized in its financial statements because it suspended the equity method:

- its share of the investee's net losses;
  - its share of the investee's other comprehensive losses; and
  - the normal amortization or accretion of its basis differences that it would have recognized during the suspension period.
- 



#### Question 4.4.50

**How does an investor determine the amount of excess losses to recognize when it has committed additional financial support to the investee?**

**Interpretive response:** The amount of excess losses an investor recognizes may be affected by the:

- nature of the support;
- amount of support promised or due from the investee's other investors; and
- ability of the other investors to provide support.

When other investors have also committed to provide additional financial support to the investee, and have demonstrated the ability to provide that support, the investor recognizes excess losses only for its share of the investee's losses. We believe the investor should determine its share of the losses based on the proportion of its level of promised support relative to the promised support of the other investors. This proportion may differ from the investor's percentage ownership interest in the investee's common stock.

If the other investors have not committed additional financial support, or if they have not demonstrated the ability to provide promised support, the investor may need to recognize excess losses equal to 100% of the investee's losses.

If an investor has explicitly or implicitly committed to only a certain amount of future funding, we believe the investor should continue to recognize excess losses beyond its committed funding amount, unless it would discontinue funding at that level and allow the investee to cease operations.

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#### Example 4.4.20

**Investor committed to fund future excess losses of investee**

Investee has three investors: Investor A, Investor B and Investor C. When Investee was formed in Year 1, the investors contributed a total of \$300 in capital, in proportion to their ownership interests of 40%, 20% and 40%, respectively. None of the investors have made additional contributions since Investee's formation. Investee is a voting interest entity under Topic 810.

During Year 2, Investee incurred a loss of \$500. On Investee's formation, Investors A and B contractually agreed to fund its future excess losses (i.e. losses in excess of Investee's net assets), if necessary, in a ratio equal to that of their respective initial ownership interests (2:1). Investors A and B are financially stable and can provide their promised level of support.

In Year 2, Investors A, B and C recognize \$300 of losses (i.e. equal to Investee's net assets) based on their percentage ownership interests. Investors A and B also recognize their share of Investee's excess losses (i.e. in excess of Investee's net assets) based on the agreed 2:1 ratio.

#### Investor A's equity in losses from Investee

Investor A computes its equity in losses from Investee as follows.

Share of the losses equal to Investee's net assets <sup>1</sup>	\$ 120
Share of excess losses <sup>2</sup>	133
<b>Investor A's total equity in losses from Investee</b>	<b>\$253</b>
Notes:	
1. \$300 of Investee's losses × 40% ownership interest.	
2. \$200 excess losses × 67% (2/3) funding commitment.	

If Investor B does not, or cannot, fund its share of the excess losses, Investor A would recognize 100% of Investee's excess losses.

#### Investor B's equity in losses from Investee

Investor B computes its equity in losses from Investee as follows.

Share of the losses equal to Investee's net assets <sup>1</sup>	\$ 60
Share of excess losses <sup>2</sup>	67
<b>Investor B's total equity in losses from Investee</b>	<b>\$127</b>
Notes:	
1. \$300 of Investee's losses × 20% ownership interest.	
2. \$200 excess losses × 33% (1/3) funding commitment.	

If Investor A does not, or cannot, fund its share of the excess losses, Investor B would recognize 100% of Investee's excess losses.

#### Investor C's equity in losses from Investee

Investor C computes its equity in losses from Investee as follows.

Share of the losses equal to Investee's net assets <sup>1</sup>	\$120
Share of excess losses	-
<b>Investor C's total equity in losses from Investee</b>	<b>\$120</b>
Note:	
1. \$300 of Investee's losses × 40% ownership interest.	

Investor C recognizes its share of Investee's losses to the extent that amount reduces its \$120 (40% × \$300) to zero. It does not recognize excess losses because it has not explicitly or implicitly agreed to fund losses in excess of its investment in Investee.



**Question 4.4.60****How does an investor determine the amount of investee losses to attribute to its in-substance common stock?**

**Interpretive response:** An investor may use the relative holdings approach or HLBV to determine the amount of investee losses to attribute to its investment in an investee's in-substance common stock. This includes the situation in which the investor does not own voting common stock of the investee.

[Section 4.4.30](#), and [Questions 4.4.90](#) and [4.4.100](#) provide additional guidance.

**Question 4.4.70****How does an investor present its negative investment?**

**Interpretive response:** An investor presents a negative investment account arising from recognizing excess losses as a liability. The caption should reflect the nature of the balance. For example, an investor may label the liability:

- accumulated losses of unconsolidated investees in excess of investment;
- estimated losses on investments; or
- estimated liability – guarantee of obligations of unconsolidated investee.

The investor includes excess losses in its 'equity in earnings (or losses) from investees line' in its income statement.

**Question 4.4.80****How does an investor account for excess losses when it no longer guarantees the investee's obligations?**

**Interpretive response:** If an investee extinguishes its obligations that were previously guaranteed by the investor, the investor stops recognizing excess losses from that point forward. The investor reverses its related liability with an adjustment to equity in earnings (or losses) from the investee and should consider disclosing this adjustment, if material. [\[323-10-35-19 – 35-22, TPA 2220.13\]](#)

**Question 4.4.85****How does an investor account for excess losses when an investee's imminent return to profitability no longer appears assured?**

**Background:** An investor continues to recognize its share of an investee's excess losses when the investee's imminent return to profitability appears

assured. See [Question 4.4.20](#) for conditions suggesting that an investee's imminent return to profitability appears assured.

**Interpretive response:** If the investee's imminent return to profitability no longer appears assured (e.g. the unprofitable conditions are no longer expected to be temporary or nonrecurring), an investor stops recognizing excess losses from that point forward. The investor reverses its related liability with an adjustment to equity in earnings (or losses) from the investee and should consider disclosing this adjustment, if material.

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### 4.4.30 Investor has other investments



#### Excerpt from ASC 323-10

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

**35-23** The guidance in the following paragraph applies to situations in which both of the following conditions exist:

- a. An investor is not required to advance additional funds to an investee.
- b. Previous losses have reduced the common stock investment account to zero.

**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.

#### Pending Content

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-2

**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~~, 326-20, or 326-30 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 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 Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 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 ~~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 financing receivables~~loans~~. The adjusted basis is the cost basis adjusted for the ~~valuation~~ allowance for credit losses account ~~recorded~~recognized in accordance with Topic 326 on measurement of credit losses~~Subtopic 310-10~~ for an investee ~~loan~~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 Subtopic 310-10, 320-10, or 321-10, the investor should perform all of the following steps to determine the amount of equity method loss to report at the end of a period:

- a. Apply this Subtopic to determine the maximum amount of equity method losses.
- b. Determine whether the adjusted basis of the other investment(s) in the investee is positive, and do the following:
  1. If the adjusted basis is positive, the adjusted basis of the other investments shall be adjusted for the amount of the equity method loss based on the investments' seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the debt security's basis from which subsequent changes in fair value are measured. Paragraph 321-10-35-5 explains that for investments accounted for in accordance with Subtopic 321-10, this adjusted basis becomes the equity security's basis from which subsequent changes in fair value are measured.
  2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference

between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported. Example 4 (see paragraph 323-10-55-30) illustrates the application of (b)(2).

- c. After applying this Subtopic, apply Subtopics 310-10, 320-10, and 321-10 to the adjusted basis of the other investments in the investee, as applicable.
- d. Apply appropriate generally accepted accounting principles (GAAP) to other investments that are not within the scopes of Subtopics 310-10, 320-10, or 321-10.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.

**Pending Content**

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-2

**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, 320-10, or 321-10, the investor should perform all of the following steps to determine the amount of equity method loss to report at the end of a period:

- a. Apply this Subtopic to determine the maximum amount of equity method losses.
- b. Determine whether the adjusted basis of the other investment(s) in the investee is positive, and do the following:
  - 1. If the adjusted basis is positive, the adjusted basis of the other investments shall be adjusted for the amount of the equity method loss based on the investments' seniority. Paragraph 320-10-35-3 explains that, for investments accounted for in accordance with Subtopic 320-10, this adjusted basis becomes the debt security's basis from which subsequent changes in fair value are measured. Paragraph 321-10-35-5 explains that for investments accounted for in accordance with Subtopic 321-10, this adjusted basis becomes the equity security's basis from which subsequent changes in fair value are measured.
  - 2. If the adjusted basis reaches zero, equity method losses shall cease being reported; however, the investor shall continue to track the amount of unreported equity method losses for purposes of applying paragraph 323-10-35-20. If one of the other investments is sold at a time when its carrying value exceeds its adjusted basis, the difference between the cost basis of that other investment and its adjusted basis at the time of sale represents equity method losses that were originally applied to that other investment but effectively reversed upon its sale. Accordingly, that excess represents unreported equity method losses that shall continue to be tracked before future equity method income can be reported. Example 4 (see paragraph 323-10-55-30) illustrates the application of (b)(2).

- c. After applying this Subtopic, apply Subtopics 310-10, 320-10, ~~and~~ 321-10, 326-20, and 326-30 to the adjusted basis of the other investments in the investee, as applicable.
- d. Apply appropriate generally accepted accounting principles (GAAP) to other investments that are not within the scopes of ~~Subtopics~~ Subtopic 310-10, 320-10, or 321-10, 326-20, or 326-30.

Example 4 (see paragraph 323-10-55-30) illustrates the application of this guidance.

• • > Percentage Used to Determine the Amount of Equity Method Losses

**35-27** The guidance in the following paragraph applies if all of the following conditions exist:

- a. An investor owns common stock (or in-substance common stock) and other investments in an investee.
- b. The investor has the ability to exercise significant influence over the operating and financial policies of the investee.
- c. The investor is not required to advance additional funds to the investee.
- d. Previous losses have reduced the common stock investment account to zero.

**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.

> Additional Investment after Suspension of Loss Recognition

**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.

As discussed in [section 4.4.10](#), an investor continues to recognize investee losses in excess of its investment (including its investment in in-substance common stock) to the extent it has made 'other investments' in the investee. These other investments include investments in preferred stock or other capital, debt securities and loans or advances.

An investor reduces its adjusted basis in other investments beginning with the most subordinate. An other investment's adjusted basis is its initial cost adjusted for the following amounts that were recognized in previous periods: [\[323-10-35-24 – 35-25\]](#)

- other-than-temporary impairments and writedowns;
- unrealized changes in fair value recognized in net income;
- allowance for loan losses;
- amortization or accretion of debt discount or premium; and
- equity method losses already attributed to that other investment.

After the investor reduces the carrying amount of an other investment for its share of the investee's losses, its adjusted carrying amount becomes its basis for the investor to apply other applicable US GAAP – i.e. Subtopics 310-10, 320-10 or 321-10; and Subtopics 326-20 or 326-30 after an investor adopts ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. [\[323-10-35-24 – 35-26\]](#)

If the investor sells the other investment, it effectively reverses the equity method losses that it recognized through reducing that other investment's carrying amount. As a result, the equity method losses that the investor had attributed to that other investment become suspended losses that the investor will need to track so that it knows when to resume applying the equity method (see [section 4.4.20](#) and [Question 4.4.40](#)). [\[323-10-35-26\]](#)

Topic 323 states that an investor with an other investment in the investee does not recognize equity method losses based solely on its percentage ownership in the investee once it has reduced the equity method investment to zero. [\[323-10-35-27 – 35-28\]](#)

The following are two approaches that an investor can apply when determining how much of the investee's losses should reduce its other investments. There may be other acceptable approaches. The investor may recognize losses based on: [\[323-10-35-28, 323-10-55-48\]](#)

- its percentage ownership interest in each type of other investment it holds (relative holdings approach); or

- changes in its claim on the investee’s net assets assuming hypothetical liquidation at book value (HLBV – see [section 4.3](#)).

Topic 323’s illustration of these two approaches is reproduced below.

When an investor reduces its other investments to zero, it stops applying the equity method and resumes only when its share of the investee’s net income equals its suspended losses – i.e. the share of the investee’s net losses that the investor did not recognize. An investor restores its adjusted basis in its other investments beginning with the most senior. The investor does not restore decreases in the carrying amount of its other investments that result from applying other US GAAP – e.g. reductions resulting from other-than-temporary impairments of debt securities. [\[323-10-35-20 – 35-22\]](#)

If an investor makes an additional investment in the investee after it has suspended applying the equity method, it determines whether that investment represents funding of previous suspended losses. If so, the investor recognizes its previously suspended losses to the extent of the additional funding.



### Excerpt from 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:

- Ownership level of particular investment (Case A)
- Change in investor claim on investee book value (Case B).

**55-49** Cases A and B share all of the following assumptions:

- Investee was formed on January 1, 20X0.
- 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.
- 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.
- 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).
- Investor A is not obligated to provide any additional funding to Investee. As of the beginning of 20X1, the adjusted basis of Investor’s total combined investment in Investee is \$200, as follows.

Common stock	\$ -
Preferred stock	\$ 100
Loan	\$ 100

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

20X1	\$(160)
20X2	\$(200)
20X3	\$ 500

g. Investee's balance sheet is as follows.

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

•• > 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 ( $50\% \times \$160 = \$80$ ). 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 ( $50\% \times \$40 = \$20$ ) and, because the adjusted basis of the preferred stock will then be reduced to zero, record the remaining equity method loss to the adjusted basis of the loan (the next most senior level of capital) ( $60\% \times \$160$  [that is,  $\$200 - \$40$  applied to the preferred stock] = \$96). Investor A would record the following journal entry.

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

**55-53** In 20X3, in accordance with this Subtopic, Investor A would record the equity method income first to the loan until its adjusted basis is restored ( $60\% \times \$160 = \$96$ ), then to the preferred stock until its adjusted basis is restored ( $50\% \times \$200 = \$100$ ), and finally to the common stock ( $40\% \times \$140 = \$56$ ). Investor A would record the following journal entry.

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



• • > Case B: Change in Investor Claim on Investee Book Value

**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.

**55-55** With respect to 20X1, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X1, it would have \$207 available to distribute. Investor A would receive \$120 (Investor A's 60% share of a priority claim from the loan [\$100] and a priority distribution of its preferred stock investment of \$20 [which is 50% of the \$40 remaining to distribute after the creditors are paid]). Investor A's claim on Investee's book value at January 1, 20X1, was \$200 (60% × \$167 = \$100 and 50% × \$200 = \$100). Therefore, during 20X1, Investor A's claim on Investee's book value decreased by \$80 and that is the amount Investor A would recognize in 20X1 as its share of Investee's losses. Investor A would record the following journal entry.

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

**55-56** With respect to 20X2, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X2, it would have \$7 available to distribute. Investor A would receive \$4 (Investor A's 60% share of a priority claim from the loan). Investor A's claim on Investee's book value at December 31, 20X1, was \$120 (see the preceding paragraph). Therefore, during 20X2, Investor A's claim on Investee's book value decreased by \$116 and that is the amount Investor A would recognize in 20X2 as its share of Investee's losses. Investor A would record the following journal entry.

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

**55-57** With respect to 20X3, if Investee hypothetically liquidated its assets and liabilities at book value at December 31, 20X3, it would have \$507 available to distribute. Investor A would receive \$256 (Investor A's 60% share of a priority claim from the loan [\$100], Investor A's 50% share of a priority distribution from its preferred stock investment [\$100], and 40% of the remaining cash available to distribute [\$140 × 40% = \$56]). Investor A's claim on Investee's book value at December 31, 20X2, was \$4 (see above). Therefore, during 20X3, Investor A's claim on Investee's book value increased by \$252 and that is the amount Investor A would recognize in 20X3 as its share of Investee's earnings. Investor A would record the following journal entry.

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



### Question 4.4.90

#### How does an investor apply the relative holdings approach to measure excess losses?

**Interpretive response:** When an investor recognizes investee losses based on the relative holdings approach, the investor performs the following steps.

**Step 1:** Determine what types of other investments the investor holds in the investee.

**Step 2:** Put each other investment type in order of relative priority in liquidation, listing the most junior securities first – e.g. preferred stock may be first and senior secured debt may be last.

**Step 3:** Determine how much of each type of other investment the investor holds relative to the total amount outstanding for that type.

**Step 4:** For the most junior other investment, multiply the investee's loss by the investor's percentage ownership in that class of other investment.

**Step 5:** Repeat Step 4 until the carrying amount of the most junior other investment has been reduced to zero.

**Step 6:** Move to the next most junior other investment. Apply Steps 4–6 to that next most junior investment. Continue applying Steps 4–6 for each remaining type of other investment from the most junior to the most senior until the carrying amounts of those other investments have been reduced to zero.

**Step 7:** When the carrying amounts of all other investments have been reduced to zero, stop applying the equity method – unless the investor has guaranteed obligations of the investee or is otherwise committed to provide additional financial support (see [section 4.4.20](#)). Begin tracking suspended losses – i.e. the investor's share of the investee's net losses that it is not recognizing.

**Step 8:** When the investee has reported enough net income so that the investor's share of that net income equals the investor's suspended losses, restore the other investments' carrying amounts for the investor's share of net income, beginning with the most senior other investment.



### Example 4.4.30

#### Recognizing losses based on ownership in other-than-common stock

Investor has three investments in Investee and applies the equity method. In ascending order of seniority (i.e. beginning with the most junior), the investments and their carrying amounts are as follows.

	Carrying amount
40% of Investee's common stock outstanding	\$1,000
80% of Investee's non-voting preferred stock	\$ 600
30% of Investee's unsecured debt	\$ 150

Investor has not guaranteed Investee's obligations or otherwise committed to provide additional financial support to Investee.

When recognizing its share of Investee's losses, Investor recognizes (in this order):

- 40% of Investee's losses until its share equals \$1,000 – i.e. it has reduced its common stock investment to zero.
- 80% of Investee's losses until its share equals \$600 – i.e. it has reduced its preferred stock investment to zero.
- 30% of Investee's losses until its share equals \$150 – i.e. it has reduced its debt security investment to zero.

Once Investor has reduced its investments in Investee to zero, it discontinues applying the equity method.



#### Question 4.4.100

#### How does an investor apply HLBV to measure excess losses?

**Interpretive response:** As discussed in [section 4.3](#), under HLBV the investor computes at the beginning and end of the reporting period its share of the investee's net assets – assuming the investee liquidated its net assets at their book values and distributed to the investors the proceeds based on the distribution waterfall in the investment agreement. The investor generally considers only its claim on the book-value liquidation proceeds and does not consider costs associated with a hypothetical liquidation event – e.g. debt prepayment penalties that would be assessed on early extinguishment.

The decrease in the investor's share of the investee's net assets from the beginning to the end of the reporting period (after adjusting for cash contributions and distributions) represents the investor's share of the investee's losses from its investment.

After an investor measures its share of the investee's losses using HLBV, it recognizes those losses by reducing the carrying amounts of its other investments, beginning with the most junior. When the investor has reduced the carrying amount of the most junior investment to zero, it moves to the next most junior investment. The investor repeats this process until it has recognized its entire share of the investee's losses or has reduced to zero all of its investments in the investee.

When the investor has reduced the carrying amounts of all of its other investments, it stops applying the equity method – unless it has guaranteed obligations of the investee or is otherwise committed to provide additional

financial support (see [section 4.4.20](#)). It then begins tracking any suspended losses.

When the investee has reported enough net income so that the investor's share of that net income equals its suspended losses, the investor restores the other investments' carrying amounts for its share of net income, beginning with the most senior other investment.

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#### Question 4.4.110

**Is either the relative holdings approach or HLBV preferable?**

**Interpretive response:** No. We do not believe either approach is preferable.

Topic 323 states only that it is not appropriate for an investor to measure its share of equity method losses based solely on its percentage of common stock ownership when it has other investments in the investee. [\[323-10-35-28\]](#)

The amount of equity method losses that an investor recognizes under the relative holdings or HLBV approach will often be similar, but both will differ significantly from the amount equal to its common stock ownership percentage multiplied by the investee's net loss.

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#### Question 4.4.120

**If an investor has a loan to the investee, does it estimate credit losses before it attributes equity method losses to the loan?**

**Interpretive response:** No. The investor should estimate the allowance for credit losses *after* it attributes equity method losses to the loan. The same guidance applies to other investments in the scope of Subtopic 310-10 or 320-10.

An investor that has reduced its equity method investment to zero but has a loan to the investee should sequence its application of US GAAP as follows. [\[323-10-35-26\]](#)

**Step 1:** Apply Topic 323 to determine the amount of investee losses the investor must attribute to the loan (see [Questions 4.4.90](#) and [4.4.100](#)).

**Step 2:** Determine whether the adjusted basis of the loan is positive.

- If yes, the investor attributes equity method losses to it.
- Otherwise, the investor no longer recognizes equity method losses, but instead tracks the amount of suspended losses to know when to resume recognizing equity method income.

The loan's adjusted basis is its initial cost adjusted for the following amounts that were recognized in previous periods: [\[323-10-35-24 – 35-25\]](#)

- writedowns (or other-than-temporary impairment if the loan is a debt security);
- unrealized changes in fair value recognized in net income (if the loan is a debt security classified as trading);
- allowance for loan loss;
- amortization or accretion of discount or premium (if the loan is a debt security or financing receivable); and
- equity method losses that have already been attributed to the loan.

**Step 3:** Apply Subtopic 310-10 (or Subtopic 320-10 if the loan is a debt security) to the adjusted basis of the loan. This step includes estimating credit losses.

When an investor attributes equity method losses to a loan in Step 2, it decreases that loan's amortized cost basis. That decrease in the amortized cost basis may result in the investor recognizing a lower amount of credit losses in Step 3 than it would have if equity method losses had not been attributed to the loan.

This guidance will be applied the same way after the investor adopts ASU 2016-13, Measurement of Credit Losses on Financial Instruments – i.e. an investor will measure credit losses under Topic 326 in Step 3, after it allocates equity method losses. Section 15.2.10 of KPMG Handbook, [Credit Impairment](#), provides additional interpretive guidance on, and examples of, the interaction between Topics 323 and 326.



#### Question 4.4.130

**If an investor has other investments that it measures at fair value, does it remeasure those investments before it attributes equity method losses?**

**Interpretive response:** No. The investor generally remeasures its other investment to fair value *after* it attributes equity method losses to it.

An investor that has reduced its equity method investment to zero but has other investments in the investee should sequence its application of US GAAP as follows. [323-10-35-26]

**Step 1:** Apply Topic 323 to determine the amount of investee losses the investor must attribute to the other investments (see [Questions 4.4.90](#) and [4.4.100](#)).

**Step 2:** Determine whether the adjusted basis of the other investment is positive.

- If yes, the investor attributes equity method losses to it.
- Otherwise, the investor no longer recognizes equity method losses, but instead tracks the amount of suspended losses to know when to resume recognizing equity method income.

The other investment's adjusted basis is its initial cost adjusted for the following amounts that were recognized in previous periods: [323-10-35-24 – 35-25]

- other-than-temporary impairment if the other investment is a debt security classified as available-for-sale;
- unrealized changes in fair value recognized in net income (if the other investment is a debt security classified as trading or an equity security);
- amortization or accretion of discount or premium if the other investment is a debt security classified as available-for-sale; and
- equity method losses that have already been attributed to the other investment.

An other investment's adjusted basis does not include adjustments to fair value that the investor recognized in its OCI. As a result, an investor with a debt security that is classified as available-for-sale excludes any previous fair value adjustments from its adjusted basis.

**Step 3:** Apply Topic 321 (if the other investment is an equity security) or Topic 320 (if the other investment is a debt security) to the adjusted basis of the other investment. This step generally includes remeasuring the other investment to fair value as required under the relevant Topic.

See [Question 4.4.140](#) for additional discussion about the accounting for equity method losses after an investor has reduced its equity method investment to zero and holds an other investment that it measures using the measurement alternative under Topic 321.



### Question 4.4.140

**Does an investor offset its fair value adjustment with equity method losses that it has suspended in a memo account?**

**Interpretive response:** Not necessarily. As discussed in [Question 4.4.130](#), if an investor has reduced to zero an other investment that is in the scope of Topic 321 (the other investment is an equity security) or Topic 320 (the other investment is a debt security) and the investee incurs additional losses, it:

- first, computes (and tracks in a memo account) the amount of suspended losses for the reporting period, and
- second, applies Topic 321 or Topic 320 to the adjusted basis of the other investment.

Applying Topic 321 or Topic 320 includes remeasuring the other investment to fair value unless the investor applies the measurement alternative to its other investment – e.g. that investment is preferred stock that is not in-substance common stock and does not have a readily determinable fair value. If the investor applies the measurement alternative to its other investment, it remeasures the other investment under Topic 321 only if there is an observable transaction in the same or similar security.

If an observable transaction occurs, we believe the investor generally remeasures the investment to fair value as of the date that the observable transaction occurred, regardless of whether it has accumulated suspended losses in its memo account as of that date.

The EITF discussed this issue in 2019 and considered the following alternative views, which we believe are also acceptable. [\[EITF Issue 19-A\]](#)

- The investor remeasures the other investment to fair value, but then reduces that fair value carrying amount by the amount of any newly suspended losses computed for the current reporting period.
- The investor remeasures the other investment to fair value, but then reduces that fair value carrying amount by the amount of cumulative suspended losses in the memo account as of the next reporting date.

## 4.5 Other comprehensive income



### Excerpt from ASC 323-10

- > Other Comprehensive Income

**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 recognizes in its OCI its share of an investee's OCI with a corresponding increase or decrease to the carrying amount of its equity method investment. In its AOCI disclosures, the investor may report what portion comprises its share of the investee's AOCI. [\[323-10-35-18\]](#)



### Question 4.5.10

**Does an investor recognize its share of the investee's OCI resulting from hedge accounting?**

**Interpretive response:** Yes. While Topic 323 does not specifically require an investor to recognize its share of the investee's cash flow and net investment hedging adjustments, we believe the investor should apply the same guidance that it does for the investee's other equity adjustments reported in OCI.



**Example 4.5.10**  
**Investor recognizing its share of the investee's OCI**

On January 1, Year 1, Investor acquired a 25% equity method interest in Investee for \$10,000 in cash.

In Year 1, Investee reported net income of \$20,000 and a gain in OCI (for a derivative designated in a cash flow hedge) of \$4,000.

Investor records the following entries in Year 2; income taxes are ignored.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	10,000	
Cash		10,000
<i>To record purchase of investment in Investee on January 1.</i>		
Investment in Investee	6,000	
Equity in earnings of Investee <sup>1</sup>		5,000
OCI <sup>2</sup>		1,000
<i>To recognize Investor's share of Investee's earnings and OCI.</i>		
Notes:		
1. Investee's \$20,000 net income × 25% ownership interest.		
2. Investee's \$1,000 OCI × 25% ownership interest.		



**Question 4.5.20**  
**Does an investor recognize its share of an investee's foreign currency translation adjustments?**

**Interpretive response:** Yes, an investor recognizes in OCI its proportionate share of the foreign currency translation adjustments recognized by the investee. [323-10-35-8, 35-18]

In addition, as discussed in [Question 5.3.50](#), if the investor's functional currency differs from the investee's, the investor translates the investee's financial statements as if it were a consolidated subsidiary and recognizes in its OCI the resulting translation adjustment. [830-10-15-5]

Section 4 of KPMG Handbook, [Foreign currency](#), provides guidance specific to foreign currency translation considerations for equity method investments.



## 4.6 Investee capital transactions



### Excerpt from ASC 323-10

• > Investee Capital Transactions

**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.

**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.

**35-17** Dividends received from an investee shall reduce the carrying amount of the investment.

An investee's capital activity can result in the investor:

- increasing its ownership interest, which it accounts for as an acquisition (see [Question 4.6.60](#) and [section 6.2](#));
- decreasing its ownership interest, which it accounts for as a sale (see [Question 4.6.60](#) and [section 6.3](#));
- increasing its claim on the investee's net assets, which may result in an increase to equity in earnings, either at a point in time or over time (see [Questions 4.6.20](#) and [4.6.40](#));
- decreasing its claim on the investee's net assets, which may result in a decrease to equity in earnings, either at a point in time or over time (see [Questions 4.3.25](#), [4.6.10](#), [4.6.20](#), [4.6.50](#)); or
- receiving cash, which it generally accounts for as a reduction of its investment (see [Question 4.6.90](#)).



### Question 4.6.10

**Do an investee's preferred dividends affect an equity method investor's equity in earnings?**

**Interpretive response:** It depends.

#### Cumulative preferred stock

When an investee has outstanding preferred stock in which the shareholder is entitled to dividends regardless of whether the investee has earnings ('cumulative preferred stock'), the accumulating dividends decrease the investor's claim on the investee's net assets. An investor computes its share of earnings or losses after deducting the preferred dividends – regardless of whether those dividends have been declared. [[323-10-35-16](#)]

**Non-cumulative preferred stock**


If a preferred shareholder legally does not have a right to dividends and dividends have not been declared, we believe the investor does not need to adjust the investee’s earnings or losses before computing its share.

**Redeemable preferred stock**

The investee may be required under Topic 480 to classify mandatorily redeemable preferred stock as a liability, and to initially measure it at fair value with subsequent changes in value recognized as interest cost. [480-10-30-1, 35-3]

Because the investee recognizes value changes in the liability in its earnings and not through retained earnings like cumulative preferred stock, the investor does not need to adjust the investee’s earnings before it computes its share of the investee’s earnings or losses.

The investee may have outstanding redeemable preferred stock that it does not classify as a liability but does accrete to its redemption amount through an adjustment to its retained earnings. Similar to cumulative preferred stock dividends, the investor reduces the investee’s earnings for the accretion related to those preferred shares before it computes its share of the investee’s earnings or losses. [480-10-S99-1]

 **Example 4.6.10**  
**Effect of preferred dividends on an investor’s equity in earnings**

On January 1, Year 1, Investor acquired a 25% equity method interest in the voting common stock of Investee for \$2,000,000 in cash. Investee has issued non-voting cumulative preferred stock to other investors that require it to pay a 10% fixed-rate dividend annually.

For the year ended December 31, Year 1, Investee reported net income of \$800,000 and accrued preferred dividends of \$60,000.

Investor’s share of Investee’s earnings is computed as follows. Income taxes are ignored, and it is assumed that there are no basis differences or intra-entity transactions.

Investee’s net income	\$ 800,000
Minus preferred dividends	(60,000)
<b>Investee’s net income after preferred dividends</b>	<b>740,000</b>
Multiplied by Investor’s ownership percentage	25%
<b>Investor’s equity in earnings of Investee</b>	<b>\$185,000</b>

Investor’s investment in Investee as of December 31, Year 1 is \$2,185,000: \$2,000,000 initial investment plus \$185,000 equity in earnings.



### Question 4.6.20

#### How does an investor account for an investee's sale of an NCI in its consolidated subsidiary?

**Background:** Under Topic 810, when an entity reduces its ownership interest in a consolidated subsidiary but retains control, it recognizes as an adjustment to paid-in capital the difference between the amount of the newly issued NCI and the proceeds it received. [810-10-45-23]

If an equity method investee sells a portion of its interest in a subsidiary to other investors, its adjustment to additional paid-in capital will result in an increase or decrease in the amount of the equity method investor's share of the investee's net assets even though the investor's percentage ownership interest in the investee did not change. This also occurs if the investee's subsidiary issues shares to other investors.

**Interpretive response:** We understand that there is diversity in practice in accounting for these transactions.

One view is that the investor should not immediately adjust the carrying amount of its investment when the investee (or the investee's consolidated subsidiary) recognizes the NCI. The ownership interest in the investee has not changed, and the investee has recognized no gain or loss.

However, the investor would *identify* its share of the change in the investee's additional paid-in capital as an adjustment to its overall basis difference in the investment. The investor subsequently accounts for changes in its adjusted overall basis difference through an adjustment to equity in earnings over time as if the investee were a consolidated subsidiary. Sections 3.3 and 5.3 provide additional discussion about how an investor identifies and subsequently accounts for basis differences. [323-10-35-13]

We believe this view is most consistent with the principles of Topic 323.

Other views include the investor recognizing an:

- immediate adjustment to its equity in earnings of the investee, similar to a noncontributing investor's accounting when its share of the investee's net assets increases as a result of another investor funding the investee's share-based compensation expense (see section 5.4); or
- adjustment to equity, similar to the investor's accounting for its share of a change in the investee's OCI (see section 4.5).



### Question 4.6.30

#### How does an investee's application of pushdown accounting affect the equity method investor's accounting?

**Background:** An investee acquired through a business combination may choose to apply pushdown accounting to its financial statements. When applying pushdown accounting, an investee adjusts the carrying amounts of its

assets and liabilities to the amounts recognized by its parent. [805-50-25-4, 30-10 – 30-12]

**Interpretive response:** If the equity method investor's ownership interest in the investee has not changed, we do not believe the investee's application of pushdown accounting affects its share of earnings (losses) of the investee.

The equity method investor continues to compute its equity in earnings assuming the investee had not applied pushdown accounting. This may require the investor to track its share of the investee's pushdown accounting adjustments because the investee will be reporting its net income on a post-pushdown basis.

For example, if the investee recognizes a new amortizable intangible asset in pushdown accounting and includes in its net income the related amortization, the equity method investor adjusts the investee's reported net income to remove that amortization before applying its ownership percentage to compute its equity in earnings.



#### Question 4.6.40

**How does a noncontributing investor account for an increase in its capital account arising from another investor's disproportionate contribution?**

**Background:** As discussed in [section 5.4](#), an investor may grant share-based payment awards to compensate an employee of an equity method investee (the contributing investor) and the other investors do not proportionately fund the investee's related compensation cost (the noncontributing investors). If the grant was not agreed to in connection with the investor's acquisition of the investment: [323-10-25-3 – 25-5]

- the contributing investor expenses the cost of the share-based payment awards to the extent its claim on the investee's book value has not increased; and
- the noncontributing investors recognize, in equity in earnings, their respective increases in their capital accounts.

Topic 323 provides no guidance on other situations involving disproportionate contributions that do not result in changes in ownership.

**Interpretive guidance:** We believe it is appropriate for a noncontributing investor to analogize to Topic 323's guidance on how to account for investor grants of share-based payment awards to the employees of an investee. Applying that guidance by analogy results in the noncontributing investor recognizing, in equity in earnings of the investee, an amount equal to the increase in its claim on the investee's net assets resulting from the disproportionate funding from the contributing investor (the contributing investor's 'excess contribution').



### Question 4.6.50

#### How does a contributing investor account for its disproportionate contribution?

**Background:** [Question 4.6.40](#) discusses the accounting by a noncontributing investor for an increase in its capital account arising from another investor's disproportionate contribution. The guidance is based on Topic 323 guidance addressing the accounting for investor grants of share-based payment awards to employees of an investee when the grant was not agreed to in connection with the investor's acquisition of its investment.

Applying that same guidance to the contributing investor would require it to expense its disproportionate contribution.

**Interpretive response:** We believe the contributing investor should not necessarily expense its disproportionate contribution but should consider the substance of the transaction when determining how to account for it. When different investors contribute at different per share amounts, the transaction may include other elements that need to be accounted for separately – e.g. a separate class of investment, payment for services or acquisition of an intangible asset.



### Question 4.6.60

#### How does an investor account for an investee's common (or in-substance common) equity issuance or repurchase?

**Interpretive response:** The investor's accounting for an investee's share issuance or repurchase depends on the facts and circumstances.

- If the investor buys newly issued shares and increases or maintains its ownership percentage, it accounts for the purchase at cost – see [Question 6.2.30](#).
- If the investor buys newly issued shares and decreases its ownership percentage, it accounts for the transaction as an acquisition and a partial disposition – see [Question 6.3.150](#) and [Example 6.3.90](#).
- If the investor does not participate in an investee's sale of newly issued shares, its ownership percentage decreases and it accounts for the transaction as a sale – see [Question 6.3.110](#) and [Example 6.3.70](#).
- If the investor sells shares to the investee in a treasury stock transaction and increases its ownership percentage, it accounts for the transaction as a purchase – see [Question 6.2.40](#).
- If the investor sells shares to the investee in a treasury stock transaction and decreases its ownership percentage, it accounts for the transaction as a sale – see [Question 6.2.40](#).

- If the investor does not participate in the investee's treasury stock transaction, its ownership percentage increases and it accounts for the transaction as a purchase – see [Question 6.2.50](#).



#### Question 4.6.70

#### How does an investor account for an investee's issuance, repurchase or retirement of other-than-common (or other than in-substance common) equity?

**Interpretive response:** An investee's issuance, repurchase or retirement of other-than-common (or other than in-substance common) equity instruments generally does not affect the investor's equity method interest. If those securities are convertible to common equity (e.g. stock options, warrants, convertible preferred stock, convertible debt, and other similar securities), the investor accounts for the dilution of its common equity interest only when those securities are exercised or converted into common stock. [323-10-15-13 – 15-19]

However, even before conversion, the investor should evaluate (1) whether those instruments currently affect its ability to exercise significant influence and (2) how the investee's net income or loss will be affected.

If the equity method investor holds those convertible securities, it accounts for those investments under applicable US GAAP – i.e. those investments are not part of the equity method investment unless they are in-substance common stock. If the investor later converts another investment into an additional common equity interest, it accounts for the conversion as a purchase that may result in continued application of the equity method or consolidation (if the investor controls the investee on conversion). [Chapter 2](#) provides guidance on how to account for the initial recognition of an equity method investment.



#### Question 4.6.80

#### Does an investor recognize a transaction gain/loss on dividends from a foreign investee?

**Interpretive response:** It depends. An investor does not recognize transaction gains or losses on the declaration of dividends by a foreign investee. The dividend, like any other equity transaction, is translated at the historical exchange rate – i.e. the transaction date exchange rate. [830-10-45-18]

However, the investor does recognize a translation adjustment in OCI for changes in the exchange rate between the last reporting date and the dividend declaration date. In addition, the investor recognizes a transaction gain or loss for changes in exchange rates during the period between the declaration and payment of dividends because the dividend receivable is a monetary asset (see [Question 5.2.140](#)). [830-30-45-12]

Section 4 of KPMG Handbook, [Foreign currency](#), provides guidance on intra-entity dividends.

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### Question 4.6.90

#### How does an investor account for dividends received in excess of the carrying amount of the investment?

**Interpretive response:** Topic 323 requires an investor to reduce the carrying amount of its investment when dividends are received. However, it does not address how the investor should recognize dividends that exceed the carrying amount of its investment ('excess distributions'). [\[323-10-35-17\]](#)

Generally, an investor recognizes an excess distribution as a reduction in the carrying amount of its investment even if the excess distribution reduces the investment account below zero. The investor typically applies this accounting regardless of whether the dividend is a distribution of cash from the investee's operations or financing transactions because, in many cases, it is not clear that a distribution from an equity method investee represents the culmination of an earnings process.

However, we believe it is acceptable for an investor to recognize excess distributions in equity in earnings of the investee only if the investor has no implicit or explicit obligation to provide additional financial support to the investee.

If an investor recognizes an excess distribution in equity in earnings, we believe that generally it should discontinue applying the equity method and suspend recognizing its share of the investee's future earnings until the total of those unrecognized earnings exceeds the excess distribution previously recognized in earnings. This approach is similar to the approach an investor uses when resuming equity method accounting after suspending its recognition of equity method losses when its investment account has been reduced to zero (see [section 4.4](#)).

The SEC staff has expressed a similar view on when it is appropriate for an investor to recognize excess distributions in earnings. The staff has indicated that it would not object to an equity method investor recognizing in income an excess distribution resulting from the investee's distribution of refinancing proceeds if the investor is not liable for the obligations of the investee and has not otherwise committed to provide the investee with additional financial support. [\[2008 AICPA Conf\]](#)

We believe that an investor should disclose its accounting policy for investee distributions.

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## 4.7 Lag periods and different fiscal years



### Excerpt from ASC 323-10

**35-6** If financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

The investor recognizes its share of the investee's earnings or losses based on the investee's US GAAP financial statements. In some cases, the investee does not prepare its US GAAP financial statements timely enough for the investor to apply the equity method as of the same date as its financial statements.

In that case, the investor may use the investee's most recent financial statements, even when a lag exists, if: [323-10-35-6, 810-10-45-12]

- the lag does not exceed 93 days;
- the lag is consistent from period to period, including for quarterly and annual reporting periods; and
- the investee's most recent financial statements have been prepared for a reporting period of equal length to the investor's reporting period.

The inability to obtain timely financial information from an investee, either currently or on a lag basis, may suggest that an investor does not have the ability to exercise significant influence over the investee.



### Question 4.7.10

**How does an investor that applies lag reporting compute its equity in earnings in the first and last period of its investment?**

**Interpretive response:** We believe the investor should not recognize its share of investee earnings that (1) arose before it acquired the investment or (2) are reported to the investor after it disposed of the investment. This convention will result in the investor recognizing its share of the investee's earnings for a shorter period than the investor's ownership period.



### Example 4.7.10

**Lag reporting in the acquisition and disposition periods**

Investor invests in Investee on June 1 and will account for its investment under the equity method. Investor will recognize its share of Investee's earnings on a two-month lag.



### Period before acquisition

For its reporting period ended June 30, Investor has access to Investee's financial results only through April 30. We believe Investor should recognize no equity in earnings of Investee for its June 30 reporting period because it has no right to Investee's earnings reported through April 30.

In Investor's quarter ended September 30, it recognizes its share of Investee's earnings based on Investee's latest financial information – i.e. July 31 (a two-month lag), but only for the period of time that Investor has held the investment – i.e. June and July.

### Period after sale

In the period that Investor sells its investment, it recognizes its share of Investee's earnings or losses based only on Investee's financial information available at the date of disposal.

Investor sells its investment on May 31 of the following year and recognizes in its June 30 financial statements its share of Investee's earnings for February and March, because March is the last period of Investee's financial information available to Investor as of the May 31 sale date.

Investor does not report equity in earnings of Investee in its quarter ended September 30, even though Investee presumably has financial information available for April and May.

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#### Question 4.7.20

**How does an investor recognize equity in earnings for quarterly reporting when the investee does not report quarterly?**

**Interpretive response:** If an investor has exhausted all efforts to obtain the investee's interim financial information, we believe it should estimate its share of the investee's earnings or losses for the interim period. The investor should base its estimate on all information available to it through interaction with the investee.

An investor's inability to obtain reliable interim results from its investee may call into question whether the investor has the ability to exercise significant influence over the investee.

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#### Question 4.7.30

**May an investor recognize equity in earnings when the investee reports interim results on a lag but annual results without a lag?**

**Interpretive response:** No. If an investor reports its share of investee earnings on a lag for interim reporting, we believe it should continue to report on a lag for annual reporting. This would be true even if the investee's annual financial

information is available before the investor issues its annual financial statements.

Topic 323 requires lag reporting to be consistent from period to period. We believe departing from lag reporting for annual financial statements, while still reporting interim periods on a lag basis, produces inconsistent results from interim period to interim period, and from the interim periods to the annual period. [323-10-35-6]

For example, a calendar year-end investor began the year reporting its interim results for an investee on a quarter lag; its first quarter equity in earnings was based on the investee's fourth quarter results. If the investor then tried to eliminate the lag for its annual reporting period, it would need to recast its first quarter results to recognize its equity in earnings based on the investee's first quarter results. We believe Topic 323's requirement to apply a consistent lag period addresses this complication.

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#### Question 4.7.35

**If an investor applies lag reporting for one investment, must it do so for all its investments?**

**Interpretive response:** No. We believe an investor's use of lag reporting is specific to each individual investment.

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#### Question 4.7.40

**How does an investor that recognizes its share of investee earnings on a lag report the investee's adoption of a new accounting standard?**

**Interpretive response:** We believe that an investor that recognizes its share of the investee's earnings on a lag also should report the effects of the investee's change in accounting principle on a lag.

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#### Example 4.7.20

**Lag reporting – new accounting standard**

Investor and Investee are calendar year-end private companies that are required to adopt ASU 2016-13, Measurement of Credit Losses on Financial Instruments, on January 1, 2023. On adopting ASU 2016-13, both companies expect to recognize a cumulative effect adjustment to transition from measuring credit losses under Topic 310 to new Topic 326.

Investor applies the equity method to its investment in Investee and both companies prepare quarterly information; however, Investor includes its share of Investee's earnings on a quarter lag.

In its quarter ended March 31, 2023, we believe Investor should continue to recognize its share of Investee's credit losses that arose during the period from October 1, 2022 to December 31, 2022, which are measured under Topic 310, because it reports Investee's results on a quarter lag.

In its quarter ended June 30, 2023, we believe Investor should reflect Investee's adoption of ASU 2016-13 and recognize its share of Investee's cumulative-effect adjustment in its retained earnings.



#### Question 4.7.50

#### How does an investor account for changes in the lag period?

**Interpretive response:** An investor reports a change to (or elimination of) a lag period as a change in accounting principle under Topic 250. Topic 250 requires a reporting entity to retrospectively apply a voluntary change in accounting principle, unless it is impracticable to do so. In addition, the investor needs to demonstrate that the change is preferable and provide the required Topic 250 disclosures. [810-10-45-13, 250-10-45-9 – 45-40, 50-1 – 50-3]

Chapter 3 of KPMG Handbook, [Accounting changes and error corrections](#), provides guidance on accounting changes.



#### Question 4.7.55

#### How does an investor consider material intervening events during the lag period?

**Background:** There may be events that arise during the lag period that have a material impact on the financial statements of the investor and the investee. Topic 323 does not provide specific guidance on how an investor should consider these material intervening events.

**Interpretive response:** We believe an investor should disclose all material intervening events.

We also understand that some investors analogize to Topic 810, which indicates when consolidating on a lag that "recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations." Therefore, in limited circumstances it may be acceptable to recognize such events in the financial statements. However, consistent with [Question 4.7.60](#), an investor should not adjust for current valuations of assets after the lag period – i.e. an adjustment that the investee has not yet recognized – or events that would result in more than 12 months of earnings or expenses in order to keep the lag period consistent. [810-10-45-12]

While an investor generally would not adjust the investee's underlying financial information for circumstances that arise after the end of the lag period, it should consider that information when evaluating its investment for other-than-

temporary impairment. We do not believe Topic 323's guidance that permits an investor to use underlying investee financial information on a lag extends to the investor-level impairment analysis. As a result, we believe an investor should evaluate the investment for other-than-temporary impairment at the investor's reporting date based on the conditions existing as of that date (see [Question 5.5.10](#)). If an impairment is other-than-temporary, we believe the investor should reduce the carrying amount of its investment to its fair value as of the investor's reporting date.

For example, Investee reports on a one-month lag and Investor identifies an other-than-temporary impairment on March 31. The investor reduces the carrying amount of its investment as of March 31 to its fair value on that date, not its fair value on February 28.



#### Question 4.7.60

#### How does an investor account for a current valuation when the investee reports on a lag?

**Interpretive response:** Because an investor that uses lag reporting must reflect a consistent lag each period, we do not believe it should adjust the investee's financial information for the effects of a current valuation – i.e. one that the investee has not yet recognized – when it recognizes its share of the investee's earnings. However, the investor should consider whether disclosure is appropriate.



#### Example 4.7.30

#### Lag reporting – periodic investee valuations

Investor holds an equity investment in Investee and reports its share of Investee's earnings on a one-month lag. Investor and Investee have calendar year-ends and prepare monthly and quarterly financial information.

Investee is a financial institution that holds mortgage servicing rights. Investee uses an external firm to value those rights at the end of each calendar quarter. The external firm sends copies of its quarterly valuation report to Investee and Investor.

On July 25, Investor and Investee receive the external firm's June 30 valuation.

When preparing its June 30 financial statements, Investor should include its share of Investee's earnings for the three months ended May 31 – i.e. on a one-month lag. That financial information includes adjustments that Investee made to the mortgage servicing assets based on the March 31 valuation.

Investor should not adjust Investee's underlying earnings through May 31 for the June 30 valuation when it computes its share of Investee's earnings.

However, if Investor expects the June 30 valuation to have a material effect on its September 30 financial statements, it should disclose that information in its June 30 notes to the financial statements.

While Investor should not adjust Investee's results through May 31 when computing its share of Investee's earnings through June 30, it should consider whether the June 30 valuation report suggests a potential impairment of its investment in Investee at June 30. If so, Investor should perform an impairment analysis and recognize any other-than-temporary impairment in its June 30 financial statements based on the fair value of its investment as of June 30.

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#### Question 4.7.61

**How does an investor that applies lag reporting compute equity in earnings after an other-than-temporary impairment?**

**Interpretive response:** We believe an investor that applies lag reporting computes equity in earnings after the impairment charge in the same manner it did before the impairment charge – i.e. on a lag.

However, when an investor recognizes an impairment charge, its overall basis difference – i.e. the difference between the carrying amount of its investment and its share of the investee's underlying net assets – changes. As discussed in [Question 5.5.40](#), we believe there are at least two acceptable approaches for allocating an other-than-temporary impairment charge to the basis differences associated with each of the investee's underlying assets and liabilities.

Under the first method, an investor allocates the impairment first to equity method goodwill, next to the basis differences associated with long-lived assets on a pro-rata basis and last to the basis differences associated with the remaining assets in a systematic and rational manner.

Under the second method, an investor first prepares a new memo purchase price allocation to newly identify basis differences, next adjusts its existing basis differences to match the new basis differences and last allocates the remainder to equity method goodwill.

After the investor allocates its other-than-temporary impairment charge to the individual basis differences, it subsequently accounts for those basis differences as if the investee was a consolidated subsidiary (see [section 5.3](#)). The investor recognizes in its equity in earnings of the investee adjustments to those basis differences in the same periods that the investee makes adjustments to depreciate, deplete, impair, amortize or accrete the related underlying assets or liabilities.

There may be other acceptable approaches.

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#### Example 4.7.35

**Lag reporting – other-than-temporary impairment**

##### Year 1

On January 1, Year 1, Investor acquires a 20% interest in Investee for \$1,000,000.

Investee's net book value, fair value and Investor's share of each are summarized in the following table.

	Fair value	Net book value	Difference
Investee's net assets	\$5,000,000	\$4,000,000	\$1,000,000
Investor's ownership interest	20%	20%	20%
<b>Investor's share of Investee's net assets</b>	<b>\$1,000,000</b>	<b>\$ 800,000</b>	<b>\$ 200,000</b>

The excess of Investor's investment over its share of Investee's net book value is \$200,000.

When performing its memo purchase price allocation, Investor:

- attributes \$150,000 of the \$200,000 excess to a building owned by Investee (which has a remaining useful life of 25 years); and
- attributes \$50,000 of the excess to land.

Income taxes are ignored in this example.

Investor and Investee are calendar year-end companies and Investor includes its share of Investee's earnings on a quarter lag. Investor also recognizes its basis differences on a lag (see [Question 4.7.70](#)).

At September 30, Year 1, Investee has reported break-even results, which reflects its operations through June 30. Investor has recognized a \$3,000 charge to equity in earnings of Investee related to the amortization of its basis difference associated with the building:  $(\$150,000 \text{ basis difference} \div 25 \text{ year remaining useful life}) \times 6/12$ .

Also in September, Investee experiences the loss of a major customer, triggering Investor to analyze whether there has been a potential loss in value of its investment.

At September 30, Year 1, Investor determines that:

- the fair value of its investment is \$750,000; this is \$247,000 less than its carrying amount of \$997,000 (\$1,000,000 cost minus \$3,000 in basis difference amortization); and
- the impairment is other-than-temporary.

Investor allocates the \$247,000 other-than-temporary impairment on a pro rata basis to the basis differences in the building and the land. The allocation of the impairment loss and the adjustments to Investor's basis differences are as follows.

	Unadjusted basis diffs Sept. 30, Year 1	Impairment loss allocation	Adjusted basis diffs Sept. 30, Year 1
Land	\$ 50,000	\$ 62,690 <sup>1</sup>	\$ (12,690)
PP&E (building)	147,000	184,310 <sup>2</sup>	(37,310)
	<b>\$197,000</b>	<b>\$247,000</b>	<b>\$ (50,000)</b>

Notes:
1. $\$50,000 / \$197,000 \times \$247,000$ .
2. $\$147,000 / \$197,000 \times \$247,000$ .

Investor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Equity in earnings of Investee	247,000	
Investment in Investee		247,000
<i>To recognize impairment of investment in Investee.</i>		

Investor’s share of Investee’s earnings for the period from January 1 to June 30, Year 1 is zero. This is true because Investee reported break-even results for that period.

After the other-than-temporary impairment, Investor’s carrying amount is summarized in the following table.

Carrying amount at January 1	\$1,000,000
Basis difference amortization through June 30	(3,000)
Other-than temporary impairment	(247,000)
<b>Carrying amount at September 30</b>	<b>\$ 750,000</b>

## Year 2

At December 31, Year 1, Investor receives Investee’s September 30 results. Through September 30, Year 1, Investee has reported break-even results except for an impairment of its long-lived assets.

At September 30, Year 1, Investee determined that:

- the undiscounted cash flows of its only asset group (comprising the PP&E and the land) are not sufficient to recover its carrying amount; and
- the fair value of its asset group is \$3,750,000; this is \$250,000 less than its carrying amount of \$4,000,000.

Investee recognizes a \$250,000 impairment charge on its long-lived assets. Investor’s share is \$50,000 ( $\$250,000 \times 20\%$ ).

After recognizing the impairment, Investee’s net book value, fair value and Investor’s share of each are summarized in the following table.

	Fair value	Net book value	Difference
Investee’s net assets	\$3,750,000	\$3,750,000	\$ 0
Investor’s ownership interest	20%	20%	20%
<b>Investor’s share of Investee’s net assets</b>	<b>\$ 750,000</b>	<b>\$ 750,000</b>	<b>\$ 0</b>

Investor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Equity in earnings of Investee	50,000	
Investment in Investee		50,000
<i>To recognize Investor's share of Investee's loss.</i>		

After recognizing its share of Investee's impairment charge, Investor's carrying amount is \$700,000 (\$750,000 – \$50,000). Its share of Investee's net assets is \$750,000 and its basis difference is (\$50,000).

As discussed in [Question 4.7.61](#), Investor recognizes in its equity in earnings of Investee an adjustment to its basis differences in the same period that Investee makes the adjustment to impair the related underlying assets.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	50,000	
Equity in earnings of Investee		50,000
<i>To recognize the elimination of Investor's basis difference.</i>		

After Investor records the above journal entries, its carrying amount is summarized in the following table.

Carrying amount at September 30	\$ 750,000
Equity in earnings of Investee	(50,000)
Basis difference adjustment	50,000
<b>Carrying amount at December 31</b>	<b>\$ 750,000</b>



### Question 4.7.70

**How does an investor account for its basis differences when the investee reports on a lag?**

**Interpretive response:** We believe an investor may apply either of the following approaches but must apply its approach consistently.

#### **Basis differences on a lag**

Under this approach, the investor amortizes its basis differences in the same period that the investee amortizes the related underlying assets and liabilities – i.e. the basis difference amortization is also reported on a lag.

This approach integrates the accounting for the investor's basis differences with the investee's underlying assets and liabilities. Therefore, it results in the



investor reporting an amount of equity in earnings that is more consistent with what it would report if the investee were a consolidated subsidiary.

An investor that uses this approach does not recognize basis difference amortization in the period it acquires the investment. This is because it does not recognize its share of the investee's earnings or losses in that period (see [Question 4.7.10](#)).

#### **Basis differences without a lag**

Under this approach, the investor begins amortizing its basis differences immediately on acquisition.

This approach separates the accounting for the investor's basis differences from the accounting for the investee's underlying assets and liabilities. Topic 323 allows an investor to recognize its share of the investee's financial results on a lag (and consistently apply that lag). However, supporters of this approach believe that the guidance does not extend to the investor-level basis difference amortization.

An investor that uses this approach recognizes basis difference amortization in the period it acquires the investment even though it does not recognize its share of the investee's earnings or losses in that period (see [Question 4.7.10](#)).



#### **Question 4.7.75**

**At what rate should an investor translate a foreign investee's financial statements when the investee reports on a lag?**

**Interpretive response:** We believe the investor should translate a foreign investee's financial statements using the latest reporting date of the investee – i.e. the lag date.

While we do not believe the investor should adjust its translation for the effects of changes in exchange rates after the lag date, it should consider whether disclosure is appropriate.

[Question 5.3.50](#) provides additional guidance on translating investee financial statements.



#### **Question 4.7.80**

**How does an investor compute its share of the investee's earnings if the investee has a different fiscal year end?**

**Interpretive response:** Similar to an investor that reports investee activity on a lag because more recent information is not available, we believe that for an investor and investee with different year-ends, the investor should use the most recent investee financial information available when computing its share of the investee's earnings or losses.

If the most recent investee financial information available to the investor is the information that the investee prepared at its fiscal period-end, we believe the investor may use that information if the investee's fiscal period-end does not differ by more than three months from the investor's. If the difference is more than three months, the investor should obtain from the investee more recent financial information to compute its share of the investee's earnings.

This approach is consistent with the guidance in Topic 810 that indicates that a parent generally may consolidate subsidiary financial information if the difference in the reporting periods is not more than about three months. [323-10-35-6, 810-10-45-12]

An investor should consider disclosing the existence of different year-ends and intervening events that may materially affect its financial position or results of operations.

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#### Example 4.7.40 Different fiscal years (1)

Investee has a March 31 year-end and provides monthly and quarterly financial statements to Investor on a one-month lag. Investor has a December 31 year-end.

Investor should use Investee's November 30 financial statements to compute its share of Investee's earnings for its December 31 year-end financial statements. Investor includes Investee's operations from December 1 to November 30 in its annual financial statements even though Investee's fiscal year is April 1 to March 31.

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#### Example 4.7.50 Different fiscal years (2)

Investee has a January 31 year-end and provides monthly and quarterly financial statements to Investor. Investor has a December 31 year-end and Investee's monthly financial statements arrive in time for Investor to compute its share of Investee's earnings for the same period as its reporting period.

Because Investee's December monthly financial statements arrive in time for Investor's December reporting, Investor does not need to report Investee's activity on a lag.

Investor should use Investee's December financial statements to compute its share of Investee's earnings for its December 31 year-end financial statements. Investor includes Investee's operations from January 1 to December 31 in its annual financial statements even though Investee's fiscal year is February 1 to January 31.

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### Example 4.7.60 Different fiscal years (3)

Investee has a September 30 year-end and provides quarterly and annual financial statements to Investor. Investor has a December 31 year-end and Investee's quarterly financial information does not arrive in time for Investor to compute its share of Investee's earnings for the same period as its reporting period.

Investor should use Investee's September 30 financial statements to compute its share of Investee's earnings for its December 31 year-end financial statements. Investor includes Investee's operations from October 1 to September 30 in its annual financial statements.

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# 5. Recognizing investor-level adjustments

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**New items added in this edition: \*\***

**Items significantly updated in this edition: #**

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### 5.2 Intra-entity profits and losses

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**Example**

- 5.5.10 Impairment of an equity method investment

## 5.1 How the standard works

Under the equity method, an investor periodically adjusts the carrying amount of its investment for:



The investor generally recognizes each component in the same way it would if the investee were a consolidated subsidiary.

Chapter 4 discusses how the investor recognizes its share of the investee’s underlying financial activity – i.e. earnings and losses, OCI and capital transactions.

This chapter focuses on how the investor adjusts its share of the investee’s activity to arrive at total equity in earnings of the investee.

Investor-level adjustment	Investor accounting
<b>Intra-entity eliminations</b>	Investor generally eliminates some or all intra-entity profits and losses on asset transfers until realized by the investor or investee in transactions with third parties.
<b>Basis differences</b>	Investor adjusts equity in earnings for changes in the basis differences identified in its memo purchase price allocation completed on acquisition.  Typical adjustments include depreciation, depletion, amortization, and accretion for differences between the investor’s share of the fair value of the investee’s identifiable assets and assumed liabilities and their carrying amounts in the investee’s US GAAP financial statements.
<b>Equity method goodwill</b>	Investor does not amortize equity method goodwill unless it applies the accounting alternative for private companies and NFPs, which generally requires a 10-year amortization period.
<b>Other-than-temporary impairment</b>	If investor determines that the fair value of an equity method investment is less than its carrying amount at the reporting date and the impairment is other-than-temporary, it reduces the carrying amount of the investment to its fair value. The charge to the income statement is recognized through equity in earnings of the investee.

In this chapter, we refer to the following additional Topics and Subtopics only by their Codification reference.

- Subtopic 205-20, Presentation of Financial Statements—Discontinued Operations
- Topic 255, Changing Prices
- Topic 280, Segment Reporting
- Topic 321, Investments—Equity Securities

- Topic 323, Investments—Equity Method and Joint Ventures
- Subtopic 323-740, Investments—Equity Method and Joint Ventures—Income Taxes
- Topic 350, Intangibles—Goodwill and Other
- Subtopic 350-20, Intangibles—Goodwill and Other—Goodwill
- Topic 360, Property, Plant, and Equipment
- Topic 606, Revenue from Contracts with Customers
- Subtopic 610-20, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets
- Topic 740, Income Taxes
- Topic 805, Business Combinations
- Subtopic 805-50, Business Combinations—Related Issues
- Topic 810, Consolidation
- Topic 815, Derivatives and Hedging
- Topic 820, Fair Value Measurement
- Subtopic 825-10, Financial Instruments—Overall
- Topic 830, Foreign Currency Matters
- Topic 835, Interest
- Topic 845, Nonmonetary Transactions
- Topic 850, Related Party Disclosures
- Subtopic 970-323, Real Estate—General—Investments—Equity Method and Joint Ventures
- Subtopic 970-835, Real Estate—General—Interest
- Topic 980, Regulated Operations



## 5.2 Intra-entity profits and losses



### Excerpt from ASC 323-10

- > Intra-Entity Gains and Losses

**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.

**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).



### Excerpt from ASC 323-30

**25-2** The elimination of intra-entity profits and the accounting for income taxes as provided for in paragraph 323-10-35-7 shall also apply to unincorporated joint ventures.



### Excerpt from ASC 970-323

• > Other Considerations

**35-22** Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) shall be accounted for as distributions rather than as interest income by the investors.



### Excerpt from ASC 970-835

> Income from Loans or Advances to a Venture

**35-1** An investor-lender that does not capitalize interest on its own real estate construction and development projects (see Subtopic 835-20) shall account for interest on loans and advances that are not in substance capital contributions in accordance with the following recommendations:

- a. All interest income on the investor's loans or advances to the venture shall be deferred if either of the following conditions is present:
  1. Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.
  2. There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.
- b. If neither of the conditions in (a) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture shall be recorded as earned.
- c. If the conditions in (a) or (b) are not present, a portion of interest income from loans and advances to a venture shall be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed in paragraphs 970-323-35-

8 through 35-10 for recording the investor’s share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.

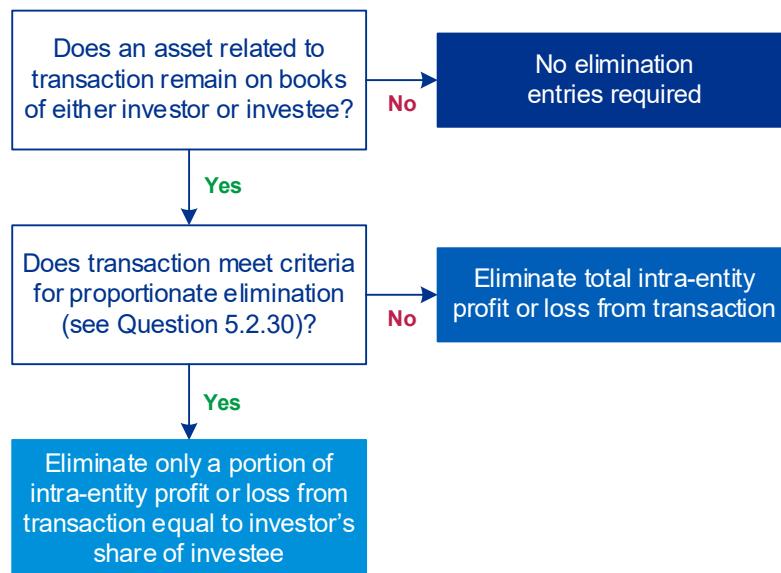
See paragraph 970-323-35-22 regarding situations where certain amounts of interest are accounted for as distributions rather than as interest income.

An investor and investee may agree to execute transactions outside the investment relationship that will generate an ‘intra-entity’ income or loss. Those transactions can take many forms, including asset sales (e.g. inventory, nonfinancial assets, businesses), lending and other financial relationships, and service contracts.

**Question 5.2.10**  
**What conditions result in the investor eliminating intra-entity profit or loss?**

**Interpretive response:** Whether an investor eliminates no, some or all intra-entity profit in a transaction with an investee depends on the nature of their relationship and the asset or service transferred.

The following decision tree provides guidance for how the investor generally accounts for transfers of assets and services to or from its investee after the transferor has concluded that revenue recognition is appropriate under Topic 606.



The decision tree does not apply to the following investor/investee transactions, including when the investee is a JV. [323-10-35-7]

Transaction	Applicable US GAAP
<b>Investee share transactions</b>	Guidance in Topic 323 on increases and decreases of ownership; such transactions are discussed in <a href="#">chapter 6</a> because they may affect the level of ownership. [323-10-35-36, 40-1]
<b>Investor’s transfer of a subsidiary (or group of assets that is a business or non-profit activity) to investee</b>	Guidance in Topic 810 on changes in ownership, including the deconsolidation of a subsidiary. [323-10-35-7(a) – 35(7)(b), 810-10-40-3A – 40-5, 45-21A – 45-24]  Section 7.6 of KPMG Handbook, <a href="#">Consolidation</a> , provides additional guidance.
<b>Investor’s transfer of a nonfinancial asset to noncustomer investee</b>  <b>Investor’s transfer of a subsidiary that (1) is not a business and (2) holds only nonfinancial assets and in-substance nonfinancial assets, to noncustomer investee</b>	Guidance in Subtopic 610-20 on accounting for transfers of nonfinancial assets and in-substance nonfinancial assets to noncustomers. [323-10-35-7(c), 610-20-32-2 – 32-6]  <a href="#">Questions 5.2.100</a> and <a href="#">5.2.130</a> and sections A, D and F of KPMG Handbook, <a href="#">Revenue: real estate</a> , provide additional guidance.

**Question 5.2.20#**  
**When does an investor eliminate intra-entity profit or loss?**

**Interpretive response:** The investor partially or totally eliminates from the balance sheet and income statement intra-entity profits or losses arising from transactions with its investee only when assets from the intra-entity transaction remain with either the investor or the investee. The investor recognizes the ‘unearned intra-entity profit’ when the asset is: [323-10-35-7 – 35-11]

- sold to a third party – typically is the case for inventory; or
- realized through consumption of the asset in the purchaser’s operations – typically is the case for a sale of depreciable nonfinancial assets to a customer).

The assets affected are those that are the subject of the intra-entity transaction (e.g. inventory sold between the investor and investee) and typically generate profit or loss on transfer. If assets associated with the sale do not remain with the investor or investee, the investor does not eliminate the profit or loss. [323-10-35-7 – 35-12]

Regardless of whether an investor eliminates some or all of the intra-entity profit or loss, it must recognize the tax effects of the transfer. These effects may include the investor recognizing:

- current taxes on the sale (see [Question 5.2.150](#));
- deferred taxes related to the asset sold (see [Question 5.2.150](#)); and

- deferred taxes on the change to the investor's outside basis difference in its investment because of the profit deferral (see [Questions 3.3.100](#) and [5.3.30](#)).

In addition, Topics 323 and 825 do not specifically address the elimination of intra-entity profit or loss when an investor elects the fair value option for a would-be equity method investment. If an investor elects the fair value option, we believe the investor should not eliminate any intra-entity profit or loss arising from transactions with its investee. See [Question 2.3.20](#) for additional guidance related to the fair value option.



### Question 5.2.30

#### How much intra-entity profit or loss does an investor eliminate?

**Interpretive response:** When assets associated with an intra-entity transaction remain with the investor or investee in either a downstream (investor sale to investee) or upstream (investee sale to investor) transaction, the investor generally eliminates only its share of an intra-entity profit and recognizes in equity in earnings the remainder (if the criteria for profit recognition are met – e.g. under Topic 606).

This differs from a parent's accounting for transactions with a subsidiary because Topic 810 requires the parent to eliminate all of the intra-entity profit or loss. [[323-10-35-7](#), [35-9](#), [35-11](#), [323-30-25-2](#)]

However, an investor must eliminate all intra-entity profit if the: [[323-10-35-7](#), [35-10](#), [323-30-25-2](#)]

- investor controls the investee through voting interests or other similar contractual means but does not consolidate the investee; and
- intra-entity transaction is not executed at arm's length (see [Question 5.2.170](#)).

If both conditions are met, the investor does not recognize in its financial statements any of the profit from the transfer until it is realized in a transaction with a third party.

Because Topic 810 requires an investor to consolidate an entity in which it holds a *controlling financial interest*, we believe it is unusual for an equity method investor to *control* the investee through voting interests or other means such as: [[323-10-35-10](#)]

- guarantees of indebtedness;
- extension of credit;
- other special arrangements with the investee for its benefit; or
- ownership by the investor of investee warrants, convertible securities, etc.

However, there may be circumstances in which an investor does not have a controlling financial interest in an investee but does conclude it has sufficient control of the investee to require full profit elimination. Evaluating whether the investor's control over the investee is sufficient to require full intra-entity profit elimination when a transaction is not at arm's length requires judgment. An

investor considers all relevant facts and circumstances when evaluating those situations.

An investor cannot presume that a transaction with its equity-method investee has been carried out at arm's length because investees are related parties under Topic 850. [323-10-35-10, 850-10-20, 50-5]



### Question 5.2.40

#### What is the appropriate financial statement presentation for unearned intra-entity profit?

**Interpretive response:** An investor may defer an intra-entity profit with a credit to: [323-10-55-28 – 55-29]

- the equity method investment balance;
- inventory (or long-lived assets); or
- unearned revenue (or similar account) for downstream sales.

#### Upstream sales

In an upstream sale, we believe an investor should record the elimination of intra-entity profit as a reduction to the carrying amount of its equity method investment in the investee, or the carrying amount of the asset purchased.

In the income statement, we believe an investor should record the elimination of intra-entity profit as a reduction to equity in earnings of the investee.

When the profit is ultimately realized (at a point in time through a sale with a third party or over time through consumption of the asset), we believe the investor should recognize the profit in a manner consistent with its balance sheet presentation. For example, if the investor reduces its PP&E account for unearned intra-entity profit, it generally recognizes the periodic reduction of that unearned profit with a credit to depreciation expense. If the investor reduces its investment account for unearned intra-entity profit, it generally recognizes the periodic reduction of that unearned profit with a credit to equity in earnings of the investee.

#### Downstream sales

In a downstream sale, we believe an investor generally should record the elimination of intra-entity profit as a reduction to the carrying amount of its equity method investment in the investee, even if the amount causes a negative investment balance that is presented as a liability.

This is because the asset transferred (e.g. inventory or PP&E) is recognized on the investee's financial statements at the investee's cost, which includes the intra-entity profit. By reducing the carrying amount of its investment, the investor effectively reduces the carrying amount of that asset in its memo accounts.

While we believe an investor generally should reduce its investment account to eliminate the intra-entity profit in a downstream sale, unearned revenue presentation also is acceptable.

In the income statement, we believe an investor generally should record the elimination of intra-entity profit and subsequent recognition as an adjustment to equity in earnings of the investee or revenue. By adjusting revenue at the sale date, the investor effectively reflects the transaction as a sale of the asset at cost to the extent of its ownership interest. Other income statement presentation approaches may also be acceptable, depending on the facts and circumstances.

### Disclosures

Topic 850 includes an equity method investee in the definition of related party. As a result, an investor that executes a significant intra-entity transaction with its investee should consider whether it is required to disclose the transaction under that Topic. [850-10-20, 50-1 – 50-6]



### Example 5.2.10

#### Upstream intra-entity transaction with proportionate elimination

Investor, a vacuum manufacturer, owns 40% of Investee’s common stock, and accounts for its investment under the equity method. Investor does not control Investee through a majority voting interest or by any other means.

On January 1, Year 1, Investee contracts with Investor to produce 100 vacuum motors for Investor. Investee charges Investor \$50 for each vacuum motor delivered, which results in Investee earning a \$10 profit for each motor (Investee’s cost basis is \$40 per motor).

By March 1, Year 1:

- Investee delivered to Investor all 100 motors and recognized the related revenue under Topic 606.
- Investor sold 50 vacuums that contained the motors produced by Investee.
- Investor had 50 motors remaining in its work-in-progress inventory.

#### Investor’s accounting

Investor eliminates its proportionate share of Investee’s profit related to the 50 motors that remain in its inventory. Investor does not eliminate the profit:

- on the 50 motors it purchased from Investee and sold to third parties (as part of the vacuums); or
- attributable to the other investors’ 60% ownership interest in the 50 motors that remain in Investor’s inventory.

Investor computes its elimination entry as follows.

Motors remaining in Investor’s raw materials inventory	50
Investee profit per motor	\$ 10
Investee profit on Investor’s unsold motors	\$500
Investor’s ownership percentage in Investee	40%
<b>Amount of profit to eliminate</b>	<b>\$200</b>

### Scenario 1: Unearned intra-entity profit eliminated against investment

Investor records the following journal entry to eliminate the unearned intra-entity profit.

	<i>Debit</i>	<i>Credit</i>
Equity in earnings of Investee	200	
Investment in Investee (unearned profit)		200
<i>To eliminate unearned intra-entity profit.</i>		

Investor's elimination entry reduces its share of Investee's results of operations and its share of Investee's underlying net assets. Investor's raw materials inventory balance still includes the embedded profit on the 50 unsold motors.

The following is Investor's inventory account activity.

Purchase of 100 motors for \$50/motor	\$ 5,000
Cost of goods sold for 50 motors	(2,500)
<b>Ending balance</b>	<b>\$ 2,500</b>

Investor's ending inventory account equals Investee's selling price (and Investor's cost basis) for the 50 unsold motors: 50 motors × \$50 per motor.

### Scenario 2: Unearned intra-entity profit eliminated against inventory

If Investor had elected to reduce inventory instead of the investment, it would record the following journal entry to eliminate the unearned intra-entity profit.

	<i>Debit</i>	<i>Credit</i>
Equity in earnings of Investee	200	
Inventory (unearned profit)		200
<i>To eliminate unearned intra-entity profit.</i>		

The following is Investor's inventory account activity.

Purchase of 100 motors for \$50/motor	\$ 5,000
Cost of goods sold for 50 motors	(2,500)
Unearned profit elimination	(200)
<b>Ending balance</b>	<b>\$ 2,300</b>

Investor's ending inventory account would equal the 50 unsold motors times Investee's cost basis plus 60% (ownership of Investee held by other investors) of Investee's profit – i.e.  $\$2,300 = 50 \times \$40 + (60\% \times \$500)$ .





### Question 5.2.50

#### Does the investee also eliminate the profit or loss associated with intra-entity transactions?

**Interpretive response:** No. Only the investor eliminates the profit on downstream and upstream intra-entity transactions. However, the investee's transaction with the investor is a related party transaction that may be subject to disclosure under Topic 850. [850-10-20, 50-1 – 50-6]



### Question 5.2.60

#### Should an investor eliminate profit or loss on an upstream or downstream consumed service transaction?

**Interpretive response:** No. An investor generally does not eliminate intra-entity profit on sales or purchases of consumed services because intra-entity profits normally are eliminated only when assets resulting from the transfer remain on the investor's or investee's financial statements. [323-10-35-7 – 35-12]

However, an investor does eliminate intra-entity profit on service transactions if the related costs are capitalized (see [Question 5.2.120](#)).



### Example 5.2.20

#### Upstream consumed service transaction

Investor executes an agreement with Investee to move Investee's products from Dallas to New Orleans for \$100. Investor owns 30% of Investee's common stock, and accounts for its investment under the equity method.

Investor completes the service and Investee pays Investor in the normal course of business. Investor does not eliminate any portion of the intra-entity transaction with Investee. It recognizes:

- revenue of \$100 when control of the services transfers to Investee; and
- as a reduction in equity in earnings, \$30 (Investee's \$100 cost × 30%) for its share of Investee's cost to hire Investor.



### Question 5.2.65

#### Does an investor eliminate lease income or expense on an intra-entity operating lease?

**Interpretive response:** No. We believe an investor should not eliminate lease income or expense because the intra-entity operating lease is analogous to a consumed service transaction (see [Question 5.2.60](#)).

Further, we believe an investor should not eliminate a right-of-use asset if it is the lessee in the intra-entity operating lease because:

- ownership and ongoing recognition of the leased asset remains with the investee as lessor (see [Question 5.2.20](#)); and
- the right-of-use asset and lease liability do not represent the capitalization of a previously provided service cost (see [Question 5.2.120](#)).



### Question 5.2.70

#### Does an investor eliminate profit or loss on an intra-entity derivative transaction?

**Interpretive response:** No. Investors do not eliminate intra-entity profit on intra-entity derivative transactions. This is because these transactions do not involve the sale of an asset that generates a profit or loss. [[323-10-35-7](#) – [35-12](#)]



### Question 5.2.80#

#### How does an investor account for interest on loans and advances to or from an investee?

**Interpretive response:** We believe the guidance for an investor's accounting for loans and advances to an investee that is a real estate venture generally also applies to lending transactions with other equity method investees. We also believe that guidance may be analogous for loans from an investee.

#### Loans and advances to an investee

For loans and advances to an investee, Subtopic 970-323 requires an investor to first determine whether all the investors in the investee are required to make loans and advances proportionate to their equity interests. If so, these amounts may be in-substance capital contributions. If they are, the investor accounts for the interest received similar to a dividend – i.e. the investor reduces its equity method investment rather than recognizing the amount as interest income. [[970-323-35-22](#)]

Subtopic 970-835 provides the following guidance on the investor's accounting for loans and advances that are not in-substance capital contributions.

1. An investor defers interest income on the loan if (a) collectibility of principal or interest is in doubt or (b) there is a reasonable expectation that the other investors will not bear their share of losses. [[970-835-35-1\(a\)](#)]
2. If neither of the conditions in 1. are met, the investor recognizes interest income as earned if the investee (a) records interest as an expense or (b) capitalizes interest, but the investor recognizes its equity in earnings amounts as if the investee has recognized interest expense to conform to the investor's accounting policies. [[970-835-35-1\(b\)](#)]
3. If neither of the previous two accounting outcomes apply, the investor defers a portion of the interest income based on its ownership interest in the investee. (An example of 2. not applying is when the investee

capitalizes interest and the investor does not adjust for it in its equity method pick-up.) However, an evaluation similar to that discussed in paragraphs 35-8 to 35-10 of Subtopic 970-323 for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan. [970-835-35-1(c)]

### Loans and advances from an investee

In contrast, Topic 970 does not address an investor's accounting for loans and advances from an investee. We believe loans from an investee to an investor and the accounting for interest should be evaluated consistently with the guidance in Subtopic 970-835 discussed above. That is, if the investor capitalizes interest paid to the investee, the investor should eliminate the intra-entity profit or loss in a similar manner to [Question 5.2.120](#).

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### Question 5.2.90

#### Does an investor eliminate profit or loss on an intra-entity sale of a business?

**Interpretive response:** No. When an investor transfers to an equity method investee a controlling financial interest in a business, it does not eliminate intra-entity profit. [323-10-35-7]

Under Topic 810, the investor deconsolidates the subsidiary by removing its net assets and recognizing a gain or loss in net income that is measured as the difference between: [810-10-40-3A, 480-10-S99]

- the aggregate of:
  - the fair value of the consideration received;
  - the fair value of any retained NCI in the former subsidiary at the date of deconsolidation; and
  - the carrying amount of NCI (excluding adjustments related to redeemable NCIs) in the former subsidiary (including AOCI attributable to the NCI) at the date of deconsolidation; and
- the carrying amount of the former subsidiary's assets and liabilities.

For additional discussion, see [Question 6.3.80](#).

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### Question 5.2.100

#### Does an investor eliminate profit or loss on a downstream intra-entity sale or contribution of a nonfinancial asset?

**Interpretive response:** It depends on whether the investee is a customer.

##### **Investee is a customer**

If an investor sells or contributes a nonfinancial asset to an investee in a customer transaction, it will apply the same guidance about profit elimination that applies to inventory sales (see [Questions 5.2.20](#) and [5.2.30](#)).

It will entirely or proportionately eliminate the intra-entity profit or loss and recognize the unearned intra-entity profit when the asset is sold to a third party – e.g. in a sale of inventory, land or other nondepreciable asset.

If the asset sold is a depreciable asset, the investor recognizes the unearned intra-entity profit over time; the profit is realized through consumption of the asset in the investee’s operations – e.g. as the asset depreciates.

If a nonfinancial asset is surrendered in a nonmonetary exchange, the investor first determines whether Topic 845 precludes profit recognition (see [Question 5.2.130](#)).

##### **Investee is a not a customer**

If an investor sells or contributes a nonfinancial asset to an investee that is not a customer, it does not eliminate the profit or loss.

Subtopic 610-20 requires an investor to measure the profit or loss on the transfer of a nonfinancial asset to a noncustomer as the difference between the amount of consideration received and the carrying amount of the nonfinancial (or in substance nonfinancial) asset. An investor applies the same guidance to the transfer of (1) an in-substance nonfinancial asset and (2) a subsidiary that is not a business and holds only nonfinancial assets and in-substance nonfinancial assets. [610-20-15-2 – 15-4, 32-2 – 32-5, 323-10-35-7(c)]

The consideration received includes the fair value of any incremental NCI in the investee that owns the asset post-sale. The incremental NCI received may take the form of additional ownership interests or increases to the investor’s capital account. The investor initially measures its incremental NCI at fair value and does not eliminate the profit or loss on the sale.

Sections A, D and F of KPMG Handbook, [Revenue: real estate](#), provide additional guidance and examples on how a seller applies Subtopic 610-20 when it retains an equity method interest in the buyer.

We believe most sales of nonfinancial assets to an equity method investee will be noncustomer transactions and therefore the investor will account for them under Subtopic 610-20.



**Example 5.2.30**  
**PP&E purchased by noncustomer investee**

Investor, a manufacturing company, owns 30% of Investee’s common stock, and accounts for its investment under the equity method.

Investor sells to Investee a tool die machine for \$1 million, which results in Investor earning a \$100,000 gain (Investor’s cost basis is \$900,000).

Investor had been using the tool die machine in its manufacturing process but has decided to discontinue the product it was producing. Investor applies Subtopic 610-20 to its sale of the machine. Because Investor applies Subtopic 610-20 to the sale, the transaction is excluded from Topic 323’s intra-entity profit elimination guidance. Investor recognizes the sale under Subtopic 610-20 as if it had sold the machine to a third party.

	<i>Debit</i>	<i>Credit</i>
Cash	1,000,000	
Net carrying amount – machine		900,000
Gain on sale – machine		100,000
<i>To recognize gain on sale of machine.</i>		



**Example 5.2.40**  
**PP&E purchased by customer investee**

Investor, a manufacturing company, owns 30% of Investee’s common stock, and accounts for its investment under the equity method.

On January 1, Year 1, Investor sells to Investee a tool die machine for \$1 million, which results in Investor earning a \$100,000 profit (Investor’s cost basis is \$900,000). Investor’s business is manufacturing tool die machines and it applies Topic 606 to its sale of the machine.

Investee is also a manufacturing company but plans to use the tool die machine to produce carpentry tools. Investee estimates that the machine has a 10-year life with a zero salvage value and plans to depreciate it on a straight-line basis.

**Investor’s accounting**

Investor applies Topic 323’s intra-entity profit elimination guidance because Topic 606 applies to the sale.

Because the tool die machine will remain on Investee’s books for an extended period (10 years), Investor will defer its profit on the intra-entity transaction and recognize it over 10 years as Investee depreciates the machine.

Investor records the following entries over the life of the machine.

**Year 1**

	<i>Debit</i>	<i>Credit</i>
Cash	1,000,000	
Cost of goods sold	900,000	
Net carrying amount – machine		900,000
Revenue – machine		1,000,000
<i>To recognize gain on sale of machine.</i>		
Revenue – machine <sup>1</sup>	30,000	
Investment in Investee (unearned profit)		30,000
<i>To eliminate Investor’s proportionate share of gain.</i>		
Investment in Investee	3,000	
Equity in earnings of Investee		3,000
<i>To recognize 1/10 of unearned intra-entity profit as Investee recognizes depreciation expense.</i>		
Note:		
1. \$100,000 profit × 30% ownership interest.		

**Each of Years 2 to 10**

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	3,000	
Equity in earnings of Investee		3,000
<i>To recognize 1/10 of unearned intra-entity profit as Investee recognizes depreciation expense.</i>		

Question 5.2.110

**Does an investor eliminate profit or loss on an upstream intra-entity purchase of a nonfinancial asset?**

**Interpretive response:** Yes. Topic 323’s exclusion from its intra-entity profit elimination guidance is limited to a transaction with an investee that is accounted for under Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets. It does not extend to a purchase transaction; investors generally account for purchases of nonfinancial assets under Topics 350 and 360. In addition, Subtopic 970-323 indicates that an investor that purchases real estate from an investee does not recognize as income its share of the investee’s profit. [323-10-35-7, 970-323-30-7]

As a result, we believe an investor must apply the intra-entity profit elimination guidance when it purchases any nonfinancial asset.

As discussed in [Question 5.2.20](#), when the investor does not expect to realize the asset's benefits through a sale transaction with third parties, but rather through consumption of the asset in its operations, it recognizes the unearned intra-entity gain over time as the asset depreciates. [\[970-323-30-7\]](#)

If a nonfinancial asset is purchased in a nonmonetary exchange, the investor first determines whether Topic 845 precludes profit recognition (see [Question 5.2.130](#)).



### Example 5.2.50 PP&E purchased by investor

Investor, a manufacturing company, owns 30% of Investee's common stock, and accounts for its investment under the equity method. Investor does not control Investee through a majority voting interest or any other means.

On January 1, Year 1, Investee sells to Investor a tool die machine for \$1 million, which results in Investee earning a \$100,000 profit (Investee's cost basis is \$900,000). Investee had been using the tool die machine in its manufacturing process but has decided to discontinue the product it was producing. Investee applies Subtopic 610-20 to its sale of the machine.

Investor plans to use the tool die machine to produce carpentry tools. Investor estimates that the machine has a 10-year life with a zero salvage value and plans to depreciate it on a straight-line basis.

#### Investor's accounting

Investor applies Topic 323's intra-entity profit elimination guidance because it does not account for the purchase under Subtopic 610-20; instead, it accounts for the transaction as an asset acquisition under Subtopic 805-50.

Because the tool die machine will remain on Investor's books for 10 years, Investor will eliminate its proportionate share (Investor does not control Investee through a majority voting interest) of Investee's profit and recognize it over 10 years as it depreciates the machine.

Investor records the following entries over the life of the machine.

#### Scenario 1: Unearned profit eliminated against investment

##### Year 1

	<i>Debit</i>	<i>Credit</i>
Machine	1,000,000	
Cash		1,000,000
<i>To recognize purchase of machine.</i>		
Equity in earnings of Investee <sup>1</sup>	30,000	
Investment in Investee (unearned profit)		30,000
<i>To eliminate Investor's proportionate share of Investee's profit.</i>		

Note:  
1. \$100,000 profit × 30% ownership interest.

**Each of Years 1 to 10**

	Debit	Credit
Investment in Investee	3,000	
Equity in earnings of Investee		3,000
<i>To recognize 1/10 of unearned profit as Investor recognizes depreciation expense.</i>		

**Scenario 2: Unearned profit eliminated against machine**

**Year 1**

Investor also could have eliminated the intra-entity profit by reducing the machine account (see [Question 5.2.40](#)). If it reduces the machine account instead of the investment, it records the following entries over the life of the machine.

	Debit	Credit
Machine	1,000,000	
Cash		1,000,000
<i>To recognize purchase of machine.</i>		
Equity in earnings of Investee <sup>1</sup>	30,000	
Machine (unearned profit)		30,000
<i>To eliminate Investor's proportionate share of Investee's profit.</i>		
Note: 1. \$100,000 profit × 30% ownership interest.		

Investor's ending machine account is equal to Investee's cost basis plus 70% (ownership of Investee held by other investors) of Investee's profit – i.e.  $\$970,000 = \$900,000 + (70\% \times \$100,000)$ . [[323-10-55-28](#) – [55-29](#)]

**Each of Years 1 to 10**

	Debit	Credit
Investment in Investee	3,000	
Depreciation expense		3,000
<i>To recognize 1/10 of unearned profit as Investor recognizes depreciation expense.</i>		





### Question 5.2.120

#### Does an investor eliminate profit or loss on an intra-entity capitalized service transaction?

**Background:** Capitalized service transactions occur when the investor provides services to the investee and the investee capitalizes those costs (or vice versa). For example, an investee may hire the investor to perform construction services for a new factory and capitalize those costs as part of the resulting factory asset.

**Interpretive response:** Yes. Similar to other intra-entity transactions that result in an asset that remains with either the investor or the investee, the investor eliminates its proportionate share of the profit unless total elimination is required (see [Question 5.2.30](#)). [970-323-35-7]

As discussed in [Question 5.2.20](#), the investor recognizes the unearned intra-entity profit:

- at a point in time, when the asset is sold to a third party – e.g. in a sale of inventory, land or other nondepreciable asset; or
- over time, as the profit is realized through consumption of the asset in its operations – i.e. as the asset depreciates.



### Example 5.2.60

#### Upstream capitalized intra-entity service

Investor owns 30% of Investee's common stock, and accounts for its investment under the equity method. Investor does not control Investee through a majority voting interest or by any other means.

During Year 1, Investor hires Investee to provide development services for a new factory it is building. Investor pays Investee \$10 million for the services, which results in Investee earning a \$1 million profit.

Investor estimates that the factory, including the capitalized development services, has a 20-year life with a zero salvage value and plans to depreciate it on a straight-line basis.

#### Investor's accounting

Investor must apply Topic 323's intra-entity profit elimination guidance.

Because the factory will remain on Investor's books for 20 years, it will eliminate its proportionate share of Investee's profit and recognize it over 20 years as it depreciates the factory.

Investor records the following entries over the life of the factory.

### Scenario 1: Unearned profit eliminated against investment

#### Year 1

	<i>Debit</i>	<i>Credit</i>
Factory – development services	10,000,000	
Cash		10,000,000
<i>To capitalize development services.</i>		
Equity in earnings of Investee <sup>1</sup>	300,000	
Investment in Investee (unearned profit)		300,000
<i>To eliminate proportionate share of Investee's profit.</i>		
Note:		
1. \$1,000,000 profit × 30% ownership interest.		

#### Each of Years 1 to 20

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	15,000	
Equity in earnings of Investee		15,000
<i>To recognize 1/20 of unearned profit as Investor recognizes depreciation expense.</i>		

### Scenario 2: Unearned profit eliminated against factory

#### Year 1

Investor also could have eliminated the intra-entity profit by reducing the factory account (see [Question 5.2.40](#)). If it reduces the factory account instead of the investment, it records the following entries over the life of the factory.

	<i>Debit</i>	<i>Credit</i>
Factory – development services	10,000,000	
Cash		10,000,000
<i>To capitalize development services.</i>		
Equity in earnings of Investee <sup>1</sup>	300,000	
Factory (unearned profit)		300,000
<i>To eliminate proportionate share of Investee's profit.</i>		
Note:		
1. \$1,000,000 profit × 30% ownership interest.		

Investor's ending factory account is equal to Investee's cost plus 70% (ownership of Investee held by other investors) of Investee's profit – i.e.  $\$9,700,000 = \$9,000,000 + (70\% \times \$1,000,000)$ . [[323-10-55-28](#) – [55-29](#)]

**Each of Years 1 to 20**

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	15,000	
Depreciation expense		15,000
<i>To recognize 1/20 of unearned profit as Investor recognizes depreciation expense.</i>		

**Question 5.2.130**

**Does an investor eliminate profit or loss on an intra-entity nonmonetary exchange?**

**Interpretive response:** It depends. An investor applies Topic 323’s intra-entity profit elimination principles regardless of whether the consideration paid or received is cash or other assets.

Before an investor determines how much intra-entity profit to eliminate, it first determines the profit. For example, in some nonmonetary exchanges, there is no profit. Under Topic 845, an exchange is measured based on the investor’s recorded amount if it: [\[845-10-30-3 – 30-8\]](#)

- involves assets whose fair values are not determinable within reasonable limits;
- is a nonmonetary exchange between entities in the same line of business to facilitate sales to customers or potential customers; or
- lacks commercial substance.

An investor generally measures an asset received as consideration in an exchange between an investor and investee at its fair value, unless Topic 845 requires carryover basis. Measurement at fair value results typically in an intra-entity profit or loss.

The following table summarizes how an investor measures an asset received in a nonmonetary exchange with an investee and whether it should eliminate intra-entity profit or loss.

Outbound asset or issued equity	Measurement of inbound asset <sup>1</sup>
Controlling financial interest in a business	<ul style="list-style-type: none"> <li>— Fair value <a href="#">[810-10-40-5]</a></li> <li>— The investor does not eliminate intra-entity profit. <a href="#">[323-10-35-7]</a></li> </ul>
Nonfinancial asset (or in-substance nonfinancial asset) transferred to a noncustomer	<ul style="list-style-type: none"> <li>— Fair value (or stand-alone selling price if fair value cannot be reasonably estimated)<sup>2,3</sup> <a href="#">[610-20-32-2 – 32-5]</a></li> <li>— The investor <b>does not</b> eliminate intra-entity profit. <a href="#">[323-10-35-7]</a></li> </ul>
Nonfinancial asset transferred to a customer	<ul style="list-style-type: none"> <li>— Fair value (or stand-alone selling price if fair value cannot be reasonably estimated) <a href="#">[606-10-32-2 – 32-27]</a></li> </ul>

Outbound asset or issued equity	Measurement of inbound asset <sup>1</sup>
	<ul style="list-style-type: none"> <li>— The investor does eliminate intra-entity profit. [323-10-35-7]</li> </ul>
Service transferred to a customer	<ul style="list-style-type: none"> <li>— Fair value (or stand-alone selling price if fair value cannot be reasonably estimated) [606-10-32-2 – 32-27]</li> <li>— The investor <b>does not</b> eliminate intra-entity profit unless the service is capitalized. [323-10-35-7]</li> </ul>
Investor's equity instruments	<ul style="list-style-type: none"> <li>— (1) Grant-date fair value or (2) fair value of the equity method investment received or fair value of the equity instruments issued, whichever is more reliably measurable<sup>4</sup> [718-10-30-2 – 30-3, 505-50-30-2, 30-11]</li> <li>— The investor <b>does</b> eliminate intra-entity profit. [323-10-35-7]</li> </ul>
<p>Notes:</p> <ol style="list-style-type: none"> <li>1. Chapter 3 of KPMG Handbook, <a href="#">Asset Acquisitions</a>, provides guidance on how to initially measure an asset received in exchange for noncash consideration.</li> <li>2. This measurement applies even if the equity method investee holds the outbound nonfinancial asset after the transfer – e.g. the investor transfers a nonfinancial asset into a newly formed partnership in exchange for an equity method investment in that newly formed partnership. [610-20-32-4]</li> <li>3. Sections A, D and F of KPMG Handbook, <a href="#">Revenue: Real estate</a>, provide additional guidance and examples of how to account for a transfer of a nonfinancial asset to an equity method investment.</li> <li>4. Topic 718 (stock compensation) contemplates that the goods acquired in exchange for the share-based payment awards issued are to be used or consumed in the issuer's operations. As a result, the investor can use grant-date fair value measurement under Topic 718 if this is true. However, other views may be acceptable depending on the circumstances. This includes, for example, measuring the cost of the equity method investment based on the acquisition-date fair value of the equity instruments given or the fair value of the equity method investment – whichever is more clearly evident and therefore more reliably measurable.</li> </ol>	

Question 5.2.140

**How does an investor account for intra-entity transactions denominated in a foreign currency?**

**Interpretive response:** An investor generally accounts for the foreign currency effects of an intra-entity transaction with its investee that is denominated in a foreign currency in the exact manner that it would account for that same transaction if executed with a third party. However, the elimination of intra-entity profit creates some complexity.

**Monetary items resulting from the transaction**

A monetary asset (liability) is money or a claim to receive (pay) a sum of money, the amount of which is fixed or determinable without reference to future prices

or specific goods or services. Monetary assets and liabilities include (but are not limited to) loans receivable or payable, accounts receivable or payable, and cash balances and investments in held-to-maturity debt securities. [255-10 Glossary, 255-10-55-1 – 55-13]

The investor and investee generally recognize foreign exchange transaction gains or losses on monetary assets, and liabilities that result from intra-entity transactions, in net income. [830-20-35-1]

However, when the transaction is of a long-term investment nature – i.e. settlement is not planned or anticipated in the foreseeable future – the investor recognizes those foreign exchange gains and losses in OCI as part of its translation adjustment. No such exception for transactions that are long-term investment in nature applies to the separate financial statements of the investee – it recognizes all foreign exchange transaction gains or losses in net income. As a result, when the investor recognizes its share of the investee's net income, it isolates the transaction gain or loss resulting from the intra-entity transaction and recognizes it in OCI rather than in equity in earnings. [830-20-35-3 – 35-4]

### Nonmonetary assets resulting from the transaction

Nonmonetary assets include (but are not limited to) inventories, property plant and equipment, goodwill, intangible assets and equity securities. The economic significance of these items depends heavily on the value of the specific good or service. [255-10-50-51, 55-1 – 55-13, 830-10-45-18]

If a nonmonetary asset remains on a foreign investee's balance sheet in a downstream intra-entity transaction (or on the investor's balance sheet in an upstream transaction), the investor uses the exchange rate in effect on the transaction date to eliminate the related profit. The investor then proportionately (or totally) eliminates the intra-entity profit as discussed in this chapter. [830-30-45-10, 323-10-35-7]

In addition, if a nonmonetary asset remains on the investee's balance sheet at the end of the reporting period, the investor remeasures its original cost basis in the transferred asset. The investor does not recognize the effects of changes in exchange rates on the intra-entity profit that is embedded in the investee's cost basis until the asset is sold to a third party. [830-30-45-3]

Section 3 of KPMG Handbook, [Foreign currency](#), provides guidance on how to account for intra-entity foreign transactions and Section 4 discusses foreign currency translation.



### Example 5.2.70

#### Eliminating intra-entity profit denominated in a foreign currency

Investor, a multinational company, has a 40% interest in Investee's common stock and accounts for its investment under the equity method. Investor does not control Investee through a majority voting interest or by any other means.

Investor's functional currency is the US dollar (\$) and Investee's functional currency is the British pound (£).

On November 1, Year 1, when the conversion rate was \$2 = £1, Investor sold goods to Investee for \$40. Investor's cost of the goods was \$30. Investee recognized the purchase at £20. The £20 inventory value on Investee's books comprised the following.

Investor's cost (\$30 cost ÷ 2)	£15
Investor's intra-entity profit (\$10 intra-entity profit ÷ 2)	£ 5

Between November 1 and December 31, Year 1, the exchange rate moves to \$1.60 = £1. The inventory remains on Investee's balance sheet at December 31, Year 1.

### Investor's accounting

Investor proportionately eliminates \$4 of the intra-entity profit (\$10 intra-entity profit × Investor's 40% interest in Investee) and defers it until Investee sells the goods to a third party (or Investee consumes the goods in its operations).

	Debit	Credit
Equity in earnings of Investee	4	
Investment in Investee (unearned profit)		4
<i>To eliminate proportionate share of Investor's profit.</i>		

When Investor determines its share of Investee's underlying net assets at December 31, Year 1, it translates only the £15 cost component of Investee's inventory account using \$1.60 = £1 – i.e. the rate at December 31.

As a result of the translation, Investor's share of Investee's inventory changes from \$12 ((£15 × 2) × 40%) to \$9.60 ((£15 × 1.6) × 40%). Investor recognizes the \$2.40 change in its share of Investee's underlying net assets in OCI as part of its translation adjustment.

Question 5.2.150

**Does an investor defer the tax effects of an intra-entity asset transfer?**

**Background:** Topic 740 requires a parent to defer the tax effects from an intra-entity transfer of inventory to a subsidiary while that inventory remains within the consolidated group. [740-10-25-3(e)]

**Interpretive response:** No. Inventory transferred to an equity method investee does not remain within the investor's consolidated group. As a result, even if the investor eliminates some or all of the profit, it generally recognizes in its income statement the full tax effects of the sale, just as it would if the sale was executed with a third party.

As discussed in [Question 5.2.20](#), those effects may include the investor recognizing:

- current taxes on the sale;
- reversal of deferred taxes related to the asset sold; and

- deferred taxes on the change to the investor's outside basis difference in its investment because of the profit deferral (see [Questions 3.3.100](#) and [5.3.30](#)).



### Question 5.2.160

#### Does an investor eliminate intra-entity profit on a downstream sale to a regulated investee?

**Background:** Topic 980 provides guidance on how regulated entities account for rate actions by regulators. In some cases, regulators will direct entities to apply an accounting principle that conflicts with principles specified in the non-industry topics of US GAAP. Topic 980 provides a framework for a regulated entity to determine when those regulatory policies should be reflected in its US GAAP financial statements. For additional discussion, see [Question 4.2.50](#).

**Interpretive response:** It depends. Intra-entity profit on downstream sales to regulated affiliates is not eliminated if the sales price is reasonable and probable of being recovered by future revenues through the rate-making process. [980-810-45-1]

The sales price is generally considered reasonable if the applicable regulator accepts it. [980-810-45-2]



### Question 5.2.170

#### What factors should an investor consider when evaluating whether a transaction is at arm's length?

**Background:** When the investor controls the investee through voting interests or other similar contractual means, it must conclude that the intra-entity transaction was executed at arm's length in order to eliminate only its share of the profit (see [Question 5.2.30](#)).

**Interpretive response:** We believe existence of the following indicators suggest that an intra-entity transaction has been executed at arm's length, which allows an investor to only proportionately eliminate the profit. While the absence of a single indicator does not necessarily mean that proportionate profit recognition is inappropriate, an investor should exercise professional judgment when evaluating whether an intra-entity transaction has been executed at arm's length.

#### **The transaction is an in-substance sale to the other investors**

In an in-substance downstream sale, the other investors share in the risks and rewards of ownership of the transferred asset(s) and assume a proportionate share of the obligation to pay the transaction price. We believe this indicator is met if the other investors have provided, or are obligated and able to provide, the necessary support if the investee's funds from operations are not sufficient to pay the transaction price. The other investors should have an adequate amount of capital to support that they can bear the risks of ownership of the assets subject to the intra-entity transaction without exhausting their equity.

For upstream transactions (sale from investee to investor), the in-substance sale indicator may seem less important. However, Topic 323 indicates that an investor should eliminate the same percentage of intra-entity profit regardless of whether the transaction is downstream or upstream. [323-10-35-11]

#### **The investor cannot unilaterally initiate and execute the intra-entity transaction**

We believe this indicator is met when the investor is unable to unilaterally initiate and execute the intra-entity transaction to increase its (or the investee's) reported profits. It is likely that only the party with a controlling financial interest in the investee, if any, has the power to unilaterally initiate and execute transactions.

#### **The transaction price approximates stand-alone selling price**

We believe this indicator is met if the intra-entity transaction is executed at a price that is:

- offered to all customers;
- approximates the fair value of the asset(s) transferred; or
- equals the price charged in similar transactions with unaffiliated parties.

#### **The investor expects to receive the transaction price**

We believe this indicator is met if the investor expects to collect the transaction price. Although immediate realization in cash is not required, we believe the investor should be able to support probable collection in the investee's ordinary course of business.



### Example 5.2.80

#### **Upstream intra-entity transaction with total elimination**

Investor, a toy company, owns 25% of Investee's common stock, and accounts for its investment under the equity method.

On January 1, Year 1, Investee contracts with Investor to produce 1,000 dolls for Investor. Investor concludes that it must entirely eliminate the intra-entity profit from the sale of the dolls that it fails to sell to a third party by the end of the reporting period.

Investee charges Investor \$5 for each doll delivered, which results in Investee earning a \$1 profit for each doll (Investee's cost basis is \$4 per doll). By March 1, Year 1:

- Investee delivered to Investor all 1,000 dolls and recognized the related revenue under Topic 606;
- Investor sold 700 of the dolls produced by Investee; and
- Investor had 300 dolls remaining in its finished goods inventory.

#### **Investor's accounting**

Because Investor must entirely eliminate the intra-entity profit from the sale of the dolls that it fails to sell to a third party by the end of the reporting period, it eliminates all of Investee's profit related to the 300 dolls that remain in



Investor's finished goods inventory. Investor does not eliminate the profit on the 700 dolls it purchased from Investee and sold to third parties.

Investor eliminates intra-entity profit in two journal entries.

The first entry eliminates the portion of intra-entity profit recognized by Investee in its income statement related to the 300 dolls that remain in Investor's inventory at March 31, Year 1. Investor computes its elimination entry as follows.

Dolls remaining in Investor's finished goods inventory	300
Investee profit per doll	\$ 1
Investee profit on Investor's unsold dolls	\$300
Investor's ownership percentage in Investee	25%
<b>Amount of profit to eliminate</b>	<b>\$ 75</b>

Investor records the following journal entry to eliminate the unearned intra-entity profit.

	<i>Debit</i>	<i>Credit</i>
Equity in earnings of Investee	75	
Inventory (unearned profit)		75
<i>To remove Investor's share of Investee's profit from equity in earnings.</i>		

The second entry further adjusts Investor's inventory account so that the 300 dolls remaining are carried at Investee's cost.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee <sup>1</sup>	225	
Inventory		225
<i>To adjust Investor's inventory to Investee's cost for 300 dolls</i>		

Note:

- \$300 profit × 75% outside ownership interest.

The following is Investor's inventory account activity.

Purchase of 1,000 dolls for \$5/doll	\$ 5,000
Cost of goods sold for 700 dolls	(3,500)
Unearned profit elimination	(75)
Reclassification entry	(225)
<b>Ending balance</b>	<b>\$ 1,200</b>

Investor's ending inventory account equals Investee's cost basis in the 300 unsold dolls: 300 dolls × \$4 per doll.

## 5.3 Basis differences and equity method goodwill



### Excerpt from ASC 323-10

- > Basis Difference

**35-13** A difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary. Paragraph 350-20-35-58 requires that the portion of that difference that is recognized as goodwill not be amortized. However, if an entity within the scope of paragraph 350-20-15-4 elects the accounting alternative for amortizing goodwill in Subtopic 350-20, the portion of that difference that is recognized as goodwill shall be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. Paragraph 350-20-35-59 explains that equity method goodwill shall not be reviewed for impairment in accordance with paragraph 350-20-35-58. However, equity method investments shall continue to be reviewed for impairment in accordance with paragraph 323-10-35-32.

- > Contingent Consideration

**35-14A** If a contingency is resolved relating to a liability recognized in accordance with the guidance in paragraph 323-10-25-2A and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the investment. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess shall reduce the cost of the investment.



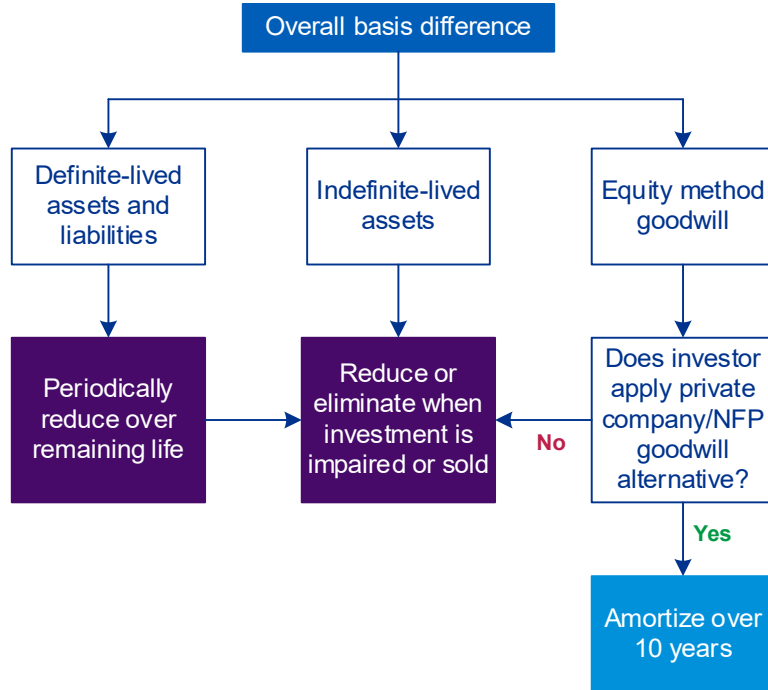
### Excerpt from ASC 350-20

#### Accounting Alternative

- > Transactions

**15-4** A **private company** or **not-for-profit entity** may make an accounting policy election to apply the accounting alternative in this Subtopic. The guidance in the Accounting Alternative Subsections of this Subtopic applies to the following transactions or activities:

- Goodwill** that an entity recognizes in a business combination in accordance with Subtopic 805-30 or in an **acquisition by a not-for-profit entity** in accordance with Subtopic 958-805 after it has been initially recognized and measured
- Amounts recognized as goodwill in applying the equity method of accounting in accordance with Topic 323 on investments—equity method and joint ventures, and to the excess reorganization value recognized by entities that adopt fresh-start reporting in accordance with Topic 852 on reorganizations.



As discussed in [section 3.3](#), once an investor has measured the cost of the equity method investment, it generally allocates that cost to its share of the investee’s underlying assets and liabilities.

When the investee is a business, the investor uses the acquisition method principles in Topic 805 to allocate cost in its memo purchase price allocation – i.e. based on the fair value of each of the investee’s assets and liabilities. This includes separately identifiable intangible assets that the investee does not have recognized on its financial statements. If, after identifying its share of the fair value of the investee’s net assets, the investor has a residual amount of unallocated cost (excess cost), that excess is equity method goodwill. [323-10-35-13, 805-20]

If the investee is not a business, the investor initially allocates cost in its memo purchase price allocation based on its share of the fair value of the investee’s net assets. If, after identifying its share of the fair value of the investee’s net assets, the investor has excess cost, that excess generally reduces the investor’s share of the investee’s noncurrent nonfinancial assets (excluding indefinite-lived intangible assets, see [Question 3.3.60](#)) based on relative fair values. The investor does not recognize equity method goodwill. [323-10-35-13, 805-50]

### **Equity method goodwill**

An investor does not amortize equity method goodwill unless it is a private company or NFP and has elected the accounting alternative in Subtopic 350-20. Under the accounting alternative, the investor amortizes the equity method goodwill on a straight-line basis over 10 years; or less than 10 years if the investor demonstrates that a shorter useful life is more appropriate. An investor that has elected to subsume certain intangibles into goodwill under a separate

alternative is also required to apply the goodwill amortization alternative. [323-10-35-13, 350-20-35-58, 35-62 – 35-64]

An investor does not separately review equity method goodwill for impairment, whether or not it is amortized. Instead, an investor evaluates its investment in total to determine whether a decrease in value has occurred that is other than temporary. If so, the investor allocates its OTTI to components of its overall basis difference, including goodwill, and recognizes an impairment loss in its equity in earnings of the investee (see [Question 5.5.40](#)). [323-10-35-32 – 35-32A, 350-30-35-58]

An investor also reduces equity method goodwill when it reduces its ownership interest in the investee (see [section 6.3](#)).

### **Contingent consideration**

An investor accrues a liability for contingent consideration when the investor's share of the fair value of the investee's net assets exceeds the investor's initial cost – i.e. the acquisition is a bargain purchase (see [Question 3.2.90](#)).

The amount the investor accrues as part of its cost basis is the lesser of the: [323-10-25-2A, 30-2A – 30-2B, 55-2B]

- maximum amount of contingent consideration; or
- excess of the investor's share of the fair value of the investee's underlying net assets over the initial cost measurement – i.e. the bargain purchase amount.

When the contingency is resolved and the consideration is issued (or becomes issuable), the investor recognizes the difference between the fair value of the contingent consideration issued (or issuable) and the liability as an adjustment to the cost of the investment.

An investor also accrues a liability for contingent consideration if US GAAP other than Topic 805 requires recognition (see [Question 3.2.80](#)). [323-10-30-2A]

As a result, if the contingent consideration arrangement meets the requirements in Topic 815 to be accounted for as a derivative, the investor includes its fair value in the initial cost of the equity method investment. However, the investor does not adjust the cost basis of the investment for subsequent changes in the fair value of the derivative. Instead, subsequent fair value changes are accounted for under Topic 815. [815-10-15-83, 30-1, 35-1]

### **Basis differences**

As discussed in [section 3.3](#), after the investor allocates its cost, it determines whether differences exist between the amount allocated to its share of each of the investee's assets and liabilities and its share of the carrying amount of each of the investee's underlying assets and liabilities as reported under US GAAP. Those differences are referred to as the investor's basis differences. The total difference between the investor's carrying amount and its share of the investee's net asset is sometimes referred to as the 'aggregate' or 'overall' basis difference.

The investor subsequently accounts for basis differences as if the investee were a consolidated subsidiary. As a result, the investor recognizes in its equity

in earnings of the investee adjustments to those basis differences in the same periods that the investee makes adjustments to depreciate, deplete, impair, amortize or accrete the related underlying assets or liabilities. [323-10-35-5, 35-13]

An investor reduces its basis differences when it other-than-temporarily impairs (see [Question 5.5.40](#)) or reduces its ownership interest in the investee (see [section 6.3](#)).



### Question 5.3.10

#### How does an investor account for the basis difference related to an asset that the investee has not recognized?

**Interpretive response:** If the investee had not previously recognized an asset or liability in its financial statements that the investor has identified in its memo purchase price allocation, the investor may use its accounting policy for similar assets and liabilities that it owns directly.

For example, an investor identifies, and allocates value to, a customer relationship intangible asset that has not been recognized by the investee. The investor has similar intangible assets that it amortizes on an accelerated pattern over three years. The investor should recognize the charge in each of the next three years for the amortization of the investee's customer relationship intangible asset in the same income statement line in which it records its share of the investee's earnings.



### Question 5.3.20

#### How does an investor account for the basis difference related to a non-depreciable asset?

**Interpretive response:** An investor does not amortize a basis difference related to a non-depreciable asset – e.g. an indefinite-lived intangible asset or land. [323-10-35-5, 35-13]

In addition, similar to equity method goodwill, an investor does not review these assets individually for impairment. Instead, an investor evaluates its investment in total to determine whether a decrease in value has occurred that is other than temporary. If so, the investor recognizes an impairment loss in its equity in earnings of the investee. [323-10-35-32 – 35-32A, 350-30-35]

[Section 5.5](#) provides additional discussion.



### Example 5.3.10 Subsequent accounting for basis differences

Investor acquires a 20% interest in Investee (a business) for \$1,000,000.

Investee's net book value, fair value and Investor's share of each are summarized in the following table.

	Fair value	Net book value	Difference
Investee's net assets	\$5,000,000	\$4,000,000	\$1,000,000
Investor's ownership interest	20%	20%	20%
<b>Investor's share of Investee's net assets</b>	<b>\$1,000,000</b>	<b>\$ 800,000</b>	<b>\$ 200,000</b>

The excess of Investor's investment over its share of the net book value of Investee is \$200,000.

When performing its memo purchase price allocation, Investor attributes \$100,000 of the \$200,000 excess to a building owned by Investee and \$50,000 of the excess to the related land. The remaining useful life of the building is 30 years.

The remaining excess of Investor's investment over its share of Investee's underlying assets of \$50,000 is not associated with a specific identifiable tangible or intangible asset and is identified as equity method goodwill.

Investee reports net earnings of \$500,000 for the year.

#### Investor's accounting

Investor measures its equity in earnings of Investee as shown in the following table. This example ignores deferred taxes.

Investor's share of Investee's earnings <sup>1</sup>	\$100,000
Amortization of basis difference – building <sup>2</sup>	(3,333)
<b>Equity in earnings of Investee</b>	<b>\$ 96,667</b>
Notes:	
1. \$500,000 net earnings × 20% ownership interest.	
2. \$100,000 basis difference related to the building ÷ 30 years.	

Investor records the following journal entry.

	Debit	Credit
Investment in Investee	96,667	
Equity in earnings of Investee		96,667
<i>To recognize equity in earnings of Investee.</i>		

Investor does not amortize the \$50,000 basis difference related to the land because it is a non-depreciable asset. It also does not amortize the \$50,000 of equity method goodwill.



**Question 5.3.30**

**How does an investor account for deferred taxes associated with its equity method investment?**

**Interpretive response:** Basis differences represent incremental temporary differences for which the investor identifies deferred taxes in its memo purchase price allocation. As those basis differences change (e.g. as a result of amortization), the investor likewise recognizes changes in the related deferred taxes under Topic 740 (see [Question 3.3.90](#)). The investor recognizes this activity in its equity method accounting – i.e. by adjusting its equity method investment balance and equity in earnings.

In addition, because an investor generally accounts for an equity method investment using the cost method for tax purposes, a temporary difference also arises between the tax basis and the financial statement carrying amount of the investment when the investor recognizes its equity in earnings of the investee. This difference is referred to as the investor’s ‘outside basis difference’ in the investment.

The investor generally classifies the deferred tax asset or liability for its outside basis difference in the same line item as its other deferred tax balances. [Question 3.3.100](#) provides additional guidance on how an investor should identify and measure deferred taxes on its outside basis difference in the investment and [Question 7.2.50](#) discusses income statement presentation.

Sections 2 and 10 of KPMG Handbook, [Accounting for income taxes](#), provide additional guidance on and illustrations of how an investor should account for deferred taxes associated with equity method investments.



**Example 5.3.20**

**Subsequent accounting for the tax effects of basis differences**

Investor acquires a 20% interest in Investee (a US-based business) for \$1,000,000.

Investee’s net book value, fair value and Investor’s share of each are summarized in the following table.

	Fair value	Net book value	Difference
Investee’s net assets	\$5,000,000	\$4,000,000	\$1,000,000
Investor’s ownership interest	20%	20%	20%
<b>Investor’s share of Investee’s net assets</b>	<b>\$1,000,000</b>	<b>\$ 800,000</b>	<b>\$ 200,000</b>

The excess of Investor's investment over its share of the net book value of Investee is \$200,000.

When performing its memo purchase price allocation, Investor attributes \$150,000 of the \$200,000 excess to a building owned by Investee and \$50,000 of the excess to the related land. The remaining useful life of the building is 30 years.

Investor also identifies in its memo purchase allocation a \$42,000 incremental deferred tax liability (\$200,000 overall basis difference  $\times$  Investee's statutory 21% tax rate) related to these basis differences, which results in \$42,000 of equity method goodwill.

Investee reports net earnings of \$500,000 for the year. Investor's tax rate is 21% and it does not have the ability to liquidate its Investee investment tax-free.

### Investor's accounting

Investor measures its equity in earnings of Investee as shown in the following table.

Investor's share of Investee's earnings <sup>1</sup>	\$100,000
Amortization of basis difference – building <sup>2</sup>	(5,000)
Deferred tax benefit – building <sup>3</sup>	1,050
<b>Equity in earnings of Investee</b>	<b>\$ 96,050</b>
Notes:	
1. \$500,000 net earnings $\times$ 20% ownership interest.	
2. \$150,000 basis difference related to the building $\div$ 30 years.	
3. Change in deferred taxes for the basis difference related to the building of \$5,000 $\times$ Investee's tax rate.	

Investor records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	96,050	
Equity in earnings of Investee		96,050
<i>To recognize equity in earnings of Investee.</i>		

Investor does not amortize the \$50,000 basis difference related to the land because it is a non-depreciable asset. It also does not amortize the \$42,000 of equity method goodwill.

Investor also recognizes a \$20,171 (\$96,050 equity in earnings  $\times$  Investor's 21% tax rate) deferred tax liability/expense for the tax effect of the outside basis difference in its investment in Investee, which arises when Investor recognizes its equity in earnings of Investee.





### Question 5.3.40

#### Does an investor capitalize interest on an equity method investment?

**Interpretive response:** It depends. An investor capitalizes as a component of its equity method investment a portion of its interest cost during an investee's start-up phase if the investee: [\[835-30-15-5\(c\)\]](#)

- has activities in progress necessary to commence its planned principal operations; and
- is using funds to acquire or construct qualifying assets for the investee's planned operations, even if the investee is not using the specific funds advanced from or invested by the investor.

The amount of the investor's 'qualifying assets' on which to capitalize interest cost includes its investment in the investee's common stock, other-than-common equity, and loans and advances to the investee (or on its behalf). [\[835-30-15-5 – 15-6\]](#)

When evaluating whether the assets acquired or constructed by the investee meet the requirements for the investor to capitalize interest on its investment, the investor should carefully analyse the investee's operations similar to how it would analyse its own operations when determining whether it may capitalize interest on its own constructed or acquired assets.

The investor will have a series of judgments to make in completing its analysis, including: [\[835-20-15-5 – 15-6, 25-2 – 25-5, 30-2 – 30-6\]](#)

- whether the investee has commenced its principal operations – e.g. if an investee is operating some assets but constructing others, it has commenced operations; the investor cannot capitalize interest on a portion of its investment;
- whether the investee's assets represent qualifying assets under Topic 835;
- the length of the capitalization period; and
- the appropriate amount of interest to be capitalized.

In order for an investment to be considered a qualifying asset under Topic 835, the investment must be accounted for under the equity method. We do not believe an investor may capitalize interest on an investment for which it has elected the fair value option under Subtopic 825-10.

An investor subsequently accounts for the basis difference related to capitalized interest similar to how it would account for other basis differences related to PP&E. [\[323-10-35-5, 35-13\]](#)



### Question 5.3.50

#### Does an investor translate a foreign investee's financial statements into its functional currency?

**Interpretive response:** Yes. If the investor's reporting currency differs from the investee's, the investor translates the investee's financial statements as if the investee were a consolidated subsidiary and recognizes in its OCI the resulting translation adjustment. [830-10-15-5, 830-30-45-1]

In addition, an investor's equity method goodwill and basis differences related to a foreign investee are denominated in the investee's functional currency. As a result, the investor translates those assets and liabilities at the current exchange rate and recognizes the related adjustments in OCI. [830-10-15-6, 830-30-45-11]

Section 4 of KPMG Handbook, [Foreign currency](#), provides interpretive guidance specific to foreign currency translation considerations for equity method investments.



### Question 5.3.60

#### Can an investor hedge an equity method investment?

**Interpretive response:** It depends. Topic 815 prohibits an investor from designating equity method investments as hedged items or transactions in a fair value or cash flow hedge. This includes a prohibition on hedging the forecasted purchase or sale of an equity method investment (see [Question 3.2.50](#)). [815-20-25-43b(1), 25-43c(5), 25-15h(1)]

However, Topic 815 allows an investor to hedge the foreign currency risk of a net investment in a foreign operation, which includes a foreign equity method investment.

Sections 6.5.20 and 12.2 of KPMG Handbook, [Derivatives and hedging](#), provide additional discussion about, and illustrations of, hedging and equity method investments.



### Question 5.3.70

#### May an investor apply hedge accounting to an item or transaction of an equity method investee?

**Interpretive response:** Generally, no. We believe an entity cannot apply hedge accounting to the following items or transactions:

- recognized assets or liabilities of an equity method investee;
- a forecasted transaction between an equity method investee and a third party; or
- a firm commitment of an equity method investee.

This is because there is no direct exposure to changes in fair value or variability in cash flows attributable to an entity's interest in the equity method investment. [815-20-25-46A]

As for transactions with the investee, an investor:

- cannot designate in a fair value hedge a 'firm commitment' with its investee – this is because a firm commitment must be between two unrelated parties; but
- can designate in a cash flow hedge a forecasted transaction if the effects of that transaction will not be eliminated and the other hedge criteria are met.

Question 6.5.10 of KPMG Handbook, [Derivatives and hedging](#), provides additional discussion about, and illustrations of, hedging and equity method investments.

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### Question 5.3.80

#### How does an investor account for incremental contingent consideration paid when the contingency is resolved?

**Interpretive response:** As discussed in [Question 3.2.90](#), an investor includes contingent consideration in its initial cost of an equity method investment when the investor's share of the fair value of the investee's net assets exceeds the investor's initial cost – i.e. the acquisition is a bargain purchase. [323-10-25-2A]

The liability reduces the bargain purchase amount initially allocated to the nonfinancial assets acquired (excluding current assets, see [Question 3.3.60](#)).

When the contingency is ultimately resolved, the investor recognizes the difference between the fair value of the contingent consideration issued (or issuable) and the liability as an adjustment to the cost of the investment. In its memo purchase price allocation, we believe an investor generally should allocate this additional amount to the investee's noncurrent nonfinancial assets (excluding indefinite-lived intangible assets, see [Question 3.3.60](#)) based on relative fair values. [323-10-35-14A]

Chapter 4 of KPMG Handbook, [Asset acquisitions](#), provides additional discussion on how to account for contingent consideration in an asset acquisition.

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## 5.4 Share-based compensation granted to investee employees



### Excerpt from ASC 323-10

> Share-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 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 share-based compensation funded on its behalf).

> 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.

#### Implementation Guidance and Illustrations

Example 2: Share-Based Compensation Granted to Employees of an Equity Method Investee

**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.

**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, 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, 20X1, before granting the stock options, Entity C's investment balance is \$800,000.

**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, 20X. 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.

	12/31/20X1	12/31/20X2	12/31/20X3
<b>To record cost of stock compensation and Entity C's additional investment for costs incurred by Entity A on behalf of investee</b>			
<b>Entity A (Contributing Investor)</b>			
Investment in Entity B <sup>(a)</sup>	\$ 16,000	\$ 16,000	\$ 16,000
Expense <sup>(b)</sup>	24,000	24,000	24,000
Additional paid-in capital	\$40,000	\$40,000	\$40,000
<b>Entity B (Investee)</b>			
Fixed asset	\$ 40,000	-	-

Expense	-	\$ 40,000	\$ 40,000
Additional paid-in capital	\$40,000	\$40,000	\$40,000
<b>Entity C (noncontributing investor)</b>			
Investment in Entity B	\$ 16,000	\$ 16,000	\$ 16,000
Contribution income <sup>(c)</sup>	\$16,000	\$16,000	\$16,000
<b>To record Entity A's and Entity C's share of the earnings of investee (same entry for both Entity A and Entity C)</b>			
<b>Entity A and Entity C</b>			
Investment in Entity B	\$ 80,000	\$ 80,000	\$ 80,000
Equity in earnings of Entity B	\$80,000	\$80,000	\$80,000
<b>Consolidated impact of all the entries made by Entity A and Entity C</b>			
<b>Entity A</b>			
Investment in Entity B	\$ 96,000	\$ 96,000	\$ 96,000
Expense	24,000	24,000	24,000
Additional paid-in capital	\$40,000	\$40,000	\$40,000
Equity in earnings of Entity B	80,000	80,000	80,000
<b>Entity C</b>			
Investment in Entity B	\$ 96,000	\$ 96,000	\$ 96,000
Contribution income	\$16,000	\$16,000	\$16,000
Equity in earnings of Entity B	80,000	80,000	80,000
<p>a. Entity A recognizes as an expense the portion of the costs incurred that benefits the other investors (in this Example, 60 percent of the cost or \$24,000 in 20X1, 20X2, and 20X3) and recognizes the remaining cost (40 percent) as an increase to the investment in Entity B. As Entity B has recognized the cost associated with the stock-based compensation incurred on its behalf, the portion of the cost recognized by Entity A as an increase to its investment in Entity B (40 percent) is expensed in the appropriate period when Entity A recognizes its share of the earnings of Entity B.</p> <p>b. It may be appropriate to classify the debit (expense) within the same income statement caption as equity in earnings of Entity B.</p> <p>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.</p>			
<b>55-25</b> A rollforward of Entity B's net assets and a reconciliation to Entity A's and Entity C's ending investment accounts follows.			
	<b>12/31/20X1</b>	<b>12/31/20X2</b>	<b>12/31/20X3</b>
Net assets of Entity B			
Beginning net assets	\$2,000,000	\$2,240,000	\$2,480,000
Contributed capital	40,000	40,000	40,000
Net income	200,000	200,000	200,000
Ending net assets	\$2,240,000	\$2,480,000	\$2,720,000
Entity A's and Entity C's share	x 40%	x 40%	x 40%
Entity A's and Entity C's equity in net assets of Entity B	896,000	992,000	1,088,000

Entity A's and Entity C's ending investment balance	896,000	992,000	1,088,000
Remaining unamortized basis difference	\$ -	\$ -	\$ -

**55-26** A summary of the calculation of share-based compensation cost by year follows.

#### Calculation of the Share-Based Compensation Cost by Year

Year Ended	A = Grant Date Fair Value of Options	B = % Vested	C = (A x B) Amount of Cumulative Compensation Cost to Be Recognized	D = Cumulative Cost Previously Recognized	E = C - D Current Year Cost
20X1	\$ 120,000	33%	\$ 40,000	\$ -	\$ 40,000
20X2	\$ 120,000	66%	\$ 80,000	\$ 40,000	\$ 40,000
20X3	\$ 120,000	100%	\$ 120,000	\$ 80,000	\$ 40,000

•• > 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.

When an investor grants share-based payment awards to an employee of an equity method investee and the grant was not agreed to in connection with the acquisition of its investment, it accounts for those awards as nonemployee awards. If the other investors do not proportionately fund the investee's related compensation cost, the investor expenses as incurred the cost of the share-based payment awards to the extent its claim on the investee's book value has not increased. The noncontributing investors recognize in equity in earnings their respective increases in their capital accounts. [323-10-25-3 – 25-5]

For example, assume a 40% investor grants to an investee's employee \$100 in share-based payment awards and the other investors do not contribute. Because the investee recognizes contributed capital of \$100 but increases the 40% investor's capital account by only \$40 (\$100 total capital contribution x 40%), the investor recognizes a \$60 expense and a \$40 increase to its investment to offset the \$100 credit to its additional paid-in capital. The noncontributing investors recognize a total of \$60 in earnings for the increases in their capital accounts. In the period the investee expenses the related compensation expense, all investors will recognize their share in equity in earnings.

The contributing investor generally measures the share-based payment awards at the fair value of the equity instruments issued. [505-50-30-2, 30-11]

If the investor's relative ownership percentage in the investee increases, it accounts for the grant as consideration paid to acquire additional investee ownership interests (see [chapter 6](#)).

Section 1 of KPMG Handbook, [Share-based payment](#), provides additional discussion and examples of how an investor accounts for share-based payment awards to the employees of an equity method investee.

## 5.5 Other-than-temporary impairment



### Excerpt from ASC 323-10

> Decrease in Investment Value

**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.

An equity method investment is impaired if its fair value under Topic 820 is less than its carrying amount.

When an investor concludes that its investment is impaired at the reporting date, it must determine whether the impairment is temporary or other-than-temporary. If an investor concludes that an impairment is other-than-temporary, it reduces the carrying amount of the investment to its fair value by recognizing a charge to its income statement.

In addition, the investor may need to recognize a deferred tax asset if the tax basis of its investment exceeds its financial statement carrying amount after it has been reduced for the impairment. The investor evaluates whether it needs a valuation allowance on that deferred tax asset based on the nature of the



taxable income – e.g. capital, ordinary, foreign that it would need to generate to realize it.



### Question 5.5.10

#### When does an investor evaluate the investment for impairment?

**Interpretive response:** We believe an investor should evaluate its equity method investment for impairment at the end of each reporting period if the investment consists of equity securities with readily determinable fair values.

For other investments, we believe the investor should evaluate impairment when:

- it otherwise has estimated the fair value of the equity method investment – e.g. for disclosure purposes under Subtopic 825-10;
- an event or change in circumstances occurs that may have a significant adverse effect on the investment’s fair value; or
- the investee has recognized a series of operating losses or recognizes an impairment loss in its financial statements.



### Question 5.5.20

#### What factors does an investor consider in the OTTI analysis?

**Interpretive response:** ‘Other-than-temporary’ does not mean permanent and evaluating whether an impairment is temporary requires judgment.

We believe an equity method investor should consider the same factors that the SEC staff suggested for evaluating other-than-temporary impairment of equity securities before application of Topic 321. [\[320-10-S99-1\]](#)

Those factors are:

- the length of time and extent to which the fair value of the investment has been less than its carrying amount;
- the investee’s financial condition and near-term prospects, including recent operating losses or specific events that may negatively influence its future earnings potential; and
- the intent and ability of the investor to retain its investment for a period of time sufficient to allow for an anticipated recovery in fair value.

We believe that if the investor must sell or intends to sell an impaired equity method investment and does not expect its fair value to fully recover to its carrying amount before the sale, the impairment is other-than-temporary and the investor recognizes the writedown of the investment in earnings in the period in which it decides to sell or concludes it must sell.



### Question 5.5.30

#### How does an investor present and disclose an OTTI?

**Interpretive response:** An investor generally classifies an impairment charge in the same line of the income statement that it presents its equity in earnings of the investee.

We believe the investor should include the following information in the notes to the financial statements in the period in which it recognizes OTTI:

- a description of the impaired equity method investment, including the investee's name and the investor's percentage ownership of its common stock;
- the facts and circumstances leading to the impairment;
- the amount of the impairment loss;
- the method (or methods) used for determining fair value of the investment – e.g. based on a quoted market price or another valuation technique; and
- if applicable, the segment in which the impairment charge is reported under Topic 280.



### Question 5.5.40

#### How does an investor allocate OTTI to the components of its overall basis difference?

**Background:** When an investor recognizes an impairment charge, its overall basis difference – i.e. the difference between the carrying amount of its investment and its share of the investee's underlying net assets – decreases. [Section 3.2](#) provides additional guidance on how to identify basis differences at acquisition and [section 5.3](#) discusses how to subsequently account for those basis differences.

**Interpretive response:** We believe an investor may allocate its OTTI in the following order.

**Step 1:** Reduce any equity method goodwill to zero.

**Step 2:** Reduce the individual basis differences related to the investee's long-lived assets pro rata based on their amounts relative to the overall basis difference at the impairment date.

**Step 3:** Reduce the individual basis differences of the investee's remaining assets in a systematic and rational manner.

There may be other acceptable approaches. For example, an investor also may:

- prepare a new memo purchase price allocation on the impairment date;
- determine new basis differences based on that allocation;
- adjust its existing basis differences to match the new basis differences; and
- allocate the remainder to equity method goodwill.

**Example 5.5.10****Impairment of an equity method investment**

On January 1, Year 1, Investor acquires a 20% interest in Investee (a business) for \$1,000,000.

Investee's net book value, fair value and Investor's share of each are summarized in the following table.

	Fair value	Net book value	Difference
Investee's net assets	\$5,000,000	\$4,000,000	\$1,000,000
Investor's ownership interest	20%	20%	20%
<b>Investor's share of Investee's net assets</b>	<b>\$1,000,000</b>	<b>\$ 800,000</b>	<b>\$ 200,000</b>

The excess of Investor's investment over its share of Investee's net book value is \$200,000.

When performing its memo purchase price allocation, Investor:

- attributes \$100,000 of the \$200,000 excess to a building owned by Investee (which has a remaining useful life of 25 years);
- attributes \$50,000 of the excess to land;
- identifies the excess \$50,000 as equity method goodwill.

Income taxes are ignored in this example.

Through September 30, Year 1, Investee has reported break-even results and Investor has recognized a \$3,000 charge to equity in earnings of Investee related to the amortization of its basis difference associated with the building:  $(\$100,000 \text{ basis difference} \div 25 \text{ year remaining useful life}) \times 9/12$ .

Also in September, Investee experiences the loss of a major customer, triggering Investor to analyse whether there has been a potential loss in value of its investment.

At September 30, Year 1, Investor determines that:

- the fair value of its investment is \$850,000; this is \$147,000 less than its carrying amount of \$997,000 (\$1,000,000 cost minus \$3,000 in basis difference amortization); and
- the impairment is other-than-temporary.

When allocating the \$147,000 impairment to its memo accounts, Investor first reduces its \$50,000 equity method goodwill to zero. It then allocates on a pro rata basis the remaining loss of \$97,000 to the basis differences in the building and the land. The allocation of the impairment loss and the adjustments to Investor's basis differences are as follows.

	Unadjusted basis diffs Sept. 30, Year 1	Impairment loss allocation	Adjusted basis diffs Sept. 30, Year 1
Equity method goodwill	\$ 50,000	\$ 50,000	\$ 0
Land	50,000	32,993 <sup>1</sup>	17,007
PP&E (building)	97,000	64,007 <sup>2</sup>	32,993
	<b>\$197,000</b>	<b>\$147,000</b>	<b>\$50,000</b>
Notes:			
1. $\$50,000 / \$147,000 \times \$97,000$ .			
2. $\$97,000 / \$147,000 \times \$97,000$ .			

### Investor's accounting

Investor records the following journal entry.

	Debit	Credit
Equity in earnings of Investee	147,000	
Investment in Investee		147,000
<i>To recognize impairment of investment in Investee.</i>		



### Question 5.5.50

**How does an investor consider the CTA when evaluating OTTI for a foreign investment?**

**Interpretive response:** An investor generally evaluates OTTI based on its functional currency – i.e. based on its investment balance only, excluding the CTA.

However, an investor is required to include the CTA as part of its carrying amount when evaluating OTTI when it has committed to a plan that will cause it to reclassify the CTA to earnings. [830-30-45-13]

Topic 830 provides no guidance on how an investor should determine whether it has 'committed to a plan' to dispose of the investment. We believe that if the investment is to be held and used as described in Topic 360, the CTA does not influence the investor's OTTI. [360-10-45-9]

Section 4 of KPMG Handbook, [Foreign currency](#), provides guidance on how foreign currency affects OTTI for foreign equity method investments.



### Question 5.5.60

#### Does an investor accrue costs to sell when an equity method investment is held for sale?

**Background:** An investor is required to present as a discontinued operation a component of an entity, including an equity method investment that is a component of an entity, if it meets the discontinued operation definition and the held-for-sale criteria in Subtopic 205-20. [205-20-45-1A – 45-2]

Topic 360 provides similar held-for-sale criteria for long-lived assets and requires an owner to measure those assets at fair value less costs to sell. [360-10-45-9 – 45-11, 35-40]

Equity method investments are outside the scope of Topic 360. [360-10-15-15(d)]

**Interpretive response:** No. We believe an equity method investor should recognize and measure OTTI based on the guidance in Topic 323, even if the investment meets Subtopic 205-20's held-for-sale criteria.

See section 2.4 of KPMG Handbook, [Foreign currency](#), for guidance on the scope of Subtopic 205-20.



### Question 5.5.70#

#### How does an investor measure OTTI of investments in qualified affordable housing projects before the adoption of ASU 2023-02?

**Background:** An investor in a qualified affordable housing project applies Subtopic 323-740 when accounting for its investment (i.e. LIHTC investment).

Before the adoption of ASU 2023-02, Subtopic 323-740 allows an investor in a qualified affordable housing project to apply as an accounting policy election the PAM if certain criteria are met. Otherwise, the investor applies Topic 323 or a modified cost method that is illustrated in Subtopic 323-740.

Subtopic 323-740 does not directly address how to measure OTTI when an investor accounts for a qualified affordable housing investment under the equity method. However, it does include an illustrative example in which OTTI is measured as the difference between the carrying amount of the investment and the remaining tax credits allocable to the investor. The example also states that an investor could measure the impairment as the difference between the carrying amount of the investment and the total tax benefits it expects to be generated by the investment. These measurement alternatives differ from the guidance in Topic 323 (and Subtopic 970-323), which requires an investor to reduce to fair value an equity method investment that is other-than-temporarily impaired.

**Interpretive response:** Given the inconsistency in the guidance, we believe each of the three measurement approaches described above is acceptable. An investor should consistently apply its elected accounting policy. See [Question 5.5.75](#) for guidance after adoption of ASU 2023-02.

Appendix B of KPMG Handbook, [Accounting for income taxes](#), provides additional guidance on how to account for investments in qualified affordable housing projects before the adoption of ASU 2023-02.

ASU 2023-02 is effective on January 1, 2024 for calendar year-end public business entities and January 1, 2025 for all other calendar year-end entities. Early adoption is permitted.

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### Question 5.5.75\*\*

#### How does an investor measure OTTI of investments in tax equity investments after the adoption of ASU 2023-02?

**Interpretive response:** An investor in tax equity investments that generate income tax credits and other income tax benefits may elect to apply Subtopic 323-740 when accounting for its investment.

After the adoption of ASU 2023-02, Subtopic 323-740 provides the option to elect the PAM on a tax credit program-by-program basis to account for certain investments made for the purpose of receiving income tax credits and other income tax benefits. If the PAM is elected, it is only applied if specific criteria are met. Otherwise, the investor applies the equity method of accounting in Topic 323. Section 6 of KPMG Handbook, [Tax credits](#), provides additional guidance on the PAM.

ASU 2023-02 removed the equity method impairment example for LIHTC investments in Subtopic 323-740 (see [Question 5.5.70](#)). As a result of this change, LIHTC investments, as well as other tax equity investments, accounted for under the equity method must apply the impairment guidance in Subtopic 323-10 (and 970-323). Under that guidance, an investor is required to reduce its equity method investment to fair value when the investment is other-than-temporarily impaired.

ASU 2023-02 is effective on January 1, 2024 for calendar year-end public business entities and January 1, 2025 for all other calendar year-end entities. Early adoption is permitted.

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# 6. Changes in ownership and degree of influence

## Detailed contents

**New item added in this edition: \*\***

**Item significantly updated in this edition: #**

### 6.1 How the standard works

### 6.2 Increases in ownership or influence

#### Questions

- 6.2.10 Can the equity method be triggered without the investor increasing its ownership interest?
- 6.2.20 How does an investor measure its cost basis when an additional investment triggers transition to the equity method? #
- 6.2.30 How does an investor account for an investee's share issuance?
- 6.2.40 How should an investor account for an investee's treasury stock purchase when it participates?
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**Examples**

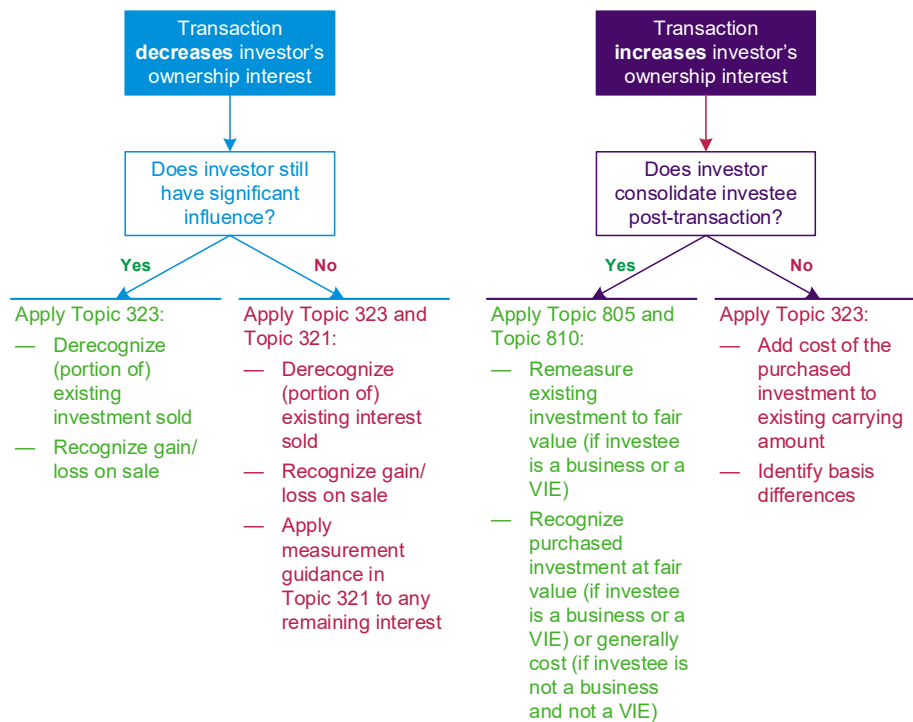
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## 6.1 How the standard works

An equity method investor's ownership percentage or degree of influence may change for many reasons. Purchase or sale of equity ownership interests by the investor or the investee is the most common.

The investor's accounting for the transaction and measurement of any retained interest in the investee depends on whether the change results in a change in the accounting method – i.e. from equity method to consolidation under Topic 810 or fair value measurement under Topic 321.

The following diagram summarizes the investor's accounting when there are increases or decreases in its ownership or degree of influence over an existing equity method investee.



In this chapter, we refer to the following additional Topics and Subtopics only by their Codification reference.

- Topic 321, Investments—Equity Securities
- Topic 323, Investments—Equity Method and Joint Ventures
- Topic 606, Revenue from Contracts with Customers
- Subtopic 610-20, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets
- Topic 740, Income Taxes
- Topic 805, Business Combinations
- Subtopic 805-10, Business Combinations—Overall

## 6. Changes in ownership and degree of influence

- Subtopic 805-50, Business Combinations—Related Issues
- Topic 810, Consolidation
- Topic 815, Derivatives and Hedging
- Topic 830, Foreign Currency Matters
- Topic 845, Nonmonetary Transactions
- Topic 860, Transfers and Servicing
- Subtopic 970-323, Real Estate—General—Investments—Equity Method and Joint Ventures

## 6.2 Increases in ownership or influence



### Excerpt from ASC 323-10

#### > Other Considerations

##### • > Changes in Level of Ownership or Degree of Influence

**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.

#### > Change in Level of Ownership or Degree of Influence

##### • > Increase in Level of Ownership or Degree of Influence

**35-33** Paragraph 323-10-15-12 explains that an investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 323-10-15-3 (that is, acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). If an investment qualifies for use of the equity method (that is, falls within the scope of this Subtopic), the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. The current basis of the investor's previously held interest in the investee shall be remeasured in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable, immediately before adopting the equity method of accounting. For purposes of applying paragraph 321-10-35-2 to the investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or a similar investment of the same issuer that results in it applying Topic 323, the entity shall remeasure its previously held interest at fair value immediately before applying Topic 323.

**35-34** The carrying amount of an investment in common stock of an investee that qualifies for the equity method of accounting as described in paragraph 323-10-15-12 may differ from the underlying equity in net assets of the investee. The difference shall affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary. However, if the investor is unable to relate the difference to specific accounts of the investee, the difference shall be recognized as goodwill and not be amortized in accordance with Topic 350.

An investor's ownership interest (or degree of influence) typically increases because:

- the investor acquires additional voting interests;
- the investee acquires or retires voting interests; or

- the investor acquires other securities, residual interests, financial instruments or contractual rights over the investee.

While increases in ownership (or degree of influence) often occur through transactions in which the investor participates, the investor should continually monitor its investee for other changes that may affect its accounting. These include changes in the investee's capital structure, organizational structure and operational management.

When an investor's ownership level increases, it must determine whether that increase triggers a change in accounting method.

### ***Increases that trigger a change in accounting method***

The following summarizes the accounting for changes in the degree of influence.

<b>Degree of influence</b>	<b>Control</b>	<p>An increase from having significant influence to a controlling financial interest in an investee triggers a transition from accounting for an equity method investment to consolidation under Topic 810.</p> <p>If the investee is a business, the investor applies the guidance on business combinations and remeasures to fair value its existing investment and recognizes the fair value of its new investment under Topic 805. [805-10-25-9, 805-20]</p> <p>If the investee is not a business and not a VIE, the investor applies the guidance on asset acquisitions and recognizes its new investment at cost under Subtopic 805-50. [805-50-30-3]</p> <p>If the investee is not a business and is a VIE, the investor applies the guidance on VIE consolidation and generally recognizes the fair value of its new investment under Topic 810 and may recognize a gain or loss. [810-10-30-3 – 30-4]</p>
	<b>Significant influence</b>	<p>An increase from having little to no influence to significant influence over an investee triggers a transition from accounting for a passive financial instrument under Topic 321 to an equity method investment under Topic 323.</p> <p>The investor adds to the carrying amount of its existing investment the cost of its new investment and immediately begins applying the equity method of accounting. [323-10-30-2, 35-33]</p>
	<b>Passive investor</b>	<p>A passive investor accounts for its investment under Topic 321.</p>

Chapter 2 provides guidance on how an investor evaluates whether it has significant influence (see section 2.4) and chapter 3 discusses how an investor initially recognizes and measures an equity method investment (see section 3.2 for measuring cost and section 3.3 for allocating cost).

This chapter discusses how an existing equity method investor accounts for increases in its ownership interest.

### ***Increases that do not trigger a change in accounting method***

Increases in ownership that do not give an equity method investor a controlling financial interest are recognized at cost. The investor then completes a memo purchase price allocation by (see [section 3.3](#)):

- allocating the incremental cost to its newly acquired share of the fair value of the investee's net assets;
- identifying whether the purchase results in a cost surplus (which it identifies as equity method goodwill if the investee is a business or generally allocates to the investee's noncurrent nonfinancial assets if the investee is not a business) or a cost shortage (which it generally allocates to its newly acquired share of the investee's noncurrent nonfinancial assets on a relative fair value basis);
- identifying basis differences, if any, which result from differences between the amounts that the investor allocated to its newly acquired share of the investee's assets and liabilities, and its share of the corresponding carrying amounts of those assets and liabilities on the investee's financial statements; and
- making memo entries to track the results of its allocation.



#### Question 6.2.10

#### **Can the equity method be triggered without the investor increasing its ownership interest?**

**Interpretive response:** Yes. While increases in an investor's degree of influence often occur through purchase transactions, the investor should continually monitor its investee for other changes that may trigger use of the equity method.

Common examples of changes that may result in the investor obtaining the ability to exercise significant influence include:

- changes in board participation;
- the investee's emergence from bankruptcy;
- lapse of rights previously contractually granted by the investor to other investors; and
- lapse or removal of severe foreign exchange restrictions, controls or other governmentally imposed uncertainties.

[Section 2.4](#) provides additional discussion on significant influence.

When an investor increases its ownership (or its influence) to a level at which it can exercise significant influence over the investee, it immediately begins applying the equity method. [\[323-10-30-2, 35-33\]](#)

**Question 6.2.20#****How does an investor measure its cost basis when an additional investment triggers transition to the equity method?**

**Interpretive response:** When an investor increases its ownership and triggers the requirement to use the equity method, it does so prospectively by adding the cost of acquiring the additional interest in the investee to the 'current basis' of the investor's previously held interest. [323-10-35-33]

If the investor measured its previously held interest at fair value under Topic 321, we believe the current basis of its previously held interest on transition to the equity method is its fair value at the date the equity method must be applied.

If the investor measured its previously held interest using the measurement alternative under Topic 321, the current basis of that interest on transition to the equity method depends on whether the investor acquired additional identical or similar investments of the same issuer in an orderly transaction. [321-10-30-1, 321-10-35-1 – 35-2]

- If so, the current basis is remeasured to fair value immediately before applying the equity method.
- If not, the cost of the additional interest is added to the basis under the measurement alternative to arrive at the current basis.

In many cases, the purchase price of the additional interest is a reliable indication of fair value for an investor applying this view. However, a fair value measurement under Topic 820 may differ from the observed transaction price; judgment is required to determine what (if any) adjustments an investor should make to the observed transaction price.

**Example 6.2.10#****Purchase of an additional investment that triggers the equity method**

On January 1, Year 1, Investor purchased a 10% common stock investment in Investee for \$100. Investee's common stock does not have a readily determinable fair value and Investor has not identified any basis differences.

Investor applies Topic 321 to its investment and has elected the measurement alternative. Investor has recognized no adjustments to the \$100 cost that it recognized as the initial carrying amount at purchase.

On January 1, Year 2, Investor purchases an additional 30% common stock investment in Investee for \$600, which gives it the ability to exercise significant influence over Investee. Investor concludes that the purchase is of an identical investment of the same issuer in an orderly transaction and the per share transaction price for its additional 30% interest is a reliable indication of fair value.

Investor records the following entries on January 1, Year 2.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee <sup>1</sup>	100	
Unrealized gain on equity securities <sup>1</sup>		100
<i>To recognize increase in value of Investor's existing 10% interest in Investee.</i>		
Investment in Investee	600	
Cash		600
<i>To recognize purchase of additional interest.</i>		
Note:		
1. Fair value of existing 10% interest of \$200 ( $(\$600 \div 30\%) \times 10\%$ ) minus carrying amount of \$100.		

When performing its memo purchase price allocation, Investor will allocate its total \$800 carrying amount to its share of the fair value of Investee's underlying assets and liabilities and identify whether equity method goodwill and basis differences exist. [Chapter 2](#) provides additional guidance on how an investor should allocate its cost basis when acquiring an equity method investment.



### Question 6.2.30

#### How does an investor account for an investee's share issuance?

**Interpretive response:** It depends.

When an investee issues additional ownership interests, its current investors may purchase none, some or all of the interests offered.

#### Investor increases its ownership percentage

When an equity method investor buys enough newly issued ownership interests of the investee to increase its ownership percentage, it accounts for the purchase at cost. If the investor does not have a controlling financial interest in the investee after the purchase, it completes a memo purchase price allocation for the cost to acquire the incremental interest (see [section 3.3](#)). [323-10-35-33, 35-5, 35-13]

See the accounting for Investor B (and Investor C) in [Example 6.3.90](#) for an illustration of how to account for an increase in ownership interest after an investee share issuance.

#### Investor maintains its ownership percentage

When an equity method investor buys only enough newly issued ownership interests of an investee to maintain its ownership percentage, it accounts for the purchase at cost and adjusts its investment account. [323-10-30-2]

The investor's claim on the investee's cash increases as a result of this transaction; however, its proportionate claim to the investee's other assets and



liabilities does not. Consequently, the investor does not perform a memo purchase price allocation.

### Investor decreases its ownership percentage

When an equity method investor participates in the share issuance but does not buy enough newly issued ownership interests to maintain its pre-transaction ownership percentage, it accounts for the transaction as an acquisition of additional interests and a partial disposition (see [Question 6.3.150](#)).

When the investor does not participate, it accounts for the investee share issuance as if the investor sold a proportionate share of its investment (see [Question 6.3.110](#)). [323-10-40-1]

[Section 6.3.30](#) provides guidance on how an investor accounts for dilution transactions.



### Question 6.2.40

#### How should an investor account for an investee's treasury stock purchase when it participates?

**Interpretive response:** When an investee repurchases from investors its own common stock to be held as treasury stock and the equity method investor participates, the investor's accounting depends on whether its share of the investee's underlying net assets increases or decreases.

### Investor increases its ownership percentage

If the investor sells back to the investee a smaller proportion of the total number of shares repurchased by the investee than its pre-transaction ownership interest, the investor is a net purchaser and its post-transaction ownership interest in the investee increases.

The equity method investor accounts for this transaction as if it directly purchased additional shares from a third party for no cost. Because the investor pays nothing (i.e. its incremental cost is zero) for its additional interest in the investee, it makes no adjustment to its investment account to reflect the increase in its ownership; but does recognize a decrease to the investment account for cash received in the share repurchase. [323-10-35-33]

However, the ownership change does affect the relationship between the financial statement carrying amount of the investor's investment (which declines as a result of the share repurchase) and its new share of the investee's underlying net assets. This causes a change to the investor's basis differences and is accounted for prospectively. [323-10-35-5, 35-13]

For example, if the investor's share of the investee's net assets went from \$100 to \$110 after the treasury stock purchase, the investor allocates that \$10 basis difference to its share of the investee's underlying assets and liabilities. The investor makes memo entries to track the results of that allocation and subsequently accounts for the incremental basis difference as if the investee were a consolidated subsidiary.

Section 3.3 provides additional guidance on how an investor identifies basis differences. Section 5.3 addresses the subsequent accounting for those basis differences.

### Investor decreases its ownership percentage

If the investor sells back to the investee a larger proportion of the total number of shares repurchased by the investee than its pre-transaction ownership percentage, the investor accounts for the dilution as a partial disposition. [323-10-40-1]

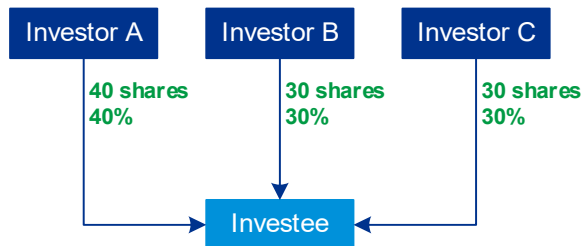
Section 6.3.30 provides guidance on how an investor accounts for dilution transactions. Question 6.3.160 addresses dilution transactions in which the investee buys back treasury shares.



### Example 6.2.20

#### Investee repurchase of its common stock – investor participates

As of January 1, Year 1, Investee has 100 shares of common stock outstanding and three common stock investors. The following diagram illustrates the ownership structure of Investee.



Investee's net assets include only the initial contributions from the three investors and retained earnings from its operations.

None of the investors have identified basis differences in their memo purchase price allocations – i.e. the carrying amounts of their investments equal their respective share of Investee's net assets.

### Treasury stock purchase

On June 30, Year 1, Investee repurchases 10 shares from each of its investors at \$15 per share in cash.

On June 29, Year 1, immediately before the repurchase, Investee's total net assets were \$1,000.

### Investee's accounting

Investee records the following journal entry for its share repurchase.

## 6. Changes in ownership and degree of influence

	<i>Debit</i>	<i>Credit</i>
Treasury stock (contra-equity) <sup>1</sup>	450	
Cash		450
<i>To recognize share repurchase.</i>		
Note:		
1. 30 shares of common stock repurchased × \$15 per share.		

**Investors' accounting**

The holdings of each of the investors are as follows before and after the repurchase.

	<b>Interest before</b>	<b>Calculation<sup>1</sup></b>	<b>Interest after</b>	<b>Calculation<sup>1</sup></b>
Investor A	40%	40/100 shares	42.8%	30/70 shares
Investor B	30%	30/100 shares	28.6%	20/70 shares
Investor C	30%	30/100 shares	28.6%	20/70 shares
	<b>100%</b>		<b>100.0%</b>	
Note:				
1. Based on shares of common stock outstanding.				

**Investor A**

Investor A records the following journal entry for its share sale.

	<i>Debit</i>	<i>Credit</i>
Cash <sup>1</sup>	150	
Investment in Investee		150
<i>To recognize sale of shares in Investee.</i>		
Note:		
1. 10 shares repurchased by Investee × \$15 per share.		

Next, Investor A performs its memo purchase price allocation, to identify any difference between its adjusted cost basis and its new share (42.8%) of Investee's underlying net assets.

Investment in Investee on June 29, Year 1 <sup>1</sup>	\$ 400
Minus: proceeds received from shares repurchased	(150)
Adjusted carrying amount in Investee	\$ 250
Minus: Post-transaction share of the underlying net assets of Investee <sup>2</sup>	(235)
<b>Excess of Investor A's cost over its post-transaction share of Investee's underlying net assets</b>	<b>\$ 15</b>

Notes:

1. \$1,000 (Investee's pre-transaction equity) × 40% (pre-transaction interest in Investee).
2. \$550 (Investee's \$1,000 pre-transaction equity minus \$450 treasury stock purchase) × 42.8% (post-transaction interest in Investee).

Because Investor A paid nothing for its additional 2.8% interest in Investee, it makes no adjustment to the adjusted basis of its investment account.

However, because the ownership change created a \$15 overall basis difference, it allocates that basis difference based on its share of the fair value of Investee's underlying assets and liabilities. After identifying the source(s) of the overall basis difference, it accounts for it prospectively. [323-10-35-5, 35-13]

### Investor B's and Investor C's accounting

Investors B and C each record the following journal entry for the share sale.

	<i>Debit</i>	<i>Credit</i>
Cash <sup>1</sup>	150	
Investment in Investee		150
<i>To recognize sale of shares in Investee.</i>		

Note:

1. 10 shares repurchased by Investee × \$15 per share.

To account for the dilution, Investors B and C each measure the difference between their adjusted cost basis in their investment in Investee and their share of Investee's underlying net assets.

Investment in Investee on June 29, Year 1 <sup>1</sup>	\$ 300
Minus: proceeds received from shares repurchased	(150)
Adjusted carrying amount in Investee	\$ 150
Minus: Post-transaction share of Investee's underlying net assets <sup>2</sup>	(157)
<b>Dilution gain: excess of Investor B's (and Investor C's) post-transaction share of Investee's underlying net assets over its cost</b>	<b>\$ 7</b>

Notes:

1. \$1,000 (Investee's pre-transaction equity) × 30% (pre-transaction interest in Investee).
2. \$550 (Investee's \$1,000 pre-transaction equity minus \$450 treasury stock purchase) × 28.6% (post-transaction interest in Investee).

Investors B and C each account for the decrease in their ownership percentage as a partial disposal of their interest and recognize a \$7 dilution gain in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	7	
Gain on dilution		7
<i>To recognize dilution gain from Investee's share repurchase.</i>		

These calculations assume that Investors B and C have no overall basis difference related to their investments in Investee. If there was, they would each adjust their dilution gain for a pro rata portion of that basis difference (see [Questions 6.3.120 and 6.3.130](#)).



### Question 6.2.50

**How does an investor account for an investee's treasury stock purchase when it does not participate?**

**Interpretive response:** When an investee repurchases from investors its own common stock to be held as treasury stock and the equity method investor does not participate, the equity method investor's ownership interest increases.

Like a participating investor that sells back to the investee a smaller proportion of the total shares repurchased (see [Question 6.2.40](#)), we believe the nonparticipating equity method investor accounts for this transaction as if it directly purchased additional shares from a third party for no cost.

Because the nonparticipating equity method investor pays nothing (i.e. its incremental cost is zero) for its additional interest in the investee, it makes no adjustment to its investment account when its ownership interest changes. [\[323-10-30-2\]](#)

However, the ownership change does affect the relationship between the financial statement carrying amount of its investment and its share of the investee's underlying net assets. This causes a change to the investor's basis differences and is accounted for prospectively. [\[323-10-35-13\]](#)

[Question 6.2.40](#) provides additional guidance and [Example 6.2.20](#) illustrates the accounting.



### Question 6.2.60#

**How does an investor transition from the equity method to consolidation when it obtains a controlling financial interest?**

**Interpretive response:** When an equity method investor increases its ownership (or its influence) to a level at which it obtains a controlling financial interest in the investee, it stops applying the equity method.

### **Investor and seller are under common control**

If the investor and seller are under common control, the investor does not remeasure its previously held interest in the investee. Instead, the investor measures the newly acquired assets and liabilities at the common control parent's carrying amounts; this is regardless of whether pushdown accounting was previously applied. The investor recognizes in equity any difference between the consideration paid and the net assets recognized. Section 28 of KPMG Handbook, [Business combinations](#), provides additional guidance.

### **Investor and seller are not under common control**

If the investor and seller are not under common control, the investor's accounting for the transaction depends on the nature of the investee over which it obtains a controlling financial interest. [\[805-10-25-9, 805-20\]](#)

### ***Investee is a business***

The investor remeasures its previously held equity method interest to its acquisition-date fair value and reclassifies the related CTA, if any, from AOCI. The investor recognizes the remeasurement and reclassification as a gain or loss in earnings. [\[805-10-25-10\]](#)

After the investor remeasures its existing interest, it initially measures at fair value the newly acquired assets, liabilities and NCI under Topic 805 and Topic 810.

Section 9 of KPMG Handbook, [Business combinations](#), provides additional guidance and examples on how to apply the acquisition method when the investor has a previously held equity method interest.

Section 4 of KPMG Handbook, [Foreign currency](#), discusses how to account for the CTA in a step acquisition.

### ***Investee is not a business and not a VIE***

If the investee is not a business and not a VIE, the investor generally does not remeasure its previously held interest in the investee. While Subtopic 805-50 – which provides guidance on asset acquisitions – does not specifically address these situations, it indicates that assets are recognized based on their cost to the acquiring entity. We believe measuring the previously held equity method interest at its carryover basis is the approach that is most consistent with that principle. [\[805-50-30-1\]](#)

However, we are aware of some diversity in practice in this area. We understand that, in certain circumstances, some investors remeasure a previously held equity method interest to fair value at the acquisition date by analogy to the guidance on business combinations.

The investor initially measures its investment in the newly consolidated subsidiary at its cost. We believe there are multiple acceptable approaches to allocating total cost in this scenario. Under one approach, the investor allocates its entire cost (the carrying amount of its previously held interest plus the incremental cost) based on relative fair values. Under another approach, the investor allocates (1) its incremental cost based on relative fair values and (2) the carrying amount of its previously held interest based on its previous proportionate share of each asset. [Question 3.3.60](#) discusses allocating cost when the investee is not a business.

There are also multiple acceptable approaches to allocating cost to NCI. We believe an acquirer has an accounting policy election to measure NCI either at (1) carryover basis or (2) fair value. If an investor uses carryover basis, it measures the NCI based on the carrying amounts within the acquired entity.

Chapter 3 of KPMG Handbook, [Asset Acquisitions](#), provides additional guidance and examples on how to account for asset acquisitions when the investor has a previously held interest.

### ***Investee is not a business but is a VIE***

If the investee is not a business but is a VIE, the guidance in Subtopic 805-50 on asset acquisitions does not apply. Instead, the investor (now primary beneficiary) applies the guidance in Topic 810 and generally recognizes and measures the assets, liabilities and NCI of the newly consolidated VIE using the acquisition method principles in Subtopic 805-20 on business combinations. However, there are two significant differences. [\[805-50-15-4, 810-10-30-3\]](#)

- The investor measures assets and liabilities that it transferred to the investee at, after, or shortly before the date it obtained its controlling financial interest based on what the carrying amounts would have been had the investor not transferred those assets and liabilities.
- Because the VIE is not a business, the investor (now primary beneficiary) is precluded from recognizing goodwill and may recognize a gain or loss on initial consolidation.

Any gain or loss is measured as the difference between: [\[810-10-30-4\]](#)

- the aggregate of:
  - the fair value of the consideration paid;
  - the fair value of any NCI; and
  - the reported amount of any previously held interests; and
- the net amount of the VIE's identifiable assets and liabilities recognized and measured under Subtopic 805-20.

### **Income tax implications**

When an investor remeasures its investment, it generally results in an additional deferred tax liability because it creates or increases a taxable outside basis difference in the investment (see [Question 3.3.100](#)). For a discussion of presentation in the income statement, see [Question 7.2.50](#).

In some situations when an equity method investor gains control, it may also be able to derecognize a deferred tax liability associated with its taxable outside basis difference when the investee becomes a subsidiary – e.g. if the subsidiary is domestic, at least 50%-owned after the increase in ownership and can be recovered tax-free. The investor derecognizes that liability with a corresponding adjustment in the income statement (see [Question 7.2.50](#)).

An equity method investor with an existing deferred tax liability for its outside basis difference in a foreign equity investment derecognizes that deferred tax liability on transition from the equity method to consolidation if it meets the indefinite reversal criterion. [\[740-30-25-7 – 25-8, 25-15\]](#)

If the equity method investor had a deferred tax asset for its outside basis difference, it must eliminate that deferred tax asset as an adjustment to the

income statement unless it is apparent the deferred tax asset will reverse in the foreseeable future. [740-30-25-9 – 25-10]

Section 6 of KPMG Handbook, [Accounting for income taxes](#), provides additional guidance on how to account for the income tax effects of business combinations. Section 10 provides additional guidance on how to account for the tax effects of asset acquisitions.



### Example 6.2.30

#### Investor's influence increases from significant influence to a controlling financial interest in an investee that is not a business and not a VIE

Investor has a 25% equity method investment in Investee with a carrying amount of \$250. Investee is not a business and not a VIE.

Investor did not identify basis differences in its memo purchase price allocation – i.e. the carrying amount of its investment equals its share of Investee's net assets.

Investor acquires an additional 30% equity interest in Investee for \$360. The purchase results in Investor obtaining a controlling financial interest in Investee.

Because Investee is not a business, Investor accounts for the transaction as an asset acquisition. In accounting for the purchase, Investor does not remeasure its previously held equity method interests, and initially measures NCI at carryover basis.

Investor recognizes the following journal entry in its consolidated financial statements. As discussed in [Question 6.2.60](#), we believe there are multiple acceptable approaches to allocating Investor's total cost (\$1,060) to Investee's individual assets and liabilities on consolidation.

	<i>Debit</i>	<i>Credit</i>
Net assets of Investee – 30% <sup>1</sup>	360	
Net assets of Investee – 25% <sup>2</sup>	250	
Net assets of Investee – 45% <sup>3</sup>	450	
Investment in Investee (25%)		250
NCI		450
Cash		360
<i>To recognize obtaining control of Investee.</i>		
Notes:		
1. Cash paid for the additional 30% interest in Investee.		
2. Existing 25% interest remains at its carrying amount at the date of obtaining control.		



3. NCI is equal to 45% of the current carrying amount of Investee's net assets:  $45\% \times$  implied carrying amount of Investee's net assets of \$1,000 (Investor's carrying amount of \$250  $\div$  25%).



### Question 6.2.70

#### How does an investor present the investee's operations in the year it obtains a controlling financial interest?

**Interpretive response:** When an equity method investee becomes a consolidated subsidiary during the year, the investor includes in its consolidated revenue and expenses only the subsidiary's activity arising after the date of consolidation. The investor reports its share of the investee's pre-consolidation earnings in equity in earnings.

When the investor presents comparative financial statements, it continues to present equity in earnings of the investee under Topic 323 for those periods before it obtained a controlling financial interest.



### Question 6.2.80

#### How does an investor account for suspended losses when it obtains a controlling financial interest?

**Background:** An investor typically discontinues applying the equity method when its investment is reduced to zero. It suspends recognizing its share of additional losses after that point unless it has guaranteed the investee's obligations, is committed to provide the investee financial support or has other investments in the investee. If the investee returns to profitability, the investor resumes the equity method after its share of the investee's net income equals the losses the investor did not recognize (referred to as 'suspended losses'). [323-10-35-20 – 35-22]

[Section 4.4](#) provides additional guidance on how to account for equity method losses when the equity method investment has been reduced to zero.

**Interpretive response:** An investor's suspended losses have no accounting consequence when it obtains a controlling financial interest. The investor applies the guidance in Subtopic 805-10 for business combinations, Subtopic 805-50 for asset acquisitions, or Topic 810 for initially consolidating VIEs (see [Question 6.2.60](#)).

The investor does not recognize the suspended losses at the acquisition date or retroactively adjust prior period financial statements to recognize the losses. This applies to a transaction whether it is a business combination, an asset acquisition or the initial consolidation of a VIE.

## 6.3 Decreases in ownership or influence

### 6.3.10 Overview

When an investor's ownership interest in an existing equity method investee decreases, it accounts for the transaction as a sale, regardless of whether the investor's interest is (1) sold to a third party (or back to the investee) or (2) diluted because of an investee share issuance.

When the investor's ownership decreases, it derecognizes the carrying amount of the interest sold and recognizes a gain or loss in earnings. While an investor typically presents its gain or loss on sale in continuing operations, the sale of an equity method investment may qualify for discontinued operations presentation (see [section 7.2](#)). [323-10-35-35, 40-1, 323-30-35-4, 205-20-45-1B – 45-1C]

If the investor retains an investment in the investee after the transaction, its subsequent accounting for that investment depends on whether it retained or lost significant influence.

- If the investor continues to have the ability to exercise significant influence, it continues applying the equity method for its retained interest.
- If not, the investor stops applying the equity method and applies the guidance in Topic 321. The investor's post-sale carrying amount becomes its cost basis under Topic 321 for the purpose of future accounting. [323-10-35-36]

### 6.3.20 Sales, exchanges and distributions



#### Excerpt from ASC 323-10

> Change in Level of Ownership or Degree of Influence

• > Decrease in Level of Ownership or Degree of Influence

**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.

**35-36** An investment in voting stock of an investee may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions and the investor may thereby lose the ability to influence policy, as described in that paragraph. An investor shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this paragraph. Upon the discontinuance of the equity method, an investor shall remeasure the retained investment in accordance with paragraph 321-10-35-1 or 321-10-35-2, as applicable. For purposes of applying paragraph 321-10-35-2 to the investor's retained investment, if the investor identifies observable price changes in

orderly transactions for the identical or a similar investment of the same issuer that results in it discontinuing the equity method, the entity shall remeasure its retained investment at fair value immediately after discontinuing the equity method. Topic 321 also addresses the subsequent accounting for investments in equity securities that are not consolidated or accounted for under the equity method.

• • > Other Comprehensive Income upon Discontinuation of the Equity Method

**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.



### Excerpt from ASC 323-30

> Discontinuance of the Equity Method

**35-4** Paragraph 323-10-35-39 provides guidance on discontinuance of the equity method for a limited partnership because the conditions in paragraph 970-323-25-6 are met.

## Sales

An investor generally applies Topic 860 when accounting for the derecognition of an equity method investment. On sale, the investor recognizes in earnings a gain or loss that is generally equal to the difference between the selling price and the carrying amount of the common stock sold. [323-10-35-5]

When an equity method investment meets the definition of an 'in-substance nonfinancial asset', the investor applies Subtopic 610-20 when accounting for

the derecognition. On sale, the investor recognizes a gain or loss in earnings that is generally equal to the difference between the transaction price and the carrying amount of the investment. [610-20-15-2, 32-2 – 32-6]

An equity method investment is an in-substance nonfinancial asset if: [610-20-15-5 – 15-7]

- it is held by a subsidiary that is not a business;
- substantially all of the fair value of the assets within the subsidiary is concentrated in nonfinancial assets; and
- the subsidiary is being sold to a noncustomer.

An equity method investment that is not held by a subsidiary can also be an in-substance nonfinancial asset if:

- it is promised in a contract along with other assets;
- substantially all of the fair value of the assets subject to the contract is concentrated in nonfinancial assets; and
- the contract is with a noncustomer.

### Exchanges

An investor that exchanges an equity method investment for another equity method investment (or another asset) also applies Topic 860 (or Subtopic 610-20, if the outbound equity method investment is an in-substance nonfinancial asset) when determining whether to derecognize the investment. However, when the investor/transferor receives as consideration an asset other than another equity method investment, it considers the initial measurement required by other GAAP for that inbound asset. [805-50-30-2, 805-20-30]

### Distributions

An investor that distributes to its shareholders an equity method investment determines the measurement attribute of that distribution based on whether or not it is a pro rata distribution (see [Questions 6.3.90](#) and [6.3.100](#)). [845-10-30-10]



#### Question 6.3.10

**Does the investor consider adjustments it made to other investments in the investee when it sells only the equity method investment?**

**Interpretive response:** Yes. The investor may have adjusted its basis in another investment in the investee because its share of the investee's losses reduced its equity method investment balance to zero (see [section 4.4.30](#)). In that case, we believe the investor should include the reversal of that adjustment in the gain or loss on the sale of the equity method investment. [323-10-35-25]

Because the investor would reverse that adjustment if the investee recognized equity method income in future periods, we believe it is directly associated with the equity method investment and therefore disappears when the investment disappears. We do not believe it creates a new cost basis in the other investment that carries forward after selling the equity method investment.



### Question 6.3.20

#### How does an investor account for the sale of an undivided interest?

**Interpretive response:** An investor applies Topic 860 (or Subtopic 610-20) when it sells an equity method investment.

We believe Topic 860 (or Subtopic 610-20) likewise applies to sales of all undivided interests that are accounted for under the equity method, including undivided interests in (see [section 2.3.50](#)):

- ventures for which the investor uses one-line presentation;
- ventures for which the investor uses proportionate consolidation; and
- real property for which the investor is required, or elects, to apply the equity method under Subtopic 970-323.

Section A of KPMG Handbook, [Revenue: real estate](#), provides additional guidance about derecognizing undivided interests.

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### Question 6.3.30

#### How does the investor determine the carrying amount in a partial sale of its investment?

**Interpretive response:** A common approach in practice is average cost. The investor computes the average carrying amount per share of investee common stock, based on its total carrying amount. The first-in first-out and specific identification methods are also acceptable.

The investor includes in its total carrying amount all the financial statement accounts that will be settled on derecognition of the equity investment. This includes:

- the unamortized difference between the investor's carrying amount and its underlying share of the investee's net assets (the aggregate basis difference, see [sections 3.3](#) and [5.3](#));
- intra-entity profits and losses that have been deferred – including those that have been presented outside of the investment account (see [section 5.2](#));
- the adjustments made to the carrying amount of other interests in the investee because the equity method investment account was reduced to zero (see [section 4.4](#) and [Question 6.3.10](#));
- amounts included in the investor's AOCI, such as the CTA and the investor's share of the investee's AOCI (see [section 4.5](#) and [Question 6.3.50](#)).

The investor excludes the carrying amount of other investments in and liabilities to the investee if they will be settled separately from the disposition of the equity investment.

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**Example 6.3.10****Investor sells investee common stock**

Investor owns 40% of Investee's common stock – i.e. 400 of the 1,000 shares of common stock Investee has outstanding. Investor accounts for its investment under the equity method.

The carrying amount of Investor's investment is \$10,000 and includes:

- Investor's excess of cost over its share of Investee's underlying net assets.
- Its share of Investee's earnings and losses since Investor acquired its investment in Investee on January 1, Year 1.
- A \$2,000 credit included in AOCI related to its share of Investee's OCI.

On January 1, Year 4, Investor sold 100 shares of Investee common stock (a 10% interest), to a third party for \$4,000, or \$40 per share. Investor's remaining 30% interest continues to allow it to exercise significant influence over Investee.

**Calculation of gain or loss on sale**

The average carrying amount for each common share of Investee stock is \$25. This is the total carrying amount of the investment (\$10,000) divided by the number of shares of common stock Investor held before the sale (400 shares).

Investor then calculates the total carrying amount of common stock sold by multiplying the average carrying amount per share (\$25) by the number of shares of common stock sold (100 shares): \$2,500.

Investor also proportionately adjusts the amount in AOCI for reduction in its ownership percentage (\$2,000 × 25% reduction in ownership).

As a result, Investor's gain on sale of Investee's shares of common stock is as follows.

Proceeds received from sale of 100 shares of common stock	\$ 4,000
Minus average carrying amount of common stock sold	(2,500)
Adjustment to AOCI	500
<b>Gain on sale of Investee common stock</b>	<b>\$ 2,000</b>

**Example 6.3.20****Calculating the average carrying amount of common stock sold – multiple investment tranches**

On December 31, Year 5, Investor owns 2,000 shares of Investee common stock, which it acquired in three transactions:

- 1,200 shares of common stock for total consideration of \$30,000;
- 400 shares of common stock for total consideration of \$5,000; and
- 400 shares of common stock for total consideration of \$6,000.

Investor began applying the equity method when it initially acquired the first tranche of 1,200 shares. Investee has 5,000 shares issued and outstanding.

On January 1, Year 6, Investor sells 500 shares of Investee common stock to a third party for \$14,000.

At the time of sale, Investor's carrying amount of its investment in Investee is \$46,000.

### Calculation of gain or loss on sale

The average carrying amount of Investor's investment in the common stock of Investee on the date of sale is \$23 per common share. This is the carrying amount of the investment (\$46,000) divided by 2,000 shares.

Investor then calculates the total carrying amount of common stock sold by multiplying the average carrying amount per share (\$23) by the number of shares of common stock sold (500 shares): \$11,500.

As a result, Investor's gain on sale of Investee's common stock is as follows.

Proceeds received from sale of 500 shares of common stock	\$ 14,000
Minus average carrying amount of common stock sold	(11,500)
<b>Gain on sale of Investee common stock</b>	<b>\$ 2,500</b>



### Question 6.3.40#

#### How does an investor transition from the equity method when it loses significant influence?

**Background:** Under Topic 321, a company generally measures an equity investment at fair value and recognizes changes in fair value in net income.

However, a company may choose to measure an equity investment that does not have a readily determinable fair value using a measurement alternative. Under the alternative, the investment is measured at cost minus any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. Topic 321 requires that if an investor identifies such an observable price, it measures its equity security at fair value under Topic 820 as of the date that the observable transaction occurred. [321-10-35-2]

**Interpretive response:** When an investor's ownership or level of influence decreases and triggers the requirement to stop using the equity method, the existing carrying amount of the investment under the equity method becomes the carrying amount of the investment as of the date of the change in accounting method. [323-10-35-36]

The carrying amount of the investment on discontinuing the equity method includes any adjustment needed to reverse amounts in the investor's AOCI related to its share of the investee's AOCI. If the investor has a credit balance in AOCI that exceeds its investment balance, it recognizes that excess in earnings. [323-10-35-39]

**Prospective fair value measurement under Topic 321**

If the investor will measure the remaining equity interest at fair value under Topic 321, we believe it should:

- establish its initial carrying amount as the existing carrying amount when it stopped the equity method; and
- immediately adjust that carrying amount to its fair value.

**Prospective application of the measurement alternative under Topic 321**

If the investor will measure the remaining equity interest using the measurement alternative and is discontinuing the equity method because an orderly transaction has occurred in the same or similar investment of the investee, the investor remeasures its retained investment at fair value immediately after it no longer applies the equity method. [321-10-30-1, 323-10-35-36]

If the investor is discontinuing the equity method for reasons other than an orderly transaction in the same or similar investment of the investee (e.g. it loses board representation), the carrying amount of the retained investment established at the end of equity method accounting is not adjusted before applying the measurement alternative. [321-10-30-1]

**Example 6.3.30****Discontinuing equity method when the investee has OCI (1)**

Investor has a 19% ownership interest in Investee. Investor has been applying the equity method to its investment since acquisition because of its participation on Investee's board of directors.

Due to a recent restructuring of Investee, Investor lost its board representation and its ability to exercise significant influence over Investee. On the date of the restructuring, Investor's carrying amount for its investment in Investee is \$100, \$10 of which was recognized with a credit to Investor's OCI for its share of Investee's unrealized gains on available-for-sale debt securities.

When Investor discontinues the equity method, the carrying amount of its investment in Investee is \$90: its \$100 carrying amount minus the \$10 gain reclassified to the investment account from Investor's AOCI.

**Scenario 1: Fair value under Topic 321**

Immediately after accounting for the loss of significant influence, Investor adjusts the \$90 carrying amount to fair value through net income in the line item in which unrealized gain or loss on securities is reported.

**Scenario 2: Measurement alternative under Topic 321**

Investor maintains the \$90 carrying amount after accounting for the loss of significant influence. Absent impairment, Investor will remeasure the carrying amount if and when there is a price change observable in an orderly transaction for the identical or similar investment of the same issuer or the investment is impaired.



Investor does not adjust the \$90 carrying amount to fair value through net income. This is because there has been no orderly transaction for the identical or similar security of Investee that provides an observable price.



### Example 6.3.40#

#### Discontinuing equity method when the investee has OCI (2)

Investor has a 40% ownership interest in Investee and applies the equity method to its investment.

Investor sells 30% (or 75%) of its investment to a third-party investor for \$2,500, which reduces its interest to 10%, in an orderly transaction in the same or similar investment of Investee. Investor concludes that it can no longer exercise significant influence and discontinues the equity method.

Just before the sale, Investor's carrying amount for its investment in Investee was \$3,000, \$400 of which was recognized with a credit to Investor's OCI for its share of Investee's prior period pension activity.

Investor records the following journal entry at the date of sale.

	<i>Debit</i>	<i>Credit</i>
Cash	2,500	
AOCI <sup>1</sup>	300	
Investment <sup>2</sup>		2,250
Gain on sale		550
<i>To recognize gain on sale by reducing existing carrying amount and AOCI by 75%.</i>		
AOCI <sup>3</sup>	100	
Investment		100
<i>To adjust carrying amount of investment for remaining amount in AOCI.</i>		
Notes:		
1. \$400 × 75%.		
2. \$3,000 × 75%.		
3. \$400 – \$300.		

When Investor discontinues the equity method, the carrying amount of its investment in Investee is \$650: \$750 (\$3,000 pre-sale carrying amount × 25%), minus the \$100 gain that Investor reclassified to the investment account from its AOCI.

#### Scenario 1: Fair value under Topic 321

Immediately after accounting for the loss of significant influence, Investor adjusts the \$650 carrying amount to fair value through net income in the line item in which unrealized gain or loss on securities is reported.

**Scenario 2: Measurement alternative under Topic 321**

Immediately after accounting for the loss of significant influence, Investor adjusts the \$650 carrying amount to fair value (because it is an orderly transaction in the same or similar investment of Investee) through net income in the line item in which unrealized gain or loss on securities is reported. See [Question 6.3.40](#) for guidance that applies when it is not an orderly transaction in the same or similar investment of Investee.

**Question 6.3.50****When does an investor reduce or eliminate the CTA associated with an equity method investment?**

**Interpretive response:** Topic 830 requires investors (in subsidiaries or equity method investments) to recognize as part of the gain or loss on sale of a foreign investee the entire translation adjustment component of AOCI attributable to that investee (see [Question 5.3.50](#)). This includes the amounts that the investor has recognized in the translation adjustment as a result of applying net investment hedge accounting (see [Question 5.3.60](#)).

This guidance applies only to: [\[830-30-40-1 – 40-1A, 815-35-35-1\]](#)

- the complete (or substantially complete) sale, exchange or liquidation of a direct investment in a foreign entity;
- the deconsolidation of a direct investment in a foreign entity; and
- an increase in ownership interest that results in an existing equity method investee becoming the investor's subsidiary in a business combination (see [Question 6.2.60](#)).

Topic 830 also requires an equity method investor that sells a portion of its equity method investment to recognize as part of its gain or loss on the partial sale a pro rata portion of the CTA attributable to that investment. This includes the effects of applying net investment hedge accounting. [\[830-30-40-2\]](#)

If the investor no longer has the ability to exercise significant influence and therefore discontinues the equity method because of the partial sale, it: [\[323-10-35-37 – 35-39\]](#)

- recognizes as part of its gain or loss on the partial sale a pro rata portion of the CTA attributable to that investment; and
- reclassifies from AOCI to the remaining investment account, the remainder of the related CTA (see [Example 6.3.40](#)).

If after recognizing the pro rata portion of the CTA, the remainder of the CTA (and any other balances in the investor's AOCI attributable to the investee) exceeds the remaining investment balance, the investor recognizes that amount in earnings.

Section 4 of KPMG Handbook, [Foreign currency](#), provides discussion and examples on how to account for translation adjustments on sale or liquidation.



### Question 6.3.60#

## How does an investor account for an exchange of an equity method investment for another asset or group of assets?

**Interpretive response:** An investor generally applies Topic 860 (or Subtopic 610-20 (see [section 6.3.20](#)) when determining whether to derecognize an equity method investment.

An investor that exchanges its equity method investment in the scope of Topic 860 for an individual asset or group of assets that is not a business recognizes the inbound asset(s) at fair value. How that asset is measured differs based on whether the inbound asset(s) is (1) an individual asset or group of assets or (2) an entity that is a VIE that is not a business (a nonbusiness VIE).

[Question 6.3.105](#) provides guidance on accounting for the receipt of nonmonetary assets on dissolution of an investee.

### Individual asset or group of assets

If the inbound asset (including an equity method investment) or group of assets is not a business, the investor/transferor initially measures the inbound asset(s) at its fair value and allocates that amount to each asset using the asset acquisition guidance in Subtopic 805-50 (see [Question 3.3.05](#) of KPMG Handbook, [Asset acquisitions](#)). [[860-20-30-1](#), [805-50-30-2](#), [323-10-30-2](#), [845-10-55-2](#)]

When the investor derecognizes the equity method investment, it recognizes a gain or loss for the difference between the measurement of the inbound asset(s) and the carrying amount of its equity method investment. The investor also recognizes as part of its gain or loss any CTA associated with the investment (see [Question 6.3.50](#)).

### Controlling financial interest in a nonbusiness VIE

If the inbound asset is:

- a controlling financial interest in an entity; and
- the entity is a VIE that is not a business,

the investor generally measures the inbound assets (excluding goodwill), liabilities and NCIs at fair value using the acquisition method principles in Subtopic 805-20 on business combinations.

However, the investor measures assets and liabilities that it transferred to the VIE at, after, or shortly before the date it obtained its controlling financial interest based on what the carrying amounts would have been had the investor not transferred those assets and liabilities. For example, if the investor receives a controlling financial interest in a VIE that now holds the outbound equity method investment, it continues to measure that equity method investment at its carrying amount immediately before the exchange. [[810-10-30-3](#)]

The investor generally recognizes a gain or loss when it initially consolidates a nonbusiness VIE and measures it as the difference between: [[810-10-30-4](#)]

- the aggregate of:
  - the fair value of the consideration paid;
  - the fair value of any NCI; and
  - the reported amount of any previously held interests; and
- the net amount of the VIE's identifiable assets and liabilities recognized and measured under Subtopic 805-20.

See [Question 6.3.70](#) for additional discussion of how an investor accounts for an exchange of an equity method investment when it receives a controlling financial interest in an entity (or a group of assets) that is a business.



### Question 6.3.70

**How does an investor account for an exchange of an equity method investment for a controlling financial interest in a business?**

**Interpretive response:** An investor generally applies Topic 860 or Subtopic 610-20 when determining whether to derecognize an equity method investment.

An investor that exchanges its equity method investment for a controlling financial interest in a business measures the inbound assets, liabilities and NCI at fair value under Topic 805. [\[810-10-30-2\]](#)

When the investor derecognizes the equity method investment, it recognizes a gain or loss for the difference between the measurement of the inbound asset(s) and the carrying amount of its equity method investment. [\[860-10-40, 610-20-32-2 – 32-6\]](#)

However, if the investor receives a controlling financial interest in the entity that now holds the outbound equity method investment, it continues to measure that equity method investment at its carrying amount immediately before the exchange, including any related CTA. It also defers any gain that results from measuring most of the inbound assets at fair value. The investor derecognizes the equity method investment and recognizes the deferred gain when it loses control of the investment – e.g. when it sells the investment to a third party. [\[805-30-30-8\]](#)



### Question 6.3.80#

**How does an investor transition to the equity method when it loses a controlling financial interest in its consolidated subsidiary?**

**Interpretive response:** At the point an investor loses its controlling financial interest in a consolidated subsidiary, it begins applying the equity method if it has the ability to exercise significant influence over the investee. If not, the investor accounts for the investee under Topic 321.

There are two primary ways an investor transitions from consolidation to the equity method.

### **Subsidiary is a business or a non-profit activity**

The investor deconsolidates the subsidiary by removing its net assets and recognizing a gain or loss in net income that is measured as the difference between: [810-10-40-3A, 480-10-S99]

- the aggregate of:
  - the fair value of the consideration received;
  - the fair value of the retained NCI in the former subsidiary at the date of deconsolidation;
  - the carrying amount of the NCI (excluding adjustments related to redeemable NCIs) in the former subsidiary (including AOCI attributable to the NCI) at the date of deconsolidation; and
- the carrying amount of the former subsidiary’s assets and liabilities.

The loss of control and the related deconsolidation of a subsidiary is a significant economic event that causes the parent-subsidiary relationship to end and an investor-investee relationship to begin. As a result, the investor measures a retained ownership interest in the investee at its fair value upon deconsolidation when the equity method begins. This fair value measurement becomes the investor’s cost basis in its equity method investment, which is allocated to the acquired assets and liabilities so the investor can identify and account for its basis differences (see [chapter 2](#)). [323-10-30-2, 35-5, 35-13]

While an investor typically presents its gain or loss on sale in continuing operations, the deconsolidation of a subsidiary may qualify for discontinued operations presentation (see [Question 7.3.60](#)).

Section 7.6 of KPMG Handbook, [Consolidation](#), provides additional discussion and examples of changes in a parent’s ownership that result in loss of a controlling financial interest. KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), provides additional guidance on discontinued operations presentation and disclosure.

### **Subsidiary is not a business and holds only nonfinancial assets and in-substance nonfinancial assets**

The investor deconsolidates the subsidiary by removing its net assets and recognizing a gain or loss in net income that is measured as the difference between: [610-20-32-3 – 32-5]

- the aggregate of:
  - the transaction price under Topic 606;
  - the carrying amount of liabilities assumed by the buyer; and
- the carrying amount of the former subsidiary’s assets and liabilities.

The investor’s retained ownership interest in the investee is included in the transaction price – as noncash consideration – and measured at fair value at the contract inception date. This fair value measurement becomes the investor’s cost basis in its equity method investment, which is allocated to the acquired

assets and liabilities so the investor can identify and account for its basis differences (see [chapter 2](#)). [610-20-32-3, 606-10-32-21, 323-10-30-2, 35-5, 35-13]

While an investor typically presents its gain or loss on sale in continuing operations, the deconsolidation of a subsidiary may qualify for discontinued operations presentation (see [Question 7.3.60](#)).

Section F of KPMG Handbook, [Revenue: real estate](#), provides additional guidance about changes in a parent's ownership that result in loss of a controlling financial interest when the subsidiary is not a business and holds only nonfinancial assets and in-substance nonfinancial assets.

KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), provides additional guidance on discontinued operations presentation and disclosure.

### Other subsidiaries

An investor applies other guidance on derecognizing a subsidiary if the transaction is a: [810-10-40-3A]

- conveyance of oil and gas mineral rights – apply Subtopic 932-360.
- transfer of a good or service in a contract with a customer – apply Topic 606.
- nonmonetary exchange – apply Topic 845.
- transfer of a financial asset – apply Topic 860.

### Income tax implications

Topic 740 permits a parent company to apply certain exceptions to the recognition of deferred taxes on its outside basis differences in its subsidiaries. Most of those exceptions do not apply to equity method investments. As a result, when the investor deconsolidates a subsidiary, it may need to recognize a deferred tax asset or liability on its outside basis difference in the equity method investment.

For example, as it relates to its outside basis difference in a subsidiary investment, a parent does not recognize: [740-30-25-7 – 25-10]

- a deferred tax liability, if the subsidiary is at least 50%-owned and is domestic; or
- a deferred tax asset, unless it is apparent it will reverse in the foreseeable future.

When the investor transitions to the equity method, it must recognize deferred taxes for those outside basis differences because the exceptions do not apply to outside basis differences in equity method investments.

Topic 740 also allows a parent not to recognize a deferred tax liability on its taxable outside basis difference in a foreign subsidiary investment if it has met the indefinite reversal criterion. When an investor transitions to the equity method, it is required to recognize a deferred tax liability on transition from consolidation to the equity method for the outside basis difference in the foreign investments.

An investor recognizes deferred taxes on an outside basis difference that arises after it begins applying the equity method – unless another one of the Topic 740

exceptions applies. See [Question 3.3.100](#) for additional discussion. [740-30-25-15 – 25-18]

Sections 2 and 10 of KPMG Handbook, [Accounting for income taxes](#), provide additional guidance on identifying and measuring deferred taxes for outside basis differences on subsidiaries and equity method investments.

### Share-based payment implications

As discussed in [section 5.4](#), when an investor grants share-based payment awards to an employee of an equity method investee, it accounts for those awards as nonemployee awards. If the other investors do not proportionately fund the investee's related compensation cost, the investor expenses as incurred the cost of the share-based payment awards to the extent its claim on the investee's book value has not increased. [323-10-25-3 – 25-4]

When a parent company reduces its interest in a consolidated subsidiary and that former subsidiary becomes an equity method investee, the investee's employees are no longer the parent's employees. As a result, if the investee's employees have unvested share-based payment awards at that date, the investor could face accounting consequences due to their change in status from employee to nonemployee. We believe those consequences depend on the terms of the awards and whether modifications have been made to those awards. In addition, if the investee's employees have vested share-based payment awards at that date, there can be accounting consequences if the vested awards are modified. [718-10-35-10 – 35-11]

Section 1 of KPMG Handbook, [Share-based payment](#), provides additional guidance and examples on how an investor accounts for a change in grantee status.



### Question 6.3.90

#### How does an investor account for a pro rata distribution of an equity method investment?

**Interpretive response:** An equity method investor accounts for a pro rata distribution of investee common stock to its shareholders like a spinoff under Topic 845. The investor measures the distribution at the carrying amount of the equity method investment distributed. [845-10-30-10]



### Example 6.3.50

#### Equity method investor pro rata distribution of investee common stock

Investor owns 300 shares of Investee common stock, which represents a 30% ownership interest. Investor accounts for its investment under the equity method. The investment's carrying amount is \$30,000 and its fair value is \$65,000.

Investor decides to distribute via dividend its common stock in Investee to its three stockholders based on their ownership interests in Investor – i.e. on a pro

rata basis. Each stockholder owns one-third of Investor's stock, so each stockholder will receive 100 shares of Investee common stock.

Because Investor will distribute its investment in Investee to its stockholders on a pro rata basis, Investor measures the dividend at the carrying amount of its common stock in Investee.

Investor records the following journal entry for the distribution.

	<i>Debit</i>	<i>Credit</i>
Retained earnings – Investor	30,000	
Investment in Investee		30,000
<i>To recognize distribution of Investee common stock.</i>		



### Question 6.3.100

#### How does an investor account for a non-pro rata distribution of an equity method investment?

**Interpretive response:** An equity method investor's non-pro rata distribution to one or more of its shareholders of investee common stock is a nonreciprocal transfer under Topic 845.

The investor measures the distribution at fair value and recognizes a gain or loss in net income. The amount of the gain or loss is equal to the difference between the fair value of the investee common stock distributed and its carrying amount at the date of distribution. [\[845-10-30-10\]](#)



### Example 6.3.60

#### Equity method investor non-pro rata distribution of investee common stock

Investor owns 300 shares of Investee common stock, which represents a 30% ownership interest. Investor accounts for its investment under the equity method. The investment's carrying amount is \$30,000 and its fair value is \$65,000.

Investor decides to distribute via dividend its common stock in Investee to one of its three stockholders.

Because Investor will distribute its investment in Investee to only one of its stockholders, Investor measures the dividend at the fair value of its common stock in Investee and recognizes the resulting gain or loss in net income.



Investor records the following journal entry for the distribution.

	<i>Debit</i>	<i>Credit</i>
Retained earnings – Investor	65,000	
Gain on distribution		35,000
Investment in Investee		30,000
<i>To recognize distribution of Investee common stock.</i>		



### Question 6.3.105\*\*

**How does an investor initially measure nonmonetary assets distributed by an investee upon dissolution?**

**Interpretive response:** It depends. An investee accounted for under the equity method may be dissolved and distribute all of its nonmonetary assets to its investors in a nonreciprocal transfer (i.e. a dividend-in-kind). The accounting by the investor in a nonreciprocal transfer depends on the nature of the assets received.

If the investor receives net assets that meet the definition of a business, it records the business at fair value in accordance with Topic 805. Accordingly, the investor/acquirer records a gain or loss for the difference between the fair value of the equity method investment (previously held equity interest) and its carrying amount. See KPMG Handbook, [Business combinations](#), for additional guidance.

If the investor receives nonmonetary assets that are not a business or VIE, it measures the assets received at fair value in accordance with Topic 845. The investor considers the recognition and measurement guidance in Topic 805-50 for purposes of allocating fair value to those assets. [\[845-10-30-10 – 30-14\]](#)

If the investor receives a VIE that is not a business, it accounts for the transaction at fair value consistent with the guidance in Topic 810 (see [Question 6.3.60](#)). [\[810-10-30-3 – 30-4\]](#)

If upon dissolution, the receipt of assets is not a business and not a nonreciprocal transfer, the investor considers other GAAP (e.g. Subtopic 805-50, Topic 860) and the upstream transaction guidance in Topic 323 (see [Question 5.2.40](#)).

### 6.3.30 Ownership dilution transactions



#### Excerpt from ASC 323-10

> Investee Capital Transactions

**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.

Topic 323 requires an equity-method investor to account for dilution transactions like it sold a proportionate share of its investment. Dilution transactions most often occur when the investee issues additional equity interests and can result in the investor no longer applying the equity method. [323-10-40-1]

While the same general principles for accounting for sales (discussed in [section 6.3.20](#)) apply to dilution transactions, their application can be complex depending on the parties and investee securities involved.



#### Question 6.3.110

**How does an investor account for the investee's sale of equity interests when it does not participate?**

**Background:** An equity method investor generally determines its share of the investee's net assets using its ownership percentage in the investee's equity interests. When an investee sells additional equity interests to parties other than the equity method investor, the equity method investor's percentage ownership interest decreases. This results because there is an increase in the total number of investee equity interests outstanding without a proportionate increase in the number of shares held by the equity method investor.

**Interpretive response:** The investor is required to account for an investee share issuance as if the investor sold a proportionate share of its investment. If the investee's selling price per share is more or less than the investor's carrying amount per share, the investor recognizes in earnings a gain or loss on the sale. This guidance applies regardless of whether the investee issues shares for cash or services – e.g. in a share-based payment arrangement (see [Question 6.3.130](#)). [323-10-40-1]

[Section 6.3.20](#) provides additional guidance on how to account for partial dispositions, including how to determine the carrying amount of the investment when only a portion is sold (see [Question 6.3.30](#)).



### Question 6.3.120

#### How does an investor compute its gain or loss on a dilution transaction?

**Interpretive response:** An investor measures a dilution gain or loss as the difference between its post-transaction share of the investee's underlying net assets and its pre-transaction share.

- The investor calculates its post-transaction share of the investee's underlying net assets by multiplying its post-transaction ownership percentage by the investee's total post-transaction underlying net assets.
- The investor calculates its pre-transaction share of the investee's underlying net assets by multiplying its pre-transaction ownership percentage by the investee's total pre-transaction underlying net assets.

If the investor's post-transaction share of the investee's underlying net assets is less than its pre-transaction share, the investor recognizes a dilution loss. If the investor's post-transaction share of the investee's underlying net assets exceeds its pre-transaction share, the investor recognizes a dilution gain.

When computing its dilution gain or loss, the investor also includes a pro rata portion of: [\[830-30-40-2\]](#)

- the unamortized difference between the investor's carrying amount and its underlying share of the investee's net assets (its aggregate basis difference);
- AOCI related to the investee – e.g. CTA (see [Question 6.3.50](#)); and
- deferred intra-entity profits and losses.

The investor also includes in its gain or loss a portion of the adjustments that it made to the carrying amounts of other interests when the carrying amount of its equity method was reduced to zero (see [Question 6.3.30](#)).

When the investor must recognize equity in earnings related to an investee share issuance (e.g. share issuance is in connection with a share-based payment arrangement), the interaction of the guidance on how to account for dilution gains and losses and how to recognize equity in earnings can be complex. We have identified two acceptable approaches for that situation, which are discussed in [Question 6.3.130](#).

We believe the guidance in this Question applies to equity method investments in corporate and non-corporate structures. However, a non-corporate investor may need to more carefully consider the investee's governing documents when determining its post-transaction share of the net assets. If the investee's governing documents do not reallocate the newly contributed capital to existing investors, the transaction may not result in any change to those noncontributing investors' share of the underlying net assets.

**Example 6.3.70****Investee sale of shares when the investor buys no shares**

As of January 1, Year 1, Investor holds 40% (or 40 shares) of Investee's 100 shares of common stock outstanding. Investor accounts for its investment under the equity method. Investor did not identify basis differences in its memo purchase price allocation – i.e. the carrying amount of its investment equals its share of Investee's net assets.

On June 30, Year 1, Investee issues 30 shares to a third party for \$450, or \$15 per share.

On June 29, Year 1, immediately before the common stock issuance, Investee's net assets were \$1,000.

Investor calculates its position before and after the transaction as follows.

	Interest before	Calculation	Interest after	Calculation
Interest held	40%	40/100 shares	30.8%	40/130 shares
Share of underlying net assets	\$400	\$1,000 × 40%	\$447	(\$1,000 + \$450) × 30.8%

Investor records the \$47 dilution gain (\$447 – \$400) in the following journal entry.

	Debit	Credit
Investment in Investee	47	
Gain on dilution		47
<i>To recognize dilution gain from Investee's share issuance.</i>		

In this example, Investor had no overall basis difference related to its investment in Investee. If there were, Investor would adjust its dilution gain for a pro rata portion of that basis difference (see [Questions 6.3.30](#) and [6.3.120](#)).

**Question 6.3.130****How does an investor compute its dilution gain or loss on a dilution that results from a share-based payment arrangement?**

**Interpretive response:** We have identified two acceptable approaches for recognizing a dilution gain or loss that results from the investee issuing shares in a share-based payment arrangement.

**Method 1: Hypothetical liquidation at book value**

**Step 1:** The investor recognizes its percentage share of the investee's net income.

**Step 2:** The investor determines whether there is a dilution gain or loss by computing the difference between:

- its share of the investee's underlying net assets at the reporting date using HLBV; and
- its investment balance, after the adjustment it made in Step 1.

Method 1 is described in two steps to more easily compare it to Method 2, but it could be applied in a single step by comparing the investor's end-of-period share of the investee's underlying net assets to its beginning-of-period share and making a single entry to adjust its equity in earnings.

**Method 2: Basis adjustment**

**Step 1:** Same as Step 1 in Method 1. The investor recognizes its percentage share of the investee's net income.

**Step 2:** The investor records a memo entry to restore its investment account balance to its share of the investee's net assets before the dilution. This memo entry results in a new overall basis difference in the investment.

**Step 3:** The investor determines whether there is a dilution gain or loss by computing the difference between its share of the investee's underlying net assets as of the reporting date and its investment in the investee, which excludes the investor's newly created basis difference from Step 2.

Method 2 results in an investment balance that is less than the investor's share of the investee's underlying net assets at the reporting date. Topic 323 requires that the investor account for that overall basis difference as if the investee were a consolidated subsidiary. As a result, the investor amortizes or accretes the basis difference account established in Step 2 to equity in earnings over time. [323-10-35-5]

Methods 1 and 2 result in the investor recognizing the same amount of equity in earnings over time but attribute that equity in earnings to different periods.

Applying these methods is more complex when the share-based awards vest over multiple reporting periods. Investors should consult their advisors in accounting for these transactions

**Example 6.3.80****Investee share grant in a share-based payment arrangement**

As of January 1, Year 1, Investor holds 40% (or 40 shares) of Investee's 100 shares of common stock outstanding. Investor accounts for its investment under the equity method.

On January 1, Investee's assets and equity are \$100. Investor is carrying its investment at \$40, which equals its share of Investee's underlying net assets on an HLBV basis (see [section 4.3](#) for additional discussion).

During Year 1, Investee issues to its management 10 shares of its voting common stock with a grant date fair value of \$3 per share. The shares are fully vested on the grant date and Investee recognizes share-based compensation expense of \$30.

After the share grant, Investor's ownership percentage decreases to 36% (40 shares divided by 110 total shares outstanding).

For Year 1, Investee has no revenue or expenses other than the compensation expense. Its net loss for the year is \$30 and its equity at the end of the year is \$100.

### Analysis

We believe Investor has two options (see [Question 6.3.130](#)):

#### Method 1: Hypothetical liquidation at book value

**Step 1:** Investor recognizes \$12 in equity in losses (Investee's net loss of \$30 × Investor's ownership interest of 40%) with a corresponding decrease to its investment in Investee.

**Step 2:** Investor computes its \$8 dilution gain as the difference between its share of Investee's net assets as of December 31 using HLBV and its investment balance, after the adjustment it made in Step 1.

Investor's share of Investee's net assets <sup>1</sup>	\$ 36
Minus: Investor's investment account <sup>2</sup>	(28)
<b>Dilution gain</b>	<b>\$ 8</b>
Notes:	
1. \$100 Investee net assets × 36% Investor's ownership percentage.	
2. \$40 beginning investment balance – \$12 decrease from Step 1.	

Under Method 1, Investor's ending investment account balance is \$36, which is 36% of Investee's net assets.

Investment in Investee – beginning balance	\$ 40
Minus: equity in losses in Investee	(12)
Dilution gain	8
<b>Investment in Investee</b>	<b>\$ 36</b>

Investor's equity in earnings is a \$4 loss (\$12 loss from picking up a 40% share of the compensation expense offset by the \$8 dilution gain), which equals the overall change in Investor's share of Investee's net assets from the beginning of the year to the end of the year (\$40 – \$36).

Method 1 is illustrated in two steps to more easily compare it to Method 2, but it could be applied in a single step by comparing Investor's end-of-year share of Investee's underlying net assets (\$36) to its beginning-of-year share (\$40) and making a single entry to recognize a \$4 loss in equity in earnings.

**Method 2: Basis adjustment**

**Step 1:** Same as Step 1 in Method 1. Investor recognizes a \$12 expense (Investee's net loss of \$30 × Investor's ownership interest of 40%) in equity in earnings with a corresponding decrease to its investment in Investee.

**Step 2:** Investor records a memo entry to restore its investment account balance to \$40 (i.e. Investor's share of the net assets before the dilution) and establish a new overall basis difference in the investment.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee (share of Investee's net assets)	12	
Investment in Investee (basis difference in Investee)		12
<i>To restore Investor's share of Investee's net assets to its pre-transaction share.</i>		

**Step 3:** Investor computes its \$4 dilution loss as the difference between its share of Investee's net assets as of December 31 and its investment in Investee (share of Investee's net assets), which excludes Investor's newly created \$12 basis difference from Step 2.

Investor's share of Investee's net assets <sup>1</sup>	\$ 36
Minus: Investment in Investee (share of Investee's net assets) <sup>2</sup>	(40)
<b>Dilution loss</b>	<b>\$ 4</b>
Notes:	
1. \$100 Investee net assets × 36% Investor's ownership percentage.	
2. \$40 beginning investment balance – \$12 decrease from Step 1 + \$12 increase from Step 2.	

Under Method 2, Investor's ending investment account balance is \$24, which is less than Investor's share of Investee's net assets (\$36) as of December 31.

Topic 323 requires Investor to account for that overall basis difference as if Investee were a consolidated subsidiary. As a result, Investor would accrete the Investment in Investee (basis difference) account established in Step 2 (\$12) to equity in earnings over time.

Investment in Investee – beginning balance	\$ 40
Minus: equity in losses in Investee	(12)
Plus: memo entry to restore investment account	12
Minus: memo entry to establish basis difference	(12)
Dilution loss	(4)
<b>Investment in Investee</b>	<b>\$ 24</b>

Investor's equity in earnings is a \$16 loss (\$12 loss from picking up a 40% share of the compensation expense plus the \$4 dilution loss).

Methods 1 and 2 result in Investor recognizing the same amount of equity in earnings over time but attribute that equity in earnings to different periods.



### Question 6.3.140#

#### How does an investor transition from the equity method when it loses significant influence in a dilution transaction?

**Interpretive response:** Like other dilution transactions, the investor first accounts for the reduction in its ownership interest as if it sold a proportionate share of its investment and recognizes a dilution gain or loss based on the difference between its post-transaction share of the investee's underlying net assets and its pre-transaction share (see [Questions 6.3.110](#) and [6.3.120](#)). [323-10-40-1]

The investor then must determine the accounting for its retained interest. When an investor's ownership decreases and triggers the requirement to stop using the equity method, the existing carrying amount of the investment under the equity method becomes the carrying amount of the investment as of the date of the change in accounting method. [323-10-35-36, 35-39]

As discussed in [Question 6.3.40](#), determining the 'carrying amount of the investment' at the date of the change depends on how the investor will be measuring the investment after the change.

#### Prospective fair value measurement under Topic 321

If the investor will measure the remaining equity interest at fair value under Topic 321, we believe it should:

- establish its initial carrying amount as the existing carrying amount when it stopped the equity method; and
- immediately adjust that carrying amount to its fair value.

#### Prospective application of the measurement alternative under Topic 321

If the investor will measure the remaining equity interest using the measurement alternative and is discontinuing the equity method because an orderly transaction has occurred in the same or similar investment of the investee, the investor remeasures its retained interest in the investee to fair value.

If the investor is discontinuing the equity method for reasons other than the existence of an orderly transaction in the same or similar investment of the investee, the equity method accounting is not adjusted before applying the measurement alternative.



**Example 6.3.85#****Investee sale of shares when the investor buys no shares and loses significant influence**

As of January 1, Year 1, Investor holds 25% (or 25 shares) of Investee's 100 shares of common stock outstanding. Investor accounts for its investment under the equity method. Investor did not identify basis differences in its memo purchase price allocation – i.e. the carrying amount of its investment equals its share of Investee's net assets.

On June 30, Year 1, Investee issues 50 common shares to a third party for \$2,500, or \$50 per share. The \$50 per share price represents fair value for Investee's common shares.

On June 29, Year 1, immediately before the common stock issuance, Investee's net assets were \$4,000.

**Step 1: Investor recognizes dilution gain or loss**

Investor calculates its position before and after the transaction as follows.

	Interest before	Calculation	Interest after	Calculation
Interest held	25%	25/100 shares	16.7%	25/150 shares
Share of underlying net assets	\$1,000	$\$4,000 \times 25\%$	\$1,086	$(\$4,000 + \$2,500) \times 16.7\%$

Investor records the \$86 dilution gain ( $\$1,086 - \$1,000$ ) in the following journal entry.

	Debit	Credit
Investment in Investee	86	
Gain on dilution		86
<i>To recognize dilution gain from Investee's share issuance.</i>		

In this example, Investor had no overall basis difference related to its investment in Investee. If there were, Investor would adjust its dilution gain for a pro rata portion of that basis difference (see [Questions 6.3.30](#) and [6.3.120](#)).

**Step 2: Investor transitions from the equity method**

When Investor discontinues the equity method, the carrying amount of its investment in Investee is \$1,086.

**Scenario 1: Fair value under Topic 321**

Immediately after accounting for the loss of significant influence, Investor adjusts the \$1,086 carrying amount to fair value through net income in the line item in which unrealized gain or loss on securities is reported.

Investor records the unrealized gain in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee <sup>1</sup>	164	
Unrealized gain on equity securities <sup>1</sup>		164
<i>To recognize increase in value of Investor's existing 16.7% interest in Investee.</i>		
Note:		
1. Fair value of existing 16.7% interest of \$1,250 (25 shares × \$50 per share) minus carrying amount of \$1,086.		

### Scenario 2: Measurement alternative under Topic 321

Immediately after accounting for the loss of significant influence, Investor adjusts the \$1,086 carrying amount to fair value through net income in the line item in which unrealized gain or loss on securities is reported.

Investor records the unrealized gain in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee <sup>1</sup>	164	
Unrealized gain on equity securities <sup>1</sup>		164
<i>To recognize increase in value of Investor's existing 16.7% interest in Investee.</i>		
Note:		
1. Fair value of existing 16.7% interest of \$1,250 (25 shares × \$50 per share) minus carrying amount of \$1,086.		



### Question 6.3.150

**How does an investor account for a transaction in which it buys additional investee shares and is diluted?**

**Interpretive response:** When an equity method investor does not buy enough newly issued ownership interests to maintain its pre-transaction ownership percentage, it accounts for the transaction as an acquisition of additional interests and a partial disposition. It does so by measuring its dilution gain or loss as the difference between its post-transaction share of the investee's net assets and its pre-transaction share *after* adjusting that pre-transaction share for acquiring the additional shares.

- The investor calculates its post-transaction share of the investee's underlying net assets by multiplying its post-transaction ownership percentage by the investee's total post-transaction underlying net assets.
- The investor calculates its pre-transaction share of the investee's underlying net assets by:
  - first multiplying its pre-transaction ownership percentage by the investee's total pre-transaction underlying net assets; and

- adding the amounts it paid to purchase the additional common stock of the investee.

If the investor's post-transaction share of the investee's underlying net assets is less than its adjusted pre-transaction share, it recognizes a dilution loss. If the investor's post-transaction share of the investee's underlying net assets is greater than its adjusted pre-transaction share, it recognizes a dilution gain (see [Question 6.3.120](#)).

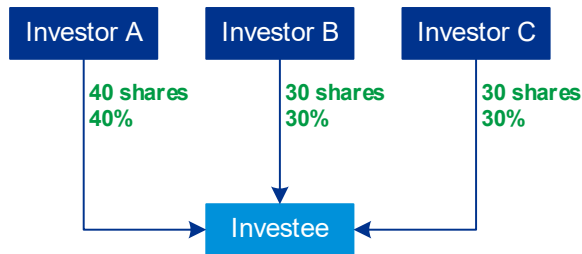
[Question 6.2.30](#) provides guidance on how to account for an investee's share issuance when the investor increases or maintains its ownership percentage.



### Example 6.3.90

#### Investee sale of common stock when the investor buys additional shares

As of January 1, Year 1, Investee has 100 shares of common stock outstanding and three common stock investors. The following diagram illustrates Investee's ownership structure.



Investee's net assets include only the initial contributions from the three investors and retained earnings from its operations.

None of the investors have identified basis differences in their memo purchase price allocations – i.e. the carrying amounts of their investments equal their respective share of Investee's net assets.

#### Investee share issuance

On June 30, Year 1, Investee issues 50 \$1 par value shares of common stock at \$15 per share. Investors A, B and C purchase 10, 20 and 20, respectively, of the new shares offered.

On June 29, Year 1, immediately before the new common stock issuance, Investee's total net assets were \$1,000.

#### Investee's accounting

Investee records the following journal entry for the share issuance.

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	<i>Debit</i>	<i>Credit</i>
Cash <sup>1</sup>	750	
Common stock		50
Additional paid-in capital		700
<i>To recognize new common stock issued.</i>		
Note:		
1. 50 shares of common stock issued × \$15 per share.		

**Investors' accounting**

The holdings of each of the investors are as follows before and after the stock issuance.

	<b>Interest before</b>	<b>Calculation</b>	<b>Interest after</b>	<b>Calculation</b>
Investor A	40%	40/100 shares	33.33%	50/150 shares
Investor B	30%	30/100 shares	33.33%	50/150 shares
Investor C	30%	30/100 shares	33.33%	50/150 shares
	<b>100%</b>		<b>100.00%</b>	

**Investor A's accounting**

Investor A records the following journal entry for its share purchase.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee <sup>1</sup>	150	
Cash		150
<i>To recognize purchase of additional shares in Investee.</i>		
Note:		
1. 10 shares purchased × \$15 per share.		

To determine the amount of its dilution gain or loss, Investor A computes the difference between its post-transaction and adjusted pre-transaction share in Investee's underlying net assets.

Investment in Investee – adjusted balance <sup>1</sup>	\$ 550
Minus: post-transaction share of Investee net assets <sup>2</sup>	(583)
<b>Dilution gain</b>	<b>\$ 33</b>
Notes:	
1. \$1,000 Investee's pre-transaction equity × 40% Investor A's ownership + \$150 purchase price for 10 shares.	
2. \$550 (Investee's \$1,000 pre-transaction equity plus \$750 in issuance proceeds) × 33.33% (post-transaction interest in Investee).	

Investor A recognizes the \$33 dilution gain in the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee	33	
Gain on dilution		33
<i>To recognize dilution gain from share purchase and Investee's share issuance.</i>		

In this example, Investor A had no overall basis difference related to its investment in Investee. If there was, Investor A would adjust its dilution gain for a pro rata portion of that basis difference (see [Questions 6.3.30](#) and [6.3.120](#)).

### Investor B's and Investor C's accounting

Investors B and C each record the following journal entry for the share purchase.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee <sup>1</sup>	300	
Cash		300
<i>To recognize purchase of additional shares in Investee.</i>		
Note:		
1. 20 shares purchased × \$15 per share.		

Next, Investors B and C each perform their memo purchase price allocation, to identify any difference between their adjusted cost basis and their new share (33.33%) of Investee's underlying net assets.

Investment in Investee on June 29, Year 1	\$ 300
Plus: Amount paid for newly issued shares	300
Adjusted carrying amount in Investee	\$ 600
Minus: Post-transaction share of Investee's underlying net assets <sup>1</sup>	(583)
<b>Excess of Investor cost over post-transaction share of Investee's net assets</b>	<b>\$ 17</b>
Note:	
1. \$550 (Investee's \$1,000 pre-transaction equity plus \$750 in issuance proceeds) × 33.33% (post-transaction interest in Investee).	

Investors B and C each allocate their \$17 basis difference based on their share of the fair value of Investee's underlying assets and liabilities. After identifying the source(s) of the overall basis difference, they account for it prospectively.

**Example 6.3.100****Accounting for a simultaneous dilution and issuance of call options in investee stock**

Investor, an automobile company, holds 47% of the equity shares of Investee. Investor and Investee are listed on a foreign stock exchange and have significant public shares outstanding. Investor accounts for its investment in Investee under the equity method.

During Year 5, through a series of planned and contemporaneously executed transactions, Investor's equity interest in Investee changed as follows.

- **Additional shares.** Both Investor and an independent financial investor purchase additional shares in Investee based on the quoted share price. After the purchase, Investor's interest in Investee is reduced to 42% because the financial investor purchased proportionately more shares than Investor. The purchase price per share (and Investor's post-transaction share of Investee's underlying net assets) was higher than Investor's carrying amount per share (and its adjusted pre-transaction share of Investee's underlying net assets).

- **Call option.** The purchase agreement granted Investor the right to acquire additional Investee shares at a fixed price (call option). Investor's call option is a freestanding derivative under Topic 815 and can be exercised at any time within the next 18 months. Under foreign regulations, Investor was required to pay a deposit of 10% of the exercise price to Investee.

If Investor exercises the call option, Investee will apply the deposit to the amount owned for the purchase. If Investor does not exercise the call option, Investee keeps the deposit.

The call option is in the money (i.e. the fair value of the shares underlying the option is greater than the fixed exercise price) at the date of issuance and has become more so as of December 31, Year 5, which is Investor's fiscal year-end.

If Investor exercises the call option, its equity interest in Investee will increase to 49%.

- **Integrated transaction.** Investor, Investee and the independent financial investor intended for the share purchase and the call option grant to be one integrated transaction. The common share purchase agreement and the shareholder approval documents specify that the transactions are integrated and that one cannot be completed without the other. The share purchase and option grant closed contemporaneously.

**Investor's accounting**

**Step 1:** Investor recognizes its purchase of additional Investee common stock at cost.

**Step 2:** Investor recognizes the dilution of its equity interest in Investee from 47% to 42%. To determine the amount of its dilution gain or loss, Investor computes the difference between its post-transaction and adjusted pre-transaction share in Investee's underlying net assets. Investor recognizes a

dilution gain because its post-transaction share of Investee's underlying net assets is greater than its adjusted pre-transaction share.

**Step 3:** Investor recognizes as a derivative asset the fair value of the call option on the issuance date. Because the derivative's fair value is greater than the nonrefundable deposit that Investor paid to Investee (10% of the call option's exercise price), Investor recognizes a gain on issuance. We believe Investor should include this benefit as an additional dilution gain.

Investor records the following journal entry for the transaction.

	<i>Debit</i>	<i>Credit</i>
Investment in Investee – share purchase	Cost	
Investment in Investee – dilution gain	Dilution gain	
Derivative asset	Fair value	
Cash to acquire shares		Cost
Cash for nonrefundable deposit		10% of ex. price
Overall dilution gain		Dilution gain + Derivative gain
<i>To recognize additional investment and dilution in Investee.</i>		

Investor recognizes in earnings changes in the derivative's fair value.

If Investor exercises the call option, the cost of acquiring the shares would include the amount paid on settlement (exercise price) plus the then-current fair value of the derivative. Investor would complete a memo purchase price allocation for the total cost to acquire the incremental interest (see [Question 6.2.30](#)).



### Question 6.3.160

#### How does an investor account for a dilution resulting from an investee treasury stock purchase?

**Interpretive response:** When the investor sells back to the investee a larger proportion of the total number of shares repurchased by the investee than its pre-transaction ownership percentage, the investor accounts for the dilution as a partial disposition.

The investor measures its dilution gain or loss as the difference between its post-transaction share of the investee's net assets and its pre-transaction share *after* adjusting that pre-transaction share for its sale of shares back to the investee.

- The investor calculates its post-transaction share of the investee's underlying net assets by multiplying its post-transaction ownership percentage by the investee's total post-transaction underlying net assets.
- The investor calculates its pre-transaction share of the investee's underlying net assets by:

## 6. Changes in ownership and degree of influence

- first multiplying its pre-transaction ownership percentage by the investee's total pre-transaction underlying net assets; and
- then subtracting the amount it received on sale of the shares back to the investee.

If the investor's post-transaction share of the investee's underlying net assets is less than its adjusted pre-transaction share, it recognizes a dilution loss. If the investor's post-transaction share of the investee's underlying net assets is greater than its adjusted pre-transaction share, it recognizes a dilution gain.

See the accounting by Investors B and C in [Example 6.2.20](#) for an illustration of how to account for a decrease in ownership interest after an investee share repurchase.

[Question 6.2.40](#) provides guidance on how to account for an investee's treasury stock repurchase when the investor increases or maintains its ownership percentage. [Question 6.2.50](#) discusses an investee treasury stock transaction in which the investor does not participate.

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# 7. Presentation and disclosure

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## 7.1 How the standard works

An investor generally presents an equity method investment in one line on the balance sheet and its related earnings effect in one line in the income statement. The investor generally presents its share of an investee's OCI in its OCI.

Topic 323 includes a list of disclosures that an investor should provide related to an equity method investment. Those disclosures generally focus on:

- the investor's ownership interest, potential changes to it and its relation to the 20% presumption of significance influence;
- basis differences; and
- the investees' financial results (when material to the investor).

The SEC also requires an investor to file separately investee financial statements or provide investee summary financial data when certain conditions exist.

The SEC also provides guidance on other disclosure matters relative to related party transactions.

In this chapter, we refer to the following additional Topics and Subtopics only by their Codification reference.

- Subtopic 205-20, Presentation of Financial Statements—Discontinued Operations
- Topic 250, Accounting Changes and Error Corrections
- Topic 260, Earnings Per Share
- Topic 323, Investments—Equity Method and Joint Ventures
- Subtopic 825-10, Financial Instruments—Overall
- Topic 850, Related Party Disclosures

## 7.2 Presentation



### Excerpt from ASC 323-10

#### > The Equity Method—Overall Guidance

**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.

**45-2** The investor's share of accounting changes reported in the financial statements of the **investee** shall be classified separately.

#### > Reporting Comprehensive Income

**45-3** An investor may combine its proportionate share of investee other comprehensive income amounts with its own other comprehensive income components and present the aggregate of those amounts in the statement in which other comprehensive income is presented.

### **Balance sheet**

An equity method investor presents its equity method investments on the balance sheet as a single amount. That amount generally includes for each investment: [\[323-10-45-1\]](#)

- the investor's cost to acquire the investment, which comprises its memo purchase price allocation (see [chapter 3](#));
- adjustments made for dividends received or other investee capital activity (see [chapter 4](#));
- adjustments made to recognize the investor's share of investee activity, such as its earnings and OCI (see [chapter 4](#)); and
- adjustments made to recognize investor-level activity, such as intra-entity profit or loss eliminations, amortization/accretion of basis differences and other-than-temporary impairments (see [chapter 5](#)).

### **Income statement**

The investor also presents its equity in earnings of its investees in the income statement as a single amount. That amount generally includes for each investee: [\[323-10-45-1\]](#)

- adjustments made to recognize the investor's share of investee earnings or losses (see [chapter 4](#));
- adjustments made for some investee capital activity, such as disproportional changes made to the investor's claim on the investee's net assets (see [section 6.3](#)); and

- adjustments made to recognize investor-level activity, such as intra-entity profit or loss eliminations, amortization/accretion of basis differences and OTTI (see [chapter 5](#)).

S-X Rule 5-03(b) requires registrants to present equity in earnings after income tax expense, but states that it may be presented elsewhere if justified by the circumstances.

### **Statement of comprehensive income and changes in stockholders' equity**

An investor may combine with its own OCI components its share of the investee's OCI components and present the aggregate amounts in its financial statements. [323-10-45-3]

### **Cash flows**

An investor presents its equity in earnings as an adjustment to its net income when arriving at its net cash flows from operating activities.

When the investor receives a distribution from its investee during the reporting period, it determines whether the distribution is a return *on*, or return *of*, its investment. [230-10-45-21D]

- Distributions that are returns *on* an investment are cash flows from operating activities.
- Distributions that are returns *of* an investment are cash flows from investing activities.

An investor may elect the cumulative earnings approach or the nature of distributions approach to determine whether a distribution is a return *on* or *of* its investment. [230-10-45-21D]

### **Exceptions to one-line presentation**

There are limited exceptions to the Topic 323 one-line financial reporting principle. For example, certain industries may present their proportionate share of the investee's individual assets, liabilities, and components of comprehensive income in their financial statements. This presentation often is referred to as proportionate consolidation (see [section 2.3.50](#)). [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1]



#### Question 7.2.10

#### **When is it appropriate to use proportionate consolidation instead of one-line presentation?**

**Interpretive response:** As discussed in [section 2.3.50](#), equity method investors in the construction and extractive industries may present their proportionate share of the investee's individual assets, liabilities, and components of comprehensive income in their financial statements if the investee also operates in a construction or extractive industry. This presentation is often referred to as proportionate consolidation. [810-10-45-14, 910-810-45-1, 930-810-45-1, 932-810-45-1]

A combination of one-line presentation and proportionate consolidation is also used in the construction industry. For example, it is common for a construction industry investor to present its investment on one line on the balance sheet but present its proportionate share of the investee's components of comprehensive income in the income statement.

An investor also may present undivided interests in real property using proportionate consolidation presentation if certain conditions are met.

See additional discussion on undivided interests and proportionate consolidation in [Questions 2.3.150](#) and [2.3.160](#).



### Question 7.2.20

#### How does an investor classify distributions received from equity method investees in the statement of cash flows?

**Background:** When an investor receives a distribution from an equity method investee, it should determine whether the distribution is a return *on*, or return *of*, its investment. [\[230-10-45-21D\]](#)

- Distributions that are returns *on* an investment are cash flows from operating activities
- Distributions that are returns *of* an investment are cash flows from investing activities.

**Interpretive response:** An investor may elect one of the following approaches to determine whether a distribution is a return *on* or *of* its investment. The investor should consistently apply, and disclose, its chosen policy to all its equity method investments. [\[230-10-45-21D\]](#)

#### Cumulative earnings approach

Under this approach, the investor compares the cumulative distributions it receives to its cumulative equity in US GAAP earnings of the investee, as adjusted for the investor's amortization of basis differences. [\[230-10-45-21D\]](#)

- Cumulative distributions received up to the amount of the cumulative equity in US GAAP earnings represents returns *on* investment classified as cash flows from operating activities.
- Cumulative distributions received that exceed the cumulative equity in US GAAP earnings represent returns *of* investment classified as cash flows from investing activities.

#### Nature of the distribution approach

Under this approach, the investor classifies distributions from an investee by evaluating the facts, circumstances and nature of each distribution. We believe the investor should consider the nature of the activity that led to the distribution, including whether the distribution was generated through the investee's normal course of business, or through activities outside of its normal course of business – e.g. a liquidating dividend, or distributions funded from the sale of PP&E at the end of its useful life. [\[230-10-45-21D\]](#)

Section 9.3 of KPMG Handbook, [Statement of cash flows](#), provides additional discussion and examples.

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### Question 7.2.30

#### Can an equity method investment be a discontinued operation?

**Interpretive response:** Yes. An investor should report in discontinued operations its equity in earnings of an investee if the disposal (or planned disposal) of that investment represents a strategic shift that has (or will have) a major effect on the investor's operations and financial results. [\[205-20-45-1B, 45-1C\]](#)

The investor begins discontinued operations presentation at the earlier of when: [\[205-20-45-1E\]](#)

- the Subtopic 205-20 held-for-sale criteria are met, or
- disposal occurs (through sale, abandonment or distribution to shareholders in a spin-off).

KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), provides additional guidance on discontinued operations presentation and disclosure.

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### Question 7.2.40

#### How does an investor present a gain or loss on the sale of an equity method investment?

**Interpretive response:** If the equity method investment is not a discontinued operation (see [Question 7.2.30](#)), we believe an investor may present a gain or loss on the sale of an equity method investment either:

- in equity in earnings of the investee; or
  - as a separate line within other (nonoperating) income or loss.
- 



### Question 7.2.50

#### How does an investor present tax expense on equity in earnings of the investee?

**Interpretive response:** Most public investors are required under S-X Rule 5-03(b) to present equity in earnings of equity method investees after income tax expense, but before discontinued operations. However, some investors present equity in earnings as a separate component of pre-tax income; for example, investors that conduct business largely through unconsolidated investees whose operations have been integrated into the investor's business or are otherwise closely related.

An income tax assessed on an investor's equity in earnings is similar to an income tax on investment income. As a result, we believe an investor should present that amount in:

- income tax expense, if the investor presents its equity in earnings as an increase (decrease) of income before income tax expense; or
- equity in earnings of the investee, if the investor presents equity in earnings entirely below income tax expense in its income statement.

We believe an investor should apply this guidance regardless of which party (investor or investee) physically remits the income tax; in some cases, the investee withholds the tax on the investor's behalf.

Section 10 of KPMG Handbook, [Accounting for income taxes](#), provides additional discussion.

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### Question 7.2.60

#### How does an investor report a discontinued operation of an equity method investee?

**Interpretive response:** We believe an investor should present its share of an investee's discontinued operations in equity in earnings of the investee.

Topic 323 states an investor's share of earnings of an equity method investee should be presented as a single amount *except for* its share of the accounting changes reported by the investee. It does not include similar guidance about presenting discontinued operations separately. [323-10-45-1 – 45-2]

The investor should consider disclosing in the notes to the financial statements the amount of earnings or losses attributable to the investee's discontinued operations. [323-10-45-1 – 45-2]

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### Question 7.2.70

#### Are there any EPS considerations for equity method investments?

**Interpretive response:** When computing its diluted EPS, an equity method investor considers the dilutive effect of securities issued by the investee.

When computing its diluted EPS, an investor includes in its numerator an amount equal to (1) the investee's diluted EPS, multiplied by (2) the number of investee shares it owns. As a result, if an investee's diluted EPS decreases because of an assumed increase in its common stock outstanding, the investor's numerator when computing its diluted EPS will decrease.

The effect is limited to the investor's numerator because the number of shares of common stock issued by the investor does not change on the assumed conversion of the investee's securities.

Section 6.17 of KPMG Handbook, [Earnings per share](#), provides additional guidance on how equity method investments affect an investor's EPS.

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### Question 7.2.80

#### When does an investor begin including shares issued to acquire an equity method investment in the denominator of its basic EPS?

**Interpretive response:** An investor may issue common stock to acquire an equity method investment. While an acquisition of an equity method investment is not addressed in Topic 260, we believe the investor includes the shares it issues as consideration in the denominator for basic EPS from the date it initially accounts for the equity method investment. This approach replicates the accounting for the acquisition of other assets or asset groups (including the effect of contingently issuable shares). [260-10-55-17]

Section 6.7 of KPMG Handbook, [Earnings per share](#), provides additional guidance.

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### Question 7.2.90

#### What other presentation guidance should an investor consider?

**Interpretive response:** An investor also should consider the following guidance on how to present:

- deferred income taxes associated with an investor's basis differences (see [Questions 3.3.90](#) and [5.3.30](#));
  - deferred income taxes associated with an investor's outside basis difference (see [Questions 3.3.100](#) and [5.3.30](#));
  - deferred income tax benefits received from an investee in a tax credit structure when the deferral method is used (see [Question 4.3.24](#));
  - a negative investment balance resulting from excess investee losses (see [Question 4.4.70](#));
  - its share of the investee's translation adjustment (see [Question 4.5.20](#));
  - its translation of a foreign investee's financial statements (see [Question 5.3.50](#));
  - deferral and recognition of intra-entity profit (see [Question 5.2.40](#));
  - other-than-temporary impairment (see [Question 5.5.30](#));
  - income taxes when transitioning from the equity method to consolidation (see [Question 6.2.60](#));
  - pre-consolidation investee earnings when transitioning from the equity method to consolidation (see [Question 6.2.70](#)); and
  - on the balance sheet, statement of comprehensive income and statement of cash flows related party transactions, including intra-entity transactions with an investee (see [Question 7.3.30](#)).
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## 7.3 Disclosure



### Excerpt from 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.

> Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons

• > Annual Financial Statements

**S50-1** See paragraph 235-10-S99-1, Regulation S-X Rule 4-08(g), for requirements to provide summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons.

• > Interim Financial Statements

**S50-2** See paragraph 270-10-S99-1, Regulation S-X Rule 10-01(b)(1), for requirements to provide summarized financial information in interim financial statements for subsidiaries not consolidated or 50 percent or less owned persons.

> SEC Staff Guidance

• > Staff Accounting Bulletins

•• > SAB Topic 6.K.3, Undistributed Earnings of 50% or Less Owned Persons

**S99-1** The following is the text from SAB Topic 6.K.3, Undistributed Earnings of 50% or Less Owned Persons.

Facts: Rule 4-08(e)(2) of Regulation SX requires footnote disclosures of the amount of consolidated retained earnings which represents undistributed earnings of 50% or less owned persons (investee) accounted for by the equity method. The test adopted in ASR 302 to trigger disclosures about the registrant's restricted net assets (Rule 4-08(e)(3)) includes the parent's equity in the undistributed earnings of investees.

Question: Is the amount required for footnote disclosure the same as the amount included in the test to determine disclosures about restrictions?

Interpretive Response: Yes. The amount used in the test in Rule 4-08(e)(3) should be the same as the amount required to be disclosed by Rule 4-08(e)(2). This is the portion of the registrant's consolidated retained earnings which represents the undistributed earnings of an investee since the date(s) of acquisition. It is computed by determining the registrant's cumulative equity in the investee's earnings, adjusted by any dividends received, related goodwill write-downs, and any related income taxes provided.

•• > SAB Topic 6.K.4.b, Application of Significant Subsidiary Test to Investees and Unconsolidated Subsidiaries

**S99-2** The following is the text of SAB Topic 6.K.4.b, Application of Significant Subsidiary Test to Investees and Unconsolidated Subsidiaries.

b. Summarized financial statement requirements.

Facts: Rule 4-08(g) of Regulation S-X requires summarized financial information about unconsolidated subsidiaries and 50% or less owned persons (investee)

to be included in the footnotes to the financial statements if, in the aggregate, they meet the tests of a significant subsidiary set forth in Rule 1-02(w).

Question 1: Must a registrant which includes separate financial statements or condensed financial statements for unconsolidated subsidiaries or investees in its annual report to shareholders also include in such report the summarized financial information for these entities pursuant to Rule 4-08(g)?

Interpretive Response: No. The purpose of the summarized information is to provide minimum standards of disclosure when the impact of such entities on the consolidated financial statements is significant. If the registrant furnishes more information in the annual report than is required by these minimum disclosure standards, such as condensed financial information or separate audited financial statements, the summarized data can be excluded. The Commission's rules are not intended to conflict with the provisions of FASB ASC subparagraph 323-10-50-3(c) (Investments—Equity Method and Joint Ventures Topic) which provide that either separate financial statements of investees be presented with the financial statements of the reporting entity or that summarized information be included in the reporting entity's financial statement footnotes.

Question 2: Can summarized information be omitted for individual entities as long as the aggregate information for the omitted entity(s) does not exceed 10% under any of the significance tests of Rule 1-02(w)?

Interpretive Response: The 10% measurement level of the significant subsidiary rule was not intended to establish a materiality criteria for omission, and the arbitrary exclusion of summarized information for selected entities up to a 10% level is not appropriate. Rule 4-08(g) requires that the summarized information be included for all unconsolidated subsidiaries and investees. However, the staff recognizes that exclusion of the summarized information for certain entities is appropriate in some circumstances where it is impracticable to accumulate such information and the summarized information to be excluded is de minimis.

## 7.3.10 Overview

### **Topic 323 requirements**

Topic 323 requires the investor to disclose for each investee: [\[323-10-50-3\]](#)

- the investee's name and its percentage ownership;
- why it does not apply the equity method if it holds at least a 20% ownership interest in a significant investee, or why it does if it holds less than a 20% ownership interest;
- the overall basis difference in the investment, if any – i.e. the difference between the carrying amount and the investor's share of the investee's underlying net assets (see [section 3.3](#));

- material effects to the investor’s share of the investee’s earnings that may result from conversion, exercise or issuance of investee convertible securities or outstanding options or warrants; and
- the aggregate fair value if a quoted market price is available.

In addition, if the investor’s equity method investments are material in aggregate, it may need to provide summarized balance sheet and income statement information for those investments. The investor may provide that information for each investment individually or in groups. [323-10-50-3c]

Topic 323 indicates that an investor should consider the significance of an investment to its financial position and results of operations when determining the extent of its disclosures. [323-10-50-2]

### **SEC requirements**

When certain quantitative thresholds are met, the SEC also requires an investor to: [323-10-S50-1 – S50-2]

- file separately an investee’s financial statements in the period it is acquired;
- file separately an investee’s annual financial statements with the investor’s Form 10-K filing; and
- provide summarized financial information for investees in the notes to financial statements.



#### Question 7.3.10

#### **How should an investor report an investee’s retrospective accounting changes?**

**Interpretive response:** If an equity method investee reports a retrospective change in accounting principle under Topic 250, the investor generally reflects the direct effects of its share through retrospective adjustment of its equity in earnings of the investee.

In addition, we believe the investor should provide the relevant change in accounting principle disclosures required by Topic 250 in its financial statements for the annual reporting period in which the change is made. In the post-change interim reporting periods, the investor should disclose the effect of the change on income from continuing operations, net income and related per-share amounts, if applicable. [250-10-45-5]

Chapter 3 of KPMG Handbook, [Accounting changes and error corrections](#), provides guidance on accounting changes.

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### Question 7.3.20

#### How does an investor disclose transactions between investor and investee?

**Interpretive response:** Intra-entity transactions between an equity method investor and investee are related party transactions under Topic 850.

The investor and investee should disclose the following information about material intra-entity transactions: [850-10-50-1]

- the nature of the relationship;
- for each period for which an income statement is presented, a description of the transactions (whether or not value was ascribed to them) and other information necessary to understand their effects on the financial statements;
- for each period for which an income statement is presented, the dollar amounts of transactions and the effects of any change in the method of establishing the terms from those used in the preceding period; and
- for each period in which a balance sheet is presented, the amounts due from or to the investee (or investor), terms and manner of settlement.

An investor cannot presume a transaction with an investee was executed at arm’s length. [850-10-50-5]

See [Question 7.3.30](#) for additional disclosure considerations if the investor is an SEC registrant.



### Question 7.3.30

#### What are the additional disclosure considerations for an SEC registrant investor?

**Interpretive response:** The following rules under Regulation S-X require an equity method investor that is not a smaller reporting company to provide investee financial information. Article 8 of Regulation S-X provides financial statement requirements for smaller reporting companies.

Rule	Requirements
<b>3-05</b>	<p>File an acquired (or probable to be acquired) investee’s financial statements when:</p> <ul style="list-style-type: none"> <li>— the investee is a business; and</li> <li>— the asset test, investment test or income/revenue test are met at the 20% threshold.</li> </ul> <p>The number of financial statement periods increases from one year to three years as the significance increases.</p> <p>An investor is also required to provide financial statements under Rule 3-05 when its acquisitions are significant in the aggregate.</p>

Rule	Requirements
3-09	<p>File an investee's annual financial statements when the investment test or the income test are met at the 20% threshold.</p> <p>The investor includes investee financial statements for the same number of periods it includes its own financial statements. The investee financial statements need to be audited only for those periods in which the investment test or the income test are met.</p>
10-01(b)(1)	<p>Include a summarized statement of comprehensive income for each investee:</p> <ul style="list-style-type: none"> <li>— that would file interim financial information if it was a registrant; and</li> <li>— whose annual financial statements are required to be filed under Rule 3-09.</li> </ul>
3-14	<p>File a statement of operations for an acquired (or probable to be acquired) investment when the:</p> <ul style="list-style-type: none"> <li>— investee's operations solely comprise real estate operations; and</li> <li>— investment test is met at the 20% level.</li> </ul>
4-08(e)(2)	<p>Disclose the amount of consolidated retained earnings that represents undistributed earnings of investees.</p>
4-08(e)(3)	<p>Describe restrictions on the ability of the investee to transfer funds to the investor in the form of dividends, loans or advances.</p> <p>Disclose separately the amount of the investee's restricted net assets for the most recently completed fiscal year.</p>
4-08(g)	<p>Include in the notes to annual financial statements, summarized investee financial information (assets, liabilities and results of operations) for all investees when the asset test, investment test or income test are met at the 10% threshold due to an individual investment or in the aggregate.</p> <p>The SEC staff recognizes that excluding summarized information for certain, but not all, investees may be appropriate if it is impractical to accumulate and the excluded information is de minimis.</p> <p>Rule 4-08(g) does not apply to investees whose financial statements have been included under Rule 3-09.</p>
4-08(k)	<p>Present separately on the balance sheet, and in the statement of comprehensive income and statement of cash flows amounts of related party transactions, including those with investees.</p> <p>Disclose intra-entity profits and losses.</p>

Article 11 of Regulation S-K also requires an investor to provide pro forma financial statements in certain situations when an investor acquires or disposes of significant investees.

The SEC's Division of Corporation Finance's [Financial Reporting Manual](#) provides additional guidance on these and other disclosure requirements and filing matters.

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#### Question 7.3.40

### When an investor elects the fair value option, may it disclose the investee's summarized financial information on a lag basis?

**Background:** Subtopic 825-10 requires an investor that has elected the fair value option for a would-be equity method investment to provide many of the disclosures required by Topic 323. This includes disclosing the investee's summarized financial information. [825-10-50-28(f), 323-10-50-3(c)]

**Interpretive response:** We believe that an investor that elects the fair value option may disclose the investee's summarized financial information on a lag. While the Topic 323 guidance about the acceptability of reporting on a lag is specific to how an investor recognizes its related equity in earnings, we believe it is acceptable to analogize to that guidance when preparing the investee's summarized financial information. [323-10-35-6]

[Section 4.7](#) provides additional discussion on lag periods and differing fiscal years.

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#### Question 7.3.50

### What foreign currency disclosures are required for foreign investees?

**Interpretive response:** An investor is required to disclose and analyze the changes during the period in its CTA. The analysis of the changes may appear in a separate financial statement, in the notes to the financial statements, or in the statement of changes in stockholders' equity. [830-30-50-1]

The investor's disclosure should include: [830-30-50-1 – 50-2, 45-20]

- amounts the investor transferred from the CTA to its net income as the result of selling all or part of an equity method investment in a foreign investee; and
- exchange rate changes that occur after the balance sheet date and the effects of those changes on unsettled balances from foreign currency transactions.

[Section 7](#) of KPMG Handbook, [Foreign currency](#), provides additional guidance.

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### Question 7.3.60

#### **Must an investor include additional disclosures when it loses a controlling financial interest in, but maintains significant influence over, a subsidiary that it reports as a discontinued operation?**

**Background:** Subtopic 205-20 requires an entity to report in discontinued operations the disposal (or planned disposal) of a component of an entity (or group of components) when the disposal represents a strategic shift that has (or will have) a major effect on the investor's operations and financial results. [205-20-45-1B, 45-1C]

In some cases, a sale of a controlling financial interest in a subsidiary will qualify for discontinued operations presentation even though the seller retains an equity method investment in the former subsidiary after the disposal.

**Interpretive response:** Yes. Subtopic 205-20 requires an investor to provide the following disclosures for each income statement period presented when it retains an equity method investment in a discontinued operation: [205-20-50-4B(d)]

- investee's pretax income after the disposal of the discontinued operation;
- investor's ownership interest pre- and post-disposal; and
- investor's share of the investee's income or loss after the disposal and the financial statement caption in which it is included.

Subtopic 205-20 also indicates that the investor's disclosures should provide information that enables users to compare the financial performance from period to period. As a result, we believe that if an investor holds other economic interests in the discontinued operation (e.g. a service contract) besides its equity method investment, it may need to provide supplemental disclosure because the pre- and post-disposal ownership percentages and share of the investee's income or loss may not capture the effect of the other economic interests. [205-20-50-4B]

KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), provides additional guidance on discontinued operations presentation and disclosure.



### Question 7.3.70

#### **When does an investor disclose summarized information for an equity method investee that it reports in discontinued operations?**

**Background:** As discussed in [Question 7.2.30](#), an investor reports in discontinued operations its equity in earnings of an investee if the disposal (or planned disposal) of that investment represents a strategic shift that has (or will have) a major effect on the investor's operations and financial results. [205-20-45-1B – 45-1C]

**Interpretive response:** An investor that reports an equity method investment in discontinued operations discloses summarized information about the

investee's assets, liabilities and results of operations if that information was disclosed previously under Topic 323. [205-20-50-7]

We believe this information is required to be separately disclosed even if it was historically provided only as part of an aggregated disclosure under Topic 323.

If the information was historically provided separately for that individual investee, the investor would not need to repeat the disclosure, but should continue to include it. [323-10-50-3(c)]

Chapter 7 of KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#), provides additional guidance on disclosures about discontinued operations.

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### Question 7.3.80

#### What other disclosure guidance should an investor consider?

**Interpretive response:** An investor also should consider the following disclosure guidance about:

- when an NFP should provide equity method disclosures (see [Question 2.3.50](#));
  - changes to its guarantees of investee obligations (see [Question 4.4.80](#));
  - its share of the investee's accumulated OCI or loss (see [section 4.5](#));
  - its accounting policy for accounting for excess investee distributions (see [Question 4.6.90](#));
  - the elimination of a lag period (see [Question 4.7.50](#));
  - events that occur after an investee's reporting period ends and the investor reports on a lag (see [Question 4.7.60](#));
  - intra-entity transactions (see [section 5.2](#) and [Question 5.2.40](#));
  - other-than-temporary impairment (see [Question 5.5.30](#)); and
  - discontinued operations of an investee (see [Question 7.2.60](#)).
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# Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with \*\* and items that have been significantly updated or revised are identified with #.

## 2. Scope

2.3.40 Investments in partnerships, unincorporated JVs and partnership-like LLCs #

### Questions

2.3.20 How does a would-be equity method investor apply the fair value option when it has other interests in the investee? #

2.3.150 How does an investor account for an undivided interest held through an interest in a legal entity? #

2.3.160 How does an investor account for ownership of an undivided interest in a specified asset? #

## 3. Initial recognition and measurement

### Questions

3.2.26 How does an investor account for funding commitments or delayed contributions? \*\*

3.2.30 How does an investor measure its cost basis when an additional purchase of investee stock triggers the equity method? #

3.2.35 How does an investor account for a commitment (or option) to purchase an ownership interest in an equity method investee? #

3.3.100 How does an investor account for deferred taxes on the outside basis difference in its investment? #

## 4. Recognizing investee activity

### Question

4.3.20 How does an investor compute its share of investee earnings when its economic rights differ from its legal ownership interest? #

### Example

4.3.15 Application of HLBV \*\*

## 5. Recognizing investor-level adjustments

### Questions

5.2.20 When does an investor eliminate intra-entity profit or loss? #

- 5.2.80 How does an investor account for interest on loans and advances to or from an investee? #
- 5.5.70 How does an investor measure OTTI of investments in qualified affordable housing projects before the adoption of ASU 2023-02? #
- 5.5.75 How does an investor measure OTTI of investments in tax equity investments after the adoption of ASU 2023-02? \*\*

## 6. Changes in ownership and degree of influence

### Questions

- 6.2.20 How does an investor measure its cost basis when an additional investment triggers transition to the equity method? #
- 6.2.60 How does an investor transition from the equity method to consolidation when it obtains a controlling financial interest? #
- 6.3.40 How does an investor transition from the equity method when it loses significant influence? #
- 6.3.60 How does an investor account for an exchange of an equity method investment for another asset or group of assets? #
- 6.3.80 How does an investor transition to the equity method when it loses a controlling financial interest in its consolidated subsidiary? #
- 6.3.105 How does an investor initially measure nonmonetary assets distributed by an investee upon dissolution? \*\*
- 6.3.140 How does an investor transition from the equity method when it loses significant influence in a dilution transaction? #

### Examples

- 6.2.10 Purchase of an additional investment that triggers the equity method #
- 6.3.40 Discontinuing equity method when the investee has OCI (2) #
- 6.3.85 Investee sale of shares when the investor buys no shares and loses significant influence #

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