



ASC Insights Series: Guide to Accounting Standards

Accounting Standards Codification 323-
Investments - Equity Method and Joint Ventures

June 2024

1. Foreword**2. Purpose****3. Background****4. Summary of Topic****5. Key Issues/
Considerations****6. Comparison with
IFRS**

Foreword

Welcome to our “**Uniquus’ ASC Insights Series: Guide to Accounting Standards**”, where we combine our collective wisdom to understand various Accounting Standard Codifications (ASCs) comprehensively and in a crisp manner. This series is an invaluable tool for accounting professionals, offering detailed explanations, illustrative examples, and our expert point of view. Designed to support your professional journey, this guide help you navigate complex accounting scenarios and deepen your knowledge.

This is the first publication in our “Uniquus’ ASC Insights Series: Guide to Accounting Standards”, focusing on “**ASC 323- Investments - Equity Method and Joint Ventures**” In this installment, we delve into the specifics of ASC 323, exploring its implications, key considerations, and practical applications. Through clear illustrations and expert commentary, we aim to make the standard accessible and actionable for practitioners.

ASC 323 provides guidance on the accounting for investments under the equity method which is applicable for the investors having an ability to exercise significant influence over the investee or investors having investments in a joint venture.

We hope you enjoy reading this document and find this series valuable!

Thank you.

Yours faithfully

For Uniquus Consultech Inc.



Sandip Khetan

*Co-Founder and Global Head,
Accounting & Reporting Consulting*



Avinash Ramkumar

*Partner, Accounting &
Reporting Consulting*

Purpose

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations

6. Comparison with
IFRS

Investors frequently enter transactions in which they make significant but not controlling investments in an entity. When investments made in common stock provide the investor with significant influence over the investee, an investor should apply the equity method of accounting unless the investor elects a fair value option for the investment. The equity method of accounting would also be used for investments in a joint venture.

This publication provides an overview of the key accounting considerations and implementation matters relating to ASC 323 (Investments - Equity Method and Joint Ventures). The technical views and accounting positions on the framework keep enhancing depending on carrying out further technical evaluations and their outcomes.

We sincerely hope you find this quick reference guide informative in identifying and evaluating the issues related to the accounting for equity method investments. We will be happy to participate in any discussions required to clarify our views enclosed in the attached publication. We look forward to hearing from you.



1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations6. Comparison with
IFRS

Background

Equity investments made by investors represent an ownership interest (for example, common stock, preferred stock, or other capital stock) in an entity, and may be made in various type of legal entities, such as corporations, limited liability partnerships or corporations. Equity investments may be accounted for as a controlled subsidiary, equity method investment, or financial asset.

The accounting for an equity investment by an investor depends on the degree of influence that can be exercised over the investee. An investor who is holding a controlling financial interest (either directly or indirectly) in another entity is required to consolidate that entity pursuant to either the variable interest entity (VIE) or voting interest entity (VOE) consolidation model, as per the principles of **ASC 810, Consolidation**. On the other hand, if it is concluded that an investor does not have a controlling financial interest, it should determine whether the equity method of accounting as prescribed by **ASC 323, Investments – Equity Method and Joint Ventures** is applicable,

ASC 323 provides guidance on the accounting for investments under the equity method. Investments within the scope of the equity method include:

- Investments in either common stock and/or in-substance common stock (for e.g. investment with a non-substantive liquidation preference or without a stated liquidation preference over the investee's common stock may be substantially similar to common stock) of corporate entities,
- Investments in entities like limited liability companies, unincorporated joint ventures, and partnerships.

The equity method is applicable **if these investments allow the investor to exercise significant influence over the investee**. Moreover, the equity method must be applied to a limited partner's interest unless the interest held by the limited partner is so minor that the limited partner has virtually no influence over the partnership's operating and financial policies.



1. Foreword

2. Purpose

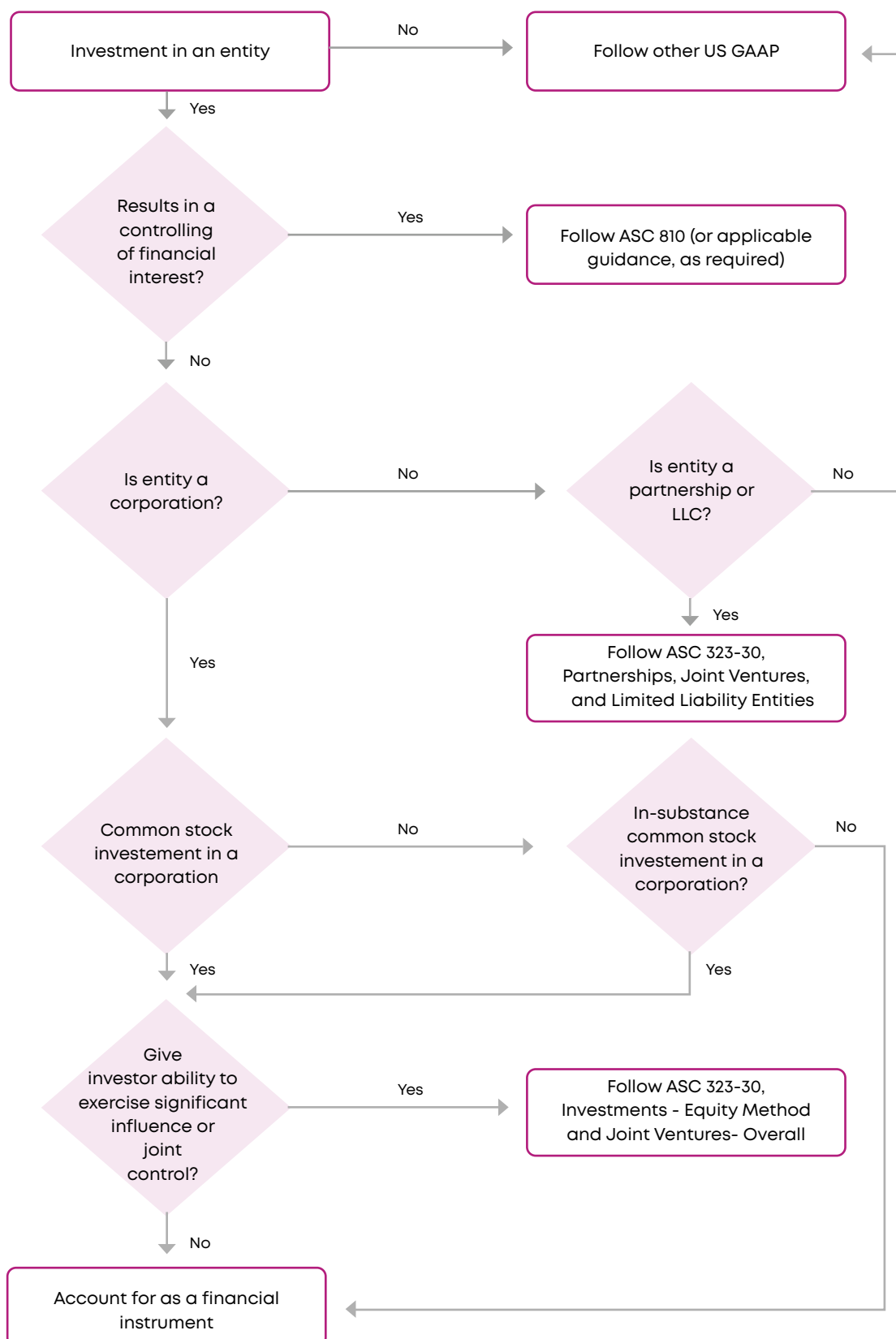
3. Background

4. Summary of Topic

5. Key Issues/ Considerations

6. Comparison with IFRS

The following flowchart summarises the accounting for equity investments:



Summary of Topic

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

4.1. Existence of Significant influence- Criteria for applying Equity method of accounting

4.2. Scope exceptions

4.3. Identification of Joint Venture

4.4. Initial recognition and measurement of Equity method investment

4.5. Subsequent measurement of Equity method investment

5. Key Issues/ Considerations

6. Comparison with IFRS

01 Existence of Significant influence- Criteria for applying Equity method of accounting

Existence of an ability to exercise significant influence over the operating and financial policies of the investee is a primary condition for applying the equity method. Determining significant influence requires evaluating the facts and circumstances related to each investment, and such an assessment should be made on an ongoing basis.

The following table summarises the Voting percentages, which is generally assumed to demonstrate the existence of significant influence:

Investor holding Investment in:	Investor does not have controlling financial interest, but owns:
Common stock	At least 20% of the outstanding voting securities
In-substance common stock	
General partnership interest in a Partnership	Any non-controlling financial Interest
Limited partnership or unincorporated joint venture	3% to 5% or more of a limited partnership or other interest
Limited liability company or partnership- Not maintaining specific ownership accounts for each investor (like a corporation)	At least 20% of the outstanding voting securities
Limited liability company or partnership- Maintaining a specific ownership account for each investor (like a limited partnership)	3%-5% or more of the outstanding voting securities

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

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

4.1. Existence of Significant influence- Criteria for applying Equity method of accounting

4.2. Scope exceptions

4.3. Identification of Joint Venture

4.4. Initial recognition and measurement of Equity method investment

4.5. Subsequent measurement of Equity method investment

5. Key Issues/ Considerations

6. Comparison with IFRS

ASC 323 provides the following list of indicators (not-all inclusive) that investors should consider when evaluating whether it has the ability to exercise significant influence over the operating and financial policies of an investee.

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



There exists a rebuttable presumption that ownership of 20% or more of the voting stock of an investee provides an investor with the ability to exercise "Significant influence". However, presumptions of whether significant influence exists may be overcome by a preponderance of evidence. The guidance provides a non-inclusive list of indicators to consider when determining whether the investor has significant influence. So reliance cannot be placed solely to voting interest held by investor since there can be a possibility that an investor holding less than 20% voting stock has the ability to exercise "Significant influence" over the investee by exercising a strategic role over the operating and financial policies of an investee through representation on the board of directors, participation in policymaking, material intra-entity transactions, interchange of managerial personnel, technological dependency.

Determining whether an investor has the "ability to exercise significant influence over operating and financial policies of the investee" requires judgment based on the facts and circumstances of each investment.



1. Foreword

2. Purpose

3. Background

4. Summary of Topic

4.1. Existence of Significant influence- Criteria for applying Equity method of accounting

4.2. Scope exceptions

4.3. Identification of Joint Venture

4.4. Initial recognition and measurement of Equity method investment

4.5. Subsequent measurement of Equity method investment

5. Key Issues/ Considerations

6. Comparison with IFRS

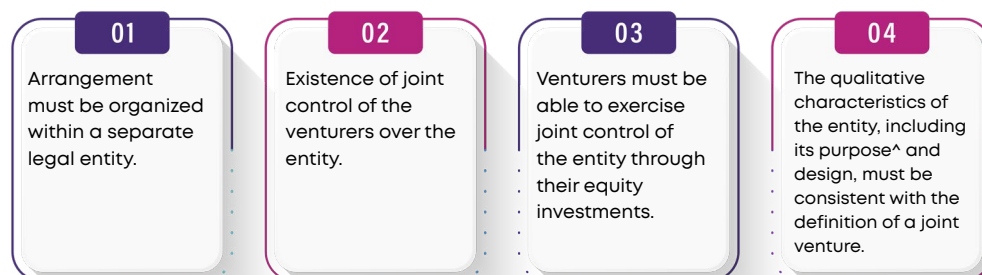
02 Scope exceptions

The equity method of accounting generally does not apply to:

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

03 Identification of Joint Venture

The joint venture is a legal entity, which must have all the following characteristics:



[^]Purpose of the entity should be sharing risks and rewards to develop a new market, product or technology; combining complementary technological knowledge; or pooling resources to develop production or other facilities.



When two or more existing operating businesses are combined to produce synergies, reduce costs, or generate growth opportunities, determining whether the combined entity qualifies as a joint venture may require significant judgment.

In these situations, there exist diversity in practice due to the lack of explicit accounting guidance for joint ventures and the inherent subjectivity of this determination. Registrants are encouraged to consult about their conclusions related to joint venture formation transactions. Ultimately, determining whether an entity is a joint venture will be based on facts and circumstances.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

4.1. Existence of Significant influence- Criteria for applying Equity method of accounting

4.2. Scope exceptions

4.3. Identification of Joint Venture

4.4. Initial recognition and measurement of Equity method investment

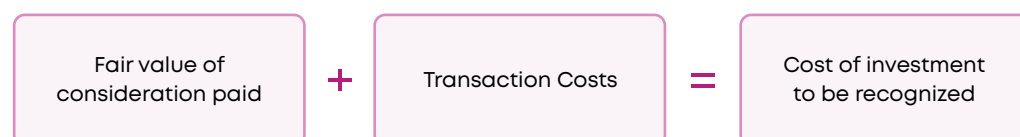
4.5. Subsequent measurement of Equity method investment

5. Key Issues/ Considerations

6. Comparison with IFRS

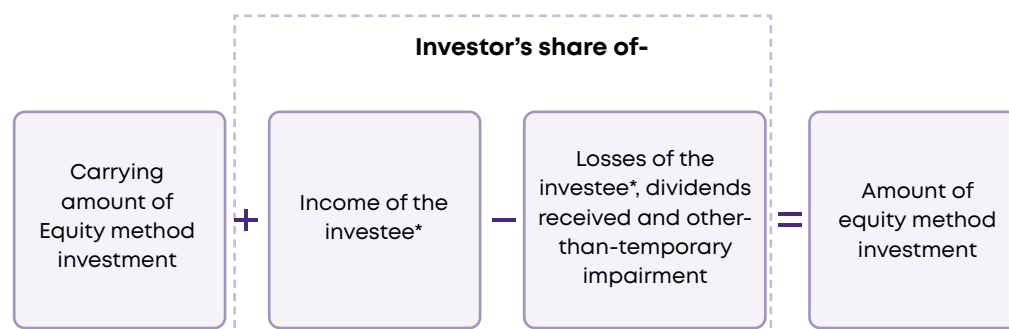
04 Initial recognition and measurement of Equity method investment

An investor is required to measure an equity method investment initially at cost. Consequently, equity method investments generally are recognized using a cost accumulation model in which the investment is recognized based on the cost to the investor, which is generally based on the fair value of the consideration paid which includes transaction costs as well. Costs incurred by an investor forming part of the cost of an equity method investment should be limited to direct costs of acquiring the equity method investment.



05 Subsequent measurement of Equity method investment

Under the equity method of accounting, investors' share of the earnings or losses of an investee shall be recognized in the periods for which they are reported by the investee in its financial statements rather than in the period in which the dividend is declared by an investee.



**Share of the earnings or losses shall reflect adjustments like those made in preparing consolidated statements including intra-entity profits and losses, basis differences and investee capital transactions.*

Key Issues/ Considerations

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

01 Accounting for changes from a financial asset to an equity method investment

Investor X acquires 17% of the common stock of Investee Y on 1 January 20X1 for \$1,350. The common stock of Investee Y has a readily determinable fair value, so Investor X measures it at fair value with unrealized gains and losses recognized in earnings. The fair value of Investor X's investment in the common stock of Investee Y was \$1,800 on 31 December 20X1. As a result, Investor X recognized \$450 of unrealized gains in earnings for the year ended 31 December 20X1.

Investor X acquires an additional 5% of Investee Y's common stock on 1 February 20X2 for \$750, resulting in a total of 22% interest. Investor X determines that it has the ability to exercise significant influence over Investee Y. The fair value of Investor X's existing 17% investment on 1 February 20X2 is \$2,250.

Analysis:

An increase in investor rights from no influence to significant influence over an investee triggers a transition from accounting for a passive financial instrument under Topic ASC 321 to an equity method investment under Topic ASC 323. As per the standard, "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." [ASC 323-10-30-2, 35-33]

If an investment qualifies for use of the equity method, the investor shall adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. The cost of acquiring the additional interest in the investee (if any) shall be added to the current basis of the investor's previously held interest.

The current basis of the investor's previously held interest in the investee shall be remeasured as per the principles of ASC 321-10-35-1 (Fair value approach) or ASC 321-10-35-2 (Measurement alternative approach), as applicable, immediately before adopting the equity method of accounting. For purposes of applying ASC 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 has resulted in it applying equity method, the previously held interest shall be remeasured by an entity at its fair value immediately, before applying the equity method.

Investor X

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

1. remeasures its investment to its fair value and
2. derecognizes the investment and recognizes an equity method investment for the total of the new carrying value of the investment (the fair value as measured in step 1), plus the cash paid.

Investor X records the following journal entries on 1 February 20X2:

Particulars	Debit	Credit
Investment in Y	\$450	
Earnings (The fair value of 17% investment is \$2,250, less the previous carrying amount of \$1,800)		\$450
Equity method investment in Y	\$3,000	
Investment in Y		\$2,250
Cash		\$750



The investor must place emphasis on the following things, on the date of change in interest to determine the appropriate recognition of Investments in the books of account:

- The assessment of whether an investor applies the equity method is based not only on changes in the investor's ownership percentage but also on changes that provide the investor with the ability to exercise significant influence over the operational and financial policies of the investee or joint control over the investee. It also requires an assessment of rights held by other investors.
- On the conclusion for the application of equity method, Investor should remeasure preexisting interest under fair value or measurement alternative approach.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations5.1. Accounting for changes
from a financial asset
to equity method
investment5.2. Accounting for
changes in interest of a
subsidiary when control
is lost but significant
influence exists5.3. Accounting for
Reciprocal interests /
Cross holdings of equity
method investments5.4. Accounting for
Equity method basis
differences5.5. Accounting for Bargain
Purchase5.6. Accounting for Stock
compensation awarded
by investor to investee
employees6. Comparison with
IFRS

02 Accounting for changes in the interest of a subsidiary when control is lost but significant influence exists

Company Z owns 80% of Company Y (**subsidiary of “Company Z”**). Company Z disposes 50% of Company Y for \$30 million, resulting in loss of control of Company Y. The fair value of the noncontrolling investment retained (i.e. 30%) at the disposal date is \$18 million. The carrying value of the identifiable net assets of Company Y is \$44 million, and there exists no goodwill. The carrying value of the 20% noncontrolling interests held by third parties in Company Y prior to the transaction is \$8.8 million.

Analysis:

When an investor loses a controlling financial interest over the investee but retains a noncontrolling investment in common stock or in-substance common stock that gives the investor significant influence over that investee entity, the investor must apply the equity method to its retained interest as per ASC 323 Investments – Equity Method and Joint Ventures.

On the date when loss of control has happened, investors have to address the following aspects from an accounting standpoint:

- How will derecognition for the investment sold be accounted for?
- How will retained interest in the investments be recognized?

Following journal entries shall be recorded by Company Z on the disposal date to record the disposal of 50% interest, to recognize the gain on the 30% retained noncontrolling investment, and for derecognition of the subsidiary (in millions):

Particulars	Debit	Credit
Cash	\$30	
Equity-method investment (Recognition of retained interest)	\$18	
NCI (Derecognition of carrying value of NCI)	\$8.8	
Net assets		\$44
Gain on sale of investment*		\$12.8

*Gain on sale of Investment = Consideration received (30) + Fair value of retained interest (18) + Carrying value of NCI (8.8) – Carrying value of former subsidiary's net assets (44) = \$12.8

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Gain on Investment, amounting to \$12.8, represents the gain on the interest sold and the retained noncontrolling investment, which would be recognized in earnings and to be disclosed in the financial statements. Additionally, the portion of the gain or loss related to the remeasurement of the retained noncontrolling investment to fair value shall also be disclosed by Company Z.

Gain on retained noncontrolling investment = Fair value of retained interest (18) – % retained of Carrying value of former subsidiary's net assets (30% of 44 = 13.2) = \$4.8.



The investor must follow the below mentioned steps on the date for loss of control in Investments:

Step 1: Deconsolidate investment and remeasure retained investment (noncontrolling interest) at fair value. Gain or loss recognized in net income as per ASC 810-10-40-5.

Step 2: Prospectively recognize the investor's share of equity investee's earnings based on retained interest, adjusted for the effects of basis differences (such as equity method goodwill), and other items.



1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

03 Accounting for Reciprocal interests / Cross holdings of equity method investments

Company A owns 40 percent of Company B, and B owns 30 percent of A. Each company has significant influence over the other and, therefore, applies the equity method.

	Entity A	Entity B
Cost of equity method investment	\$160,000	\$180,000
Net income (before equity method earnings from reciprocal holding)	\$60,000	\$110,000

Analysis:

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

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

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

As a result, Entity A's total equity method investment in Entity B would be \$204,000 ($\$160,000 + 40\% \times \$110,000$). Entity A would not reduce its equity method investment or record treasury stock for the reciprocal interest held by Entity B. Similarly, Entity B's equity method investment in Entity A would be \$198,000 ($\$180,000 + 30\% \times \$60,000$).



In the case of Reciprocal interests / Cross holdings of equity method investments, an approach that is commonly used is the application of treasury stock method. Under the treasury stock method, the investor records its share of the investee's net income, excluding any equity method earnings from the reciprocal holding. Investors should also consider the effect on earnings per share.

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

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

04 Accounting for Equity method basis differences

Investor X acquired a 40% interest in the voting common stock of Investee Y for a consideration of \$560 million. Investor X has significant influence and, therefore, applies the equity method.

On the date of acquisition, assets and liabilities existing in the books of Investee Y are as follows (in millions):

Line Item	Carrying value (CV) of Investee Y	Fair value (FV) of Investee Y	Investor X's share of Investee Y's CV	Investor X's share of Investee Y's FV
Current assets	\$500	\$500	\$200	\$200
Fixed assets	\$500	\$900	\$200	\$360
Net assets	\$1,000	\$1,400	\$400	\$560

The fixed assets have a remaining life of 10 years. Investee Y's income for Year 1 is \$250 million.

Analysis:

An equity method basis difference is defined as the variance between the cost of an equity method investment and the investor's proportionate share of the carrying value of the investee's underlying assets and liabilities. An investor must account for the equity method basis difference as if the investee were a consolidated subsidiary. However, in the investor's balance sheet, the equity method investment would be presented as a single line item.

Basis differences can be identified by the investor by performing a hypothetical purchase price allocation on the investee as of the date of the investor's investment. As per the principles of ASC 323-10-35-13, the investor accounts for the basis adjustments as if the subsidiary was a consolidated subsidiary in memo accounts. An equity method investment is presented by the investor on the balance sheet as a single amount. However, the investor must identify and account for basis differences.

After initial recognition accounting on the acquisition, basis differences assigned to identified assets and liabilities will often impact equity method earnings, with a corresponding increase or decrease in the equity investment balance.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Initial and subsequent recognition and measurement principles are summarised below:

Initial recognition:

Perform hypothetical purchase price allocation of the investee and allocate the basis differences (difference between (a) the carrying value of the investment and (b) the investor's proportionate share of the carrying amount of the investee's net assets) to multiple assets and liabilities.

Subsequent measurement:

In respect of basis differences identified on initial recognition, the investor tracks the same in "memo" accounts and amortizes and accretes them into equity method earnings and losses, depending on the nature of the respective basis difference. In other words, the equity method earnings are recognized after giving the impact of amortization/accretion of basis differences.

Initial Recognition:

Investor X records the 40% investment in Investee Y of \$560 million in its books. The basis differences of \$160 attributable to fixed assets are accounted for as part of the "memo accounts" by the investor.

Subsequent measurement (Year 1) (In millions):

Investor X's share of the investee's net income	\$100	(40% x \$250)
Amortization of fixed asset basis difference	(\$16)	(\$160/ 10 years)
Net equity method earnings to be recognized	\$84	

Deferred tax on basis differences:

The investor should identify deferred tax consequences of the equity method basis differences. Deferred tax liability/asset will be recognized in the memo and will account for positive and negative basis differences, respectively. As the investor amortizes its excess basis in the memo accounts, it would unwind the corresponding deferred tax balance as well and recognize the associated impact of the tax effects in its calculated share of the investee's earnings.

The investor should not consider whether deferred tax assets associated with the equity method basis differences are more likely than not to be realized because the deferred tax assets are not separately recognized in the investor's financial statements.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Accounting impact of tax on basis differences:

Assuming an investee tax rate of 25%, the following tax adjustments are performed in the above illustration:

Initial recognition:

A Deferred tax liability of \$40 million would be established, calculated as the \$160 million basis difference multiplied by the Investee's 25% tax rate. The Same will be recognized in the memo accounts.

Subsequent measurement (Year 1):

Deferred tax income of \$4 million would be established, calculated as the \$16 million amortization of basis difference multiplied by the Investee's 25% tax rate. Net equity method earnings after consideration of tax impact would be \$88 million (84 + 4).



The investor must account for the basis difference because when an investor records its equity method earnings, the entity reflects not only its portion of the investee's earnings, but also any effects of the basis differences related to identified assets or assumed liabilities (e.g., depreciation, amortization, revenue) and its tax impact.

05 Accounting for Bargain Purchase

An Investor acquired 25% voting common stock of Investee for a purchase consideration of \$1,000. The tax rate applicable to the Investee is 25%. On the date of acquisition, the Investor's share of the net assets of the Investee is as follows:

Line Item	Carrying value (CV) of Investee	Fair value (FV) of Investee	Investor share of Investee CV	Investor share of Investee FV
Current assets	\$1,800	\$1,800	\$450	\$450
Fixed assets	\$2,000	\$3,700	\$500	\$925
Patent	-	\$220	-	\$55
Deferred tax liability	-	(\$480)	-	(\$120)
Current liabilities	(\$800)	(\$800)	(\$200)	(\$200)
Net assets	\$3,000	\$4,440	\$750	\$1,110

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Analysis:

In rare circumstances, the fair value of consideration transferred by an investor for investment in an equity method investee may be less than the fair value of the identifiable net assets acquired, which results in an economic gain to the investor and is referred to as a "Bargain Purchase". ASC 323 does not specifically address a bargain purchase associated with an equity method investment.

In the above-mentioned scenario, there are two approaches that are generally followed i.e., 'the bargain purchase gain approach' and 'the negative basis difference approach'. It's an accounting policy choice of the Investor for the adoption of either of the approaches, but whichever approach gets initially adopted must be applied consistently.

Bargain purchase gain approach:

Under this approach, excess of the fair value of the identifiable net assets over the cost of the equity method investment would be recognized as a bargain purchase gain in earnings on the investment date, consistent with the accounting for bargain purchases in business combinations.

Investor recognizes a bargain purchase gain of \$110 (Investor share of investee FV \$1,110 less consideration paid \$1,000), and the basis differences of \$360 would be accounted for in memo accounts as per the basis difference guidance.

Negative basis difference approach:

This approach results in the investor recognizing such assets at less than their fair value in its memo accounts. That is, the investor first recognizes an investee's non-qualifying assets at fair value (unless other GAAP prescribes another measurement basis) in its memo accounts, and then it allocates the excess cost of the investment to reduce the investee's qualifying assets based on their fair value relative to the total fair value of all qualifying assets. This approach is consistent with that used in ASC 805-50 asset acquisition guidance.



1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Step 1:

With respect to assets with basis differences (i.e. the acquired patent and fixed assets), the first step includes determining what percentage of the preliminary fair value each asset makes up:

Line Item	Investor share of Investee FV	% of total
Fixed assets	925	94.4%
Patent	55	5.6%
Net assets	\$980	

Step 2:

The second step includes calculating the tax rate that should be applied to the excess amount by using the iterative calculation as illustrated in paragraphs **ASC 805-740-55-9 through ASC 805-740-55-13**¹, which considers tax rate as the applicable tax rate/ (1- applicable tax rate) i.e. 25%/ (1-25%) = 33.3%

Step 3:

Impact on deferred tax liability of excess amount = \$110 x 33.3% = \$37. The preliminary fair value of the deferred tax liability amounting to (\$120) shall be reduced by the Impact on the deferred tax liability of excess amounting to \$37, resulting in a final fair value of (\$83).

Step 4:

Impact on fixed assets and patents of excess amount along with related tax impact.

Fixed assets = (\$110 + \$37) x 94.4% = \$139. The preliminary fair value of fixed assets amounted to \$925 shall be reduced by Impact on fixed assets of excess amount (including related tax impact) amounting to \$139 resulting in final fair value of \$786.

Patents = (\$110 + \$37) x 5.6% = \$8. The preliminary fair value of Patents amounted to \$55 shall be reduced by Impact on Patent of excess amount (including related tax impact) amounting to \$8, resulting in final fair value of \$47.

Basis aforesaid calculation, the final fair value of the Investor's proportionate share of the Investee's net assets (inclusive of deferred tax liability) should be equal to the Investor's cost of the investment amounting to (\$1,000).

The adjusted basis differences of \$786, \$47, and (\$83) should be assigned to the acquired fixed assets, patent, and deferred tax liability by the investor within the equity method memo accounts.

¹ 805-740-55-10 As of the acquisition date, the goodwill for financial reporting purposes is adjusted for the tax benefit associated with goodwill using the following simultaneous equations method. In the following equation, the Preliminary Temporary Difference variable is the excess of tax goodwill over book goodwill before considering the tax benefit associated with goodwill, and the Deferred Tax Asset variable is the resulting deferred tax asset.

$(\text{Tax Rate} \div [1 - \text{Tax Rate}]) \times \text{Preliminary Temporary Difference} = \text{Deferred Tax Asset}$

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS



Generally, a bargain purchase is a rare transaction, and we believe that an important aspect of the investor assessment is understanding the facts like 'Why there is a bargain purchase', 'Why the seller would be willing to sell an interest in the investee at an amount less than what a market participant would be willing to pay', etc. Usually, a seller acts in an economically rational manner, given the fiduciary responsibility that it has to its shareholders.

Examples of common factors that may justify a bargain purchase gain, individually or in aggregate, include the following:

- The transaction was a "forced" or "distressed" sale.
- The seller was required to sell the noncontrolling interest in a less-than-optimal period of time.
- The transaction was not subject to a competitive bidding process.
- The purchase price was "fixed" (e.g., in a fixed price option) prior to the closing date of the transaction, and the fair value of the net identifiable assets of the equity method investment increased during the intervening period, thereby creating the bargain purchase.

Investors must consider these factors when disclosing the reasons for the bargain purchase in the notes to accounts of the financial statements.

06 Accounting for Stock compensation awarded by investors to investee employees

Investor A owns 40% of the voting common stock of Investee Z. Investor B holds 30% of the voting common stock of Investee Z. Investor A and Investor B have the ability to exercise significant influence over Investee Z and apply the equity method. On 2 January 20X1, Investor A grants 100 options (in the shares of Investor A) to Investee Z's employees. The options had a fair value on 2 January 20X1 (the grant date) of \$1,000. The options cliff vest in two years. None of the other investors in Investee Z shared in funding the options granted to the employees of Investee Z.

Assume that the recognition of compensation cost for the stock options is the only transaction that occurs during 20X1 and 20X2, and there were no forfeitures (assumed or actual). Basis differences and the effect of income taxes have been ignored to simplify this illustration. Assume that Investor A and Investee Z both adopted ASU 2018-07 in 20X1.

Analysis:

An investor may grant share-based payments on its own shares to employees or non-employees of an equity method investee in exchange for goods or services the employees or non-employees provide to the investee. Issues arise in both the investor's and the investee's accounting.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Investor (Grantor):

An investor may provide a stock- compensation plan for the employees of investee. Under the circumstances wherein other investors do not provide proportionate funding or the investor does not receive any consideration, such as an increase in its relative ownership percentage of the investee for the awards granted, the entire cost associated with the award should be recognized as an expense by the investor, when the investee recognizes the related expense in its books and not just its proportionate share based on ownership interest in the investee. This assumes that the awards were not agreed to and accounted for as part of the investor's acquisition of an interest in the investee.

Investee:

The investee will recognize the stock-based compensation costs incurred by the investor on its behalf with a corresponding credit to capital contribution.

Other Investors:

This also impacts the Investors who are not participating in sponsoring the stock-based compensation plan for investee employees. Such investors would recognize their respective share of the expense recorded by the investee as part of the share of earnings or losses of the investee. In addition, as the investee would have recorded an increase in its capital, the other non-contributing investors would also record their share of the investee's increase in net assets as part of their share of earnings or losses, with a corresponding increase in their equity method investment.

The journal entries for Investee Z, Investor A, and Investor B would be the following:

Investee Z

Year: 12/31/20X1		Year: 12/31/20X2	
Dr. Expense	\$500	Dr. Expense	\$500
Cr. APIC*	\$500	Cr. APIC	\$500
(to record employees' compensation in shares of the investor)		(to record employees' compensation in shares of the investor)	
*APIC- Additional Paid in Capital			

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations

5.1. Accounting for changes from a financial asset to equity method investment

5.2. Accounting for changes in interest of a subsidiary when control is lost but significant influence exists

5.3. Accounting for Reciprocal interests / Cross holdings of equity method investments

5.4. Accounting for Equity method basis differences

5.5. Accounting for Bargain Purchase

5.6. Accounting for Stock compensation awarded by investor to investee employees

6. Comparison with IFRS

Investor A (Grantor)

Year: 12/31/20X1	Year: 12/31/20X2
Dr. Equity method loss \$200 Cr. Investment \$200 (to record proportionate share of Investee Z's net loss, or 40% * \$500)	Dr. Equity method loss \$200 Cr. Investment \$200 (to record 40% of Investee Z's net loss)
Dr. Investment \$200 Dr. Equity method loss \$300 Cr. APIC \$500 (to record 40% of Investee Z's capital transactions on a step-by-step basis and 60% of the grant of options that does not result in an increase in Investor A's claim on Investee Z's book value)	Dr. Investment \$200 Dr. Equity method loss \$300 Cr. APIC \$500 (to record 40% of Investee Z's capital transactions on a step-by-step basis and 60% of the grant of options that does not result in an increase in Investor A's claim on Investee Z's book value)

Investor B (Other investor)

Year: 12/31/20X1	Year: 12/31/20X2
Dr. Equity method loss \$150 Cr. Investment \$150 (to record proportionate share of Investee Z's net loss, or 30% * \$500)	Dr. Equity method loss \$150 Cr. Investment \$ 150 (to record 30% of Investee Z's net loss)
Dr. Investment \$150 Cr. Equity method earnings \$150 (to record benefit related to Investor B's increased interest in Investee Z's net book value because of the grant of options)	Dr. Investment \$150 Cr. Equity method earnings \$150 (to record benefit related to Investor B's increased interest in Investee Z's net book value because of the grant of options)

Comparison with IFRS

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/ Considerations

6. Comparison with IFRS

Both ASC 323, Investments-Equity Method, and Joint Ventures under USGAAP and IAS 28, Investment in Associate and Joint Venture under IFRS, provide guidance on the Equity method of accounting as applicable for Investors' having ability to exercise significant influence in relation to accounting of Investment in Associates and Joint Venture.

Following table summarizes the Key differences:

	Key Provisions	USGAAP	IFRS
1.	Potential voting rights	In evaluating significant influence- - An investor would consider only "present voting privileges." In other words, potential voting rights are generally disregarded.	In evaluating significant influence- - An investor should consider "potential voting rights that are currently exercisable or convertible." However, Instruments with potential voting rights, which are contingent on the occurrence of future events or the passage of time, shall not be considered until the occurrence of the contingent event or the time frame as specified passes.
2.	Explicit significant influence investment thresholds for partnerships or LLCs.	An investment threshold of greater than 3 percent to 5 percent in a partnership or LLC that maintains specific ownership accounts is generally accounted for under the equity method of accounting, even if the investor does not have significant influence.	IFRS Accounting Standards do not provide explicit significant-influence investment thresholds for partnerships or LLCs.
3.	Equity method of accounting - Impairment	An entity must record impairment or losses in the value of an investment that represents an other-than-temporary decline. A reduction in the current fair value of an investment below its carrying amount may indicate a loss in the value of the investment. Impairment losses cannot be reversed in subsequent periods.	An entity must test an investment for impairment by comparing its recoverable amount (the higher of its value in use or its fair value less costs to sell) with its carrying amount whenever there is an indication of any impairment. Impairment losses should be reversed in a subsequent period to the extent that the recoverable amount of the associate or joint venture increases.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations6. Comparison with
IFRS

	Key Provisions	USGAAP	IFRS
4.	Exemption from applying the equity method	Equity method investments are considered financial assets, and therefore, are eligible for the fair value accounting option. Regardless of whether an entity is a venture capital or similar organization it can measure an investment in associates or joint ventures at fair value through profit or loss.	An entity can only elect fair value through profit or loss accounting for equity method investments held by venture capital organizations, mutual funds, unit trusts, and similar entities, including investment-linked insurance funds. • If an Associate or joint venture is an investment entity: In this case the equity method of accounting can be applied by either (1) recording the results of the investment entity that are at fair value or (2) undoing the fair value measurements of the investment entity. • If Associate or joint venture is not an investment entity: the entity must apply the equity method to its investments in associates and joint ventures unless it is exempt from preparing consolidated financial statements.
5.	Investments classified as held for sale	Under US GAAP, equity method investments are not classified as held for sale. Equity method accounting shall be applied by an investor until significant influence is lost.	If an equity method investment meets the held- for- sale criteria in accordance with IFRS 5, an investor records the investment at the lower of its (1) fair value less costs to sell or (2) carrying amount as of the date the investment is classified as held for sale.
6.	Conforming to investor's accounting policies	The equity investee's accounting policies do not have to be uniform with the investor's accounting policies provided the investee follows an acceptable alternative US GAAP treatment.	Investors are required to prepare the financial statements using uniform accounting policies for similar transactions and events. This is also applicable to equity method investees.

1. Foreword

2. Purpose

3. Background

4. Summary of Topic

5. Key Issues/
Considerations6. Comparison with
IFRS

	Key Provisions	USGAAP	IFRS
7.	Difference in reporting periods	A difference in reporting dates is permitted if it is not more than three months. An entity must disclose the effect of any transactions or events that materially affect the investor's financial statements during the intervening period.	The investors and investees should have the same reporting dates unless it is impracticable for them to be the same. The time gap between the dates must be no more than three months when it is impracticable. Unlike U.S. GAAP, IFRS Accounting Standards require the investor to record its share of the associate's significant transactions or events that have occurred during the gap period.
8.	Losses in excess of an investor's interest	Generally, the equity method of accounting is discontinued by an investor when the value of an investment reaches zero unless the investor has guaranteed obligations of the investee or is otherwise committed to providing further financial support to the investee. However, unlike the treatment under IFRS Accounting Standards, under U.S. GAAP, an investor must continue to recognize additional losses after the investment reaches zero if the imminent return to profitable operations appears to be assured.	An investor is typically required to discontinue the use of the equity method of accounting when the value of an investment reaches zero unless the investor has incurred legal or constructive obligations or made payments on behalf of the associate. The concept of an imminent return to profitable operations as existing under USGAAP does not exist under IFRS.
9.	Loss of significant influence	Upon the loss of significant influence, any retained interest is continued to be measured at the carrying amount of the investment at the date of the change in status, and thus, no gain or loss shall be recognized solely because of the loss of significant influence (discontinuance of the equity method of accounting).	If an entity loses significant influence over an equity method investment and the retained interest is a financial asset, the entity should measure it at fair value. The resultant gain or loss is recognized in the income statement.

A TEAM THAT YOU CAN TRUST TO DELIVER



Jamil Khatri

Co-Founder & CEO
jamilkhatri@uniquis.com



Sandip Khetan

Co-Founder, Global Head of ARC
sandip.khetan@uniquis.com



Avinash Ramkumar

Partner, ARC
avinash@uniquis.com



Sharad Chaudhry

Partner, ARC
schaudhry@uniquis.com



Sagar Lakhani

Partner, ARC
sagarlakhani@uniquis.com



Akash Loonia

Partner, ARC
akashloonia@uniquis.com



Ankit Gaba

Director, ARC
ankitgaba@uniquis.com



Puneet Chowdhary

Director, ARC
puneetchowdhary@uniquis.com



Etisha Singh

Associate Director, ARC
etishasingh@uniquis.com

To know more about us, please visit www.uniquis.com