



New Developments Summary

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NDS 2020-02

FASB clarifies interaction between ASC 321, ASC 323, and ASC 815

ASU 2020-01 clarifies accounting for equity securities, equity method investments, and certain contracts on equity securities

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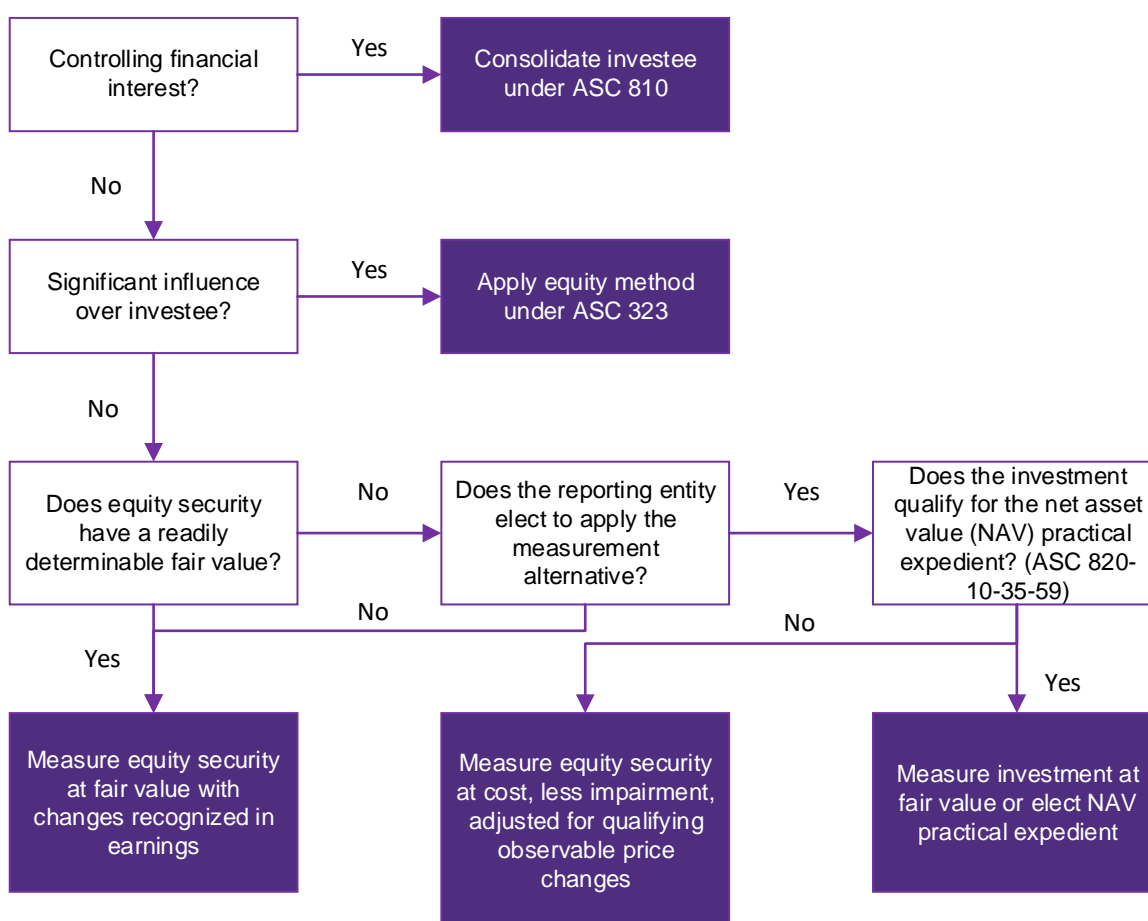
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Under ASC 321, *Investments—Equity Securities*, entities can elect to measure certain qualifying equity securities without a readily determinable fair value at cost, less impairment, which are marked to fair value when observable price changes in identical or similar investments from the same issuer occur (the “measurement alternative”). ASU 2020-01 clarifies how the guidance for equity method accounting in ASC 323 and non-derivative forward contracts and purchased options in ASC 815 interacts with the measurement alternative in ASC 321.

A. Background

The guidance in ASC 321, *Investments – Equity Securities*, requires entities to measure investments in equity securities at fair value, with changes in fair value recognized in earnings. However, ASC 321 allows entities to elect to measure certain qualifying equity securities without a readily determinable fair value at cost, less impairment, and to mark them to fair value when observable price changes in identical or similar investments from the same issuer occur (the “measurement alternative”). For more information on the measurement alternative in ASC 321, see [NDS 2016-03](#).

The following flowchart depicts how an entity should assess whether it may apply the measurement alternative to an investment in an equity security under ASC 321-10-35-2.



ASU 2020-01, *Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) – Clarifying the Interactions between Topic 321, Topic 323, and Topic 815 (a consensus of the Emerging Issues Task Force)*, clarifies how the guidance for equity method accounting in ASC 323 and non-derivative forward contracts and purchase options in ASC 815 interacts with the measurement alternative in ASC 321.

B. Application or discontinuation of the equity method of accounting

An entity that has significant influence over an investee is generally required to account for an investment in an equity security under the equity method of accounting in ASC 323, *Investments – Equity Method and Joint Ventures*. An investment in an equity security is not within the scope of ASC 321 if it is subject to the equity method of accounting under ASC 323. For investments in common stock (or in-substance common stock) of corporations that are not the functional equivalents of limited partnerships, significant influence is presumed to exist when an investor owns 20 percent or more of the investee. Investments in limited partnerships (or corporations that are the functional equivalents of limited partnerships) should generally be accounted for under the equity method unless the investor's interest is so minor (typically less than 3–5 percent) that the investor has virtually no influence over the investee. When evaluating whether an entity should apply the equity method of accounting, entities should carefully consider all relevant facts and circumstances.

As noted above, an entity that elects to account for an investment in an eligible equity security under the measurement alternative in ASC 321 should adjust the carrying amount of the investment to fair value when observable price changes in an identical or similar security of the same issuer occur. The guidance in ASU 2020-01 clarifies that a transaction that causes an equity investment either to be accounted for, or to discontinue being accounted for, under the equity method of accounting should be considered as a potential observable price change in accordance with the measurement alternative in ASC 321. If the investor determines that the transaction is an observable price change under the measurement alternative in ASC 321, then it should measure the investment at fair value either immediately before applying, or immediately upon discontinuing, the equity method.

Applying the equity method of accounting

According to the amendments in ASU 2020-01, an investor in an equity investment carried under the measurement alternative in ASC 321 should evaluate whether a transaction that triggers the application of the equity method of accounting in ASC 323 is an observable price change in an orderly transaction in identical or similar securities from the same issuer. If so, the investor should measure its equity investment at fair value immediately prior to applying the equity method of accounting, as illustrated in the following example.



Applying the equity method to an investment in an equity security previously accounted for under the measurement alternative in ASC 321

Investor A owns 15 percent (150,000 shares out of 1 million total outstanding shares) of the common stock of Company X. Company X only issues common stock. Investors B and C own 40 percent and 45 percent of the common stock of Company X, respectively. Investors A, B, and C are not related parties.

The common stock of Company X does not have a readily determinable fair value, and Investor A has elected to account for its investment in Company X under the measurement alternative in ASC 321. As of 6/30/X1, the carrying amount of Investor A's investment in the common stock of Company X is \$1.5 million (\$10/share).

On 7/1/X1, Investor A purchases an additional 10 percent (100,000 shares) of Company X's common stock from Investor C for \$2 million (\$20/share). As a result of this transaction, Investor A owns 25 percent of the common stock in Company X. Investor A determines that it now has significant

influence over Company X as a result of this transaction and therefore applies the equity method of accounting in ASC 323 to this investment. Because this transaction represents an observable price change in the same security from the same issuer, Investor A measures its entire investment at fair value prior to applying the equity method of accounting. Investor A determines that the price-per-share paid in the transaction with Investor C represents the fair value of the common stock of Company X. Accordingly, Investor A recognizes a \$1.5 million gain in earnings, as follows.

Historical investment	
Shares	150,000
Price/Share	<u>10</u>
Carrying amount	1,500,000
Fair value adjustment	
Shares	150,000
Price/Share	<u>20</u>
Total value	3,000,000
Carrying amount	<u>1,500,000</u>
Gain/(Loss)	<u>1,500,000</u>

The carrying amount of Investor A's investment when initially applying the equity method of accounting on 7/1/X1 is \$5 million.

Discontinuing the equity method of accounting

The guidance in ASU 2020-01 also clarifies that an investor in an equity investment without a readily determinable fair value that is carried under the equity method of accounting in ASC 323 should evaluate whether an event that results in the discontinuation of the equity method qualifies as an observable price change in an orderly transaction in identical or similar securities from the same issuer. If so, the investor should measure its equity investment at fair value immediately upon discontinuing the equity method of accounting, as shown in the following example.



Applying the measurement alternative in ASC 321 to an investment in an equity security upon discontinuing the equity method of accounting

Investor A owns 25 percent (250,000 shares out of 1 million total outstanding shares) of the common stock of Company X. Company X only issues common stock. Investors B and C own 40 percent and 35 percent of the common stock of Company X, respectively. Investors A, B, and C are not related parties. Investor A accounts for its investment in the common stock of Company X under the equity method of accounting in ASC 323. On 12/31/X5, the carrying amount of Investor A's investment in Company X is \$7.5 million (\$30/share).

On 1/1/X6, Investor A sells 10 percent (100,000 shares) of Company X's common stock to Investor C for \$2.5 million (\$25/share). As a result of this transaction, Investor A owns only 15 percent of the

common stock in Company X and concludes that it no longer has significant influence over Company X. Therefore, Investor A discontinues applying the equity method of accounting to this investment. Because the common stock of Company X does not have a readily determinable fair value, Investor A elects to account for its investment in the common stock of Company X under the measurement alternative in ASC 321.

Investor A determines that the transaction with Investor C is an observable price change in the identical security of the same issuer, and therefore measures its entire investment at fair value immediately upon discontinuing the equity method of accounting. Investor A determines that the price-per-share paid in the transaction with Investor C represents the fair value of the common stock of Company X. Accordingly, Investor A recognizes a \$1.25 million loss in earnings, as follows.

Realized gain/(loss) on sale	
Shares	100,000
Price/Share	<u>25</u>
Sales proceeds	2,500,000
Carrying amount	<u>3,000,000</u>
Gain/(Loss)	<u>(500,000)</u>
Fair value adjustment - remaining shares	
Shares	150,000
Price/Share	<u>25</u>
Total value	3,750,000
Carrying amount	<u>4,500,000</u>
Gain/(Loss)	<u>(750,000)</u>

The carrying amount of Investor A's investment upon discontinuing the equity method of accounting on 1/1/X6 is \$3.75 million.

C. Accounting for non-derivative forward contracts and purchased options

Under the guidance in ASC 815-10, *Derivatives and Hedging*, forward contracts and purchased options on equity securities with all of the following characteristics are accounted for in a manner consistent with investments in equity securities under ASC 321:

- The contract is entered into to purchase securities that will be accounted for under ASC 321.
- The contract's terms require physical settlement.
- The contract is not a derivative instrument pursuant to ASC 815-10.
- If a purchased option, the contract has no intrinsic value at the purchase date.

For the purposes of applying the guidance in ASC 815-10, ASU 2020-01 clarifies that an investor should not consider whether, upon settlement of the forward or exercise of the option, the investor would account for the underlying equity securities under the equity method in ASC 323 (or under the fair value option in accordance with ASC 825, *Financial Instruments*, if those equity securities would otherwise have been

accounted for under the equity method). As a result, forward contracts and purchased options for equity securities that meet the defined characteristics in the bulleted list above should be accounted for in a manner consistent with the guidance in ASC 321, regardless of whether the underlying securities would be accounted for under the equity method of accounting upon settling the forward or exercising the option.



Grant Thornton insights: Forward contract to acquire controlling financial interest

The guidance in ASC 815-10 on forward contracts and purchased options does not apply to a forward purchase contract to acquire a controlling financial interest in an acquiree. Generally, a forward purchase contract to acquire a controlling financial interest in an acquiree is not accounted for at fair value, unless it is a derivative instrument within the scope of ASC 815. ASU 2020-01 does not affect the accounting for forward contracts to acquire a controlling financial interest in an acquiree.

D. Effective date and transition

The guidance in ASU 2020-01 is effective as follows:

- *For public business entities:* Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020
- *For all other entities:* Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2021

Early adoption is permitted, including adoption in an interim period, for public business entities in periods for which the financial statements have not yet been issued and for all other entities in periods for which the financial statements have not yet been made available for issuance.

The guidance in ASU 2020-01 should be adopted prospectively at the beginning of the interim period that includes the adoption date.

Transition disclosures

All entities are required to provide the following transition disclosures in the annual financial statements in the period of adoption. If an entity issues interim financial statements, then these disclosures should be provided in each interim financial statement in the fiscal year of adoption:

- The nature of and reason for the change in accounting principle
- The method of applying the change
- A qualitative description of how the adoption of the amendments affects any line item in the financial statements

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