Accounting Relief for Businesses with Significant Equity Investments

Development-stage entities and entities with growing equity interests benefit from several standards newly effective for nonpublic companies in 2017.

Key Provisions of the Accounting Standards Updates

Accounting for Significant Equity Investments

Investor control often changes throughout an investment's life. The investor may acquire additional voting stock of the investee or the investee may buy back or retire voting stock held by other investors. Alternatively, an investor may lose control over an investment that was previously consolidated, but retain an equity method investment. Accounting Standards Update (ASU) 2016-07, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*, eliminates the investor requirement to retroactively account for an investment that becomes newly qualified for use of the equity method. Previously, investors were required to retroactively adjust the investment, results of operations and retained earnings as if the equity method had been used during all the previous periods in which the investment was held.

For an investment that was previously accounted for as a financial asset, the update requires an investor to apply the equity method of accounting subsequently from the date the investor increases its level of ownership to be eligible for the equity method or obtains the ability to exercise significant influence over the investee. The cost of acquiring the additional interest in the investee will be added to the carrying value of the previously held interest—which may be at cost, or fair value for marketable securities. The amendments require an entity with an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method.

- **Practice Point:** The effect on income at transition to the equity method will change when the new guidance on classifying and measuring financial instruments becomes effective. ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* eliminates the available-for-sale classification of equity investments. Thus, the recognition of unrealized gains and losses in accumulated other comprehensive income for an available-for-sale investment that becomes eligible for the equity method will only exist until an entity adopts the amendments in ASU 2016-01. With the adoption of ASU 2016-01, equity investments—including other ownership interests, such as partnerships, unincorporated joint ventures and limited liability companies—will be measured at fair value with changes in fair value recognized in net income, with limited exception. (See BKD's article: New Measurement & Classification Guidance for Financial Instruments)

Adjustments to Acquisition-Related Accounting Estimates

Measurement period adjustments are generally occurring because of complexities in completing certain fair value measurements, *e.g.*, **from estimating the results of an appraisal that is incomplete as of the reporting date**, or because an acquisition occurs near the acquirer's next reporting date. In either case, the assignment of amounts to the consideration transferred, the assets acquired, the liabilities assumed and any noncontrolling interests may not be complete by the acquirer's next reporting date. The acquirer reports provisional amounts, generally at fair value, based on best estimates of information available as of the reporting date and adjusts the amounts when accounting can be completed.

ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments,* eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. Instead, the acquirer will record the effect on earnings caused by changes in depreciation or amortization, or other income effects (if any) resulting from adjustments to provisional amounts in the reporting period in which the adjustment amounts are determined. The measurement period adjustments are calculated as if the accounting had been completed as of the acquisition date. All information must be complete within one year from the acquisition date as the measurement period cannot exceed one year from the acquisition date.

- **Practice Point:** Entities will no longer have to contemplate incurring costs justifying to their auditor the insignificance of measurement period adjustments, if any, and unwillingness to restate prior financial statements. Likewise, registered offerings with the U.S. Securities and Exchange Commission will no longer need to assess the materiality of retrospective measurement-period adjustments and potentially revise their historical annual audited financial statements in a new or amended registration statement.

  Important to Note: Errors, information received after the measurement period ends or information received about events or circumstances that did not exist as of the acquisition date are not measurement-period adjustments and may require prior period restatement.

Consolidation of Development-Stage Entities

ASU 2014-10, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation,* eliminates guidance that a consolidation evaluation of a development-stage entity focus on whether the entity has sufficient equity at risk to permit it to finance activities in which it is **currently** engaged.

With removal of the development-stage exception, reporting entities having an interest in a development-stage entity will apply the same consolidation guidance they would apply to other entities to determine whether the company is a variable interest entity (VIE) and whether the VIE should be consolidated—regardless of whether the entity has commenced planned principal operations or has significant revenue from its principal operations. This means acquirers will no longer be required to reconsider the sufficiency of the equity investment at risk if additional development-stage company activities are undertaken or additional assets are acquired.

The update also eliminates certain incremental financial reporting requirements and streamlines disclosure requirements for development-stage entities. The update clarifies that the guidance in Topic 275, *Risks and Uncertainties*, is applicable to development-stage entities that have not yet commenced planned principal operations.

- **Practice Point:** Removal of VIE guidance specific to development-stage entities may cause entities with interests in development-stage entities to identify more of them as VIEs, which may change prior consolidation decisions. For example, an entity purposely structured as a perpetual development-stage entity will no longer be able to avail itself of the exception and potentially avoid consolidation in perpetuity. If a development-stage entity is deemed to be a VIE, the reporting entity will be required to perform the consolidation analysis within a complex VIE model, accumulate the information needed to meet the VIE disclosure requirements—even if consolidation is not required—and perform the required reassessment each reporting period. In addition, a change in the consolidation entity could potentially affect the reporting entity's contracts, debt covenants and ability to obtain funding.

Another consolidation consideration is ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business.* This standard raises the bar for a development-stage entity to qualify as a business, primarily because of the new substantive process and output assessments. In evaluating whether a set of assets and activities is a business, determining whether the seller had historically operated the transferred set of assets and activities as a business or whether the acquirer intends to operate the transferred set as a business will not be relevant. This is because outputs (and revenues) are not required to be present at the acquisition date or at any time for an integrated set of activities and assets to qualify as a business.

- **Practice Point:** With the new guidance, more acquisitions will likely qualify as asset acquisitions versus business acquisitions. However, it is possible that enterprises in the development stage may qualify as businesses and various factors will need to be assessed. ASU 2017-01 is effective for annual periods beginning after December 15, 2018, for nonpublic business entities; reporting entities with development-stage interests may want to consider the effects of early adoption.

Inventory Measurement

Business growth often means inventory growth. In July 2015, the Financial Accounting Standards Board issued ASU 2015-11*, Inventory (Topic 330): Simplifying the Measurement of Inventory,* to simplify the subsequent measurement of inventories by replacing today's lower of cost or market (LOCOM) test with a lower of cost or net realizable value (NRV) test. For inventory within the scope of the new guidance, entities will be required to compare the cost of inventory to only one measure—its NRV—instead of three "market" measures. When evidence exists that the NRV of inventory is less than its cost—due to damage, physical deterioration, obsolescence, changes in price levels or other causes—entities will recognize the difference as a loss in earnings in the period in which it occurs.

Entities already calculate NRV when applying today's LOCOM guidance, and the new guidance doesn't change the calculation: NRV is the estimated selling price in the ordinary course of business. Entities measuring inventories of raw materials or work in process will still need to consider the costs to complete and sell finished goods, including direct selling costs such as transportation costs and sales commissions.

The guidance only applies to inventories for which cost is determined by methods **other than** last-in, first-out (LIFO) and the retail inventory method (RIM). Entities that use LIFO or RIM will continue to use existing impairment models.

- **Practice Point:** The new guidance is not expected to change how acquiring entities initially measure the cost of inventory in a business acquisition. Generally, an entity would not expect to record lower of cost or NRV write-downs immediately after recording inventories acquired in a business combination at fair value, consistent with practice within today's LOCOM guidance.

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Effective Date of Standards for Nonpublic Business Entities		
Topic	**Update**	**Effective Date**
Accounting for Significant Equity Investments	ASU 2016-07, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*	Effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted.
Adjustments to Acquisition-Related Accounting Estimates	ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*	Effective for entities other than public business entities, for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after this update's effective date with earlier application permitted for financial statements that have not yet been made available for issuance.
Consolidation of Development-Stage Entities	ASU 2014-10, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation*	Amendments to variable interest entity guidance in Topic 810, *Consolidation,* should be applied retrospectively for annual reporting periods beginning after December 15, 2016, and interim reporting periods beginning after December 15, 2017. Early application is permitted for any annual reporting period or interim period for which the entity's financial statements have not yet been made available for issuance.
Inventory Measurement	ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*	Effective for entities other than public business entities, for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period.