Joint Ventures and Equity Method Accounting

Illustrations

Example No. 1

Entities A and B (joint venturers) form a JV and each contributes cash, PP&E, intellectual property, intangible assets, management, and workforce to the JV. The JV has four board members and each venturer selects two of them. The venturers take turns electing the CEO and chairman of the board on a rotative basis.

Approval of significant decisions requires a unanimous vote of both venturers.

Thus, the parent entities (Entities A and B) have joint control over the JV.

Furthermore, the JV, as a whole, has a fair value of $220,000 (exceeding investors' contribution of $200,000 by $20,000). The JV accounts for this excess value as goodwill and accordingly reflects it in its books. The venturers (Entities A and B) account for this transaction based on the equity method of accounting.

The JV has a net income of $10,000 at the end of year 1.

The fair value of JV increases by $5,000 at the end of year 1.

	Entity A	**Entity B**	**JV**	**Consolidation Under Equity Method, Entities A and B**
Cash	$50,000	$20,000	$70,000	$35,000
Intellectual property	0	75,000	75,000	37,500
Intangible assets	5,000	5,000	10,000	5,000
PP&E	45,000	0	45,000	22,500
Goodwill	0	0	20,000	10,000
Total	$100,000	$100,000	$220,000	$110,000
Percentage of interest	50%	50%		

In this example, Entities A and B reflect any excess or deficit over the cost of their initial contribution in their earnings.

Entities A and B account for their investment using the equity method of accounting. Thus, they do not reflect the $5,000 increase in fair value in their earnings.

However, Entities A and B each reflect 50% of JV's net income of $10,000 in their investments and earnings for year 1 under equity method accounting one-line consolidation.

Example No. 2

The same facts as Example No. 1, but Entity A maintains 40% interest and Entity B maintains the remaining 60% interest.

The definition of a joint venture does not require that each investor have an equal ownership interest in the joint venture; thus, venturers A and B can still account for the venture as a JV and use the equity method of accounting.

	Entity A	**Entity B**	**JV**	**Consolidation Under Equity Method, Entity A**	**Consolidation Under Equity Method, Entity B**
Cash	$10,000	$20,000	$30,000	$12,000	$18,000
Intellectual property	0	35,000	35,000	14,000	21,000
Intangible assets	5,000	5,000	10,000	4,000	6,000
PP&E	25,000	0	25,000	10,000	15,000
Goodwill	0	0	20,000	8,000	12,000
Total	$40,000	$60,000	$120,000	$48,000	$72,000
Percentage of interest	40%	60%			

In this example, Entities A and B reflect any excess or deficit over the cost of their initial contribution in their earnings.

Entities A and B account for their investments using the "equity method of accounting." Thus, they do not reflect the $5,000 increase in fair value in their earnings.

However, Entities A and B each reflect 40% and 60% of JV's net income of $10,000 in their investments and earnings for year 1 in one-line consolidation, respectively.

Example No. 3

Entity A (an NCI – a non-controlling interest) contributes $5,000 in intangible assets and $15,000 PP&E for 20% of the new venture's interest, and it accounts for its investment under the fair value method.

Entity B makes all the significant business decisions and selects the CEO.

The newly formed entity has four board members: Entity A elects one member and Entity B elects the remaining three.

Therefore, the newly formed entity is not a joint venture because of lack of joint control.

The fair value of venture increases by $5,000 at the end of year 1.

	Entity A	**Entity B**	**New Company**	**Entity B Equity Method**	**Entity A Fair Value Method**
Cash	$0	$70,000	$70,000	$56,000	$14,000
Intellectual property	0	75,000	75,000	60,000	15,000
Intangible assets	5,000	5,000	10,000	8,000	2,000
PP&E	15,000	30,000	45,000	36,000	9,000
Goodwill	0	0	20,000	16,000	4,000
Total	$20,000	$180,000	$220,000	$176,000	$44,000
Percentage of interest	20%	80%			

In this example, Entities A and B reflect any excess or deficit over the cost of their initial contribution in their earnings.

However, since joint control does not exist, the newly formed company is not a JV.

Entity A records a $44,000 investment at fair value and uses a fair value method of accounting for its investment. It does not reflect goodwill in its investment. It reflects the increase in the fair value of venture ($1,000 = $5,000 times 20%) under the fair value method of accounting in its investment account and earnings.

Entity B consolidates the new company since it has control over it and reflects the investments of Entity A as NCI. However, it does not reflect the $4,000 ($5,000 times 80%), its share of increase in fair value in earnings.