

EQUITY METHOD: CHANGES TO SCOPE AND OTHER TARGETED IMPROVEMENTS (FASB PROPOSAL)

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SUMMARY

Under a recent proposal from the FASB, investors would apply a single threshold of significant influence to determine whether the equity method of accounting applies to investments in common stock, in-substance common stock, limited partnerships, and limited liability companies (LLCs). That is, the significant influence threshold would replace the more-than-minor influence threshold currently applied to investments in limited partnerships and similar entities.

The proposed Accounting Standards Update (“Proposed ASU”), *Investments – Equity Method and Joint Ventures (Topic 323): Equity Method of Accounting – Targeted Improvements*, would also clarify the application of the equity method, for example, with respect to complex earnings allocation structures, and would add illustrative examples.

KEY TAKEAWAYS

- ▶ Investors would need to reassess their investments in limited partnerships and similar entities on adoption, since the more-than-minor influence threshold (commonly viewed in practice as more than 3% to 5%) for applying the equity method to such investees would be replaced by the significant influence threshold.
- ▶ Investments that are no longer accounted for under the equity method due to the higher threshold would be within the scope of Accounting Standards Codification (ASC) 321, *Investments – Equity Securities*. Investors would then need to decide whether to elect the measurement alternative under that guidance for eligible investments.
- ▶ The Proposed ASU would move some guidance on allocating profits and losses when an investee has a complex allocation structure (for example, a distribution waterfall) from ASC 970-323, *Real Estate – General, Investments – Equity Method and Joint Ventures*, into ASC 323. It would also add examples illustrating one method of allocating profits and losses.
- ▶ Investments eligible for proportionate consolidation or the proportional amortization method (PAM) are expected to remain eligible for that accounting.
- ▶ Comments are due by January 11, 2027.

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WHY IS THE FASB PROPOSING CHANGES TO U.S. GAAP?

The Proposed ASU comes in response to feedback from the 2025 FASB Invitation to Comment, *Agenda Consultation*, wherein stakeholders identified two challenging areas:

- ▶ The different scopes for applying the equity method to investments in corporations and to investments in partnerships
- ▶ The lack of authoritative guidance for allocating earnings and losses in complex allocation structures

WHO WOULD THIS CHANGE AFFECT?

The Proposed ASU would primarily affect investors with investments in limited partnerships and similar entities. Such investors would need to perform a robust qualitative analysis to determine whether to apply the equity method to their investments. It would also potentially affect other investors with investments currently accounted for under the equity method, particularly if the investees have complex earnings allocation structures, as well as parents that consolidate non-wholly owned subsidiaries that have complex allocation structures.

WHAT WOULD CHANGE?

The Proposed ASU would make changes focused on two aspects of ASC 323: its scope, and the allocation of earnings and losses when the investee has a complex allocation structure.

Issue A: Scope of ASC 323

Under current U.S. GAAP, the requirement to apply the equity method differs based on the investee's legal form:

- ▶ Investments in the common stock (or in-substance common stock) of corporations, corporate joint ventures, and limited liability companies (LLCs) that do not have specific ownership accounts are accounted for under the equity method when the investor has the ability to exercise significant influence over the investee's operating and financial policies. Significant influence is presumed to exist when the investor holds 20% or more of the investee's voting stock (and does not control the investee), but that presumption may be overcome. Significant influence is presumed to not exist when the investor holds less than 20% of the investee's voting stock, but that presumption also may be overcome.
- ▶ Investments in limited partnerships, unincorporated joint ventures, and LLCs that have specific ownership accounts ("limited partnerships and similar entities") are accounted for under the equity method unless the investor's interest is so minor that the limited partner has virtually no influence over the investee (commonly viewed in practice as less than a 3% to 5% interest).

Stakeholders said that these different thresholds lead to inconsistent outcomes that are confusing, unintuitive, and difficult to explain.

The Proposed ASU would remove the separate threshold for limited partnership and similar entities and would eliminate the presumption that significant influence does not exist when the investor holds less than 20% of the investee's voting stock. Instead, investors would evaluate whether they have significant influence over such investees, using the definition and indicators of significant influence in ASC 323 (for example, representation on the investee's board of directors), which are not changing. See Chapter 2 of BDO's Blueprint, [Equity Method Investments Under ASC 323](#), for more guidance on determining whether an investor has the ability to exercise significant influence over an investee.

BDO INSIGHT: A STEP FORWARD, BUT NOT QUITE A SINGLE THRESHOLD

While the Proposed ASU is a significant step towards a single threshold, investors would still need to consider the legal form of the investee and their ownership interests when determining whether the equity method applies. Currently and under the Proposed ASU, investments in corporations are only within the scope of the equity method if the investor holds common stock (or in-substance common stock). That is, investments in preferred stock are typically outside the scope of the equity method because they generally do not meet the criteria to be in-substance common stock. This is the case regardless of whether the preferred stock investor has the ability to exercise significant influence over the investee. The Proposed ASU would **not** change this scoping guidance.

However, the guidance on in-substance common stock does not apply to limited partnerships or similar entities. Therefore, investments in limited partnerships and similar entities would be evaluated to determine whether the investor has the ability to exercise significant influence, regardless of the preferential rights of the investors.

See Chapter 1 of BDO's Blueprint, [Equity Method Investments Under ASC 323](#), for additional guidance on the scope of the equity method.

The elimination of the more-than-minor influence threshold for limited partnerships and similar entities will not automatically cause a change in the accounting for such investments. Investors must still evaluate whether they have significant influence over the investee. The Proposed ASU would:

- ▶ Remove the presumption that an investor does not have significant influence when it holds less than 20% of an investee.
- ▶ Expand references to the board of directors in ASC 323 to include functionally equivalent governing bodies in partnership structures.
- ▶ Specify that a noncontrolling general partner, or functional equivalent (such as a managing member in an LLC), has significant influence over the investee.

BDO INSIGHT: EVALUATING SIGNIFICANT INFLUENCE OVER A LIMITED PARTNERSHIP OR SIMILAR ENTITY

We generally would expect that many investments in limited partnerships and similar entities that are accounted for under the equity method today will continue to be accounted for under the equity method if the Proposed ASU is finalized. ASC 323 states that participation in policy-making processes is one indicator that an investor has the ability to exercise significant influence over the investee's operating and financial policies. An investor in a limited partnership or similar entity would need to evaluate whether its rights, including any consent or veto rights, give it the ability to exercise significant influence over an investee. Reaching a conclusion will require the application of professional judgment based on the facts and circumstances.

The Proposed ASU would require all general partners and functional equivalents to apply the equity method to account for their investments.

See Chapter 2 of BDO's Blueprint, [Equity Method Investments Under ASC 323](#), for more guidance on evaluating significant influence.

Investments currently eligible for proportionate consolidation or the PAM are expected to remain eligible for those methods under the Proposed ASU. For more guidance on which investments are eligible for the PAM, see BDO's Bulletin, [Investments in Tax Credit Structures and the Proportional Amortization Method](#).

Issue B: Complex Earnings Allocation Structures

Under the equity method, an investor recognizes its share of the investee's income or losses each reporting period, which generally is based on the investor's proportionate share of the investee's equity, assuming the equity investors share in the income and losses on a pro rata basis. However, investees often issue classes or types of equity with differing economic rights that are not necessarily shared on a pro rata basis. For example, an investee's contractual agreements (such as the limited partnership or LLC agreement) might have varying formulas for allocating income, specified costs and expenses, distributions of cash from operations, and distributions upon liquidation.

Currently, ASC 323 does not address how to allocate an investor’s share of the investee’s earnings or losses when the economics are other than pro rata. However, there is industry-specific guidance in ASC 970-323 that discusses how to allocate earnings and losses for investees with complex earnings allocation structures. The Proposed ASU would move that guidance, along with other guidance in ASC 970-323 that is not industry-specific, to ASC 323. It would also add illustrative examples to ASC 323 showing **one method** of allocating earnings in those structures. In addition, the Proposed ASU would require parents of non-wholly owned subsidiaries to consider the guidance on complex allocation structures in ASC 323 when allocating income to a noncontrolling interest (NCI).

BDO INSIGHT: PROPOSED REORGANIZATION AND NEW EXAMPLES ARE NOT EXPECTED TO CHANGE PRACTICE

While helpful in improving the organization of the Codification, the changes related to Issue B are not expected to significantly change practice, because this guidance is already widely used by those outside the real estate industry and by parents allocating income to NCI.

The FASB emphasized that the new examples are meant to be illustrative only. The possible method for allocating income is not required; other methods may also be acceptable if they accurately depict the substance of the arrangements. The new examples follow a method similar to the hypothetical liquidation at book value (HLBV) method. HLBV was popularized in a proposed statement of position, *Accounting for Investors’ Interests in Unconsolidated Real Estate Investments*, which was never finalized. In the absence of authoritative guidance, HLBV is widely used today in practice to calculate equity method income when investors disproportionately share in profits or net assets for investees in many industries (not just real estate). Parents also use it to allocate income to NCI. Accordingly, by codifying two examples that are similar to HLBV, we believe that the FASB would permit the use of HLBV to continue (when appropriate).

See Section 4.2.1 of BDO’s Blueprint, [Equity Method Investments Under ASC 323](#), and Section 7.3.3.3 in BDO’s Blueprint, [Control and Consolidation Under ASC 810](#), for more guidance on allocating income in complex structures to equity method investments and to NCI, respectively, under current U.S. GAAP.

WHEN WOULD THE CHANGES BE EFFECTIVE?

The following table summarizes the proposed transition.

	PUBLIC BUSINESS ENTITIES	ALL OTHER INVESTORS
Effective date	The FASB will determine the effective date after it considers stakeholder feedback on the Proposed ASU.	
Early adoption	Early adoption would be permitted for all investors in an interim or annual reporting period in which financial statements have not been issued or made available for issuance. An investor that adopts the guidance in an interim reporting period would be required to adopt the new guidance as of the beginning of the annual reporting period that includes that interim period.	
Transition for Issue A (Scope of ASC 323)	<p>Investments no longer accounted for under the equity method would be accounted for in one of two ways:</p> <ul style="list-style-type: none">▶ Under the ASC 321 measurement alternative: The equity method investment’s carrying amount at the date of adoption would become its new cost basis.▶ Measured at fair value or net asset value: The investor would recognize a cumulative-effect adjustment to the opening balance of retained earnings, calculated as the difference between the equity method investment’s carrying amount and its fair value, both at the date of adoption.	

PUBLIC BUSINESS ENTITIES		ALL OTHER INVESTORS	
Transition for Issue B (Complex Allocation Structures)		The guidance for complex allocation structures would be applied to new and existing equity method investments as of the date of adoption.	

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Link to [Proposed ASU](#).

The proposed ASU is not authoritative and may change before a final ASU is issued. Investors must continue to apply existing U.S. GAAP while monitoring the FASB’s standard-setting activities. Stakeholders may submit comments to the FASB through January 11, 2027, [here](#).

CONTACTS

MEREDITH TAYLOR
Professional Practice Principal, Accounting
mtaylor@bdo.com

JON LINVILLE
Professional Practice Principal, Accounting
jlinville@bdo.com

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