



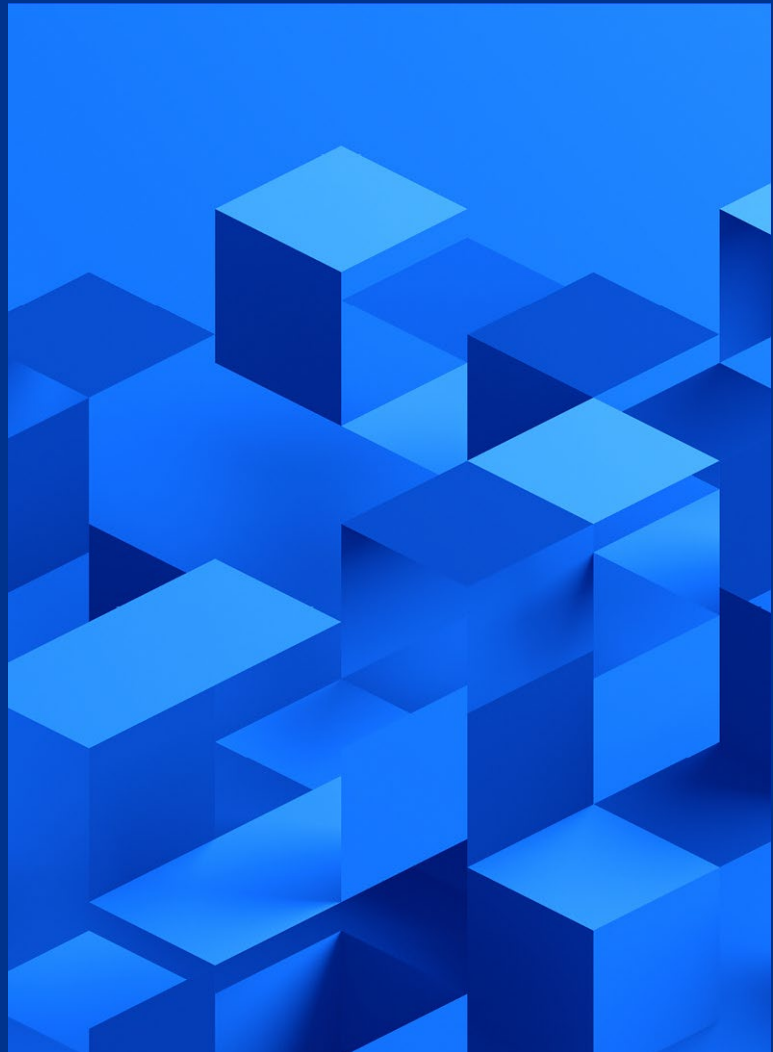
Equity method of accounting

Executive summary

US GAAP

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Still standing

The FASB has made sweeping changes in the last two decades to the accounting for investments in consolidated subsidiaries and equity securities. However, it has left the equity method of accounting for investments largely unchanged since the Accounting Principles Board released APB 18 in 1971.

The Accounting Principles Board developed the equity method with the view that its one-line consolidation premise would “best [enable] investors...to reflect the underlying nature of their investment[s].”

Notwithstanding that some have advocated eliminating the equity method of accounting, its principles have remained intact – often bending, but not yet breaking – as the capital markets evolve. New and unique investment structures often challenge those principles and push the profession to make critical judgments about their application in today’s financial reporting environment.

Our objective with this Executive Summary is to highlight those critical judgments and provide you with the equity method basics, including scope, initial recognition and measurement, recognition of investee activity and investor-level adjustments and presentation and disclosure. We also touch on accounting for changes in ownership and degree of significant influence.

Our related Handbook, [Equity method of accounting](#), expands on the equity method basics with insights, examples and perspectives, including analysis of complex capital structures and dilution transactions, based on our years of experience in this area.

Scope

An investor generally applies the equity method of accounting to its investment when it has the ability to exercise significant influence over the operating and financial decisions of the investee. While significant influence can be conveyed through a variety of different investment vehicles, an investor applies the equity method only when it has made a:

- capital investment in a partnership or partnership-like LLC; or
- common stock (or in-substance common stock) investment in a corporation, corporate joint venture or corporate-like LLC.

An investor's degree of influence tends to increase as its relative ownership in the investee's voting stock increases.

- Topic 323 (equity method and joint ventures) establishes a presumption that an investor has the ability to exercise significant influence if its direct or indirect investment in a corporation, corporate JV or corporate-like LLC is 20% or more of the investee's voting stock. Conversely, it is presumed not to have that ability when its investment is less than 20%.
- An investor in a partnership or partnership-like LLC generally applies the equity method unless its interest is so minor that it has virtually no influence. As such, investments of 3 to 5% (or more) in these entities are typically accounted for under the equity method.
- Determining whether an investor has the ability to exercise significant influence is not always clear and requires an investor to evaluate the individual facts and circumstances related to each investment.

An investor that obtains the requisite degree of influence begins applying the equity method on that date – even if that influence is expected to be temporary.

Initial recognition and measurement

An investor initially recognizes its equity method investment at cost and presents it as a single amount on its balance sheet. Once the investor has measured the cost of the investment, it prepares its memo purchase price allocation as follows.

Step 1: Allocate cost to share of investee's underlying assets and liabilities.

Step 2: Determine whether equity method goodwill exists.

Step 3: Identify basis differences.

The investor's execution of the first two steps generally depends on whether or not the investee is a business.

Excess cost	Cost shortage
<ul style="list-style-type: none">• If the investee is a business, the investor applies the acquisition method principles of Topic 805 on business combinations – including determining whether equity method goodwill exists.• If the investee is not a business, the investor generally allocates excess cost to its share of the investee's noncurrent nonfinancial assets based on relative fair values.	<ul style="list-style-type: none">• An investor generally allocates a cost shortage to its share of the investee's noncurrent nonfinancial assets based on relative fair values – regardless of whether or not the investee is a business.

Applying the equity method

Each reporting period, the investor adjusts the investment account for its share of the investee's financial activity and certain investor-level activity, such as intra-entity eliminations and basis difference amortization.

Recognizing investee activity

The investor periodically adjusts the carrying amount of its investment for its share of the investee's earnings and losses, other comprehensive income (OCI) and capital transactions. The investor generally recognizes each component in the same way it would if the investee were a consolidated subsidiary. The investor's share of the investee's earnings is the foundation of the investor's equity in earnings of the investee.

An investor typically recognizes its share of the investee's activity based on the proportion of the investee's common stock that it owns. An investor uses US GAAP to measure its share of the investee's activity and generally recognizes that share in the period in which the investee recognizes it.

An investor generally stops applying the equity method when its share of the investee's net losses has reduced its investment to zero unless it has additional investments in the investee or has committed financial support to the investee.

In complex capital structures, the allocation of earnings may differ from the distributions of cash from operations (or on liquidation). In these situations, how the investor determines its share of the investee's earnings requires careful consideration of the substance of the arrangement.

An investor recognizes in its OCI its share of an investee's OCI with a corresponding increase or decrease to its investment account.

Investee's capital activity can result in the investor:

- increasing or decreasing its ownership interest, which results in acquisition or sale accounting;
- increasing or decreasing its claim on the investee's net assets, which may result in adjustment to its equity in earnings at a point in time or over time; or
- receiving cash, which generally results in a reduction to the investment balance.

Recognizing investor-level adjustments

The investor periodically adjusts the carrying amount of its investment for the following investor-level adjustments.

Investor-level adjustment	Investor accounting
Intra-entity eliminations	Investor generally eliminates some or all intra-entity profits and losses until realized by the investor or investee in transactions with third parties.
Basis differences	Investor adjusts equity in earnings for changes in the basis differences identified in its memo purchase price allocation completed on acquisition. Typical adjustments include depreciation, depletion, amortization, and accretion for differences between the investor's share of the fair value of the investee's identifiable assets and assumed liabilities and their carrying amounts in the investee's US GAAP financial statements.
Equity method goodwill	Investor does not amortize equity method goodwill unless it applies the accounting alternative for private companies and not-for-profit entities, which generally requires a 10-year amortization period.
Other-than-temporary impairment	If investor determines that the fair value of an equity method investment is less than its carrying amount at the reporting date and the impairment is other-than-temporary, it reduces the carrying amount of the investment to its fair value. The charge to the income statement is recognized through equity in earnings of the investee.

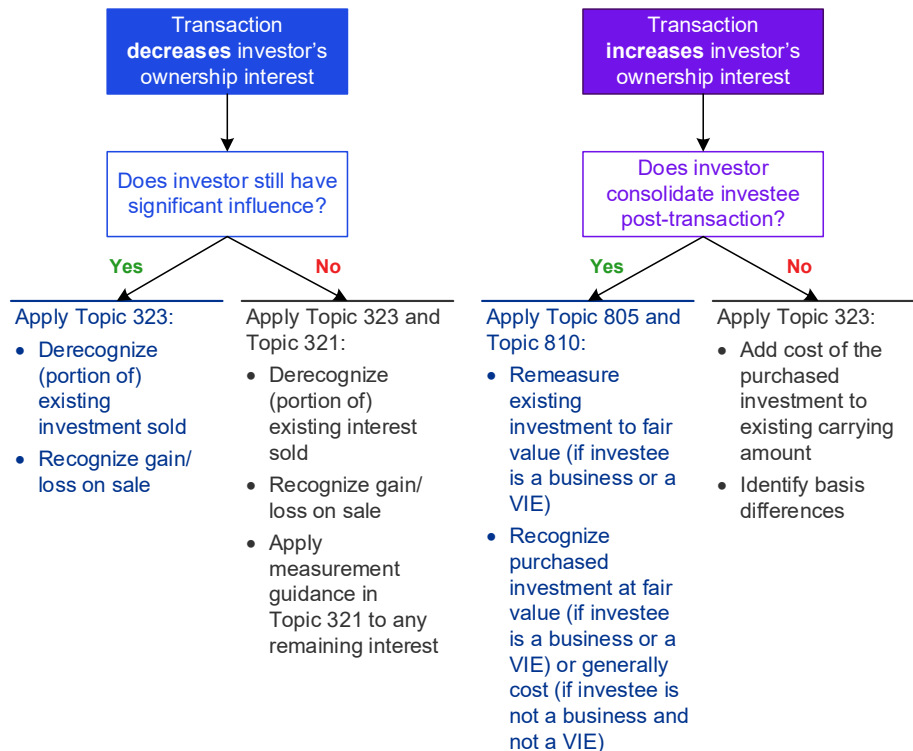
The investor generally recognizes each component in the same way it would if the investee were a consolidated subsidiary.

Changes in ownership and degree of influence

An investor's ownership percentage or degree of influence may change for many reasons. A purchase or sale of equity ownership interests by the investor or the investee is the most common.

The investor's accounting for the transaction and measurement of any retained interest in the investee depends on whether the change results in a change in the accounting method – i.e. from equity method to consolidation under Topic 810 or fair value measurement under Topic 321 (investments in equity securities).

The following diagram summarizes the investor's accounting when there are increases or decreases in its ownership or degree of influence in an existing equity method investee.



Presentation and disclosure

An investor generally presents an equity method investment in one line on the balance sheet and its related earnings effect in one line in the income statement. The amount in each line item includes the following for each investment.

Balance sheet	Income statement
<ul style="list-style-type: none">• The investor's cost to acquire the investment, which comprises its memo purchase price allocation• Adjustments made for dividends received or other investee capital activity• Adjustments made to recognize the investor's share of investee activity	<ul style="list-style-type: none">• Adjustments made to recognize the investor's share of investee earnings or losses• Adjustments made for some investee capital activity, such as disproportionate changes made to the investor's claim on the investee's net assets
<ul style="list-style-type: none">• Adjustments made to recognize investor-level activity, such as intra-entity profit or loss eliminations, amortization/accretion of basis differences and OTTI	

The investor generally presents its share of an investee's OCI in its OCI.

Topic 323 includes a list of disclosures, which generally focus on:

- the investor's ownership interest, potential changes to it and its relation to the 20% significance presumption;
- basis differences; and
- the investee's financial results (when material to the investor).

The SEC also requires an investor to file separately investee financial statements or provide investee summary financial data when certain conditions exist and provides guidance on other disclosure matters about related party transactions.

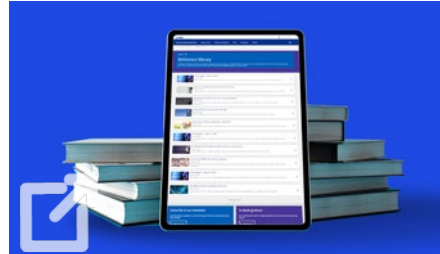
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