

FASB Interpretation No. 35

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Criteria for Applying the Equity Method of Accounting for Investments in Common Stock

an interpretation of APB Opinion No. 18

May 1981



Financial Accounting Standards Board
of the Financial Accounting Foundation
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for Investments in Common Stock**

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FIN 35: Criteria for Applying the Equity Method of Accounting for Investments in Common Stock

an interpretation of APB Opinion No. 18

FIN 35 Summary

This Interpretation clarifies the criteria for applying the equity method of accounting for investments of 50 percent or less of the voting stock of an investee enterprise (other than a corporate joint venture). APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, states that use of the equity method of accounting for the investment is required if the investor has the ability to exercise significant influence over operating and financial policies of the investee. Opinion 18 includes presumptions, based on the investor's percentage ownership, as to whether the investor has that ability, but those presumptions can be overcome by evidence to the contrary and do not override the need for judgment. If there is an indication that an investor owning 20 percent or more of an investee's voting stock is unable to exercise significant influence over the investee's operating and financial policies, all the facts and circumstances related to the investment shall be evaluated to determine whether the presumption of ability to exercise significant influence over the investee is overcome.

INTRODUCTION

1. The Board has been asked to clarify the provisions of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, regarding application of that method to investments of 50 percent or less of the voting stock of an investee enterprise (other than a corporate joint venture).

INTERPRETATION

2. Opinion 18 requires that the equity method of accounting be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. The presumptions in paragraph 17 of Opinion 18 are intended to provide a reasonable degree of uniformity in applying the equity method. The presumptions can be overcome by predominant evidence to the contrary.

3. Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary.¹

4. Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include:

- a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.
- b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.²
- c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.
- d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.³
- e. The investor tries and fails to obtain representation on the investee's board of directors.

This list is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

EFFECTIVE DATE AND TRANSITION

5. The provisions of this Interpretation shall be effective for fiscal years beginning after June 15, 1981, with earlier application encouraged. Changes in the method of accounting for investments required by this Interpretation shall be recorded in accordance with paragraphs 19(l) and (m) of Opinion 18, which provide that:

- a. If the investor discontinues application of the equity method, the earnings and losses of the investee that were previously accrued shall remain as part of the carrying amount of the investment. The carrying amount of the investment shall not be adjusted retroactively.
- b. If the investor begins applying the equity method, the investment, results of operations (current and prior periods presented), and retained earnings of the investor shall be adjusted retroactively.

This Interpretation was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board following submission to the Financial Accounting Standards Advisory Council.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

6. Paragraph 17 of Opinion 18 establishes standards for use of the equity method to account for investments in common stock other than subsidiaries and corporate joint ventures. It states that:

The [Accounting Principles] Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even

though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The [Accounting Principles] Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the [Accounting Principles] Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. When the equity method is appropriate, it should be applied in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.

7. The basic question raised is how to decide when use of the equity method is appropriate; in particular, how much weight should be given to the statement that ". . . applying judgment is necessary to assess the status of each investment" and how much weight to the presumptions based on percentage ownership? The Board has been advised that some investors view the presumptions as rigid rules and believe that achievement of 20 percent ownership requires use of the equity method to account for the investment regardless of circumstances. This Interpretation clarifies that the presumptions are to be applied using judgment and may be overcome by predominant evidence to the contrary.

8. A related question involves how an investor owning 20 percent or more of the voting stock of an investee should account for the investment if the investee opposes the investor. That opposition might be in the form of the investee's filing a lawsuit against the investor or the investee's making allegations to appropriate governmental regulatory authorities. This Interpretation clarifies that opposition by the investee requires an assessment by the investor of all the facts and circumstances of the investment to determine whether they are sufficient to overcome the presumption.

9. A third question relates to the appropriateness of using the equity method if an investor and an investee have signed an agreement under which the investor agrees to limit its shareholding in the investee. (Because the investor usually agrees not to increase its current holdings, such agreements often are called "stand-still agreements.") Those agreements are

commonly used to compromise disputes when an investee is fighting against a takeover attempt or an increase in an investor's percentage ownership. Depending on their provisions, the agreements may modify an investor's rights or may increase certain rights and restrict others compared with the situation of an investor without such an agreement. If the investor surrenders significant rights as a shareholder under the provisions of such an agreement, this Interpretation clarifies that the investor shall assess all the facts and circumstances of the investment to determine whether they are sufficient to overcome the presumption.

10. A proposed Interpretation, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*, was released for comment on December 19, 1980. The Board received 45 letters of comment on the proposed Interpretation. Certain of the comments received and the Board's consideration of them are discussed in paragraphs 11-14.

11. Some respondents believed that the Board should not finalize the proposed Interpretation because the document did not provide guidance beyond that contained in Opinion 18. The Board believes that this Interpretation provides additional guidance in two respects:

- a. It provides examples of indications that an investor may be unable to exercise significant influence over operating and financial policies of an investee.
- b. It affirms that the presumptions in Opinion 18 may be overcome by contrary evidence.

12. Some respondents suggested that the Interpretation would strengthen investees relative to investors in takeover disputes by making it more difficult for the investor to use the equity method to account for its investment. The Board disagrees with that suggestion for two reasons. First, the Board believes this Interpretation is a faithful interpretation of Opinion 18. The Board has not attempted to favor either investors or investees and does not believe that its role is to do so. The Board's role on this project is to faithfully interpret Opinion 18. Second, the Board notes that the actual cash returns on an investment and the income taxes that would be paid are unaffected by the method of accounting for the investment. Therefore, a decision not to proceed with an otherwise attractive investment simply because the equity method of accounting cannot be used would seem to be unlikely for the vast majority of companies. Conversely, an investment that is not otherwise attractive does not become so simply because the equity method will be used to account for that investment in the investor's financial statements.

13. Some respondents requested that the Interpretation explicitly provide guidance on accounting for investments of less than 20 percent. Paragraph 2 of this Interpretation states that the presumptions in paragraph 17 of Opinion 18 can be overcome. The Board believes that that statement plus the examples in Opinion 18 of ways an investor might indicate ability to exercise significant influence provide adequate guidance on accounting for investments of less than 20 percent.

14. Some respondents requested that the Interpretation provide more specific guidance, perhaps by providing some examples. The subject of "stand-still agreements" (paragraphs 4(b)

and 9) was suggested as one for which guidance is particularly needed. The Board believes, as one respondent stated, that "every investor-investee relationship is unique. . . ." Even if the Board were to provide examples, they would not necessarily be applicable to unique facts and circumstances. Professional judgment would be required in any case. Accordingly, the Board has concluded that adding examples to this Interpretation would not reduce the degree of professional judgment required.

Footnotes

FIN35, Footnote 1--Subject to the limitations on the use of the equity method identified in footnote 4 of Opinion 18. That footnote states that conditions that represent limitations on consolidation shall be applied as limitations to the use of the equity method.

FIN35, Footnote 2--See paragraph 9 of this Interpretation for a discussion of such agreements.

FIN35, Footnote 3--The subject of inability to obtain financial information also is addressed in the American Institute of Certified Public Accountants' *Codification of Statements on Auditing Standards*, AU Section 332, "Evidential Matter for Long-Term Investments," paragraph 9.