AIN-APB 18: The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18

AIN-APB 18 STATUS

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Effective Date: Interpretations No. 1 and 2—November 1971
Interpretation No. 3—February 1972

Affects: No other pronouncements

Affected by: Interpretation No. 1 amended by FAS 96, paragraph 205(i); FAS 109, paragraph 288(j); and FAS 160, paragraph C5
Interpretation No. 2 amended by FAS 96, paragraph 204; FAS 109, paragraph 287; and FAS 111, paragraph 8(p)

AICPA Accounting Standards Executive Committee (AcSEC)

Related Pronouncement: SOP 78-9

1. INTERCOMPANY PROFIT ELIMINATIONS UNDER EQUITY METHOD

Question—In applying the equity method of accounting, intercompany profits or losses on assets still remaining with an investor or investee should be eliminated, giving effect to any income taxes on the intercompany transactions. (See paragraph 19-a of APB Opinion No. 18 and paragraphs 6 and 17 of ARB No. 51.) Should all of the intercompany profit or loss be eliminated or only that portion related to the investor's common stock interest in the investee?

Interpretation—Paragraph 19 of APB Opinion No. 18 normally requires an investor's net income and stockholder's equity to be the same from application of the equity method as would result from consolidation. Because the equity method is a "one-line" consolidation, however, the details reported in the investor's financial statements under the equity method will not be the same as would be reported in consolidated financial statements (see paragraph 19-c). All intercompany transactions are eliminated in consolidation, but under the equity method intercompany profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.

[Note: For not-for-profit organizations and all other entities that prepare consolidated financial statements prior to the adoption of FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (effective for fiscal years, and interim periods within those fiscal years, beginning on or after 12/15/08), the following paragraph should read as follows:]

Paragraph 14 of ARB No. 51 provides for complete elimination of intercompany profits or losses in consolidation. It also states that the elimination of intercompany profit or loss may be allocated proportionately between the majority and minority interests. Whether all or a proportionate part of the intercompany profit or loss should be eliminated under the equity method depends largely upon the relationship between the investor and investee.

[Note: After the adoption of Statement 160, for all entities that prepare consolidated financial statements (except for not-for-profit organizations), the following paragraph should read as follows:]

Paragraph 28 of ARB No. 51, as amended, provides for complete elimination of intercompany income or losses in consolidation. It also states that the elimination of intercompany income or loss may be allocated between the parent and noncontrolling interests. Whether all or a proportionate part of the intercompany income or loss should be eliminated under the equity method depends largely upon the relationship between the investor and investee.

When an investor controls an investee through majority voting interest and enters into a transaction with an investee which is not on an "arm's length" basis, none of the intercompany profit or loss from the transaction should be recognized in income by the investor until it has been realized through transactions with third parties. The same treatment also applies for an investee established with the cooperation of an investor (including an investee established for the financing and operation or leasing of property sold to the investee by the investor) when control is exercised through guarantees of indebtedness, extension of credit and other special arrangements by the investor for the benefit of the investee, or because of ownership by the investor of warrants, convertible securities, etc. issued by the investee.

In other cases, it would be appropriate for the investor to eliminate intercompany profit in relation to the investor's common stock interest in the investee. In these cases, the percentage of intercompany profit to be eliminated would be the same regardless of whether the transaction is "downstream" (i.e., a sale by the investor to the investee) or "upstream" (i.e., a sale by the investee to the investor). The following examples illustrate how these eliminations might be made. The examples assume an investor owns 30 percent of the common stock of an investee, the investment is accounted for under the equity method, and the income tax rate to both the investor and the investee is 40 percent.

Assume an investor sells inventory items to the investee ("downstream"). At the investee's balance sheet date, the investee holds inventory for which the investor has recorded a gross profit of $100,000. The investor's net income would be reduced $18,000 to reflect a $30,000 reduction in gross profit and a $12,000 reduction in income tax expense. The elimination of intercompany profit might be reflected in the investor's balance sheet in various ways. The income statement and balance sheet presentations will depend upon what is the most meaningful in the circumstances.

Assume an investee sells inventory items to the investor ("upstream"). At the investor's balance sheet date, the investor holds inventory for which the investee has recorded a gross profit of $100,000. In computing the investor's equity "pickup," $60,000 ($100,000 less 40% of income tax) would be deducted from the investee's net income and $18,000 (the investor's share of the intercompany gross profit after income tax) would thereby be eliminated from the investor's equity income. Usually, the investor's investment account would also reflect the $18,000 intercompany profit elimination, but the elimination might also be reflected in various other ways; for example, the investor's inventory might be reduced $18,000.

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2. INVESTMENTS IN PARTNERSHIPS AND VENTURES

Question—Do the provisions of APB Opinion No. 18 apply to investments in partnerships and unincorporated joint ventures?

Interpretation—APB Opinion No. 18 applies only to investments in common stock of corporations and does not cover investments in partnerships and unincorporated joint ventures (also called undivided interests in ventures). Many of the provisions of the Opinion would be appropriate in accounting for investments in these unincorporated entities, however, as discussed below.

Partnership profits and losses accrued by investor-partners are generally reflected in their financial statements as described in paragraphs 19-c and 19-d. Likewise, most of the other provisions of paragraph 19 would be appropriate in accounting for a partnership interest, such as the elimination of intercompany profits and losses (see paragraph 19-a).

However, income taxes should be provided on the profits accrued by investor-partners regardless of the tax basis employed in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by FASB Statement No. 109, *Accounting for Income Taxes*, is appropriate.

Generally, the above discussion of partnerships would also apply to unincorporated joint ventures, particularly the elimination of intercompany profits and the accounting for income taxes. However, because the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 19-c may not apply in some industries. For example, where it is the established industry practice (such as in some oil and gas venture accounting), the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

[Issue Date: November, 1971]

3. EARLY DISCLOSURE OF MATERIAL EQUITY ADJUSTMENT

Question—APB Opinion No. 18 requires the equity method of accounting to be applied for a qualifying investment in common stock for fiscal periods beginning after December 31, 1971. The Board encouraged earlier adoption of the Opinion. If a company owns an investment in 1971 for which it does not adopt the equity method until 1972 when the retroactive application will materially change the originally reported 1971 net income, should the amount of the change be disclosed in the 1971 financial statements when they are first issued?

Interpretation—Yes, as a minimum the company should disclose in its 1971 financial statements the effect later retroactive application of the equity method will have on 1971 net income. In fact, the company should consider adopting the equity method in 1971 even though not required to do so.

The Board issued this Opinion in March 1971 and provided a relatively long interval before its effective date because of the time required for companies to accumulate information, arrange for audits of investee companies, etc. Extenuating circumstances may therefore exist for not applying the equity method in 1971. However, any material effect of subsequent retroactive application should be disclosed in the 1971 financial statements.

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