

Investments in Less Than Majority Owned Companies

6.2 OVERVIEW

The equity method should be used to account for investments, corporate joint ventures, and other investments in common stock if the investor has the ability to exercise significant influence over the operating and financial policies of the investee. When the equity method is not appropriate, the investment should be accounted for pursuant to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, or pursuant to the cost method for investments in equity securities that do not have readily determinable fair values. Investments in bonds should be recorded at cost. Premium or discount should be amortized on the interest method.

6.3 MEASUREMENT PRINCIPLES

6.3.1 Cost Method

The cost method is appropriate only for investments in equity securities having no readily determinable fair value (i.e., the shares are not publicly traded). Investments in shares for which fair value is readily determinable (and for which the equity method is not applicable because significant influence does not exist) should be accounted for in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (see Section 2, MARKETABLE SECURITIES AND FINANCIAL INSTRUMENTS).

Under the cost method, a long-term investment is recorded at cost and carried at that amount until it is sold or otherwise disposed of or until it is written down. A write-down from original cost is appropriate when dividends received represent a liquidating dividend, that is, a dividend received in excess of earnings subsequent to the investment date. Otherwise, any dividends received should be recorded as investment income.

Example 1. Dividends Received

FACTS

Assume that Client Company, Inc., owns 300,000 shares of the Hoffman Corporation representing 15% of Hoffman's outstanding shares. On December 20, 20X1, Hoffman declares a cash dividend of \$0.20 per common share.

SOLUTION

Assuming the dividend was not in excess of Hoffman's earnings since the date at which Client Company acquired the stock, the journal entry is:

Dividend receivable (300,000 × \$0.20)	60,000	
Investment income		60,000

To record dividend declaration by Hoffman Corporation.

Assuming that 50% of the dividend was in excess of Hoffman's earnings since the investment date, the following journal entry would be made:

Dividends receivable	60,000	
Investment income		30,000
Investment in Hoffman Corporation.		30,000

Impairment

An investment is deemed impaired if its fair value is less than its cost (including adjustments to the cost basis for accretion, amortization, previous other-than-temporary impairment writedowns, and hedging)

The assessment of whether an investment is deemed impaired should be made as of each (annual and interim) reporting period at the individual security level. For a cost-method investment, the evaluation of whether it is impaired should be determined as follows:

- Fair value estimated for disclosure purposes under SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, should be compared with the investment's cost.
- If an estimate of fair value has not been made under SFAS No. 107 (i.e., because SFAS No. 107 does not apply to interim periods, it is not practicable to estimate fair value, or the entity is exempt in accordance with SFAS No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, from providing fair value disclosure), an evaluation should be made regarding whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of an investment. Such "impairment indicators" include the following:
 - — A significant deterioration in the investee's earning performance, credit rating, asset quality, or business prospects.
 - — A significant adverse change in the regulatory, economic, or technological environment in which the investee operates.
 - — A significant adverse change in market conditions of the geographic area or industry in which the investee operates.
 - — Receipt of a bona fide (solicited or unsolicited) offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar securities held by the investor at an amount less than the cost of the investment.
 - — Factors raising significant concerns about the investee's ability to continue as a going concern (e.g., negative operating cash flow, working capital deficiency, noncompliance with statutory requirements or debt covenants).

Note that, if any of the foregoing impairment indicators is present, an estimate of the investment's fair value must be made. Moreover, the fair value of an investment previously determined not to be other-than-temporarily impaired should continue to be tested for impairment (i.e., fair value must be estimated in each subsequent reporting period) until (1) the investment's fair value deficiency over cost is fully recovered, or (2) an other-than-temporary impairment loss is recognized.

If the fair value of an investment is below its cost as of the end of a reporting period, the impairment must be judged as either temporary or other than temporary (which, however, does not necessarily mean the impairment is permanent). If impairment is considered other than temporary, an impairment loss should be recognized as the difference between the investment's cost and its fair value as of the end of the reporting

period (and should not take into account any partial recovery of the fair value deficiency subsequent to the balance sheet date). After recognition of the impairment loss, the fair value to which the investment has been written down becomes its new cost basis (which should not be upwardly adjusted for subsequent partial or complete recovery of the fair value deficiency).

Example 2. Impairment in Value

FACTS

Assume that Client Company, Inc. acquired 100,000 common shares of The Nora Corporation at an aggregate cost of \$850,000 on June 1, 20x1. On December 31, 20x2, Client Company estimates the fair value of the investment to be \$400,000. The decline is attributable to a severe reduction in the demand for Nora's products, which is not expected to turn around.

SOLUTION

Because the decline in fair value is deemed to be other than temporary, an impairment loss in the amount of \$450,000 would be recorded as follows:

Loss on investment	450,000	
Investment in The Nora Corporation		450,000

After the write down, the new fair value of \$400,000 becomes the new cost basis in the investment, which will not be upwardly adjusted should some or all of the fair value deficiency be recovered in the future.

6.3.2 Equity Method

Criteria for application.

The equity method should be applied for investments in corporate joint ventures, unconsolidated subsidiaries (although it is not an acceptable substitute where consolidation is otherwise appropriate), and other investees over which the investor has the ability to exercise significant influence regarding operating and financial policies. Note that the equity method also is applicable to an investment in an *unincorporated* legal entity, unless the investee is in the construction industry or in an extractive industry in which there is a longstanding practice of *proportionate* consolidation. The ability to exercise that influence may be indicated in any of the following ways:

- Representation on the investee's board of directors
- Participation in the investee's policy-making process
- Material intercompany transactions
- Interchange of managerial personnel
- Technological dependency

Determining the investor's ability to exercise such influence requires judgment to assess the status of each investment. An investment (direct or indirect) of 20% or more of the *voting* stock of an investee is presumed, however, in the absence of evidence to the contrary, to be sufficient for an investor to have the ability to exercise significant influence over an investee. Conversely, unless such ability can be demonstrated, an

investment of less than 20% leads to the presumption that the investor does not have the ability to influence significantly an investee. Note, though, that the SEC requires use of the equity method for investments in limited partnerships, unless such investments are so minor (i.e., less than 3% - 5%) that the limited partner/investor has virtually no influence over partnership operating and financial policies.

The EITF has concluded that a noncontrolling investment in a limited liability company (LLC) that maintains a separate ownership account for each investor should be accounted for under the equity method unless the limited partner's interest is so minor that the partner has virtually no influence over the partnership (using the 3% - 5% SEC guideline to determine whether influence is present).

Voting stock interest in an investee is based on common stock actually outstanding and not on shares that may become available (e.g., warrants, options, and so forth).

Evidence that an investor that owns 20% or more (but less than 51%) of the common stock is unable to exercise significant influence may be accomplished by any one of the following reasons:

- Opposition by the investee, such as litigation or complaints to government regulatory authorities, challenges the investor's ability to exercise significant influence.
- The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.
- 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.
- 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). The investor tries to obtain that information, but fails.
- The investor tries but fails to obtain representation on the investee's board of directors.

The above list is not all-inclusive; other conditions may lead to the conclusion that the investor cannot exercise significant influence.

General application.

Application of the equity method is the same for investments in corporate joint ventures and other investees (i.e., those companies that are 20% to 50% owned). For convenience, all such entities will be referred to as "investees." The following table summarizes the accounting treatment under the equity method:

Item	Accounting treatment
Difference between cost of investment equity in the net assets if the investee	The difference must be considered when determining the investor's share of the investee's income (or loss). If the difference cannot be specifically identified, it should be considered as goodwill.
Investment income (or loss)	Based on the investor's share of the investee's profits or losses adjusted certain other items discussed in this table. Classified in the investor's income statement as part of income from operations, except that the investor's share of the investee's extraordinary items or prior-period adjustments

should retain their character in the investor's income statement.

Investment carrying value	Increased (or decreased) by the investor's share of the investee's profit (or loss). Also decreased by the investor's share of dividends declared by the investee.
Intercompany profits	Eliminated until realized
Capital transaction by the investee (<i>See</i> Section 32 , CONSOLIDATED DATED AND COMBINED STATEMENTS.)	Accounted for as if the investee were a consolidated subsidiary.
Sale of investment (<i>See</i> Section 32 , CONSOLIDATED AND COMBINED STATEMENTS.)	A gain or loss as recorded based on the difference between the selling price and the carrying value of the investment.
Permanent impairment of the value of the investment (<i>See</i> Section 6.3.1 , "Cost Method," Example 2 .)	A loss in value should be recognized. Note that the EITF has concluded that, when an entity has committed to a plan to dispose of an equity method investment in a foreign entity or of a consolidated foreign subsidiary, the associated cumulative translation adjustment should be included in the carrying value of the investment for purposes of evaluating the investment for impairment. Additionally, the portion of the cumulative translation adjustment representing a gain or loss of an effective hedge of a net investment should also be included in the carrying amount of the investment when possible impairment is being tested (<i>see</i> Section 38 , FOREIGN OPERATIONS).
Investor's share of losses exceeds the carrying value of the investment (See further discussion in this section.)	When the carrying value is reduced to zero, carrying value of the investment (and net application of the equity method ceases; no advances) additional losses should be recorded <i>unless</i> the investor is obligated to provide further financial support or has guaranteed the investee's debt. Resumption of the equity method should begin only after the investor's share of the investee's subsequent profits equals the investor's share of losses <i>not</i> recognized because of suspension of the equity method. Note that the FASB Staff believes that further financial support may take the form of capital contributions, investments in preferred stock (including mandatorily redeemable preferred stock), loans, additional advances, or investments in the investee's debt securities. The EITF has reached consensus on continued application of the equity method when the investment account has a zero balance, the investee occurs additional losses, and the investor holds other securities of the investee.
Investee has outstanding cumulative preferred stock	Investor's share of earnings (or losses) is computed after deducting the investee's preferred dividend requirements.
Percentage of ownership falls below 20%	Equity method is suspended and the cost method is applied. The investment account should not be retroactively adjusted, <i>except</i> that dividends received by the investor in subsequent periods that exceed the investor's share of earnings for those periods should be used to reduce the investment.

Percentage of ownership increases to 20% or more

Equity method is applied *and* results of operations for the current and prior periods and retained earnings should be retroactively restated.

Example 3 through Example 9 illustrate the manner in which the required treatment is applied.

Example 3. Cost of Investment Differs From Underlying Equity in Net Assets of Investee — Effect on Investment Income

FACTS

Assume that Client Company, Inc., (investor) acquired a 30% interest in Bemo Corporation on January 2, 20X1, at a total cost of \$300,000. At the investment date, Bemo's book value was \$600,000. The fair value of Bemo's property and equipment on that date exceeded its book value by \$100,000. The estimated useful life of the property and equipment is 10 years, and the straight-line method is used. Also assume that Bemo reported net income of \$150,000 for 20X1 and declared and paid \$20,000 in common stock dividends.

SOLUTION

The first step is to determine the excess of cost over book value as follows:

Cost	\$300,000
Book value ($\$600,000 \times 30\%$)	<u>(180,000)</u>
Excess of cost over book value	<u>\$120,000</u>

The next step is to allocate the excess as follows:

To property and equipment ($\$100,000$ excess of fair value over book value $\times 30\%$)	\$30,000
To goodwill (remainder)	<u>90,000</u>
	<u>\$120,000</u>

The journal entry to record the investment would be:

Investment in Bemo Corporation	300,000	
Cash		300,000

The calculation of investment income for 20X1 is as follows:

Client Company's share of Bemo's net income ($\$150,000 \times 30\%$)	\$45,000
Less: Additional depreciation on the fair value increment ($\$30,000 \div 10$ years)	(3,000)
Investment income	<u>\$42,000</u>

The journal entry to record investment income for 20X1 is:

Investment in Bemo	42,000	
Investment income		42,000

The journal entry to record Bemo's dividends is:

Cash ($\$20,000 \times 30\%$)	6,000	
Investment in Bemo		6,000

The following example illustrates how deferred taxes are provided for on equity method income.

Example 3A. Equity Method Application—Provisions for Deferred Taxes

Facts

Assume the same facts as in Example 3 . Also assume that Client Company's tax rate is 40% and that Client Company qualifies for the 80% dividends-received deduction permitted by the tax laws.

Solution

SFAS No. 109 requires that a deferred tax liability be established for a temporary difference representing an excess of the amount for book purposes of an investment in an equity method investee over the tax basis of the investment. As in Example 1 , a journal entry is made to record investment income of \$42,000 in 20X1. Another journal entry is required to record the deferred tax liability as follows:

Income tax expense	3,180	
Deferred tax liability		3,180

The deferred tax amount of \$3,360 is computed as:

Investment income	\$42,000
Dividends received deduction ($\$42,000 \times .80$)	<u>(33,600)</u>
Taxable amount	8,400
Income tax rate	<u>$\times .40$</u>
Deferred income tax liability	<u>\$3,360</u>

When dividends of \$6,000 are received, a portion of the deferred tax liability is transferred to income taxes currently payable, computed as follows:

Deferred tax liability	\$3,360
Taxable dividend amount ($\$6,000 \times .20$)	\$1,200
Taxable amount of investment income	<u>8,400</u>
Ratio of taxable dividends to taxable investment income	<u>$\times .142857$</u>
Current tax liability ($\$3,360 \times .142857$)	<u>\$480</u>

The journal entry would thus be:

Deferred tax liability	480	
Income taxes currently payable		480

If Client Company were to sell its investment in Bemo on December 31 for \$400,000, the amount of the gain for book purposes would be \$64,000, computed as follows:

Selling price	\$400,000
Carrying value (\$300,000 + \$42,000 – \$6,000)	<u>(336,000)</u>
	<u>\$64,000</u>

Assuming a capital gains tax rate of 20%, the current tax liability would be \$12,800 (\$64,000 × .20). The journal entry to record the tax liability would be:

Income tax expense	9,920	
Deferred tax liability (\$3,360 – \$480)	2,880	
Income taxes currently payable		12,800

Example 4. Intercompany Profit Elimination

FACTS

Assume that Client Company, Inc. owns 60% of the Ludwig Company. In 20X1, Client Company sells inventory to Ludwig (downstream transaction) at a profit of \$18,000. On December 31, 20X1, Ludwig has all the inventory remaining on hand. Also assume that Ludwig reports net income of \$80,000 for 20X1.

SOLUTION

Client Company computes its investment income as follows:

Client Company's share of Ludwig's net income (\$80,000 × 60%)	\$48,000
Less: Intercompany profit in inventory	<u>(18,000)</u>
Investment income	<u>\$30,000</u>

Since the intercompany profit was the parent's, the investment income for the owners of the 40% (minority interest) is not affected. Had the sale been upstream (i.e., Ludwig sold inventory to Client Company), the subsidiary's net income would be overstated for 20X1 and the intercompany profit would have to be allocated between Client Company (60%) and the minority interest (40%). Accordingly, investment income for 20X1 would be \$37,200 (\$48,000 – (\$18,000 × 60%)).

Example 5. Assets to Which Excess of Cost Over Book Value Has Been Assigned Are Sold by the Investee

FACTS

Assume the same facts as in Example 3 . On December 31, 20X3, Bemo sells the property and equipment at a gain of \$90,000.

SOLUTION

Client Company's share of the gain is calculated as follows:

Client Company's share of the gain (\$90,000 × 30%)	\$27,000
Less: Unamortized fair value increment (\$30,000 ÷ \$3,000 × 3 years)	<u>21,000</u>
Client Company's share of gain	<u>\$6,000</u>

Had the property and equipment been sold at a loss, the unamortized increment would have been added to Client Company's share of the loss.

Example 6. Investor's Share of Losses Exceeds Carrying Value of Investment

FACTS

Assume that Client Company, Inc., purchased 30% of the outstanding common stock of the Lansing Corporation on January 2, 20X2. The cost of the investment was \$500,000, which was \$140,000 greater than the proportionate share of Lansing's book value on that date. The excess was allocated as follows: (1) \$100,000 to property and equipment with a useful life of 10 years, the straight-line method of depreciation to be used, and (2) the remaining \$40,000 to goodwill. Following are the results of operations for Lansing.

Year	Income (Loss)
20X1	\$100,000
20X2	(700,000)
20X3	(500,000)
20X4	(1,000,000)
20X5	(100,000)
20X6	1,100,000

SOLUTION

Assuming that Client Company, Inc., has not guaranteed Lansing's debt, is not otherwise obligated to provide further financial support, and does not hold any other of Lansing's debt or equity securities, the calculation of Client Company's investment income is as follows:

	20X1	20X2	20X3	20X4	20X5	20X6
Investment balance—beginning	\$500,000	\$520,000	\$300,000	\$140,000	0	0
Client Company's share (30% of Lansing's earnings (losses))	30,000	(210,000)	(150,000)	(300,000)	\$(30,000)	\$330,000
Amortization of excess of cost over book value:						
Property and equipment ^(a)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Income (loss) recorded by Client Company, Inc.	<u>(20,000)</u>	<u>(220,000)</u>	<u>(160,000)</u>	<u>(140,000)</u> ^(b)	<u>—</u> ^(c)	<u>104,000</u> ^(d)
Investment balance—end	<u>\$520,000</u>	<u>\$300,000</u>	<u>\$140,000</u>	<u>\$0</u>	<u>\$0</u>	<u>\$110,000</u>

^(a) \$100,000 ÷ 10 years = \$10,000

^(b) Limited to \$137,000, the balance in the investment account

^(c) No loss is recorded in 20X5 because the investment account has a zero balance.

^(d) Limited to previously recorded losses and depreciation, as follows:

$$20X4 (\$300,000 + \$10,000 - \$140,000) = \$170,000$$

$$20X5 (\$30,000 + \$10,000 - \$0) = \underline{40,000}$$

Previously unrecorded losses \$210,000

$$(\$330,000 - \$10,000 - \$210,000 = \$110,000 \text{ of income to be recorded in } 20X6)$$

Had Client Company, Inc. guaranteed Lansing's debt, had it been obligated to provide further financial support, or had it held other of Lansing's debt or equity securities, Client Company would have continued to apply the equity method even though the balance in the investment account reached zero.

Application when investment account equals zero but equity method losses continue

The FASB Staff believes that the equity method should continue to be applied when the investment account reaches a zero balance if the investor owns other debt or equity securities of the investee. The EITF has reached a consensus regarding the manner in which the FASB Staff guidance should be implemented. In particular, the consensus addresses the interaction among APB No. 18, "The Equity Method of Accounting for Investments in Common Stock", SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, and SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

- When it is not required to advance additional funds, the investor should continue to report its share of equity method losses to the extent of and as an adjustment to the *adjusted* basis of other investments in the investee. The order in which equity method losses should be applied should follow the priority of such other investments in liquidation. The *adjusted* basis of the other investments (including debt securities held and loans to the investee) is computed as the *cost* basis adjusted for, as applicable, the SFAS No. 114 valuation allowance account, and the cumulative equity method losses applied to the other investments. Cost basis is computed as original cost after further effect is given to other-than-temporary writedowns, unrealized holding gains and losses on SFAS No. 115 trading securities, and amortization of any discount or premium on debt securities or loans.
- To determine the amount of equity method loss to be reported:
- — If the adjusted basis of the other investments is positive, the investor should further adjust the adjusted basis for the amount of the equity method loss based on seniority. For SFAS No. 115 securities, the further adjusted amount is used to measure subsequent changes in fair value;
- — When the adjusted basis reaches zero, the investor should no longer report equity method losses, but should track the unreported equity method losses so that, when the investee subsequently reports income, the investor can resume the equity method and may report equity method income *exceeding* prior unrecognized equity method losses. Note that if the investor sells one of the other investments when its carrying value exceeds the adjusted basis, the difference between the cost basis and the adjusted basis represents equity method losses that were originally applied to the other investments but effectively reversed upon its sale; that excess is considered an unreported equity method loss, which the investor should track before reporting future equity method income.

- After applying APB No. 18, the investor should apply the provisions of SFAS No. 114 and/or SFAS No. 115 to the other investments.

The following example illustrates application of the foregoing consensus.

Example 7. Carrying Value Equals Zero with Continuing Equity Method Losses

FACTS

Assume that Client Company, Inc. owns 40% of BDC Corporation's outstanding common stock. Client Company also owns 40% of BDC's preferred stock (classified as an available-for-sale security) and has extended loans to BDC. As of January 1, 20X1, the carrying value of Client Company's total investment in BDC is \$200,000, as follows:

	Carrying Value	
Common stock		\$0
Loan		100,000
Preferred stock		100,000

Also assume that BDC incurred losses in 20X1 and 20X2 of \$200,000 and \$400,000 respectively. BDC had neither a profit nor a loss in 20X3. At the end of 20X1 through 20X3, the carrying value of Client Company's loan to BDC was, respectively, \$95,000, \$95,000, and \$60,000. Finally, at the end of each of those years, the fair value of preferred stock held was \$90,000, \$90,000, and \$50,000, respectively.

SOLUTION

In 20X1, Client Company would record its share of BDC's loss as follows:

Equity method loss ($\$200,000 \times 40\%$)	80,000	
Investment in preferred stock		80,000

In accordance with SFAS No. 114 , a loan loss is recorded as follows:

Loan loss	5,000	
Valuation allowance		5,000

Pursuant to SFAS No. 115 , the entry to record the change in value of the preferred stock would be:

Investment in preferred stock	70,000	
Other comprehensive income		70,000

Note that there is an unrealized gain of \$70,000 computed as follows:

Fair value at 1-1-X1	\$100,000
Effect of equity method loss	<u>(80,000)</u>
	20,000
Fair value at 12-31-X1	<u>(90,000)</u>
Unrealized gain	<u>\$70,000</u>

In 20X2, the entry to record the equity method loss would be *limited* to the *adjusted basis* of the total combined investment of \$115,000, which comprises:

Common stock		\$0
Loan		95,000
Preferred stock		<u>20,000</u>
		<u>\$115,000</u>

Thus, the journal entry would be:

Equity method loss	115,000	
Investment in preferred stock		20,000
Loan		95,000

The SFAS No. 115 adjustment would be recorded as follows:

Investment in preferred stock	20,000	
Other comprehensive income		20,000

The \$20,000 unrealized gain is computed as follows:

Fair value at 12-31-X1		\$90,000
Effect of equity method loss		<u>(20,000)</u>
		70,000
Fair value at 12-31-X2		<u>(90,000)</u>
Unrealized gain		<u>\$20,000</u>

The carrying amount at the end of 20X2 for the combined investment is \$90,000 (i.e., zero for common stock, zero for the loan, and \$90,000 for the preferred stock investment). The *adjusted basis* of the total combined investment is zero.

In 20X3, no equity method loss is incurred. Because the adjusted basis of the loan is zero, no entry is required to reflect the reduction in its carrying value from \$95,000 to \$60,000. Hence, the only journal entry to be made at the end of 20X3 is the one reflecting the change in value of the preferred stock investment as follows:

Other comprehensive income	40,000	
Investment in preferred stock		40,000

The unrealized loss is calculated simply as the difference between the fair value of \$50,000 and the carrying value of \$90,000.

The EITF has also addressed the related issue of the percentage to be used to determine the amount of equity method losses. The Task Force concluded that equity method losses should not be recognized solely on the percentage of common stock owned; rather, an entity-wide approach should be adopted. Under such an approach, equity method losses may be recognized based on the ownership level that includes other equity securities (e.g., preferred stock) and loans/advances to the investee or based on the change in the investor's claim on the investee's book value.

The following example illustrates application of the consensus based on ownership levels of individual securities.

Example 7A. Equity Method Losses Based on Ownership Levels of All Securities Held

Facts

Assume that as of December 31, 20X1, Client Company, Inc., owns 40% of the common stock of JEB Corp. Due to prior losses, Client Company's investment in JFB has been reduced to zero. Client Company also holds 50% of JFB's preferred stock outstanding and has extended loans to JFB representing 60% of all loans to JFB. Also assume JFB incurs losses in 20X2 and 20X3 of \$160,000 and \$200,000, respectively. As of December 31, 20X1, Client Company's recorded value for its investment in JFB's preferred stock is \$100,000 and its recorded value in its loans to JFB is also \$100,000.

Solution

As illustrated in Example 7 , the equity method loss is applied to preferred stock (the most senior securities held). Pursuant to the EITF consensuses, the percentage used should be 50% of the preferred stock (not 40% of the common stock owned). Thus, at the end of 20X2, Client Company would record its share (50%) of the equity method loss as follows:

Equity method loss ($\$160,000 \times .50$)	80,000	
Investment in preferred stock		80,000

In 20X3, Client Company would compute its share of JFB's \$200,000 loss as follows:

- To the remaining value of its investment in preferred stock ($.50 \times \$40,000$) (20,000)
 - To its loans to JFB @ 60% of \$160,000 ($\$200,000 - \$40,000$ applied to the preferred stock) (96,000)
- \$(116,000)

The journal entry would be:

Equity method loss	116,000	
Investment in preferred stock		20,000
Loan to JFB		96,000

The following example illustrates how equity method losses are recognized based on the change in claim on the investee's book value.

Example 7B. Equity Method Losses Based on Changes in Investee's Book Value

Facts

Assume the same facts as in Example 7A . Also assume that the JFB's balance sheets appear as follows at December 31, 20X1, 20X2, and 20X3.

	20X1	20X2	20X3
Assets	<u>\$367,000</u>	<u>\$207,000</u>	<u>\$7,000</u>

Loans	167,000	167,000	167,000
Preferred stock	200,000	200,000	200,000
Common stock	300,000	300,000	300,000
Accumulated deficit	<u>(300,000)</u>	<u>(460,000)</u>	<u>(660,000)</u>
	<u>\$367,000</u>	<u>\$207,000</u>	<u>\$7,000</u>

Solution

If, hypothetically, JFB liquidated its assets and liabilities at book value on December 31, 20X2, it would have available \$207,000 for distribution. Client Company would receive \$100,000 in repayment of the loan ($\$167,000 \times .60$) and \$20,000 from a priority distribution of preferred stock, computed as follows:

Available for distribution	\$207,000
Loan repayments	<u>(167,000)</u>
	40,000
Client Company's share of preferred stock	<u>$\times .50$</u>
	<u>\$20,000</u>

On December 31, 20X1, Client Company's claim on JFB's book value was \$200,000, calculated as follows:

Proportionate share of loan ($\$167,000 \times .60$)	\$100,000
Proportionate share of preferred stock ($\$200,000 \times .50$)	<u>100,000</u>
	<u>\$200,000</u>

During 20X2, Client Company's claim on JFB's book value decreased by \$80,000 ($\$200,000 - \$120,000$). The journal entry to record the loss (identical to the one in Example 7A) is:

Equity method loss	80,000	
Investment in preferred stock		80,000

In a hypothetical liquidation on December 31, 20X3, JFB would have \$7,000 available for distribution. Client Company would receive \$4,000 representing 60% of the amount of the loan available for repayment ($\$6,667 \times .60$). Compared with a claim of \$120,000 on December 31, 20X2, Client Company's claim would thus have decreased by \$116,000 ($\$120,000 - \$4,000$). The first \$20,000 of that decrease is applied to reduce the remaining investment in preferred stock to zero, with the remainder credited against the loan receivable, as follows:

Equity method loss	116,000	
Investment in proposed stock		20,000
Loan to JFB		96,000

Note that this journal entry is also the same as the one for 20X3 shown in Example 7A .

Example 8. Investee Has Cumulative Preferred Stock Outstanding

FACTS

Assume that Client Company, Inc., acquired 25% of the outstanding common stock of the Williams Company on January 2, 20X1, for \$500,000. In 20X1 and 20X2, Williams reported a \$300,000 profit and \$200,000 loss, respectively. Williams has outstanding 1,000 shares of 10%, \$100 par value cumulative preferred stock. No dividends were declared by Williams during 20X1 or 20X2.

SOLUTION

Client Company's share of investment income or loss for 20X1 and 20X2 is calculated as follows:

	20X1	20X2
Williams results of operations	\$300,000	\$(200,000)
Preferred dividend requirements (\$100 × 10% = \$10 × 1,000 shares)	<u>(10,000)</u>	<u>(10,000)</u>
	<u>290,000</u>	<u>(210,000)</u>
Client Company's share (25%)	<u>\$72,500</u>	<u>\$(52,500)</u>

Example 9. Investor's Ownership Falls Below 20%

FACTS

Assume that Client Company, Inc. purchased 25% of the outstanding common stock of the Rubin Company on January 2, 20X1, at a cost of \$600,000. The purchase price was \$80,000 greater than the proportionate share of Rubin's book value, which was assigned to goodwill. Also assume that on January 2, 20X3, Client Company sold a portion of its investment, thereby reducing its interest to 18%. Relevant information for Rubin is as follows:

Year	Income	Dividends
20X1	\$200,000	\$30,000
20X2	300,000	40,000
20X3	30,000	20,000
20X4	40,000	30,000
20X5	10,000	70,000

SOLUTION

For years 20X1 and 20X2, Client Company records investment income simply as \$50,000 and \$75,000, respectively.

At January 2, 20X3, the balance in the investment account is:

Beginning balance (cost)	\$600,000
Investment income:	
20X1	50,000
20X2	75,000
Less: Client Company's share (25%) of Rubin's dividends:	

20X1	(7,500)
20X2	<u>(10,000)</u>
Balance at January 2, 20X3	<u>\$707,500</u>

At January 2, 20X3, the equity method is no longer applied because Client Company's share of ownership has dropped to 18%. At that date the cost method is applied.

During 20X3, Client Company, Inc., would recognize investment income of \$3,600 (\$20,000 of dividends \times 18%). The journal entry would be:

Cash	3,600	
Investment income		3,600

Similarly, in 20X4, investment income from dividends would be \$5,400 (\$30,000 \times 18%), and the journal entry would be:

Cash	5,400	
Investment income		5,400

In 20X5, however, another calculation must be made to determine the cumulative excess of dividends received over Client Company's share of Rubin's earnings since the cost method was adopted on January 1, 20X3, as follows:

Dividends received:	
20X3	\$3,600
20X4	5,400
20X5 (\$70,000 \times 18%)	<u>12,600</u>
	<u>21,600</u>

Client Company's share of income:	
20X3 (\$30,000 \times 18%)	(5,400)
20X4 (\$40,000 \times 18%)	(7,200)
20X5 (\$10,000 \times 18%)	<u>(1,800)</u>
	<u>(14,400)</u>
Cumulative excess of dividends received	<u>\$7,200</u>

The excess must be applied to reduce the investment account balance, because the cumulative share (18%) of dividends exceeds the cumulative share of Rubin's income. The journal entry in 20X5 would be:

Cash	12,600	
Investment in Rubin Company		7,200
Investment income		5,400

To record dividends received by Rubin Company.

Example 10. Investor's Ownership Increases to 20% or More

FACTS

Assume that Client Company, Inc. acquired 10% of the outstanding common stock of the Kaskel Corporation on January 2, 20X1 for \$600,000. On that date, the underlying book value of Kaskel was \$5,200,000. The excess is attributable to goodwill. On January 2, 20X3, Client Company acquired another 10% interest at a cost of \$750,000. On that date, Kaskel's book value was \$7,100,000. This excess is also attributable to goodwill. Relevant data for Kaskel are as follows:

Year	Income	Dividends
20X1	\$200,000	\$20,000
20X2	500,000	30,000
20X3	700,000	50,000

SOLUTION

In 20X1 and 20X2, the cost method would be applied and the journal entries to record the investment and investment income would be:

20X1

Investment in Kaskel Corporation	600,000	
Cash		600,000
Cash	2,000	
Investment income (\$20,000 × 10%)		2,000

20X2

Cash	3,000	
Investment income (\$30,000 × 10%)		3,000

On January 2, 20X3, when an additional 10% interest is acquired and the equity method is applied, the following journal entries would be made:

Investment in Kaskel Corporation	750,000	
Cash		750,000
Investment in Kaskel Corporation	61,000	
Retained earnings		61,000

To record the retroactive change from the cost method to the equity method, as follows:

	20X1	20X2	Total
10% share of Kaskel's income	\$20,000	\$50,000	\$70,000
Dividends received	<u>(2,000)</u>	<u>(3,000)</u>	<u>(5,000)</u>
	<u>\$18,000</u>	<u>\$48,000</u>	<u>\$65,000</u>

The other entries for 20X3 would be:

Cash ($\$50,000 \times 20\%$)	10,000	
Investment in Kaskel Corporation		10,000

To record dividends received from Kaskel Corporation.

Investment in Kaskel Corporation	140,000	
Investment income ($\$700,000 \times 20\%$)		140,000

To record investment income from Kaskel Corporation.

Increase in ownership interest from one of significant influence to one of control.

When an investor increases its ownership interest from one of significant influence (the equity method) to one of control through a market purchase of voting securities *and* the investor previously suspended application of the equity method because the investment account had reached a zero balance, it is the SEC Staff's position that the purchase of a controlling interest should be accounted for as a step (or piecemeal) acquisition. As such, any unrecorded equity-method losses would either be allocated to identifiable tangible or intangible assets acquired or as part of goodwill. It is the Staff's position that restatement of prior-period financial statements would be inappropriate, as would recognition of a loss on the purchase.

Stock-based compensation granted to employees of an equity method investee.

The EITF reached the following consensus when an investor grants awards of its own stock to employees of an equity method investee:

- The investee should charge such stock-based compensation cost to earnings as it is incurred on its behalf (i.e., over the vesting period), with a corresponding credit to additional paid-in capital.
- The granting investor should charge such cost to expense in the same period that it is recognized by the investee. Any other (non-granting) equity method investor should recognize equity method income equal to the amount of its proportionate share of the increase in the investee's book value resulting from the increase in the investee's contributed capital.

Application to Investments Other Than Common Stock

An investor may have the ability to exercise significant influence over the operating and financial policies of an entity without holding an investment in the investee's common stock. Read literally, APB No. 18 precludes use of the equity method in such a situation. The EITF has concluded that the equity method should be applied only when an investor holds an investment in an entity's common stock or in its so-called in-substance common stock.

In-substance common stock is defined generally as an investment carrying risk and reward characteristics substantially similar to those of common stock. In making a determination of whether an investment constitutes in-substance common stock, the following factors should be taken into account:

- Whether it has subordination attributes similar to those of common stock. A substantive liquidation preference, for example, would indicate that the investment does not qualify as in-substance common stock.
- Whether it shares risks and reward characteristics of ownership similar to those of common stock. Indications that the investment is similar to common stock include: (1) its participation in the investee's earnings and losses and capital appreciation and depreciation; (2) its participation in the investee's dividend payments; and (3) the investor is able to convert the investment into common stock of the investee without significant restrictions or contingencies prohibiting the investor from participation in the capital appreciation of the investee.
- Whether the investee is required to transfer substantive value to the investor and the common stockholders do not participate in a similar manner (e.g., a mandatory redemption provision).

If, based on the foregoing factors, a conclusive determination cannot be reached, an analysis should be made of the correlation between changes in the fair value of the investment with changes in the fair value of the investee's common stock. A low correlation is indicative that the investment is not in-substance common stock.

Initial determination of whether an investment is substantially similar to common stock should be made as of the date on which the investor acquires the investment provided that, on that date, the investor has the ability to exercise significant influence over the investee's operating and financial policies. Reconsideration of that determination should be undertaken when one or more of the following events occur:

- Contractual terms relating to any of the factors considered in the initial determination are changed (i.e., subordination, ownership risks and rewards, or the mandatory transfer of value).
- The investor acquires an additional interest in an investment it already holds.
- The investor obtains the ability, which it previously did not have, to exercise significant influence over the investee.

Accounting for Investee's Other Comprehensive Income when Significant Influence is Lost

At the time significant influence is lost, the investor's share of an equity method investee's accumulated other comprehensive income should be offset against the carrying value of the investment (i.e., through a debit or credit to the investor's accumulated other comprehensive income and a corresponding credit or debit to the investment account). If the offset would result in a negative carrying amount of the investment, the investment account should be reduced to a zero balance and the excess charged against income.

6.3.3 Exchanges of Investments

The EITF has addressed two issues concerning exchanges of investments. Regarding exchanges of similar equity method investments, the Task Force concluded that the transaction should be accounted for as a nonmonetary transaction. Regarding exchanges

of cost method investments, the EITF addressed the specific situation in which an investor holds an investment in a company involved in a business combination in which shares of one of the constituent entities are exchanged for all of the outstanding shares of the other entity. The EITF reached the following consensuses:

- An investor holding shares in the acquired company should record the transaction at fair value.
- An investor holding shares in the acquiring company should continue to carry the investment at historical cost; note, however, that pursuant to SFAS No. 115, *Accounting for Investment in Certain Debt and Equity Securities*, changes in fair value are reported as unrealized gains or losses on other comprehensive income (for available-for-sale securities) or in current earnings (for trading securities).

The following example illustrates how a cost method investment in either entity is accounted for.

Example 10A. Exchange of a Cost Method Investment in a Company Involved in a Business Combination

Facts

Assume that Client Company, Inc., holds investments in two entities that are involved in a business combination. Client Company's investments in both entities are carried at cost. Client Company holds 10,000 shares of Brittany Corp. at a cost of \$100,000 and 10,000 shares of Matthew Corp. at a cost of \$120,000. Brittany and Matthew enter into a business combination in which shareholders of Matthew will receive .75 shares of stock in Brittany for each share held. After the acquisition, 1,000,000 shares of the newly combined entity will be outstanding. The fair value of each share of the new company is \$45. Former shareholders of Brittany will own 60% of the new entity.

Solution

Client Company would now own 17,500 shares of the new entity: 10,000 shares originally held in Brittany plus 7,500 shares (10,000 shares × .75) from its exchange of Matthew's shares. Client Company would account for the 7,500 shares received as follows:

Investment in Matthew	217,500	
Gain on exchange		217,500

The fair value of the 7,500 shares received is \$337,500 (7,500 shares × \$45). The cost basis of \$120,000 must thus be increased by \$217,500 (\$337,500 – \$120,000). Client Company, as the holder of shares in the acquiring company, would continue to carry its investment in Brittany at cost. Note, however, that pursuant to SFAS No. 115, fair value changes should be reported in other comprehensive income (assuming that such investment is classified in available-for-sale securities).

Assuming, for illustrative purposes, that prior to the acquisition of Matthew by Brittany, the fair value of Client Company's investment in Brittany was also its cost (\$100,000), the entry to reflect the increase in fair value in accordance with SFAS No. 115 would be:

Investment in Brittany	350,000	
Unrealized gain (other comprehensive income)		350,000

The \$350,000 unrealized gain is calculated as the current fair value of \$450,000 (10,000 shares × \$45) minus \$100,000.

6.3.4 Investments by Real Estate Investment Trusts in Service Corporations

IRS regulations impose certain restrictions on the types of operating activities that may be performed by a Real Estate Investment Trust (REIT). Thus, a REIT will usually establish a Service Corporation (SC) to perform activities, such as property management, leasing, and services to develop, contract, and sell real estate projects. For tax purposes, a REIT may not own more than 10% of the *voting* stock of an SC but is permitted to hold a substantial block of *nonvoting* equity securities.

The EITF has reached a consensus that an SC should *not* be considered an independent third party and thus the amount of costs to be capitalized by the REIT for leasing services provided by the SC is limited to the amount of such costs to be capitalized pursuant to SFAS No. 13, *Accounting for Leases*, as amended by SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, had the REIT incurred such costs directly.

The EITF has also reached a consensus that the existence of some or all of the following factors indicates that the REIT has the ability to exercise at least significant influence over the SC and that, accordingly, the REIT should *not* account for its investment in the SC using the cost method:

- The SC performs activities primarily for the REIT.
- Substantially all of the economic benefits in the SC flow to the REIT.
- The REIT has the ability to designate a seat on the board of directors of the SC.
- The REIT and the SC have common board members.
- The REIT and the SC have common officers and/or employees.
- The owners of the majority voting stock of the SC have not contributed substantial equity to the SC.
- The views of the REIT's management influence the operations of the SC.
- The REIT is able to obtain financial information from the SC that is needed to apply the equity method of accounting to its investment in the SC.

6.3.5 Investments in Bonds

Investments in bonds should be recorded at cost, including transaction fees and other acquisition costs. Any premium or discount should be amortized over the term of the bonds on the interest method. The straight-line method may be used if it produces results that are not materially different than those produced on the interest method. Note that accrued interest between interest payment dates is *not* part of the acquisition cost. When an investment in bonds is sold before maturity, any gain or loss is *not* considered an extraordinary item. Following are examples of the appropriate accounting for bonds.

Example 11. Purchase of Bonds at a Discount

FACTS

Assume that Client Company, Inc., purchases \$1 million face value bonds at \$911,370 on January 2, 20X1. The bonds pay 8% interest on December 31 and June 30. The bonds mature in six years, and the effective rate is 10%. There are no transaction fees.

SOLUTION

The entry to record the purchase is:

Investment in bonds	911,370	
Cash		911,370

At each semiannual interest date, a portion of the discount of \$88,630 (\$1,000,000 – \$911,370) must be amortized. Using the interest method, the amounts to be amortized are computed as follows:

Date	(1) Cash Interest at 4% ^(a)	(2) Interest Income at 5% ^(b)	(3) Discount to Be Amortized ^(c)	(4) Carrying Value of the Investment in Bonds ^(d)
1/2/X1	—	—	—	\$911,370
6/30/X1	\$40,000	\$45,569	\$5,569	916,939
12/31/X1	40,000	45,847	5,847	922,786
6/30/X2	40,000	46,139	6,139	928,925
12/31/X2	40,000	46,446	6,446	935,371
6/30/X3	40,000	46,769	6,769	942,140
12/31/X3	40,000	47,107	7,107	949,247
6/30/X4	40,000	47,462	7,462	956,709
12/31/X4	40,000	47,835	7,835	964,544
6/30/X5	40,000	48,227	8,227	972,771
12/31/X5	40,000	48,639	8,639	981,410
6/30/X6	40,000	49,071	9,071	990,481
12/31/X6	40,000	49,519 ^(e)	9,519 ^(e)	1,000,000

^(a). $8\% \times 0.5 \times \$1,000,000$

^(b). $10\% \times 0.5 \times \text{previous carrying value in column (4)}$

^(c). Column (2) minus column (1)

^(d). Previous carrying value plus column (3)

^(e). Rounded

^(e).

The journal entry to be made at each semiannual interest date is (using 6/30/X1 as an example):

Cash	40,000	
Investment in bonds	5,569	
Interest Income		45,569

Using the straight-line method, semiannual amortization would be \$7,386 ($\$88,630 \div 12$).

Example 12. Sale of Bonds Before Maturity

FACTS

Assume the same facts as in Example 10 , except that the bonds are sold on July 1, 20X4, at \$960,000.

SOLUTION

The gain on the sale is computed as follows:

Sale price		\$960,000
Carrying value		<u>(956,709)</u>
Gain on sale		<u>\$3,291</u>

The journal entry would be:

Cash	960,000	
Investment in bonds		956,709
Gain on sale of bonds		3,291

Note that a similar computation would be made if the bonds were retired by the issuer.

Example 13. Purchase of Bonds Between Interest Dates

FACTS

Assume that Client Company, Inc., acquires \$1 million face value bonds at \$994,380 on May 1, 20X1. The bonds pay interest at 12% on December 31 and June 30.

SOLUTION

When bonds are purchased between interest dates, the acquirer must pay the previous owner (or the issuer if the bonds are being acquired on the original issue date) any interest accrued since the last interest date. Thus, Client Company must pay the previous owner \$40,000 of interest for the period from January 1, 20X1 to April 30, 20X1 ($\$1,000,000 \times 0.12 \times 4 \div 12$). The journal entry to record the purchase of the bonds would be:

Investment in Bonds	994,380	
Interest income		40,000
Cash		1,034,380

At June 30, 20X1, the first interest date, Client Company would make the following entry (ignoring amortization of discount):

Cash	60,000	
Interest Income		60,000

Immediately after that entry, the interest income account would have a credit balance of \$20,000 (\$60,000 + \$40,000), representing \$20,000 of interest income for May and June of 20X1.

6.4 DISCLOSURES

6.4.1 Cost Method

The following disclosures are required:

- A statement that the investments are accounted for on the cost method.
- Separate identification on the balance sheet of the cost of investments accounted for under the cost method.
- The amount of dividends received in the current period.
- The amount of any dividends received in excess of the proportionate share of accumulated earnings since the date of acquisition, as a reduction of the cost of the investment.
- The amount of equity in the undistributed earnings and earnings for the current period of unconsolidated subsidiaries accounted for under the cost method. This disclosure may be made in total or by each individual subsidiary or group of subsidiaries.
- The amount of any difference between the cost of the investments, and the equity in net assets of unconsolidated subsidiaries.
- Summarized information as to assets, liabilities, and results of operations of unconsolidated subsidiaries.
- The amounts of any gains and losses on transactions with unconsolidated subsidiaries if such intercompany gains and losses are not eliminated.
- If applicable, the name of each investee in which the company owns more than 20% of the voting stock but is accounted for under the equity method, and the reason therefor.
- The quoted market value of the common stock, where available.

The following information must be disclosed (as applicable) as of the date of each annual balance sheet presented:

- The aggregate carrying amount of all cost-method investments.
- The aggregate carrying amount of such investments not evaluated for impairment.
- A statement that it was not practicable to estimate fair value or that the entity is exempt from the requirement to do so and the fact that fair value of a cost-method investment was not estimated because of the absence of any impairment indicators.

6.4.2 Equity Method

The following disclosures are required:

- Separate identification on the balance sheet of investments accounted for under the equity method.
- Separate identification in the income statement of the total amount of earnings or losses (before extraordinary items and prior-period adjustments) from investees accounted for under the equity method.

- Separate identification of the company's share of the investees' extraordinary items and prior-period adjustments.
- The name of each investee.
- The percentage of common stock ownership in each investee.
- A statement that such investments are accounted for under the equity method.
- If applicable, the name of each investee in which the company owns 20% or more of the voting stock but the investment is not being accounted for under the equity method. The reason it is not being thus accounted for should also be disclosed. Conversely, the name should be disclosed of each investee in which the company owns less than 20% of the voting stock but the investment is being accounted for under the equity method. The reason should also be disclosed.
- The amount of any difference between the carrying value of the investment and the amount of underlying equity in the net assets of the investee. The accounting treatment of that difference should also be disclosed.
- The quoted market value of the common stock, where available. This is not required for investments in subsidiaries.
- Summarized information as to assets, liabilities, and results of operations of unconsolidated subsidiaries, and separately for joint ventures or other 50% or less owned investees. This information for each type of investment may be shown individually or in groups, as appropriate.
- The effects of possible conversions, exercises, or contingent issuances of securities of an investee.
- If income taxes have not been accrued for undistributed earnings of a subsidiary, the following must be disclosed:
 - A declaration of the intention to reinvest such earnings, or
 - A declaration that remittance will be in the form of a tax-free liquidation, and
 - The cumulative amount of the undistributed earnings for which income taxes have not been accrued.

Note that income taxes are required to be accrued on undistributed earnings of investees, other than subsidiaries, and of corporate joint ventures that are accounted for under the equity method.

- Where a company's share of an investee's losses is greater than the carrying value of the investment plus advances to the investee, any future losses accrued should be shown as a liability (not as a credit balance in the asset) if application of the equity method is continued because the company has guaranteed obligations of the investee or is otherwise committed to further financial support.
- The provision for loss.
- Significant events or transactions of an investee that occur from the date of the investee's financial statements to the date of the investor's financial statements.
- Restatement of financial statements for all periods presented that are affected by a change to the equity method from another period. Restated financial statements would thus reflect the results of the change in the same manner as a step-by-step acquisition of a subsidiary.

6.4.3 Examples

Analogic Corporation (2005 Form 10-K)

Example .

9. Investments in and advances to affiliated companies:

The Company has a 44.6% equity ownership interest in SAHCO located in The People's Republic of China. During fiscal 2005, the Company recorded \$474 as its share of gains in SAHCO, as compared to its share of losses of \$584 in fiscal 2004. The carrying value of this investment was \$730 at July 31, 2005, and \$256 at July 31, 2004. At July 31, 2005 and 2004, the net receivables from this affiliate were \$725 and \$1,015, respectively. Sales to SAHCO for fiscal 2005, 2004 and 2003 were approximately \$3,546, \$6,695 and \$4,257, respectively.

On May 21, 2003, the Company acquired 1,251,313 shares of Series B Convertible Participating Preferred Stock for an equity interest of approximately 11% in PhotoDetection Systems, Inc. ("PDS") of Acton, Massachusetts. PDS, a privately held company, has developed proprietary detection systems for high-performance Positron Emission Tomography ("PET"), a rapidly growing medical diagnostic imaging modality. PET scanning is a tool in the diagnosis and management of cancer, specifically for detecting early-stage tumors and determining tissue characteristics before and after treatment. In addition, the Company also received a convertible promissory note in the principal amount of \$1,367 and an exclusive license of PDS technology for non-PET products. The convertible promissory note is convertible by the Company into 1,025,559 shares of Series B Convertible Participating Preferred Stock. If converted, the Company's equity interest would increase by 9%. During fiscal 2005, upon PDS' achievement of a technology milestone, the exclusive license of PDS technology reverted back to PDS and the Company received a warrant for the purchase of 2,250,563 shares of Series B Convertible Participating Preferred Stock. The exercise of this warrant would increase the Company's equity interest by 20%. The Company's current equity interest, the potential conversion of the promissory note into Series B Convertible Participating Preferred Stock, and the potential exercise of the warrant could result in the Company having a 40% equity interest in PDS. Additionally, under certain circumstances in the future, the Company may at its discretion, or may be required to, purchase the remaining 60% equity at its then fair value. The Company has three of the seats on PDS's seven-person board of directors. The Company, in connection with this transaction, expended a total of \$8,358 in cash during the period from May 21, 2003 to July 31, 2005. The Company accounted for this investment under the equity method due to the Company's ability to exercise significant influence over operating and financial policies and since its investment in PDS was not in the form of common stock. Effective with the second quarter of fiscal 2005, the Company changed the accounting method for its investment in PDS from the equity method to the cost method of accounting in accordance with EITF 02-14 "*Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock*" ("EITF 02-14"). Subsequently, the Company reviewed this investment for other-than-temporary impairment in accordance with Financial Accounting Standard No. 115 "*Accounting for Certain Investments in Debt and Equity Security*" ("FAS 115"). The Company determined that its investment in PDS was impaired based on its current fair value, and therefore, recorded an asset impairment charge totaling \$2,160

during the second, third, and fourth quarters of fiscal 2005. Prior to the effective date of the EITF 02-14, the Company recorded its share of PDS losses of \$759 as research and product development expenses in fiscal 2005. At July 31, 2005, the Company's investment in PDS was recorded, net of impairment charges, at \$0 value, versus a carrying value of \$593 at July 31, 2004.

During fiscal year 2005, the Company had a 14.6% equity interest in Cedara Software Corporation ("Cedara"), which is a publicly-traded Canadian company. On April 1, 2004, the Company's guarantee of certain debt owed by Cedara to its lender was cancelled, along with the security agreement between the Company and Cedara's lending bank. On November 8, 2004, the two affiliates whom the Company had appointed to the Cedara Board of Directors resigned from the Cedara Board. As a result, the Company on November 8, 2004 changed its accounting for this investment from the equity method to the cost method of accounting because the Company's ability to exercise significant influence over operating and financial policies of Cedara had ceased. On February 17, 2005, the Company sold its equity interest in Cedara for \$50,752 and realized a gain of approximately \$43,829 from the sale. During fiscal 2005, the Company entered into a six year license agreement with Cedara for \$6,000 which allows the Company to incorporate all of Cedara's software products into the Company's equipment and resell such equipment to the Company's customers. The Company entered into a maintenance contract in the amount of \$150 for the first year. At the Company's option this maintenance contract may be renewed each year at \$150. The Company has the option to further extend the license agreement for up to an additional four years on similar terms. The Company capitalized the costs of the license agreement and is amortizing the cost ratably over the life of the agreement, in the Company's product cost of sales.

Summarized financial information for all partially-owned equity affiliates at July 31 for the years then ended is as follows:

	2005	2004	
Current assets	\$32,426		\$75,476
Noncurrent assets	<u>20,141</u>		<u>31,943</u>
	<u>\$52,567</u>		<u>\$107,419</u>
Current liabilities	\$33,454		\$37,132
Noncurrent liabilities	=		<u>33</u>
	<u>\$33,454</u>		<u>\$37,165</u>
	2005	2004	2003
Net revenue	\$48,916	\$57,344	\$38,195
Gross margin	28,274	36,771	19,280
Income (loss) from operations	2,426	6,002	(12,787)
Net income (loss)	2,717	6,527	(11,766)

The carrying amount of the investments approximates the underlying ownership in the net assets of partially-owned equity affiliates which include SAHCO, Enhanced CT Technology LLC, and Cardioworks. The above information includes the Company's investment in PhotoDetection Systems Inc., prior to the change in accounting method, and Cedara prior to the Company's sale of its equity interest.

The Company recognized, as a result of foreign exchange gain and losses with respect to inter-company transactions, a gain of approximately \$83 in fiscal 2005, a loss of \$147 in fiscal 2004, and a gain of \$3,941 in fiscal 2003.

Hertz Corp. (2005 Form 10-K)

Example .

Note 1-Basis of Presentation

The accompanying condensed financial statements include only the accounts of The Hertz Corporation, or the "Company." Investments in the Company's subsidiaries are accounted for under the equity method. These condensed parent company financial statements have been prepared in accordance with Rule 12-04 of Regulation S-X, as restricted net assets of the Company's subsidiaries exceed 25% of the Company's consolidated net assets as of December 31, 2005.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted since this information is included in the Company's consolidated financial statements included elsewhere in this Form 10-K.

Enstar Group, Inc. (2005 Form 10-K)

Example .

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

(d) Partially Owned Equity Affiliates -- Partially owned equity affiliates are accounted for under the equity method of accounting. Equity method investments are recorded at cost and are adjusted periodically to recognize the Company's proportionate share of the affiliate's income or loss, additional contributions made and dividends and capital distributions received. In the event any of the partially owned equity affiliates were to incur a loss and the Company's cumulative proportionate share of the loss exceeded the carrying amount of the equity method investment, application of the equity method

would be suspended and the Company's proportionate share of further losses would not be recognized until the Company committed to provide further financial support to the affiliate. The Company would resume application of the equity method once the affiliate becomes profitable and the Company's proportionate share of the affiliate's earnings equals the Company's cumulative proportionate share of losses that were not recognized during the period the application of the equity method was suspended.

6.5 RELATED TOPICS

Section 2 , Marketable Securities

Section 8 , Intangible Assets

Section 14 , Retained Earnings

Section 21 , Income Taxes

Section 28 , Business Combinations

Section 32 , Consolidated and Combined Statements

Section 47 , Prior-Period Adjustments

Section 71 , International Financial Reporting Standards

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