EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR INVESTORS' INTERESTS IN UNCONSOLIDATED REAL ESTATE INVESTMENTS

NOVEMBER 21, 2000

Prepared by the Accounting Standards Executive Committee
American Institute of Certified Public Accountants

Comments should be received by April 15, 2001, and addressed to
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Accompanying this letter is an exposure draft of a proposed AICPA Statement of Position (SOP), *Accounting for Investors' Interests in Unconsolidated Real Estate Investments.* The proposed SOP provides guidance on accounting for investors' interests in unconsolidated real estate investments in financial statements prepared in conformity with generally accepted accounting principles (GAAP). A summary of the proposed SOP follows this letter.

The purpose of the exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties. Because the proposed SOP will replace SOP 78-9*, Accounting for Investments in Real Estate Ventures*, and SOP 78-9 has been more broadly applied to investments other than real estate, those interested in accounting for investors' interests in unconsolidated investments in other than real estate should consider commenting on the proposed SOP.

AREAS REQUIRING PARTICULAR ATTENTION BY RESPONDENTS

Comments are specifically requested on the following issues addressed by this exposure draft.

When to Use the Equity Method

Issue 1: Paragraph 8 of the proposed SOP extends the equity method to an investor in nonvoting common stock or nonredeemable preferred stock of a corporation when that investor has the ability to exercise significant influence over the investee and the stock does not meet the definition in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* of an equity security having a readily determinable fair value. Do you agree with that conclusion? If not, what accounting would you propose and why?

Issue 2: Paragraph 9 of the proposed SOP states that an investor's ability to appoint 20 percent of the investee's board of directors should lead to a presumption that, in the absence of evidence to the contrary, an investor has the ability to exercise significant influence over the investee. Do you agree that a presumption is useful in helping to achieve uniformity in application? Do you agree with the specific presumption contained in the proposed SOP? If not, what other presumption would you propose and why?

Issue 3: Paragraph 11 of the proposed SOP states that the equity method of accounting should be used by investors in noncorporate unconsolidated real estate investees outside of the scope of Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, when the investor has the ability to exercise significant influence over the investee. Those include investees such as general partnerships, limited partnerships, LLCs, and LLPs. Do you agree with that conclusion? If not, what accounting would you propose for those situations and why?

Issue 4: Paragraph 13 of the proposed SOP provides rules for investees that are organized in a "specific ownership account"-like structure in which each owner (a partner, a member) has a specific ownership account in the entity to which the owner's share of profits and losses, contributions, and distributions accrues directly. If the investor does not have the ability to exercise significant influence over the investee, the investor's accounting depends on whether its ownership interest meets the definition in FASB Statement No. 115 of an equity security having a readily determinable fair value. If the ownership interest meets that definition, the investor should apply FASB Statement No. 115; if it does not, the investor should apply the equity method. Do you agree with that conclusion? If not, how would you propose to amend it and why? Also, do you agree with the conclusion that S corporations and real estate investment trusts (REITs), which are considered "pass-through" entities for income tax purposes but which do not have separate individual ownership accounts, should not be considered specific ownership account entities for the purposes of this proposed SOP? If not, how would you treat S corporations and REITs and why?

Issue 5: Do you agree that the information necessary to apply the equity method generally will be available, or at least reasonably estimable, for investees for which the proposed SOP prescribes the equity method (see paragraphs 7 through 15)? If not, what alternative would you propose and why?

How to Apply the Equity Method—Hypothetical Liquidation at Book Value

Issue 6: The proposed SOP prescribes in paragraphs 18 and 19 the hypothetical liquidation at book value (HLBV) method as the appropriate approach to follow when applying the equity method. Do you agree the HLBV method is an appropriate and useful approach, and is its presentation in the proposed SOP understandable? If not, how would you change the approach or the presentation and why?

How to Apply the Equity Method—Negative Investments

Issue 7: Paragraph 24 of the proposed SOP carries forward the existing guidance in APB Opinion 18 and SOP 78-9 regarding when an investor might be considered "otherwise committed" to provide further financial support for the investee. For example, the proposed SOP does not provide specific guidance on whether an investor should report a negative investment in an equity method investee (rather than reporting income) when the negative investment would result from (a) a distribution by the investee of proceeds from borrowings by the investee or (b) elimination of profit on intercompany transactions between the investor and investee. Do you think AcSEC should more fully develop the concept of otherwise committed as part of this project? If so, how would you propose to define otherwise committed? Do you think AcSEC should address the specific examples previously mentioned and, if so, how would you propose to address those situations?

How to Apply the Equity Method—Basis Differences

Issue 8: Paragraphs 29 through 35 of the proposed SOP discuss the accounting for "basis differences," that is, differences between the amount of an investor's investment in an investee and the investor's claim (calculated using the HLBV method) on the reported book value of the investee. Two techniques are described: the "recast financial statements" approach and the "two component" approach. Do you agree with the methodology proposed in this section and find it understandable? If not, what changes would you propose and why?

How to Apply the Equity Method—Additional Investments

Issue 9: The proposed SOP addresses additional investments in paragraphs 36 through 38. It concludes that those situations should be addressed by evaluating the facts and circumstances of each situation rather than by "bright line" rules. Do you agree with that approach? If not, what alternative approach would you propose and why?

Issue 10: In paragraph 38, the proposed SOP states that an investor should apply the recast-financial-statements approach when making an additional investment that gives the investor a liquidation preference. Do you agree with that conclusion? If not, what alternative would you propose and why?

How to Apply the Equity Method—Investor Income Without Investee Income

Issue 11: Paragraphs 39 and 40 of the proposed SOP discuss how, under the HLBV method, an investor can recognize more income from an investee than the investee's net income under GAAP. Do you agree with that conclusion? If not, what modifications to the HLBV approach would you propose that would treat this situation differently and why?

How to Apply the Equity Method—Other Comprehensive Income and Similar Items

Issue 12: Paragraphs 44 through 47 of the proposed SOP prescribe a "with and without" HLBV method calculation to determine an investor's share of an investee's items of other comprehensive income (OCI), prior period adjustments, gain or loss from discontinued operations, cumulative effect of a change in accounting principle, and extraordinary gain or loss. If there are multiple items, the investor calculates the incremental effect first of prior period adjustments, then OCI, then the other items in the order in which they appear in an income statement. Do you agree with that approach? If not, what alternative approach would you propose and why?

Other Equity Accounting-Related Matters—Interaction With FASB Statement Nos. 114 and 115

Issue 13: Paragraphs 50 through 52 of the proposed SOP address the interaction of the equity method with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* and FASB Statement No. 115. Do you agree with the conclusions reached, which clarify the consensus in Emerging Issues Task Force (EITF) Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee"? If not, what alternative conclusions would you propose and why?

Other Equity Accounting-Related Matters—Investor Sale of an Investee

Issue 14: Paragraphs 58 through 63 of the proposed SOP discuss how the sale of an investor's interest in an unconsolidated real estate investment is the equivalent of a sale of the underlying real estate and should therefore be evaluated for sales treatment in accordance with FASB Statement No. 66, *Accounting for Sales of Real Estate*. The minimum initial investment requirement for the sale of an investor's interest to be accounted for by the full accrual method of that Statement is given as the investor's share of the minimum down payment that would have been required had the entire real estate assets of the investee been sold directly. Do you agree with this interpretation of the minimum initial investment requirement of FASB Statement No. 66? If not, what alternative interpretation would you propose and why?

Effective Date and Transition

Issue 15: The proposed SOP would be effective for financial statements issued for fiscal years beginning after December 15, 2001, and the cumulative effect of changes caused by adopting the provisions of the proposed SOP generally would be included in the determination of net income. Do you agree with these proposed transition requirements? If not, what alternative would you propose and why? Also, please comment on the practicability of the cumulative effect approach.

AcSEC welcomes comments or suggestions on any aspect of the exposure draft. When making comments, please include reference to specific paragraph numbers, including reasons for any comments or suggestions, and provide alternative wording where appropriate.

Comments on the exposure draft should be addressed to Marc Simon, Accounting Standards, File 4210.VE, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by April 15, 2001. Responses may also be sent by electronic mail to msimon@aicpa.org. Responses should not be faxed.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA library at Harborside Financial Center, 201 Plaza Three, Jersey City, NJ, after April 15, 2001, for one year.

Sincerely,

David B. Kaplan, CPA
Chair
Accounting Standards Executive Committee

Elizabeth A. Fender, CPA
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Accounting Standards Executive Committee
(1999-2000)

AICPA Staff

The staff gratefully acknowledges the contributions made to the development of this exposure draft by Leon F. Mayshak and other members of the AICPA's former Real Estate Committee, and Barry P. Robbins.

SUMMARY

This proposed Statement of Position (SOP) provides guidance on accounting for investors' interests in unconsolidated real estate investments. It provides guidance on when and how the equity method of accounting should be applied to such investments. It is intended to supersede SOP 78-9, *Accounting for Investments in Real Estate Ventures*. This proposed SOP would require the following:

- An investor holding an equity investment (including nonvoting common stock or nonredeemable preferred stock) in an investee should follow the equity method of accounting for that investee when the investor has the ability to exercise significant influence over the investee, unless the investment is in nonvoting common stock or nonredeemable preferred stock that meets the definition in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* of an equity security having a readily determinable fair value. If the stock meets that definition, the investor should apply FASB Statement No. 115. For investees such as general partnerships, limited partnerships, limited liability companies (LLCs), and limited liability partnerships (LLPs) that are organized in a "specific ownership account"-like structure and over which the investor does not have the ability to exercise significant influence, the investor's accounting depends on whether its ownership interest meets the definition in FASB Statement No. 115 of an equity security having a readily determinable fair value. If the ownership interest meets that definition, the investor should apply FASB Statement No. 115; if it does not, the investor should apply the equity method.

- The hypothetical liquidation at book value (HLBV) method should be followed when applying the equity method. HLBV is a balance-sheet-oriented approach to equity method accounting. Under HLBV, an investor determines its share of the earnings or losses of an investee by determining the difference between its "claim on the investee's book value" at the end and beginning of the period. This claim is calculated as the amount that the investor would receive (or be obligated to pay) if the investee were to liquidate all of its assets at recorded amounts determined in accordance with generally accepted accounting principles (GAAP) and distribute the resulting cash to creditors and investors in accordance with their respective priorities.

- HLBV takes into account all forms of financial interest that an investor has with respect to an investee, including common stock, preferred stock, general or limited partnership interests, debt securities, loans, advances, notes receivable, and other obligations.

- In applying HLBV, an investor should report a negative investment only to the extent it has guaranteed obligations of the investee, is otherwise committed to provide further financial support for the investee, or when the imminent return to profitable operations by the investee appears to be assured. When the amount an investor would receive or pay upon the hypothetical liquidation of an investee at book value depends on the ability of another investor to fund its negative investment, an investor's claim on the book value of an investee should include only those amounts that it is probable the other investor would fund.

- An investor has a "basis difference" when there is a difference between the amount of its investment in an investee and its claim on the book value of the investee. Generally, a basis difference should be attributed to assets or liabilities of the investee and accounted for as if the investee were a consolidated subsidiary.

- In applying HLBV, an investor may recognize more income from an investee than the investee's net income under GAAP. That can occur if an investor has a priority return on its investment and there is sufficient equity of other investors that is subordinate to the preferred investor such that the preferred investor's claim on the book value of the investee increases.

- An investor's claim on the book value of an investee can change when another investor purchases new equity interests for cash directly from the investee. Any change in the investor's claim on the book value of an investee in these situations should be recognized through the income statement or directly in paid-in capital by the investor in accordance with its accounting policy.

- An investor should report its share of an investee's prior period adjustments, items of other comprehensive income (OCI), gain or loss from discontinued operations, extraordinary items, and cumulative effect of a change in accounting principle by measuring the incremental effect of each item on the investor's claim on the book value of the investee.

- Cash distributions received by an investor during a period represent cash from operating activities except to the extent that the distributions cause an increase in the excess of cumulative distributions over cumulative share of earnings.

- Investors in real estate investees should make the disclosures required by paragraph 20 of Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Investors also should provide a summary of key provisions of the ownership agreements that govern how the investee's assets are distributed to the investors and that form the basis for the investor's application of HLBV.

This SOP provides examples throughout the text, immediately following the section to which they pertain, to make the SOP as understandable as possible.

The provisions of the proposed SOP would be effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The cumulative effect of changes caused by adopting the provisions of this proposed SOP would be recognized in the period of adoption. Restatement of financial statements issued before adoption would be prohibited.

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FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, before clearance, the FASB proposes suggestions, many of which are included in the documents.

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR INVESTORS' INTERESTS IN UNCONSOLIDATED REAL ESTATE INVESTMENTS

BACKGROUND

1. Ownership of real estate or a real estate development project by more than one entity is common. Such arrangements can be structured in a variety of ways, each with potentially different legal and economic substance. Ownership can be direct, whereby an investor owns an undivided interest in the property or project, or ownership can be through equity interests in an intermediary entity created to facilitate common ownership of the property or project. Intermediary entities include, but are not limited to, corporations, general partnerships, limited partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs), and real estate investment trusts (REITs). Investors in intermediary entities may hold common stock, preferred stock, partnership interests with varying rights and preferences, loans, advances, or debt securities of the investee and may be committed to provide additional funding to, or on behalf of, the investee.

2. The current authoritative accounting pronouncements that address the specialized accounting for investors' interests in unconsolidated real estate entities are Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (including Financial Accounting Standards Board (FASB) and AICPA Interpretations thereof), AICPA Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures,* and certain Emerging Issues Task Force (EITF) Issues and Announcements. In the years subsequent to the issuance of those pronouncements, the variety of structures used in the ownership of real estate and real estate projects has increased. As a consequence, there has been some confusion in practice about (*a*) when the equity method of accounting should be applied and (*b*) how to apply the equity method of accounting in various circumstances. That confusion has led to diversity in practice. The Accounting Standards Executive Committee (AcSEC) believes it is desirable to narrow the range of acceptable practices and is issuing this SOP in an attempt to do so. This SOP supersedes SOP 78-9. This SOP also supersedes EITF Topic No. D-46, "Accounting for Limited Partnership Investments," and clarifies EITF Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," for entities within the scope of this SOP.

3. The reader of this SOP will note that numerous examples illustrating the various concepts are contained throughout the text, immediately following the section to which they pertain. The objective is to make the SOP as understandable as possible. The examples should be read as an integral part of the text. The examples have been kept as simple as possible; they do not consider the effects of income taxes at the investee level, impairment of long-lived assets at the investee level, or any valuation allowance by an investor for potential uncollectible advances to the investee. Unless otherwise noted, they also assume that an imminent return to profitable operations by the investee does not appear to be assured in those examples in which the investor has reduced its investment to zero. In the examples, no investor is deemed to have a controlling financial interest in the investee that would require consolidation.

APPLICABILITY AND SCOPE

4. This SOP provides guidance on accounting for investors' interests in unconsolidated real estate investments (referred to as investees) in financial statements prepared in conformity with generally accepted accounting principles (GAAP). Investments that are consolidated in conformity with Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, and FASB Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*, are outside the scope of this SOP.[1]

5. This SOP also does not apply to those situations in which an investor applies the method known as pro rata consolidation (discussed in *The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretation No. 2 of APB Opinion No. 18* and in EITF Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Unincorporated Noncontrolled Ventures") to its interest in real estate. However, this SOP retains the provision of paragraph 11 of SOP 78-9 that if real property owned by undivided interests is subject to joint control by the owners, pro rata consolidation is not appropriate and, therefore, the guidance in this SOP applies. Real property is subject to joint control if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners. If the approval of two or more of the owners is not required for such decisions and each investor is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for indebtedness it incurs in connection with its interest in the property, then the investor should report the investment by recording the undivided interest in the assets, liabilities, revenue, and expenses of the investee.

6. This SOP applies to investments in qualified affordable housing projects, except those that are accounted for using the effective-yield method described in EITF Issue No. 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects." This SOP also applies to those situations in which a real estate loan is accounted for by the equity method as an investment in real estate, as described in the February 10, 1986, AICPA Notice to Practitioners, *ADC Arrangements* (which was carried forward in the AICPA Practice Bulletin No. 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*), and in EITF Issue No. 86-21, "Application of the AICPA Notice to Practitioners Regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property." This SOP does not apply to investment companies and other entities that account for substantially all assets at fair value, with changes in fair value recognized in the income statement.

CONCLUSIONS

When to Use the Equity Method

7. APB Opinion 18 addresses when to use the equity method of accounting for investments in voting common stock of investees organized in the form of a corporation. Together with FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*, APB Opinion 18 provides for the use of the equity method for (*a*) all investors in corporate joint ventures, as defined in paragraph 3 of APB Opinion 18 and (*b*) investments in

[1] In February 1999, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Consolidated Financial Statements: Purpose and Policy*, that would establish standards for when entities should be consolidated. Until completion of the FASB project, Emerging Issues Task Force (EITF) Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," may provide useful guidance.

voting common stock when the investor has the ability to exercise significant influence over operating and financial policies of the investee. AcSEC believes that guidance should apply more broadly.

8. An investor that holds nonvoting common stock or nonredeemable preferred stock of a corporation should apply FASB Statement No. 115*, Accounting for Certain Investments in Debt and Equity Securities*, if the stock meets the definition in FASB Statement No. 115 of an equity security that has a readily determinable fair value.[2] If the stock does not meet that definition, the investor should apply the equity method of accounting if the investor has the ability to exercise significant influence over the investee.

9. Determining whether an investor that holds nonvoting common stock or nonredeemable preferred stock has the ability to exercise significant influence may be difficult. If nonredeemable preferred stock has voting rights, then the presumption in paragraph 17 of APB Opinion 18 (ownership of 20 percent or more of the voting stock of an investee should lead to a presumption of significant influence) should be considered appropriate guidance. In order to achieve a reasonable degree of uniformity in application in the absence of voting rights, AcSEC concluded that an investor's ability to appoint 20 percent or more of the members of the investee's board of directors should lead to a presumption that, in the absence of evidence to the contrary, an investor has the ability to exercise significant influence over the investee. Conversely, an investor's inability to appoint 20 percent or more of the members of the investee's board of directors should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.

10. The presumptions in paragraph 9 are intended to provide a reasonable degree of uniformity in determining whether an investor has the ability to exercise significant influence over the investee. Presumptions can be overcome by predominant evidence to the contrary. An investor should look to the factors cited in paragraph 17 of APB Opinion 18, paragraph 4 of FASB Interpretation No. 35, and EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights" (protective rights versus participating rights), in reaching a judgment about whether a presumption is overcome.

11. An investor should apply the equity method of accounting to an ownership interest in a noncorporate business organization if the investor has the ability to exercise significant influence over the investee.

12. In addition, some of the “nontraditional” forms of organization that have become increasingly common subsequent to the issuance of APB Opinion 18 (specifically, general partnerships, limited partnerships, LLCs, and LLPs) share one attribute that distinguishes them from “traditional” corporations and from S corporations and REITs. In those “nontraditional” organizations, each owner (a partner, a member) has a specific ownership account in the entity to which the owner’s share of profits and losses, contributions, and distributions accrues directly. That contrasts with the owner of a C corporation holding common or preferred stock whereby that owner has no specific ownership account; stockholders simply own a certificate evidencing an ownership interest that is indistinguishable from other ownership interests in that same class of security.

[2] As stated in appendix C of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* nonredeemable preferred stock is preferred stock other than that which, by its terms, either must be redeemed by the issuing entity or is redeemable at the option of the investor.

13. AcSEC believes that difference is important in deciding when an investor in an unconsolidated real estate investment should apply the equity method of accounting. If an investor in an investee organized in a "specific ownership account"-like structure does not have the ability to exercise significant influence, it should apply (*a*) FASB Statement No. 115 if its ownership interest meets the definition in that Statement of an equity security that has a readily determinable fair value or (*b*) the equity method of accounting in all other cases.

14. As described in paragraphs 7 through 13, the equity method of accounting is appropriate for certain ownership interests. The equity method is not appropriate for an investment solely in an option or warrant held by an investor through which the investor would obtain an ownership interest upon exercise of the option or warrant. This applies to a financial instrument that is an option or warrant both in form and in substance.

15. In summary, the equity method of accounting should be used by (*a*) an investor in a corporate joint venture meeting the requirements of APB Opinion 18, (*b*) an investor holding voting common stock in an investee if the investor has the ability to exercise significant influence over the investee, (*c*) an investor holding nonvoting common stock or nonredeemable preferred stock in an investee if the investor has the ability to exercise significant influence over the investee and the stock does not meet the definition in FASB Statement No. 115 of an equity security having a readily determinable fair value, (*d*) an investor holding an ownership interest in a noncorporate investee if the investor has the ability to exercise significant influence over the investee, and (*e*) an investor holding an ownership interest in an investee organized in a specific ownership account-like structure if the investor does not have the ability to exercise significant influence over the investee and the ownership interest does not meet the definition in FASB Statement No. 115 of an equity security that has a readily determinable fair value. Appendix B presents a decision tree for when to apply the equity method of accounting.

16. Whether the equity method of accounting is required because the investee is a specific ownership account entity or through the application of APB Opinion 18, the accounting methodology described in the ensuing paragraphs of this SOP should be followed.

How to Apply the Equity Method

Objective

17. When an investor applies the equity method of accounting, the objective is to determine the effect on that investor of all transactions and other events recognized and measured under GAAP by the investee for the period. No other factors are considered—only those transactions and events that the investee recognizes in accordance with GAAP. Specifically, changes in the fair value of the investee's assets and liabilities are not considered unless those changes are recognized under GAAP by the investee. Transactions and events that the investee recognizes in accordance with GAAP can affect the investor through its holdings of equity instruments of the investee (common stock, preferred stock, general or limited partnership interests), debt instruments issued by the investee (loans, advances, notes receivable), or obligations of the investor related to the investee. When an investor applies the equity method, the methodology that is used takes into account all forms by which the investor has an interest in, or other obligations related to, the investee.

Hypothetical Liquidation at Book Value

18. AcSEC believes that a methodology referred to as the hypothetical liquidation at book value (HLBV) method is the appropriate approach to follow in applying the equity method of accounting so as to achieve the objective described in paragraph 17. The conventional way of thinking about

the equity method of accounting is income statement oriented. Under the conventional approach, an investor applies its "percentage ownership interest" to an investee's GAAP net income to determine the investor's share of the earnings or losses of the investee. That approach is difficult to use if the investee's capital structure gives different rights and priorities to its owners. In those situations, it is often difficult to describe an investor's interest in an investee simply as a specified percentage. The HLBV way of thinking about the equity method overcomes those difficulties and can be applied to both simple and complex capital structures. It is a balance-sheet-oriented approach to the equity method of accounting that is a much more versatile tool.

19. Under HLBV, an investor determines its share of the investee's earnings or losses[3] for a period by, essentially, answering the question: "How much better (or worse) off is the investor at the end of the period than it was at the beginning of the period, taking into consideration only those transactions and other events that are recognized under GAAP by the investee?" To answer that question, the investor calculates, at each balance sheet date, the amount that it would receive (or be obligated to pay) if the investee were to liquidate all of its assets at recorded amounts determined in accordance with GAAP and distribute the resulting cash to creditors and investors in accordance with their respective priorities (except as discussed in paragraph 20), including amounts that would be distributed to investors in satisfaction of any loans, receivables, or preferred securities held by them. The HLBV method does not take into account any costs that would be incurred if such actions actually were taken; for example, the HLBV method would not consider debt prepayment penalties that might be required upon early extinguishment. The amount the investor would receive (or be obligated to pay) is referred to as the investor's claim on the investee's book value. The difference between the investor's claim on the investee's book value at the end of the period and its claim at the beginning of the period represents the investor's share of the investee's earnings or losses for the period, taking into consideration any capital contributions or investments made by the investor during the period and any distributions received by the investor during the period. That is, to the extent the investor's claim on the book value of the investee changed during the period as a result of additional investments to or distributions from the investee, those effects would not be included in the investor's share of investee earnings or losses recorded in the investor's income statement.

20. In determining how cash hypothetically would be distributed to creditors and investors, the priority rights of the various creditors (including investors who are also creditors) and the priority provisions of the ownership or other related agreements are respected, with one exception. That exception relates to a situation in which an investor is also a creditor and, as creditor, has a claim that is equal in priority with claims of noninvestor creditors. In those circumstances, the investor/creditor's claim should be considered subordinate to those of the noninvestor creditors in that same priority class in applying HLBV.

21. A real estate investee often has nonrecourse debt secured by real estate. In determining how cash would be distributed hypothetically, nonrecourse debt is deemed to have a priority claim to the extent of the carrying amount of the real estate that serves as collateral. The amount of the debt in excess of the carrying amount of the collateral is deemed to be an unsecured liability. Thus, a nonrecourse creditor is deemed to have access to all the assets of the investee, not just the assets that serve as collateral. However, a nonrecourse creditor is not deemed to have access to the assets of the individual investors. If the investee's assets are insufficient to satisfy all creditors at a particular level of priority, the creditors are deemed to share in the available assets pro rata to the amount of their claims (treating investors who are also creditors in the manner described in paragraph 20).

[3] The term *share of the investee's earnings or losses* is used in Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Another way to think about this, especially when applying HLBV, is that the term represents the investor's earnings or losses that arise from its investment in the investee.

22. Examples 1 through 6 illustrate the use of HLBV.

Example 1

Hypothetical Liquidation at Book Value
Simple Capital Structure

Purpose of example: To illustrate the use of HLBV to calculate an investor's share of earnings when the investee has a simple capital structure (only one type of ownership interest in the investee)

Investee I is a corporation with three owners. Co. A owns 40% of the common stock; Co. B owns 40% of the common stock; Co. C owns 20% of the common stock.

At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$1,000
Real estate	10,000
Debt	(6,000)
Equity	$5,000

During the year X1, Investee I has income before depreciation of $2,000, and depreciation of $1,000, for a net income of $1,000. Its balance sheet at 12/31/X1 is as follows:

Cash	$3,000
Real estate	9,000
Debt	(6,000)
Equity	$6,000

Co. A determines its share of Investee I's earnings for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $12,000 available for its creditors and owners. After settling its $6,000 debt, Investee I would have $6,000 available to distribute to its owners. Co. A would receive $2,400 (40% x $6,000). Co. A's claim on Investee I's book value at 1/1/X1 was $2,000 (40% x $5,000). Therefore, during X1, Co. A's claim on Investee I's book value increased by $400 and that is the amount Co. A would recognize in X1 as its share of Investee I's earnings. (Note that this is the same result as would be obtained from applying the conventional income-statement-oriented approach to the equity method. Co. A's share of earnings would be calculated as 40% of Investee I's $1,000 net income, or $400.)

Example 2

Hypothetical Liquidation at Book Value
Complex Capital Structure

Purpose of example: To illustrate the use of HLBV to calculate an investor's share of earnings when the investee has a complex capital structure

Investee I is a limited partnership with two partners. Co. A owns 100% of the limited partnership interests and 50% of the general partnership interests. Co. B owns 50% of the general partnership interests. The limited partnership interests are entitled, on a priority basis, to return of their capital investment ($4,000) and an annual return of 10% thereon ($400). Thereafter, all remaining amounts go to the general partnership interests.

At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$ 1,000
Real estate	10,000
Debt	(6,000)
Equity	$ 5,000

During the year X1, Investee I has income before depreciation of $2,000 and depreciation of $1,000, for a net income of $1,000. No distributions were made during X1, but the priority distribution of $400 had been made in all previous years. Investee I's balance sheet at 12/31/X1 is as follows:

Cash	$3,000
Real estate	9,000
Debt	(6,000)
Equity	$6,000

Co. A determines its share of Investee I's earnings for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $12,000 available for its creditors and owners. After settling its $6,000 debt, Investee I would have $6,000 available to distribute to its owners. Co. A would receive $5,200. (Co. A would receive a priority distribution of its limited partnership capital investment of $4,000; a priority distribution of $400, being its 10% annual return thereon; and $800 for its general partnership interest, being 50% of the remaining equity of $1,600.) Co. A's claim on Investee I's book value at 1/1/X1 was $4,500 (the $4,000 priority distribution and 50% of the remaining equity). Therefore, during X1, Co. A's claim on Investee I's book value increased by $700 and that is the amount Co. A would recognize in X1 as its share of Investee I's earnings.

Example 3

Hypothetical Liquidation at Book Value
Cash Distributions to Investors

Purpose of example: To illustrate the use of HLBV to calculate an investor's share of earnings when the investee has made cash distributions to its investors

Investee I is a corporation with three owners. Co. A owns 40% of the common stock; Co. B owns 40% of the common stock; Co. C owns 20% of the common stock.

At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$1,000
Real estate	10,000
Debt	(6,000)
Equity	$5,000

During the year X1, Investee I has income before depreciation of $2,000, and depreciation of $1,000, for a net income of $1,000. Also, it pays a dividend of $3,000 pro rata to its owners ($1,200 to Co. A, $1,200 to Co. B, $600 to Co. C). Its balance sheet at 12/31/X1 is as follows:

Cash	$ -0-
Real estate	9,000
Debt	(6,000)
Equity	$3,000

Co. A determines its share of Investee I's earnings for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $9,000 available for its creditors and owners. After settling its $6,000 debt, Investee I would have $3,000 available to distribute to its owners. Co. A would receive $1,200 (40% x $3,000). Co A's claim on Investee I's book value at 1/1/X1 was $2,000 (40% x $5,000). Therefore, during X1, Co. A's claim on Investee I's book value decreased by $800. However, $1,200 of the decrease was the result of the dividend paid by Investee I. Accordingly, Co. A's claim on Investee I's book value increased by $400, excluding the effect of the dividend, and that is the amount Co. A would recognize in X1 as its share of Investee I's earnings. Co. A's investment balance can be reconciled as follows:

Balance, 1/1/X1	$2,000
Less: cash distribution	(1,200)
Add: share of Investee I's earnings	400
Balance, 12/31/X1	$1,200

Another way to look at the situation is as follows. At 1/1/X1, Co. A's investment in Investee I was $2,000. During X1, Co. A received a dividend of $1,200. According to APB Opinion 18, dividends received are applied as a reduction of the investment account, reducing the investment to $800. But at 12/31/X1, Co. A's claim on the book value of Investee I is $1,200. Thus, Co. A needs to increase its investment from $800 to $1,200, recognizing $400 of income as its share of Investee I's earnings.

Example 4

Hypothetical Liquidation at Book Value
Investor Receivable From Investee

Purpose of example: To illustrate the use of HLBV to calculate an investor's share of earnings when the investor has a receivable from the investee

Investee I is an LLC with two equal members, Co. A and Co. B. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$4,000
Real estate	10,000
Note payable to Co. A	(4,000)
Debt	(8,000)
Equity	$2,000

The note payable to Co. A is subordinate to the debt. Co. B has no further obligations or commitments with respect to Investee I. During the year X1, Investee I has a loss before depreciation of $2,000 and depreciation of $1,000, for a net loss of $3,000. Its balance sheet at 12/31/X1 is as follows:

Cash	$2,000
Real estate	9,000
Note payable to Co A	(4,000)
Debt	(8,000)
Equity	($1,000)

Co. A determines its share of Investee I's loss for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $11,000 available for its creditors and owners. After settling its $8,000 debt (which has priority over the note payable to Co. A), Investee I would have $3,000 available. Co. A would receive the entire $3,000 because of its priority claim from its note receivable. Co. A's claim on Investee I's book value at 1/1/X1 was $5,000 ($4,000 priority claim from its note receivable and 50% of the remaining $2,000). Therefore, during X1, Co A's claim on Investee I's book value decreased by $2,000 and that is the amount Co. A would recognize in X1 as its share of Investee I's loss.

Example 5

Hypothetical Liquidation at Book Value
Nonrecourse Debt Exceeds Collateral

Purpose of example: To illustrate the use of HLBV to calculate an investor's share of earnings when nonrecourse debt exceeds the carrying amount of the assets that serve as collateral

Investee I is a general partnership with two equal partners, Co. A and Co. B. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$2,000
Real estate	10,000
Equity	$12,000

During the year X1, Investee I has income before depreciation of $2,000, and depreciation of $1,000, for a net income of $1,000. The real estate has been owned for many years and has a fair value of $50,000. During X1, Investee I borrows $30,000 from a bank on a nonrecourse basis, using the real estate as collateral. That $30,000 remains in Investee I to be used for various purposes. Investee I's balance sheet at 12/31/X1 is as follows:

Cash	$34,000
Real estate	9,000
Debt	(30,000)
Equity	$13,000

Co. A determines its share of Investee I's earnings for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $43,000 available for its creditors and owners. The bank (the nonrecourse lender) would have a secured priority claim of $9,000 (the carrying amount of the real estate collateral) and be deemed an unsecured creditor for the remaining $21,000 of the debt. Investee I would have sufficient assets to repay both the secured and unsecured portions, leaving $13,000 available to distribute to its owners. Co. A would receive $6,500 (50% of $13,000). Co. A's claim on Investee I's book value at 1/1/X1 was $6,000 (50% of $12,000). Therefore, during X1, Co. A's claim on Investee I's book value increased by $500 and that is the amount Co. A would recognize in X1 as its share of Investee I's earnings.

Example 6

Hypothetical Liquidation at Book Value
Investor Receivable With Priority Claim

Purpose of example: To illustrate the use of HLBV to calculate an investor's share of earnings when the investor has a receivable with a priority claim and there are insufficient assets to satisfy all creditors

Investee I is a corporation with two equal shareholders, Co. A and Co. B. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$5,000
Real estate	20,000
Nonrecourse note payable to Co. A	(8,000)
Unsecured note payable to Co. A	(3,000)
Other unsecured liabilities	(9,000)
Equity	$5,000

The nonrecourse note payable to Co. A is secured by the real estate and, to that extent, has priority over all other liabilities. All unsecured liabilities have equal priority and have no claim on assets other than the assets of Investee I. Co. B has no further obligations or commitments with respect to Investee I. During the year X1, Investee I has a loss before depreciation of $5,000 and depreciation of $2,000, for a net loss of $7,000. Its balance sheet at 12/31/X1 is as follows:

Cash	$ -0-
Real estate	18,000
Nonrecourse note payable to Co. A	(8,000)
Unsecured note payable to Co. A	(3,000)
Other unsecured liabilities	(9,000)
Equity	($ 2,000)

Co. A determines its share of Investee I's loss for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $18,000 available. The first $8,000 would go to Co. A in respect of its secured, nonrecourse note, leaving $10,000 available for the unsecured creditors. Because Co. A's unsecured note has equal priority with the other unsecured liabilities, it is considered subordinate to those liabilities in applying HLBV (see paragraph 20). Thus, the next $9,000 would go to satisfy the other unsecured liabilities in full, leaving $1,000 for Co. A in respect of its unsecured note. Thus, in a hypothetical liquidation at book value at 12/31/X1, Co. A would receive $9,000. Co. A's claim on Investee I's book value at 1/1/X1 was $13,500 ($8,000 for the nonrecourse note, $3,000 for the unsecured note, and 50% of the remaining equity of $5,000). Therefore, during X1, Co. A's claim on Investee I's book value decreased by $4,500 and that is the amount Co. A would recognize in X1 as its share of Investee I's loss.

Negative Investments

23. The investor's investment may not always be positive—that is, the investee has positive net worth and would make distributions to its owners upon a hypothetical liquidation at book value. Sometimes, the investee has a negative net worth and the investor could be required to pay amounts back to the investee, investee creditors, or other investors upon liquidation at book value. Such a requirement could be contractual or pursuant to laws (bankruptcy or other) in the jurisdictions of the investor and investee. Those situations could arise, for example, if the investee has losses or makes distributions to its owners.

24. An investor should report a negative investment only to the extent it has a legal obligation as a general partner, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support for the investee. That is the requirement in paragraph 19(i) of APB Opinion 18. The following are examples of a circumstance in which an investor is "otherwise committed" to provide further financial support. The investor has indicated a commitment, based on such considerations as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

25. An investor should also provide for its share of an investee's losses, thus reporting a negative investment, when the imminent return to profitable operations by an investee appears to be assured, even if the investor has no legal obligation nor is otherwise committed to provide further financial support for the investee. That is the requirement of footnote 10 of APB Opinion 18, which also gives, as an example of such a circumstance, a situation in which a material, nonrecurring loss of an isolated nature does not impair the underlying profitable operating pattern of an investee.

26. Paragraph 19(i) of APB Opinion 18 describes situations in which the investor does not reduce the carrying amount of its investment below zero as the discontinuation of the equity method. Under HLBV, it is more useful to think of these circumstances as continuing to apply the equity method. It is simply that the application of the equity method through HLBV ascribes no further losses to the investor.

27. The amount an investor would receive or pay upon the hypothetical liquidation of the investee at book value may depend on the ability and intent of another investor to honor its obligation to pay amounts (that is, to fund its negative investment). In those cases, an investor's claim on the book value of the investee (positive or negative) should include only those amounts that it is probable the other investor would fund, should the other investor be called upon to do so in the amount indicated by the HLBV calculation.[4]

28. Example 7 illustrates the implications of negative investments.

[4] The term *probable* is used to mean "likely to occur," as the term is used in FASB Statement No. 5, *Accounting for Contingencies*.

Example 7

Negative Investments
Caused by Negative Net Worth

Purpose of example: To illustrate how an investor would determine the amount of its negative investment when the investee has a negative net worth

Investee I is a general partnership with two equal partners, Co. A and Co. B. Investee I used $20,000 of capital contributions ($10,000 from each partner) and $180,000 of bank debt to acquire a real estate property for $200,000. As general partners, Co. A and Co. B are each obligated for the full amount of the debt.

At inception of the partnership, Investee I's balance sheet is as follows:

Real estate	$200,000
Debt	(180,000)
Equity	$ 20,000

During the year X1, Investee I has income before depreciation of $0, and depreciation of $25,000, for a net loss of $25,000. Its balance sheet at 12/31/X1 is as follows:

Real estate	$175,000
Debt	(180,000)
Equity	($5,000)

Co. A determines its share of Investee I's loss for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $175,000 available, all of which would go to pay the bank debt, leaving a shortfall of $5,000 owed to the bank. Co. A would be required to pay $2,500 of this shortfall due to its obligation as a general partner. Co. A's claim on Investee I's book value at inception was $10,000. Therefore, during X1, Co. A's claim on Investee I's book value decreased by $12,500 and that is the amount Co. A would recognize in X1 as its share of Investee I's loss. Co. A's investment in Investee I at 12/31/X1 would be a negative $2,500.

If Co. A determines that it is not probable that Co. B would honor its $2,500 obligation to the bank as a general partner if called upon to do so, then Co. A would be required to pay the entire $5,000 shortfall to the bank. Accordingly, Co. A's investment in Investee I at 12/31/X1 would be a negative $5,000 and its share of Investee I's loss would be $15,000.

Basis Differences

29. In all of the examples thus far, the investor's investment and the investor's claim on the book value of the investee at the time the investment was made were equal. That is not always the case. A difference between the amount of the investment and the investor's claim on the book value of the investee can occur. Such a difference is referred to in this SOP as a "basis difference" and can arise in situations such as the following:

a. One investor contributes cash; the other investor contributes real estate. The investee records the real estate at the contributor's carrying amount, not fair value.[5] (Example 11 illustrates the basis difference for each investor.)

b. One investor contributes cash; the other investor contributes real estate. The investee records the real estate at fair value, not the contributor's carrying amount.[5] (Example 11 illustrates the basis difference for the investor that contributes real estate.)

c. An investor purchases an ownership interest in an existing investee from another owner, paying more (or less) for that interest than the proportionate book value of that interest as reflected in the investee's balance sheet. (Example 12 illustrates the basis difference for the new investor.)

d. An investee buys back an ownership interest from an investor, paying more (or less) for the interest than the proportionate book value of the interest, leaving the remaining investors with an increased ownership interest. (This creates a basis difference for the remaining investors similar to that illustrated in example 12 because, in effect, each of the remaining investors has indirectly purchased an additional ownership interest in the investee.)

30. When a basis difference arises, paragraph 19(b) of APB Opinion 18 says that it should be accounted for as if the investee were a consolidated subsidiary. In other words, the accounting should follow the principles of APB Opinion No. 16, *Business Combinations.* A technique that can be useful in dealing with a basis difference is something that is referred to as the "recast financial statements" approach. The investor "recasts" the investee's financial statements to reflect the investor's perspective or basis (thus eliminating the basis difference) and uses the recast financial statements in applying HLBV. That technique reflects the fact that the results obtained under the equity method of accounting should not depend on the basis for assets used by the investee, but rather on the basis of those assets from the perspective of the investor.

31. An investor should also use the recast-financial-statements approach when its initial investment in an investee has a liquidation preference. A basis difference technically might not arise in those situations because the investor's claim on the book value of the investee might be equal to the initial investment. Nevertheless, what is relevant to the investor is the fair value of the investee's assets and liabilities at the time it makes its investment, not the book value of those assets and liabilities. The recast-financial-statements approach captures the relevant fair values. Accordingly, in liquidation preference situations, the investor should determine the fair value of all of the investee's assets and liabilities, whether or not reported on the investee's balance sheet. Those assets might include intangible assets not separately identifiable, such as goodwill (being the excess of the fair value of the entity as a whole over the fair value of its separately identifiable assets and liabilities).

[5] This SOP does not address the issue of whether noncash assets contributed to a real estate investee should be recorded at fair value or the contributor's carrying amount in the financial statements of the investee. AcSEC understands that practice in this area is mixed.

32. Examples 8 through 10 illustrate the recast-financial-statements approach.

Example 8

Recast-Financial-Statements Approach
Basis Difference on Formation of Investee

Purpose of example: To illustrate how to calculate an investor's share of earnings when there is a basis difference, using the recast-financial-statements approach

Investor A contributes $10,000 cash to a newly formed real estate partnership. Investor B contributes real estate with a fair value of $10,000 and a carrying amount of $6,000. Investors A and B are equal partners in Investee I. The investee records the real estate at $6,000 in its opening balance sheet. During the year X1, Investee I has income before depreciation of $2,000 and depreciation of $600 (ten-year remaining life) for net income of $1,400.

Investor A would use the recast-financial-statements approach as follows. Investor A paid $10,000 for a 50% interest in Investee I. This implies that the fair value of Investee I at inception is $20,000. Thus, Investee I's recast balance sheet at inception is as follows:

Cash	$10,000
Real estate	10,000
Equity	$20,000

Investor A's claim on the recast book value is $10,000 (same as its investment). Investee I's recast balance sheet at 12/31/X1 is as follows:

Cash	$12,000
Real estate	9,000
Equity	$21,000

Investor A's claim on the recast book value of Investee I at 12/31/X1 is $10,500 (50% x $21,000). Therefore, during X1, Investor A's claim on Investee I's recast book value increased by $500 and that is the amount Investor A would recognize in X1 as its share of Investee I's earnings.

Note that the calculations under the recast approach are the same as those that would be done if Investee I had recorded the contributed real estate at its fair value of $10,000.

Example 9

Recast-Financial-Statements Approach
Basis Difference and Investee Negative Net Worth

Purpose of example: To illustrate the use of the recast-financial-statements approach to calculate an investor's share of earnings when there is a basis difference and the investee reports a negative net worth

Investee I is an existing corporation with the following balance sheet at 1/1/X1:

Cash	$ 3,000
Real estate	20,000
Debt	(19,000)
Equity	$ 4,000

On 1/1/X1, Co A buys 25% of the common stock of Investee I from an existing owner for $3,000. During the year X1, Investee I has a loss before depreciation of $3,000 and depreciation of $2,000 (ten-year remaining life) for a net loss of $5,000.

Co. A uses the recast-financial-statements approach in applying HLBV as follows.

Co. A paid $3,000 for a 25% interest in Investee I. This implies that the fair value of Investee I at that date was $12,000. Assuming that the difference between the fair value of Investee I and its book value is attributable solely to the real estate and not to the debt, Investee I's recast balance sheet at 1/1/X1 is as follows:

Cash	$ 3,000
Real estate	28,000
Debt	(19,000)
Equity	$ 12,000

Co. A's claim on the recast book value at 1/1/X1 is $3,000 (same as its investment). Investee I's recast balance sheet at 12/31/X1 is as follows:

Cash	$ -0-
Real estate	25,200 (a)
Debt	(19,000)
Equity	$ 6,200

(a) Calculated as the recast real estate balance at 1/1/X1 ($28,000) less one-year's depreciation of that balance based on a ten-year life ($2,800).

Co. A's claim on the recast book value of Investee I at 12/31/X1 is $1,550 (25% of $6,200). Therefore, during X1, Co. A's claim on Investee I's recast book value decreased by $1,450, and that is the amount Co. A would recognize in X1 as its share of Investee I's loss.

This example does not illustrate the tax effects on the recast balance sheet. In applying the recast-financial-statements approach (or the "two-component" approach; see paragraph 33) to an investment in a taxable entity such as a C corporation, the recast financial statements should reflect the deferred tax consequences related to temporary differences between the recast book values and the tax basis of the assets and liabilities of the investee. The recognition of those deferred tax assets and liabilities in the recast financial statements is similar to the recognition of deferred tax assets and liabilities in purchase business combinations.

Example 10

Recast-Financial-Statements Approach
Liquidation Preference

Purpose of example: To illustrate the use of the recast-financial-statements approach to calculate an investor's share of earnings when the investor has a priority in liquidation

Investee I is an existing corporation with the following balance sheet at 1/1/X1:

Cash	$ 1,000
Real estate	20,000
Debt	(19,000)
Equity	$ 2,000

On 1/1/X1, Co. A contributes $8,000 cash to Investee I for voting preferred stock, which gives Co. A significant influence over Investee I. The preferred stock carries a 10% cumulative dividend and has a liquidation preference of $8,000. At the time of the investment, Co. A estimates that the fair value of the real estate is $22,000 and the fair value of the debt is $19,000. During the year X1, Investee I has a loss before depreciation of $6,000 and depreciation of $2,000 (ten-year remaining life) for a net loss of $8,000.

Co. A uses the recast-financial-statements approach in applying HLBV as follows.

What is relevant to Co. A is the fair value of the real estate at the time it makes its investment, not the book value of the real estate. Thus, in creating a recast Investee I balance sheet at 1/1/X1 that reflects Co. A's perspective, the fair value of the real estate is used. Investee I's recast balance sheet at 1/1/X1 after Co. A's investment is as follows:

Cash	$ 9,000
Real estate	22,000
Debt	(19,000)
Equity	$12,000

In a hypothetical liquidation at book value immediately after making its investment, Co. A would receive $8,000 (the same as its investment).

Investee I's recast balance sheet at 12/31/X1 is as follows:

Cash	$ 3,000
Real estate	19,800 (a)
Debt	(19,000)
Equity	$ 3,800

(a) Calculated as the recast real estate balance at 1/1/X1 ($22,000) less one-year's depreciation of that balance based on a ten-year life ($2,200).

In a hypothetical liquidation at book value at 12/31/X1, Co. A would receive $3,800 because of its priority in liquidation. Therefore, during X1, Co. A's claim on Investee I's recast book value decreased by $4,200 and that is the amount Co. A would recognize in X1 as its share of Investee I's loss.

33. Another technique that has been used in practice to deal with a basis difference is referred to as the two-component approach. The investor's investment is thought of as comprising two components: (1) the investor's claim on the reported book value of the investee and (2) the basis difference (the difference between the first component and the total amount of the investment). Examples 11 and 12 illustrate these components.

Example 11

Basis Differences at Formation

Purpose of example: To illustrate how to calculate a basis difference arising at formation

Co. A contributes $10,000 cash to a newly formed real estate partnership. Co. B contributes real estate with a fair value of $10,000 and a carrying amount of $6,000. Cos. A and B are equal partners in Investee I. The investee records the real estate at $6,000 in its opening balance sheet.

Co. A's investment comprises two components:

(1) Its claim on Investee I's book value	$ 8,000
(2) The basis difference	2,000
Total investment	$10,000

Co. B's investment also comprises two components:

(1) Its claim on Investee I's book value	$ 8,000
(2) The basis difference	(2,000)
Total investment	$6,000

Note that if the investee were to record the real estate at $10,000 in its opening balance sheet, Co. A would have no basis difference and Co. B would have a basis difference of ($4,000).

Example 12

Basis Differences
Subsequent to Formation

Purpose of example: To illustrate how to calculate a basis difference arising subsequent to formation

Investee I is an existing corporation with the following balance sheet:

Cash	$ 2,000
Real estate	20,000
Debt	(10,000)
Equity	$ 12,000

Co. A buys 25% of the common stock of Investee I from an existing owner for $5,000. Assuming that the debt is at a market rate, this implies that the fair value of the real estate is $28,000. (Co. A is willing to pay $2,000 more than the book value for a 25% interest, therefore, the fair value of Investee I must be $8,000 higher than its book value.)

Co. A's investment comprises two components:

(1) Its claim on Investee I's book value	$3,000
(2) The basis difference	2,000
Total investment	$5,000

34. In applying the equity method of accounting, HLBV is followed for the first investment component (the investor's claim on the reported book value of the investee). The second investment component (the basis difference) is accounted for in the same manner as a purchase accounting adjustment. It is "allocated" to whichever asset(s) or liability(ies) caused the difference (including, possibly, goodwill or negative goodwill) and accounted for in the same way as that asset or liability. For example, the basis difference in both of the situations described in examples 11 and 12 is associated with the real estate and, to the extent it is not allocated to land, would be amortized over the life of the depreciable real estate, absent sale or asset impairment. The two-component approach cannot be used in situations in which the investee reports negative net worth or in which the investor obtains a liquidation preference for its investment. The problem that arises in negative net worth situations is that the first investment component may be reduced to zero even though the aggregate investment is positive. The problem in liquidation preference situations is that, as described in paragraph 31, a basis difference technically might not arise.

35. Example 13 illustrates the two-component approach for dealing with basis differences.

Example 13

Two-Component Approach
Basis Difference on Formation of Investee

Purpose of example: To illustrate how to calculate an investor's share of earnings when there is a basis difference, using the two-component approach (Note that this example uses the same fact situation as in Example 8.)

Investor A contributes $10,000 cash to a newly formed real estate partnership. Investor B contributes real estate with a fair value of $10,000 and a carrying amount of $6,000. Investors A and B are equal partners in Investee I. The investee records the real estate at $6,000 in its opening balance sheet. During the year X1, Investee I has income before depreciation of $2,000 and depreciation of $600 (ten-year remaining life), for net income of $1,400.

Investor A could use the two-component approach as follows. As described in Example 11, Investor A's claim on Investee I's book value at the date of contribution is $8,000 (first investment component). Its basis difference is $2,000 (second investment component). At 12/31/X1, Investee I's balance sheet is as follows:

Cash	$12,000
Real estate	5,400
Equity	$17,400

Investor A's claim on the reported book value of Investee I at 12/31/X1 is $8,700 (50% x $17,400), an increase of $700 during the year. Investor A's basis difference is allocated to the real estate and amortized over its remaining ten-year life, for an amortization of $200 ($2,000 basis difference ÷ 10). Thus, Investor A would recognize $500 in X1 as its share of Investee I's earnings.

Additional Investments

36. An investor may make additional investments in an investee, acquiring (either from the investee or from another investor) ownership interests, notes, receivables, or other instruments. The increase in the investor's claim on the net assets of the investee arising from an additional investment might be more or less than the amount of the investment, creating a basis difference.

37. The appropriate accounting for that basis difference requires a careful analysis of the substance of the situation. On the one hand, the basis difference might be attributable to differences between the fair values of assets (including goodwill) or liabilities and their book values. In those situations, the basis difference would be treated in the manner described in paragraphs 29 through 35. On the other hand, the basis difference might not be attributable to assets or liabilities of the investee, but rather it represents a funding by the investor of previous investee losses not recognized under HLBV.[6] In that latter circumstance, the investor should expense the basis difference immediately.

38. Often, when an investor makes an additional investment that gives the investor a liquidation preference, a basis difference technically does not arise because the investor's additional claim on the book value of the investee might be equal to the amount of the additional investment. The recast-financial-statements approach should be applied with respect to the additional investment for the reasons described in paragraph 31. AcSEC observed that this is important only in situations in which the investee subsequently reports negative net worth. Nevertheless, the basic principle should be applied.

Investor Income Without Investee Income

39. In applying the equity method of accounting under HLBV, it is possible for an investor to recognize more income from an investee than the investee's net income under GAAP (or even if the investee has a loss). That can occur if an investor has a priority return on its investment (as in a loan or preferred stock) and there is sufficient equity of other investors that is subordinate to the preferred investor such that the preferred investor's claim on the book value of the investee increases.

40. Example 14 illustrates this situation.

[6] The EITF has on its agenda a related issue, EITF Issue 00-D, "Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition." Readers should be alert to any final pronouncement.

Example 14

Investor Income Without Investee Income

Purpose of example: To illustrate how it is possible for an investor to recognize more income from an investee than the investee's GAAP net income through a hypothetical transfer of claim on net assets from another investor

Investee I is a limited partnership with two partners. Co. A owns 100% of the limited partnership interests and 50% of the general partnership interests. Co. B owns 50% of the general partnership interests. The limited partnership interests are entitled, on a priority basis, to return of their capital investment ($4,000) and an annual return of 10% thereon ($400). Thereafter, all remaining amounts go to the general partnership interests.

At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$1,000
Real estate	10,000
Debt	(6,000)
Equity	$5,000

During the year X1, Investee I has income before depreciation of $1,000 and depreciation of $1,000, for a net income of $0. No distributions were made during X1, but the priority distribution of $400 had been made in all previous years. Investee I's balance sheet at 12/31/X1 is as follows:

Cash	$2,000
Real estate	9,000
Debt	(6,000)
Equity	$5,000

Co. A determines its share of Investee I's "earnings" for X1 as follows. If Investee I liquidated its assets at 12/31/X1, it would have $11,000 available for its creditors and owners. After settling its $6,000 debt, Investee I would have $5,000 available to distribute to its owners. Co. A would receive $4,700. (Co. A would receive a priority distribution of its limited partnership capital investment of $4,000; a priority distribution of $400, being its 10% annual return thereon; and $300 for its general partnership interest, being 50% of the remaining equity.) Co. A's claim on Investee I's book value at 1/1/X1 was $4,500 (the $4,000 priority distribution and 50% of the remaining equity). Therefore, during X1, Co. A's claim on Investee I's book value increased by $200 and that is the amount Co. A would recognize in X1 as its share of Investee I's "earnings." A similar calculation would show that Co. B would recognize a loss of $200 in X1, representing a transfer of claim on net assets of $200 from Co. B to Co. A.

Investee Transactions That Reduce an Investor's Interest

41. An investor's claim on the book value of an investee can change when another investor purchases new equity interests for cash directly from the investee. Those transactions are sometimes referred to as "change-in-interest" transactions. In many respects, such a transaction is similar to a sale, albeit indirect, of a portion of the investor's ownership interest. Any change in the investor's claim on the book value of an investee in those situations should be recognized by the investor. Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 5H, *Accounting for Sales of Stock by a Subsidiary*, permits such changes to be taken through the income statement or directly to paid-in capital by the investor and describes certain situations in which gain recognition through the income statement is not appropriate. This guidance should be followed by both public and privately held enterprises. The choice by the investor of recognizing change-in-interest effects through the income statement or taking them directly to paid-in capital represents the selection of an accounting policy that should be followed consistently.

42. If a change-in-interest transaction occurs shortly after an initial contribution of real estate to an investee, the substance may be that both the contribution of real estate and the cash infusion are part of the same transaction. In such cases, no gain is recognized by the investor contributing the real estate, as described in paragraph 71 of this SOP.

43. Examples 15 and 16 illustrate change-in-interest transactions.

Example 15

Change-in-Interest Transactions
No Basis Difference

Purpose of example: To illustrate how to calculate a gain from a change-in-interest transaction when there is no basis difference

Investee I is an LLP with three members. Co. A has a 40% membership interest; Co. B has a 40% membership interest; Co. C has a 20% membership interest. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$1,000
Real estate	10,000
Debt	(6,000)
Equity	$5,000

Co. A's investment in Investee I is $2,000 (40% of $5,000). On 1/2/X1, a new investor, Co. D, purchases new membership interests directly from Investee I for $9,000. After this investment, Investee I is owned as follows: Co. A, 20%; Co. B, 20%; Co. C, 10%; Co. D, 50%.

Co. A calculates its gain or loss on this change-in-interest transaction as follows. After Co. D's investment, Investee I's balance sheet on 1/2/X1 is as follows:

Cash	$10,000
Real estate	10,000
Debt	(6,000)
Equity	$14,000

Co. A's claim on Investee I's book value at 1/1/X1 is $2,000 (40% of $5,000). Co. A's claim on Investee I's book value at 1/2/X1 is $2,800 (20% of $14,000). Thus, Co. A has a $800 gain from the change-in-interest transaction. Another way to think about this is that Co. A gave up 50% of its investment (50% of $2,000 = $1,000) and received 20% of the new capital contributed by Co. D (20% of $9,000 = $1,800).

Example 16

Change-in-Interest Transactions
Basis Difference

Purpose of example: To illustrate how to calculate a gain from a change-in-interest transaction when there is a basis difference

Investee I is an LLP with three members. Co. A has a 40% membership interest; Co. B has a 40% membership interest; Co. C has a 20% membership interest. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$1,000
Real estate	10,000
Debt	(6,000)
Equity	$5,000

Co. A's investment in Investee I is $3,000, constituting a $2,000 claim on the book value of Investee I and a $1,000 basis difference. On 1/2/X1, a new investor, Co. D, purchases new membership interests directly from Investee I for $9,000. After this investment, Investee I is owned as follows: Co. A, 20%; Co. B, 20%; Co. C, 10%; Co. D, 50%.

Co. A calculates its gain or loss on this change-in-interest transaction as follows. Because of the basis difference, Co. A recasts Investee I's balance sheet to reflect Co. A's basis. That recast balance sheet on 1/1/X1 is as follows (note that if $3,000 investment represents a 40% interest, then there is no basis difference if the equity is $7,500):

Cash	$1,000
Real estate	12,500
Debt	(6,000)
Equity	$7,500

Following Co. D's investment, Investee I's recast balance sheet on 1/2/X1 is as follows:

Cash	$10,000
Real estate	12,500
Debt	(6,000)
Equity	$16,500

Co. A's claim on Investee I's recast book value at 1/1/X1 is $3,000 (40% of $7,500). Co. A's claim on Investee I's recast book value at 1/2/X1 is $3,300 (20% of $16,500). Thus, Co. A has a $300 gain from the change-in-interest transaction. Another way to think about this is that Co. A gave up 50% of its investment (50% of $3,000 = $1,500) and received 20% of the new capital contributed by Co. D (20% of $9,000 = $1,800).

Other Comprehensive Income and Similar Items

44. FASB Statement No. 130, *Reporting Comprehensive Income*, addresses the concept of other comprehensive income (OCI). Items of OCI currently include unrealized gains and losses on available-for-sale securities, minimum pension liability adjustments, foreign currency translation adjustments, and the effective portion of gains and losses on derivatives designated as cash flow hedges. Such items affect the book value/equity of an enterprise but generally are not reported in earnings.

45. An investor's claim on the book value of an investee can change as a result of items of OCI reported by the investee. In accordance with FASB Statement No. 130 and APB Opinion 18, an investor should report its share of those items reported by the investee. An investor's share of those items is measured as the incremental effect of those items on the investor's claim on the book value of the investee. In other words, the investor's share of the investee's items of OCI is calculated by applying HLBV including, and excluding, such items. Regardless of how an investee chooses to display OCI, an investor should present its share of those amounts in the same manner as its own OCI items together with disclosure of amounts attributable to its investee(s).

46. Similarly, an investor should report separately its share of an investee's prior period adjustments and, in its income statement, its share of an investee's gain or loss from discontinued operations, extraordinary gain or loss, and cumulative effect of a change in accounting principle, if any. An investor's share of these items is measured as the incremental effect of the item on the investor's claim on the book value of the investee. The effect of a prior period adjustment is calculated first. It is the change in the investor’s claim on the book value of the investee at the beginning of the period, giving effect to the prior period adjustment, when compared with its claim without the prior period adjustment. If the investee has items of OCI and one or more of the income statement items, the order in which the investor calculates the incremental effect is: (1) OCI, (2) income statement items in the order in which they appear in an income statement (first, gain or loss from discontinued operations; then, extraordinary items; then, cumulative effect of a change in accounting principle). In other words, the incremental effect of an item of OCI is calculated by first determining the investor’s claim on the book value of the investee, assuming the investee had no items of OCI or any of the income statement items described in this section. Then, the investor’s claim is determined giving effect incrementally only to the item of OCI. The difference between the two amounts is the incremental effect of the item of OCI. If the investee also had, for example, an extraordinary item, its incremental effect would be calculated by determining the investor’s claim on the book value of the investee including both the extraordinary item and the item of OCI and comparing that with the claim on the book value with the extraordinary item excluded.

47. Examples 17 through 19 illustrate the allocation of OCI and income statement items.

Example 17

Other Comprehensive Income and Similar Items
OCI Only

Purpose of example: To illustrate how to calculate an investor's share of an investee's items of OCI

Investee I is a corporation with three owners. Co. A owns 40% of the common stock; Co. B owns 40% of the common stock; Co. C owns 20% of the common stock. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$5,000
Real estate	15,000
Debt	(22,000)
Equity	($2,000)

During the year X1, Investee I has a loss before depreciation of $1,000, depreciation of $1,000, and an OCI "gain" of $2,000 (relating to an interest rate swap that is a cash flow hedge of the floating rate debt). Co. A has no obligation to pay additional amounts with respect to Investee I. Investee I's balance sheet at 12/31/X1 is as follows:

Cash	$4,000
Real estate	14,000
Interest rate swap asset	2,000
Debt	(22,000)
Equity	($2,000) (a)

(a) Consists of "traditional" equity (par value, paid-in capital, deficit) of ($4,000) and accumulated other comprehensive income of $2,000.

Co. A determines its share of Investee I's OCI as follows. Excluding the effect of the interest rate swap asset, Investee I's equity at 12/31/X1 would have been ($4,000). Co. A's claim on that book value would have been $0 because Co. A has no obligation to pay additional amounts, even if Investee I has a shortfall in its ability to pay its creditors. Including the effect of the interest rate swap asset, Investee I's equity at 12/31/X1 was ($2,000) and Co. A's claim on that book value was also $0. Therefore, Co. A's share of Investee I's OCI in X1 is $0.

Example 18

Other Comprehensive Income and Similar Items
OCI Only

Purpose of example: To illustrate how to calculate an investor's share of an investee's items of OCI when the investee's imminent return to profitability appears to be assured

Investee I is a corporation with three owners. Co. A owns 40% of the common stock; Co. B owns 40% of the common stock; Co. C owns 20% of the common stock. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$5,000
Real estate	15,000
Debt	(18,000)
Equity	$2,000

During the year X1, Investee I has a loss before depreciation of $2,000, depreciation of $1,000, and an OCI "gain" of $1,000 (relating to an interest rate swap that is a cash flow hedge of the floating rate debt). Co. A has no obligation to pay additional amounts with respect to Investee I. Investee I's balance sheet at 12/31/X1 is as follows:

Cash	$3,000
Real estate	14,000
Interest rate swap asset	1,000
Debt	(18,000)
Equity	$0 (a)

(a) Consists of "traditional" equity (par value, paid-in capital, deficit) of ($1,000) and accumulated other comprehensive income of $1,000.

Co. A determines its share of Investee I's OCI as follows. Excluding the effect of the interest rate swap asset, Investee I's equity at 12/31/X1 would have been ($1,000). However, the OCI "gain" returned Investee I to profitability (or, more precisely, returned Investee I from negative equity). Therefore, Co. A would recognize ($1,200) as its share of Investee I's loss for X1 [($3,000) x 40%] and would, before recognizing the effect of the OCI "gain," report a negative investment of ($400) [($1,000) x 40%]. Including the effect of the interest rate swap asset, Investee I's equity at 12/31/X1 was $0 and Co. A's claim on that book value was $0. Therefore, Co. A's share of Investee I's OCI in X1 is $400. Recapping Co. A's share in X1:

Net income	($1,200)
OCI	400
Net decrease in claim on book value	($800)

Example 19

Other Comprehensive Income and Similar Items
OCI and Extraordinary Item

Purpose of example: To illustrate how to calculate an investor's share of an investee's items of OCI and an investee's extraordinary item when both exist

Investee I is a corporation with three owners. Co. A owns 40% of the common stock; Co. B owns 40% of the common stock; Co. C owns 20% of the common stock. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$ 5,000
Real estate	20,000
Debt	(15,000)
Equity	$10,000

During the year X1, Investee I has income before depreciation of $3,000, depreciation of $2,000, an extraordinary gain of $2,000, and an OCI "loss" of $500. Investee I's balance sheet at 12/31/X1 is as follows:

Cash	$10,000
Real estate	18,000
Other liabilities	(500)
Debt	(15,000)
Equity	$12,500

Co. A does the following calculations for X1. Its claim on Investee I's book value at 1/1/X1 was $4,000. Its claim on Investee I's book value at 12/31/X1 is $5,000. Therefore, there was a $1,000 increase in its claim on the book value for the year X1. Excluding both the item of OCI and the extraordinary item, Investee I's equity at 12/31/X1 would have been $11,000, and Co. A's claim on the book value would have been $4,400. Giving effect incrementally only to the item of OCI, Investee I's equity at 12/31/X1 would have been $10,500, and Co. A's claim on the book value would have been $4,200. Therefore, Co. A's share of Investee I's OCI for X1 was ($200). Further giving effect incrementally to the extraordinary item, Investee I's equity at 12/31/X1 was $12,500, and Co. A's claim on that book value was $5,000. Therefore, Co. A's share of Investee I's extraordinary item was $800. Recapping Co. A's share in X1:

Income before extraordinary item	$400
Extraordinary item	800
OCI	(200)
Net increase in claim on book value	$ 1,000

Other Equity Accounting-Related Matters

Impairment of Investment

48. According to paragraph 19(h) of APB Opinion 18, "A loss in value of an investment which is other than a temporary decline should be recognized." That paragraph provides further guidance that might be helpful in identifying such situations. If an investment is written down, the loss is considered permanent and should not subsequently be reversed by the investor other than through application of the HLBV methodology. The investee also might have an impairment of assets recognized pursuant to FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.[7]

Income Taxes

49. Differences between the investor's tax basis in the investment and the carrying amount of the investment should be accounted for in conformity with FASB Statement No. 109, *Accounting for Income Taxes*, where applicable. In addition, deferred tax consequences related to basis differences between the investor's investment and its claim on the book value of the investee should be considered in applying the recast-financial-statements approach or the two-component approach.

Interaction With FASB Statement Nos. 114 and 115

50. As described previously in this SOP, the HLBV methodology takes into account all forms of financial interest that an investor has with respect to an investee—common stock and similar residual ownership interests, preferred stock and similar preferential ownership interests, debt securities, receivables, loans, advances, and so on. Some of those financial interests might fall within the scope of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (for example, receivables, loans, and advances), or FASB Statement No. 115 (for example, debt securities and preferred stock with a readily determinable fair value). In situations in which the investor records its share of investee losses, the carrying amount of FASB Statement No. 114 and FASB Statement No. 115 instruments may be reduced from their otherwise historical cost carrying amounts. For instance, in example 4, the carrying amount of Company A's note receivable from Investee I is reduced from $4,000 at January 1, 20X1, to $3,000 at December 31, 20X1. In those situations, the interaction of equity accounting with FASB Statement Nos. 114 and 115 should be considered.

51. First, the equity method of accounting (using HLBV) is applied to the historical cost amounts of all investor financial interests in the investee, as previously described in this SOP. Then, FASB Statement Nos. 114 and 115 are applied to the resulting balances, as applicable. For FASB Statement No. 114 instruments, the carrying amount cannot exceed the amount that would be recorded through the application of FASB Statement No. 114. For FASB Statement No. 115 instruments carried at fair value, any adjustment from the carrying amount based on applying the equity method to fair value is a FASB Statement No. 115 adjustment that is recorded as an item of OCI (for available-for-sale securities) or income (for trading securities). Those conclusions are consistent with the consensus reached in EITF Issue No. 98-13. In addition to the examples that follow, that EITF consensus provides additional guidance that might be helpful in applying this accounting.

52. Examples 20 and 21 illustrate the situations just described.

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[7] In June 2000, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, that would supersede FASB Statement No. 121. Readers should be alert to any final pronouncement.

Example 20

Interaction With FASB Statement No. 114

Purpose of example: To illustrate the interaction of HLBV with FASB Statement No. 114

Investor A made a loan to Investee I in the amount of $10,000. After applying HLBV at 12/31/X1, the carrying amount of the loan was reduced to $8,000. Under FASB Statement No. 114, the loan would be carried at $7,000. Investor A reduces the carrying amount of the loan from $8,000 to $7,000 because the carrying amount of a FASB Statement No. 114 instrument cannot exceed the amount that would be reported under FASB Statement No. 114. The $1,000 reduction is considered a FASB Statement No. 114 adjustment and should be presented in the investor's income statement with other FASB Statement No. 114 adjustments.

Assume that after applying HLBV at 12/31/X2, the carrying amount of the loan would remain at $8,000 (excluding any effect of applying FASB Statement No. 114), but under FASB Statement No. 114, the loan would be carried at $9,000. Investor A increases the carrying amount of the loan from $7,000 to $8,000 at 12/31/X2. This is because the carrying amount of the loan is first calculated based on HLBV, and then a determination is made about whether FASB Statement No. 114 requires a lower carrying amount.

Example 21

Interaction With FASB Statement No. 115

Purpose of example: To illustrate the interaction of HLBV with a FASB Statement No. 115 available-for-sale security

Investor A is an existing equity investor in Investee I that has the ability to exercise significant influence and that applies the equity method of accounting for its investment. Investor A makes an additional purchase of nonvoting preferred stock from Investee I for $10,000. The preferred stock has a readily determinable fair value and, therefore, falls within the scope of FASB Statement No. 115. Investor A considers the preferred stock to be "available-for-sale." After applying HLBV at 12/31/X1, the carrying amount of the preferred stock was reduced to $8,000. The fair value of the preferred stock (which is the required measurement attribute for available-for-sale securities under FASB Statement No. 115) is $7,000. Investor A reduces the carrying amount of the preferred stock from $8,000 to $7,000, with the $1,000 reduction treated as an item of other comprehensive income.

Assume that after applying HLBV at 12/31/X2, the carrying amount of the preferred stock would be $7,000, and the fair value remains at $7,000. Investor A recognizes a loss of $1,000 in its income statement as its share of the losses of Investee I in the year X2 and also recognizes $1,000 of other comprehensive income in X2. This is because the historical cost carrying amount of the preferred stock under HLBV decreased by $1,000 in the year, while the difference between that historical cost and the fair value also changed by $1,000 (the $1,000 excess of historical cost over fair value at 12/31/X1 was reduced to $0 at 12/31/X2).

Presentation

53. The investor's investment in equity securities of an investee should be shown in the balance sheet of the investor as a single amount (paragraph 19(c) of APB Opinion 18). Any loans to the investee, receivables from the investee, or similar items held by the investor may be combined in the balance sheet with its investment in equity securities, provided that the investor does not combine current items with noncurrent items in a classified balance sheet. A negative investment, as described in paragraphs 23 through 28 of this SOP, should be shown in the balance sheet as a liability and should not be combined with positive investments in other equity method investees.

54. The investor's share of earnings or losses of an investee is ordinarily shown in the income statement of the investor as a single amount, except as described in the following sentence. As described in paragraph 46 of this SOP, the investor's share of an investee's gain or loss from discontinued operations, cumulative effect of a change in accounting principle, and extraordinary gain or loss, if any, should be reported separately in the investor's income statement. As described in paragraph 45 of this SOP, the investor's share of an investee's items of other comprehensive income should be reported in the same manner as the investor reports its own such items.

Statement of Cash Flows

55. FASB Statement No. 95, *Statement of Cash Flows*, requires an entity to present a statement of cash flows, with separate categories for cash flows from operating activities, investing activities, and financing activities. An investor that receives cash distributions from an investee during a period needs to determine whether those distributions represent cash received from operating activities or from investing activities. Essentially, cash received that represents a return on an investor's investment is an operating cash flow, whereas cash received that represents a return of investment is an investing cash flow.

56. Cumulatively, cash distributions received by an investor in excess of the investor's cumulative share of the investee's earnings represent a return of capital. Therefore, cash distributions received by an investor during a period represent cash from operating activities except to the extent that such distributions cause an increase in the excess of cumulative distributions over cumulative share of earnings.

57. Example 22 illustrates the concept.

Example 22

Statement of Cash Flows

Purpose of example: To illustrate how to distinguish cash distributions received by an investor that represent cash from operating activities from those that represent cash from investing activities

Co. A is an investor in Investee I. Through 12/31/X0, Co. A's cumulative share of Investee I's earnings is $10,000, and it has received $6,000 in cash distributions. During the year X1, Co. A's share of Investee I's earnings is $2,000, and it receives $4,000 in cash distributions. Because Co. A's cumulative share of Investee I's earnings at 12/31/X1 ($12,000) exceeds its cumulative cash distributions ($10,000), the entire $4,000 cash received in X1 is a cash flow from operating activities.

* * * * *

Co. A is an investor in Investee I. Through 12/31/X0, Co. A's cumulative share of Investee I's earnings is $10,000, and it has received $9,000 in cash distributions. During the year X1, Co. A's share of Investee I's earnings is $2,000, and it receives $4,000 in cash distributions. Because the distributions in X1 resulted in an excess of cumulative distributions over cumulative earnings of $1,000 where no excess existed at the beginning of the period, $3,000 of the cash distributions is a cash flow from operating activities and $1,000 is a cash flow from investing activities.

* * * * *

Co. A is an investor in Investee I. Through 12/31/X0, Co. A's cumulative share of Investee I's earnings is $10,000, and it has received $12,000 in cash distributions. During the year X1, Co. A's share of Investee I's earnings is $2,000, and it receives $2,000 in cash distributions. Because the distributions in X1 resulted in no increase in the excess of cumulative distributions over cumulative earnings (the excess remained at $2,000), the entire $2,000 cash received in X1 is a cash flow from operating activities.

Investor Sale of an Investee

58. The sale of an equity interest in an entity that owns and holds substantial real estate is the equivalent of a sale of an interest in the underlying real estate itself. Therefore, accounting for the sale—in particular, whether the sale qualifies for full profit recognition—is governed by FASB Statement No. 66, *Accounting for Sales of Real Estate*. That is the consensus reached in EITF Issue No. 98-8, "Accounting for Transfers of Investments That Are in Substance Real Estate." EITF Issue No. 88-24, "Effect of Various Forms of Financing under FASB Statement No. 66," provides guidance for applying FASB Statement No. 66.

59. Under FASB Statement No. 66, if the seller provides financing for part of the sales price, full profit recognition is precluded unless the buyer's initial investment (down payment) is adequate to demonstrate the buyer's commitment to pay. Paragraphs 53 and 54 of FASB Statement No. 66 set forth the minimum down payment requirements, which depend on the nature of the real estate.

60. An investor selling an interest in an investee should, therefore, determine the minimum down payment it needs to receive to qualify for full profit recognition (assuming the other FASB Statement No. 66 conditions for recognition are met). It does so in the following manner. First, the investor determines the minimum down payment that would have been required had the entire real estate assets of the investee been sold directly. That will be based on the fair value of the real estate and the applicable down payment percentage in paragraphs 53 and 54 of FASB Statement No. 66. Then, the investor determines its "share" of the down payment requirement by comparing its claim on the book value of the investee for the interest it is selling (immediately before the sale) with the total equity of the investee (reflecting the investor's basis) and applying that percentage to the full down payment requirement.

61. If the investee has debt, the minimum down payment requirement calculated as described in the preceding paragraph may equal or exceed the sales price of the interest being sold. In that case, the minimum down payment requirement is equal to the sales price.

62. Subject to the provisions of the preceding paragraphs, an investor should recognize a gain or loss on a sale of an interest in a real estate investment equal to the difference at the time of sale between the selling price of the interest and the investor's carrying amount of the interest.

63. Example 23 illustrates the calculation of the minimum down payment requirement.

Example 23

Investor Sale of an Investee

Purpose of example: To illustrate how an investor should calculate the minimum down payment it needs in a sale of an interest in an investee to qualify for full profit recognition

Investee I is a corporation with three owners. Co. A owns 40% of the common stock; Co. B owns 40% of the common stock; Co. C owns 20% of the common stock.

At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$ 1,000
Real estate	10,000
Debt	(8,000)
Equity	$ 3,000

The real estate is a multifamily residential property for primary residences with cash flow currently sufficient to service all debt. The minimum down payment requirement for such a property is 10% of the sales value. The fair value of the real estate is $14,000 and the fair value of the debt is $8,000. Co. A's claim on Investee I's book value is $1,200. On 1/2/X1, Co. A sells its entire interest in Investee I to a third party for $2,800, part of which is paid in cash, with the remainder in a note receivable.

Co. A determines the down payment it would need to receive to qualify for full profit recognition under FASB Statement No. 66 as follows. If Investee I were to sell the real estate in its entirety, the down payment requirement would be $1,400 (10% x $14,000). Co. A's share of this amount is $560, calculated as follows.

Co. A's claim on Investee I's book value	$1,200
Investee I's equity	÷ 3,000
Co. A's share, as a percentage	40%
Down payment requirement for entire real estate	x 1,400
Co. A's share, as a dollar amount	$560

Therefore, if Co. A receives at least $560 in cash at the time of sale, the minimum down payment requirement of FASB Statement No. 66 is met.

Disclosures

64. Investors in real estate investments should make the disclosures required by paragraph 20 of APB Opinion 18. Investors also should provide a summary of key provisions of the ownership or other related agreements that govern how the investee's assets are distributed to its owners and that form the basis for the investor's application of HLBV. If investors enter into transactions with investees, disclosures appropriate under FASB Statement No. 57, *Related Party Disclosures*, should be made. The investor also should comply with the provisions of FASB Statement No. 5, *Accounting for Contingencies*, relating to disclosure of contingent liabilities for commitments the investor may have made with respect to an investee. Additionally, the investor should consider the provisions of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Transactions Between Investor and Investee

Sales by Investor to Investee

65. An investor may sell goods or services (for example, real estate) to an investee. If the investee capitalizes the cost of such goods or services, the investor should defer recognition of a portion of any gain or loss on the sale. That is because, by selling goods or services to the investee, the investor is, in effect, selling a portion of the goods or services to itself. The profit or loss that is deferred is later recognized by the investor as the investee charges the cost of the goods or services to its income statement.

66. The HLBV method can be used to calculate the amount of profit or loss that should be deferred, in the following manner. From the perspective of the investor, to the extent that the sale was to itself, the carrying amount of the goods or services sold should be assumed to be the same as the cost basis to the investor. If, hypothetically, the investee were to realize only the investor's cost basis (rather than the amount the investee paid for the goods or services), the investee would realize a loss or gain. For example, if the investor sold an asset to the investee for $10,000 that had a cost to the investor of $6,000, the investor would have a $4,000 gain. If the investee then resold that asset at a price equal to the investor's cost ($6,000), it would realize a $4,000 loss (it paid $10,000 for the asset and resold it for $6,000). HLBV can be used to determine this amount, as follows. First, calculate the investor's claim on the investee's book value immediately before the sale. Then, calculate the investor's claim on the investee's book value immediately after the sale, with the assumption that the investee had immediately resold the goods or services for a price equal to the investor's cost. The difference between the investor's claim on the investee's book value immediately before and immediately after the sale is the amount of profit or loss the investor needs to defer.

67. If an investor sells a long-lived asset to an investee at a loss, the investor should consider the need to review the carrying amount of that asset for impairment, pursuant to the guidance in FASB Statement No. 121.[8]

68. Examples 24 and 25 illustrate the concept discussed in paragraphs 65 and 66.

[8] See footnote 7.

Example 24

Sales by Investor to Investee
Negative Net Worth

Purpose of example: To illustrate the use of HLBV to calculate the amount of profit to be deferred when the investor's investment has been reduced to zero

Investee I is an LLC with three members. Co. A has a 40% membership interest; Co. B has a 40% membership interest; Co. C has a 20% membership interest. At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$15,000
Real estate #1	20,000
Debt	(40,000)
Equity	($5,000)

On 1/2/X1, Co. A sells real estate to Investee I for $15,000 cash. Co. A's cost/basis in the real estate is $8,000.

Co. A calculates the gain it recognizes upon the sale of the real estate as follows. Because the buyer (Investee I) paid the entire sales price in cash, Co. A would have recognized a profit of $7,000 had the sale been to an unrelated third party. To determine the amount of that profit to be deferred by Co. A, it performs a before and after HLBV calculation, with the assumption that Investee I had immediately resold the real estate for $8,000, as follows.

Investee I's balance sheet on 1/2/X1 immediately after the sale by Co. A and the assumed resale by Investee I is as follows.

Cash	$8,000
Real estate #1	20,000
Debt	(40,000)
Equity	($12,000)

Co. A's claim on Investee I's book value immediately before the sale, assuming that Co. A is not committed, legally or otherwise, to support Investee I, was $0. Its claim on Investee I's book value immediately after the sale is still $0. Therefore, Co. A should defer none of the $7,000 profit.

Example 25

Sales by Investor to Investee
Complex Capital Structure

Purpose of example: To illustrate the use of HLBV to calculate the amount of profit to be deferred when the investee has a more complex capital structure

Investee I is a limited partnership with two partners. Co. A owns 100% of the limited partnership interests and 50% of the general partnership interests. Co. B owns 50% of the general partnership interests. The limited partnership interests are entitled, on a priority basis, to return of their capital investment ($4,000) and an annual return of 10% thereon (which has been fully paid through 1/1/X1). Thereafter, all remaining amounts go to the general partnership interests.

At 1/1/X1, Investee I's balance sheet is as follows:

Cash	$15,000
Real estate #1	20,000
Debt	(29,000)
Equity	$6,000

On 1/2/X1, Co. A sells real estate to Investee I for $15,000 cash. Co. A's cost/basis in the real estate is $10,000.

Co. A calculates the gain it recognizes upon the sale of the real estate as follows. Because the buyer (Investee I) paid the entire sales price in cash, Co. A would have recognized a profit of $5,000 had the sale been to an unrelated third party. To determine the amount of that profit to be deferred by Co. A, it performs a before and after HLBV calculation, with the assumption that Investee I had immediately resold the real estate for $10,000, as follows.

Investee I's balance sheet on 1/2/X1 immediately after the sale by Co. A and the assumed resale by Investee I is as follows:

Cash	$10,000
Real estate #1	20,000
Debt	(29,000)
Equity	$1,000

Co. A's claim on Investee I's book value immediately before the sale was $5,000. Its claim on Investee I's book value immediately after the sale is $1,000. The decrease of $4,000 is the amount of profit that should be deferred by Co. A.

69. Similar calculations need to be made if the investor makes interest-bearing loans to the investee and the investee capitalizes any or all of the interest cost. The "immediately before" and "immediately after" HLBV calculation is done by assuming that the investee does not capitalize the interest.

70. If the fee or price charged by an investor for the goods or services it provides to the investee differs significantly from that which would be charged by an unrelated party for comparable performance, the difference may reflect compensation for other goods or services provided to or by the investor or a dividend or capital transaction. The recognition of earnings from sales of goods by an investor to an investee and from services performed for a fee by an investor for the investee should be consistent with the recognition of earnings for similar transactions with unrelated parties. In other words, the amount charged that reflects compensation for other goods and services, or that reflects a dividend or capital transaction, should be accounted for in accordance with the applicable accounting literature for the nature of the transaction.

Contributions of Real Estate

71. An investor that contributes capital in the form of real estate to an investee should not recognize any gain upon that contribution because it does not represent the culmination of the earnings process. Rather, the investor's carrying amount of the real estate contributed becomes part of the investor's investment account. Such situations may create a basis difference for the contributing investor.

72. It is possible that a loss in value of real estate will be indicated by an investor's contribution thereof to an investee. In those situations, the entire loss in value (including the portion attributed to the investor's ownership interest in the investee) should be recognized by the investor upon the contribution of the real estate to the investee. That accounting recognizes that control over the asset contributed has been surrendered in exchange for a new asset (an interest in the investee). In many situations, the investor will already have recognized an impairment loss pursuant to the provisions of FASB Statement No. 121.[9]

73. A transaction that is, in substance, the sale of real estate may be structured as a contribution to capital, with a concurrent distribution. An example of such a transaction is one in which Investor A contributes to an investee real estate with a fair value of $2,000 and Investor B contributes cash in the amount of $1,000, which is immediately withdrawn by Investor A. Following the contributions and withdrawal, each investor has a 50 percent ownership interest in the investee. Similarly, a transaction that is, in substance, a capital contribution may be structured as a sale, with a concurrent cash capital contribution. Care should be taken to analyze the substance of the arrangements properly, and the accounting (as either a sale of real estate or a contribution of real estate) should be consistent with that substance.

Contributions of Services or Intangibles

74. As with contributions of real estate, an investor that contributes capital in the form of services or intangibles to an investee should not recognize any gain upon that contribution. Rather, the investor's cost or carrying amount of the services or intangibles contributed becomes part of the investor's investment account.

[9] The FASB has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, that may supersede FASB Statement No. 121. Readers should be alert to any final pronouncement.

Sales by Investee to Investor

75. An investee may sell goods or services (for example, real estate) to an investor. If the investor capitalizes the cost of such goods or services, the investor should not recognize as income its share of the investee's profits on such sale, using the HLBV approach. Rather, the investor's share of those profits should be recognized as a reduction in the carrying amount of the purchased goods or services in the investor's financial statements.

EFFECTIVE DATE AND TRANSITION

76. The provisions of this SOP are effective for fiscal years beginning after December 15, 2001. Earlier application of the provisions of this SOP is encouraged. The cumulative effect of changes caused by adopting the provisions of this SOP should be recognized in the period of adoption. That cumulative effect should be included in the determination of net income, in conformity with APB Opinion No. 20, *Accounting Changes*, except to the extent the cumulative effect results from items of OCI and from change-in-interest transactions for which the investor's accounting policy is to recognize them directly in equity. The pro forma disclosures listed in paragraph 19(d) of APB Opinion 20 are not required. Restatement of financial statements issued before adoption of this SOP is prohibited.

The provisions of this Statement need not be applied to immaterial items.

APPENDIX A

BASIS FOR CONCLUSIONS

WHEN TO USE THE EQUITY METHOD

A1. The Accounting Standards Executive Committee (AcSEC) believes that the equity method of accounting should be followed by an investor in nonvoting common stock or nonredeemable preferred stock of a C corporation if that investor has the ability to exercise significant influence over the investee and the stock does not meet the definition in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* of an equity security having a readily determinable fair value. That conclusion does not contradict Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* which addresses only investments in voting common stock and is silent with respect to investments in nonvoting common stock and preferred stock. AcSEC believes its conclusion is a logical one that draws on APB Opinion 18 as an analogy. AcSEC reasons that, if an investor has the ability to exercise significant influence over an investee, it should not matter what kind of ownership interest gives rise to that influence. Although the kind of ownership interest might affect the results of applying the equity method of accounting, it should not affect whether to apply the equity method of accounting. Because AcSEC believes that the FASB Statement No. 115 measurement attribute of fair value is the most relevant, AcSEC decided that FASB Statement No. 115 should take precedence over the equity method for investments in nonvoting common stock or nonredeemable preferred stock. AcSEC believes that the equity method of accounting is not appropriate for an investment solely in redeemable preferred stock because, according to paragraph 137 of FASB Statement No. 115, the holder of redeemable preferred stock is deemed to have a creditor relationship with the issuing entity. AcSEC looked to FASB Statement No. 115 rather than Securities and Exchange (SEC) ASR No. 268, "Redeemable Preferred Stocks," for a definition of redeemable security because FASB Statement No. 115 focuses on the distinction between an equity security and a debt security from the perspective of the holder of that security—the same focus that is relevant in the Statement of Position (SOP).

A2. APB Opinion 18 includes a presumption with respect to voting common stock that an investment of 20 percent or more of the voting stock of an investee gives the investor the ability to exercise significant influence over an investee. AcSEC believes that a similar presumption should apply to investments in nonvoting common stock and nonredeemable preferred stock to achieve a more reasonable degree of uniformity in application. AcSEC chose the ability to appoint 20 percent or more of the members of the investee's board of directors as the presumption because that ability seems rather close in nature to the rights inherent in owning 20 percent of an investee's voting stock. AcSEC observes that when an entire series of preferred stock is issued to a single investor, it is not uncommon for that investor to be given the contractual right to appoint individuals to an investee's board of directors.

A3. AcSEC also concluded that the equity method of accounting should be used by investors in unconsolidated real estate investees organized in a noncorporate form (general partnership, limited partnership, LLC, LLP) when the investor has the ability to exercise significant influence over the investee, for the same reasons as those described in the previous paragraph.

A4. AcSEC further believes that the attribute common to “specific ownership account”-like entities of each investor having its own account in the entity distinguishes such entities from more traditional forms of organization for an investee, such as a C corporation. In such situations, AcSEC believes that the cost method of accounting is not appropriate, even if the investor does not have the ability to exercise significant influence. When the investor does not have the ability to exercise significant influence in “specific ownership account”-like entities and if the investor’s ownership interest meets the definition in FASB Statement No. 115 of an equity security that has a readily determinable fair value, the investor should apply FASB Statement No. 115, as the measurement attribute of fair value is considered by AcSEC to be the most relevant. In other situations, the equity method of accounting is applied because it is viewed as necessary to satisfy the fundamental concept of accrual accounting. AcSEC understands that, at the present time, the United States federal income tax law requires separate ownership accounts for the types of entities mentioned. AcSEC is not aware of any other U.S. source that mandates such accounts.

A5. AcSEC considered the possibility that investors in "specific ownership account" entities might not be able to obtain the information necessary to apply the equity method, especially if the level of ownership is small. Although concerned about the issue, AcSEC nevertheless believes that it should be possible to obtain the necessary information, or at least make reasonable approximations from information that is available, in those situations in which the investment is material to the investor.

A6. AcSEC discussed that options and warrants held by an investor represent potential ownership interests in an entity rather than actual ownership interests. As noted in footnote 1 of this SOP, the FASB has a project on its agenda that would establish new guidance for determining when an entity should consolidate another. Under certain circumstances, that guidance would require an investor to consolidate an investee when the investor's investment consists solely of certain financial instruments (for example, convertible debt or options) other than direct ownership interests. AcSEC believes it would need to resolve some implementation issues if it adopted a broader scope. Addressing those issues would delay issuance of this SOP. AcSEC did not consider it necessary to address the broader scope at this time. AcSEC therefore concluded that, under current guidance, the equity method of accounting is not appropriate for such potential ownership interests.

OBJECTIVE OF THE EQUITY METHOD

A7. AcSEC believes that the investor's objective in applying the equity method of accounting is to determine the effect on that investor of all transactions and other events recognized and measured under generally accepted accounting principles (GAAP) by the investee for the period. This conclusion rests on the description of the equity method contained in APB Opinion 18. Specifically, paragraph 10 of APB Opinion 18 says, "Under the equity method… an investor adjusts the carrying amount of an investment for its share of the earnings or losses of the investee subsequent to the date of investment and reports the recognized earnings or losses in income….Thus, the equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles in the economic resources underlying the investments."

A8. AcSEC has also concluded that when an investor applies the equity method, the methodology that is used takes into account all forms by which the investor has an interest in, or other obligations related to, the investee. Support for this view is contained in paragraph 19(i) of APB Opinion 18, which refers to an investor's recognition of investee losses if the investor also has made advances to the investee. This view is also consistent with Emerging Issues Task Force (EITF) Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," and EITF Issue Topic D-68, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of an Investee."

HYPOTHETICAL LIQUIDATION AT BOOK VALUE

A9. This SOP sets forth an approach referred to as "hypothetical liquidation at book value" as the technique by which to apply the equity method of accounting. Although the term *hypothetical liquidation at book value* (HLBV) may be new to the accounting literature, and the balance-sheet-oriented way of thinking may be different from the more conventional income statement orientation, AcSEC nevertheless believes that HLBV is fully consistent with the equity method of accounting as described in APB Opinion 18. In simple capital structures, HLBV yields the same results as the income-statement-oriented approach. In more complex situations, in which an investor's ownership in an investee cannot readily be described as a simple percentage, HLBV can be used to produce unambiguous results, whereas it is less clear how the income-statement-oriented approach would be applied. Furthermore, the following sentence from paragraph 10 of APB Opinion 18 suggests a balance-sheet-oriented way of thinking: "Thus, the equity method is an appropriate means of recognizing increases or decreases measured by generally accepted accounting principles in the economic resources underlying the investments."

A10. In applying HLBV, AcSEC concluded that investors that are also creditors should be considered to stand “last in line,” rather than on an equal footing, with noninvestor creditors in the same priority class. AcSEC believes that treatment reflects reality in most situations and is consistent with the manner in which APB Opinion 18 has been implemented in practice. AcSEC limited this "last in line" treatment to the same priority class to avoid a result in which an investor that holds a first mortgage would be deemed to stand behind an unsecured general creditor. AcSEC noted that this method of ranking claims according to priority in applying HLBV is a clarification of the guidance in EITF Issue No. 98-13 and EITF Issue Topic D-68.[10]

NEGATIVE INVESTMENTS

A11. Paragraph 19(i) of APB Opinion 18 says that an investor should not reduce its investment below zero "unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee." Paragraph 15 of SOP 78-9, *Accounting for Investments in Real Estate Ventures,* provides guidance to help identify when an investor might be “otherwise committed” to provide further financial support. AcSEC decided to leave that guidance intact. The issue of when a substantive obligation exists (sometimes referred to as a constructive obligation)—as opposed to a legal obligation—is a difficult one that the FASB has been addressing in several of its current projects. Although AcSEC believes it would be useful to more fully develop this concept in relation to equity accounting for unconsolidated real estate investments, AcSEC concluded that it would be quite difficult and would unduly delay this SOP. Therefore, AcSEC chose to leave current guidance in place. If the FASB provides guidance on constructive obligations in one or more of its current projects, AcSEC will consider whether that guidance should be applied to the situations addressed in this SOP.

[10] EITF Issue No. 98-13, "Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee," will be updated to state that investors holding interests in unconsolidated real estate investments should look to this SOP for a clarification of the application of the guidance of that Issue.

A12. AcSEC also discussed whether certain situations, such as one in which the proceeds from a nonrecourse borrowing against appreciated assets are distributed to investors, create a substantive or constructive obligation. Without a more rigorous definition of a constructive obligation, AcSEC was not able to conclude definitively about those situations. Therefore, judgment will continue to be applied in the same way it has been in the past, until the FASB makes progress on this issue.[11]

A13. AcSEC concluded that amounts that may be due from other investors should be included in the HLBV calculations, but only to the extent those amounts would be probable of collection. AcSEC reasoned that amounts due from other investors are, in essence, potential capital contributions from those investors. The only difference from actual capital contributions is that the amounts are subject to credit risk. Because the collectibility of those amounts can directly affect the income or loss recognized by an investor, AcSEC believes that the threshold for recognition should be *probable* of collection, as the term is used in FASB Statement No. 5, *Accounting for Contingencies*.

BASIS DIFFERENCES

A14. AcSEC's conclusion that a basis difference must be ascribed to specific assets or liabilities (including goodwill or negative goodwill) and accounted for in the same manner as that asset or liability derives from paragraphs 6(b), 19(b), and 19(n) of APB Opinion 18. Specifically, paragraph 19(b) of APB Opinion 18 says, "A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary."

A15. AcSEC identified two methodologies that can be used to implement this requirement—the so-called recast-financial-statements approach and the two-component approach. Based on an analysis of both approaches, AcSEC believes that the recast-financial-statements approach can be effectively used in a greater variety of circumstances than can the two-component approach. Both approaches, however, are based on the concept that what is relevant to a particular investor is the fair value of the investee's assets and liabilities at the time the investor makes its investment, rather than the book value of the investee's assets and liabilities at that investment date.

ADDITIONAL INVESTMENTS

A16. The subject of additional investments is a difficult one. Examples can be constructed in which it is clear that a basis difference arising from an additional investment should be capitalized and treated as part of the investment. Similarly, examples can be constructed in which it is clear that a basis difference arising from an additional investment should be charged to expense immediately. AcSEC believes it is neither practicable nor desirable to establish bright line rules in this area. Rather, it will be necessary to analyze the facts and circumstances of each particular situation to form an appropriate judgment of the substance.

A17. AcSEC realizes that applying the recast-financial-statements approach to certain additional investments could entail significant cost. Perhaps for this reason, current practice does not

[11] The FASB has issued exposure drafts of two proposed Statements of Financial Accounting Standards, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets* and [*Name of Liabilities and Equity exposure draft*], that address the issue of constructive obligations. Readers should be alert to any final pronouncements.

always do so. AcSEC believes that the cost of doing so should be weighed against the likelihood that doing so will affect subsequent accounting, much as current practice already does.

INVESTOR INCOME WITHOUT INVESTEE INCOME

A18. AcSEC believes that it is possible for an investor to recognize more income from an investee than the investee's net income under GAAP. That can occur when claims on net assets are effectively transferred from one investor to another due to differing rights and preferences. That notion may seem counterintuitive when viewed from the more traditional income-statement-oriented way of thinking about the equity method. However, AcSEC believes that the investor's recognition of income resulting from certain transfers of claims on net assets is warranted when viewed from the balance sheet perspective of HLBV.

INVESTEE TRANSACTIONS THAT REDUCE AN INVESTOR'S INTEREST

A19. AcSEC's conclusion that an investor should recognize a gain or loss (subject to specific SEC guidance in this area, as noted in paragraph A21, that also should be applied by non-public companies) when another investor purchases new equity interests for cash directly from the investee is supported by paragraph 6(b) of APB Opinion 18, which states, "The investment of an investor is also adjusted to reflect the investor's share of changes in the investee's capital."

A20. In considering the application of that general guidance to real estate investments, AcSEC considered the interaction of FASB Statement No. 66, *Accounting for Sales of Real Estate,* with change-in-interest transactions. The nature of a change-in-interest transaction is that it represents an indirect sale of a portion of an investor's interest in an investee, but the cash proceeds of that sale remain with the investee, not the investor. A question arises about whether the initial down payment requirement necessary for full profit recognition under FASB Statement No. 66 is met in such circumstances. AcSEC believes that all of the requirements for full profit recognition are, indeed, met because the buyer or new investor has fully paid for its investment in cash to the investee and has, thus, demonstrated its commitment to the transaction.

A21. AcSEC acknowledges that recognition of a gain in a change-in-interest transaction could be viewed as inconsistent with the conclusion that no gain should be recognized by an investor upon its contribution of real estate to an investee, even if another investor contributes cash. Because both practices are well established, AcSEC decided not to attempt to reconcile them by eliminating one or the other. Doing so would have involved either disregarding SEC Staff Accounting Bulletin Topic 5H, *Accounting for Sales of Stock by a Subsidiary*, or changing longstanding practice supported by SOP 78-9.

OTHER COMPREHENSIVE INCOME AND SIMILAR ITEMS

A22. The requirement for an investor to report its share of an investee's items of other comprehensive income is set forth in paragraphs 120 through 122 of FASB Statement No. 130, *Reporting Comprehensive Income*. Similarly, the requirement for an investor to report its share of an investee's prior period adjustments and extraordinary items is set forth in paragraph 19(d) of APB Opinion 18. By analogy, AcSEC concluded that a similar treatment should be afforded to an investee's gain or loss from discontinued operations and cumulative effect of a change in accounting principle.

A23. AcSEC concluded that an investor should determine its share of these items in the same manner by which it determines its share of an investee's net income—that is, through the use of HLBV. An income-statement-oriented approach, whereby an investor uses its percentage ownership interest to determine its share of these items, was rejected for the same reasons AcSEC rejected that approach as the basic methodology to implement the equity method of accounting. As to the order in which to apply a "with-and-without" approach when there are multiple items for which an investor's share must be determined, AcSEC realized that any conclusion would, necessarily, be somewhat arbitrary. It selected the order it did—first, prior period adjustments, second, OCI, and third, income statement items in the order in which they appear in an income statement—as having some intuitive logic.

A24. Implicit in AcSEC's conclusion about how an investor determines its share of an investee's items of other comprehensive income is a conclusion that when an item of other comprehensive item is released through earnings, the investor does not attempt to do so-called "backward tracing" (except when there are basis differences related to items that have generated OCI). That is, the investor does not attempt to determine what its share of that item was when the item originated and use that same amount when the item "reverses" through earnings. AcSEC believes that backward tracing could be difficult to apply and would not produce demonstrably better financial reporting. AcSEC notes that the FASB reached a similar conclusion in FASB Statement No. 109, *Accounting for Income Taxes*.

IMPAIRMENT OF INVESTMENT

A25. Paragraph 19(h) of APB Opinion 18 sets forth guidance for assessing impairment of an equity method investment. With the issuance of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* some accountants reached the conclusion that an investor's investment in an investee cannot be impaired if the investee itself has no impairment of its assets (unless a basis difference exists). However, AcSEC observed that FASB Statement No. 121 specifically states its guidance does not change the impairment rules for equity method investees. Because the FASB had fairly recently decided not to change or augment the guidance in this area, AcSEC decided it also should not do so.

INTERACTION WITH FASB STATEMENT NOS. 114 AND 115

A26. AcSEC's conclusions regarding the interaction of the equity method of accounting with FASB Statement Nos. 114*, Accounting by Creditors for Impairment of a Loan,* and 115 are consistent with the consensus reached in EITF Issue No. 98-13. Because these issues had recently been addressed by the EITF, AcSEC believed it was appropriate to carry forward the EITF's conclusions and not reexamine the issues.

PRESENTATION

A27. Paragraph 19(c) of APB Opinion 18 sets forth guidance on balance sheet and income statement presentation for equity method investments. The guidance in that paragraph is the basis for AcSEC's conclusions in this area. AcSEC believes negative investments should be classified as liabilities because, under HLBV, they represent amounts that the investor would be required or otherwise committed to pay in a hypothetical liquidation at book value.

STATEMENT OF CASH FLOWS

A28. AcSEC believes that the concept of "cash flows from operations," as described in FASB Statement No. 95, *Statement of Cash Flows,* is designed to capture the cash flows from transactions that go through an entity's income statement. On that basis, AcSEC has concluded that cash received by an investor from an investee should be considered cash flows from operations as long as the cumulative cash receipts are not in excess of the investor's cumulative share of the investee's earnings.

INVESTOR SALE OF AN INVESTEE

A29. AcSEC's conclusion that the sale of an equity interest in an investee that owns and holds real estate is the equivalent of a sale of an interest in the underlying real estate itself is consistent with the consensus in EITF Issue No. 98-8, "Accounting for Transfers of Investments That Are in Substance Real Estate." A question arises in such situations about how to determine the minimum down payment requirement of FASB Statement No. 66 for the investor. Specifically, the issue is whether the down payment requirement should be the relevant FASB Statement No. 66 percentage applied to the sales price of the equity interest sold, or whether it should be the investor's share of the down payment that would be required in a sale of the real estate itself. AcSEC selected the latter approach because it is consistent with the way in which a seller of real estate encumbered by debt would calculate the required down payment in a sale of the real estate in which the buyer assumed the debt.

SALES BY INVESTOR TO INVESTEE

A30. The concept that intercompany profit should be eliminated is well established in accounting literature and practice. For equity method investments, the requirement is set forth in paragraph 19(a) of APB Opinion 18: "Intercompany profits or losses should be eliminated until realized by the investor or investee as if a corporate joint venture or investee company were consolidated."

A31. AcSEC believes that HLBV should be used to determine the amount of intercompany profit that an investor needs to eliminate or defer when selling goods or services to an investee. In the past, the amount of profit to defer was thought of as being based on the investor's ownership interest in the investee. However, for the reasons previously discussed for rejecting the income-statement-oriented way of thinking, AcSEC believes that the balance-sheet-oriented HLBV methodology is more flexible and should be used to determine the amount of intercompany profit to defer.

CONTRIBUTIONS OF REAL ESTATE

A32. AcSEC's conclusion that an investor that contributes capital in the form of real estate to an investee should not recognize any gain upon such contribution is based on the view that such a transaction does not represent the culmination of the earnings process. That conclusion is consistent with the conclusion expressed in SOP 78-9.

A33. AcSEC also concluded that if a loss in value of real estate is indicated by an investor's contribution thereof to an investee, the entire loss in value should be recognized by the investor. This is based on an analogy to paragraph 22 of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, which says: "If a loss is indicated by the terms of a transaction…, the entire indicated loss on the exchange should be recognized."

EFFECTIVE DATE AND TRANSITION

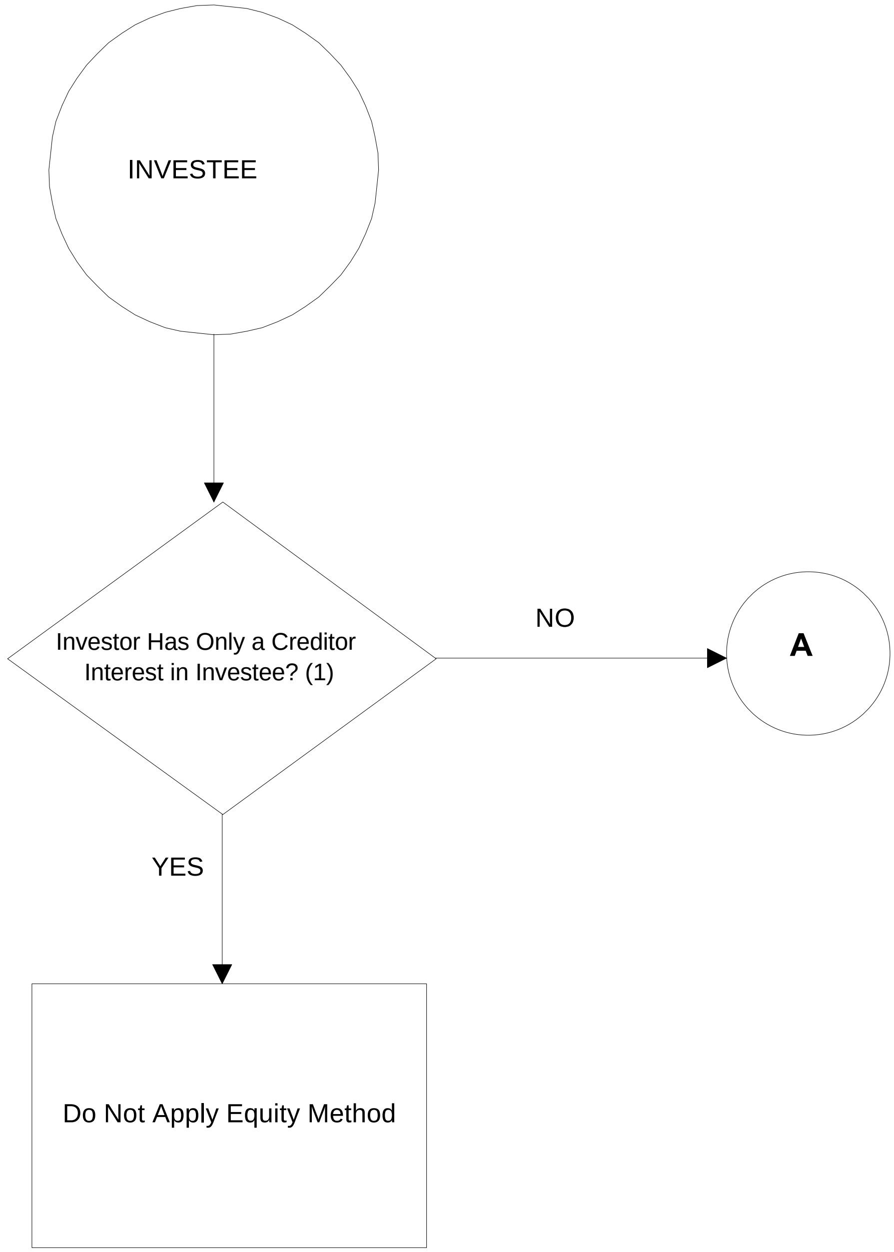
A34. AcSEC does not believe that the advantages of restating financial statements for the retroactive application of the provisions of this SOP would outweigh the disadvantages. Consequently, AcSEC concluded that the effect of adoption should be reflected as a cumulative effect adjustment.

APPENDIX B

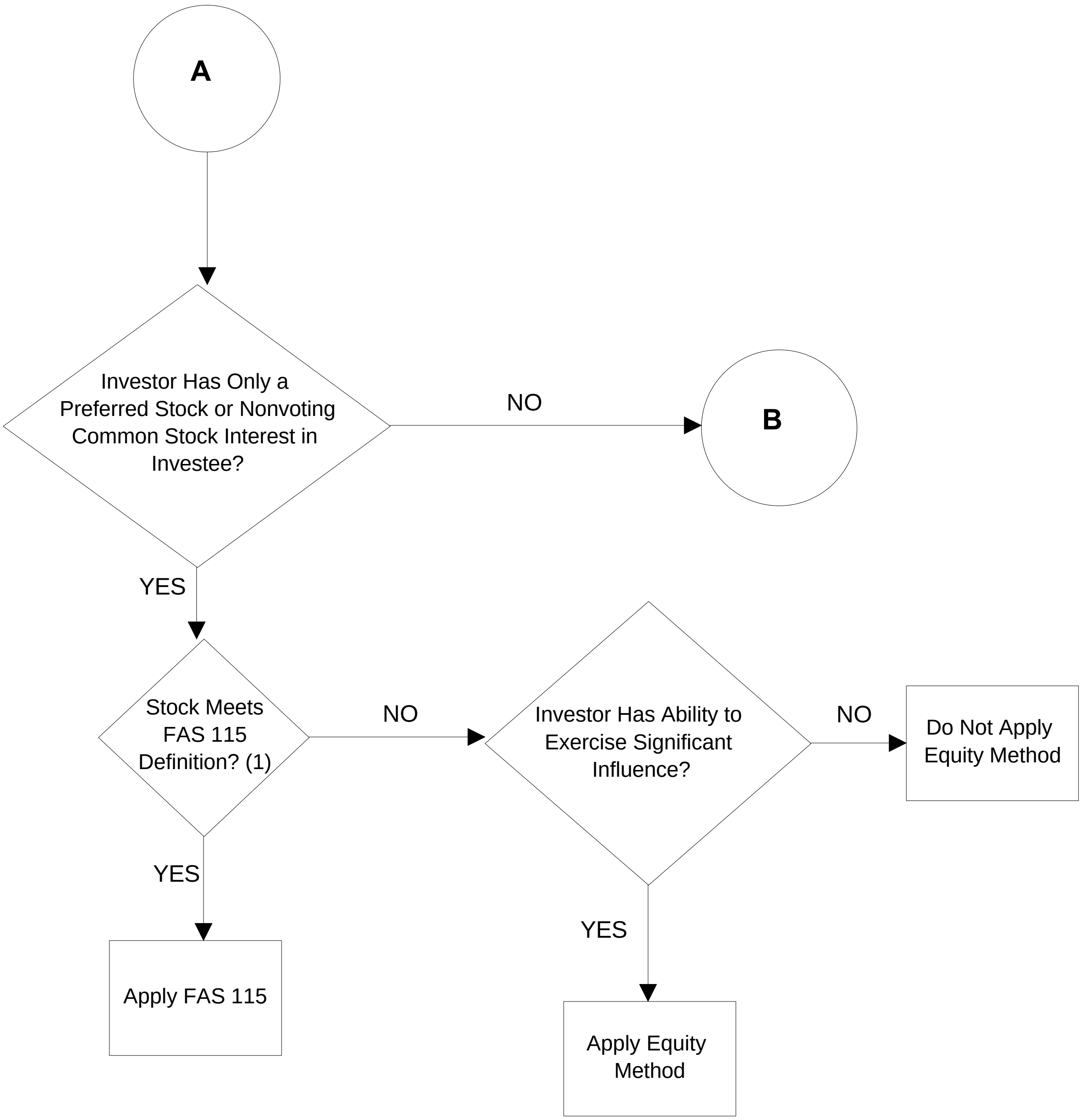
DECISION TREE

B1. The following decision tree is intended to provide an overview of the major provisions in this SOP that relate to when to apply the equity method. It should not be used without further reference to the SOP.

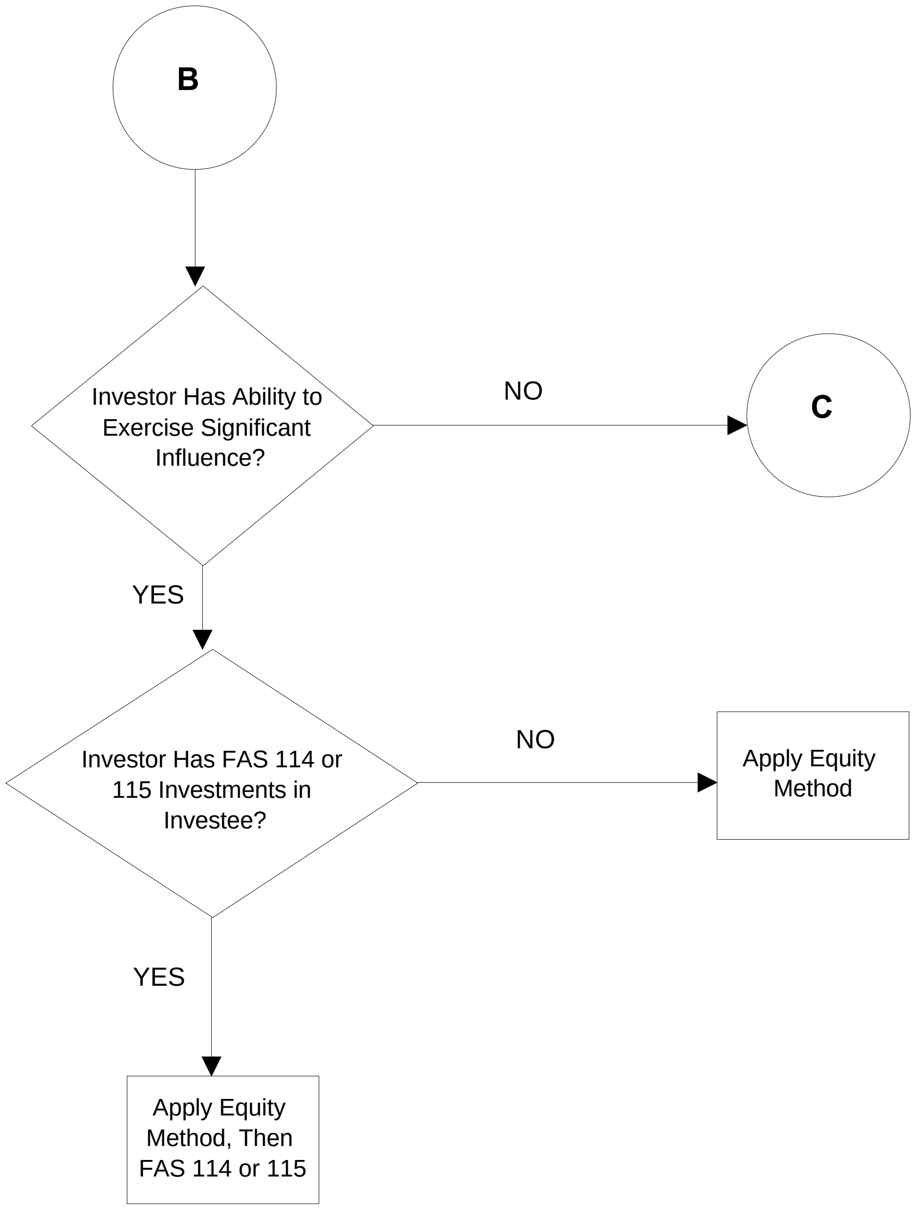
WHEN TO USE THE EQUITY METHOD

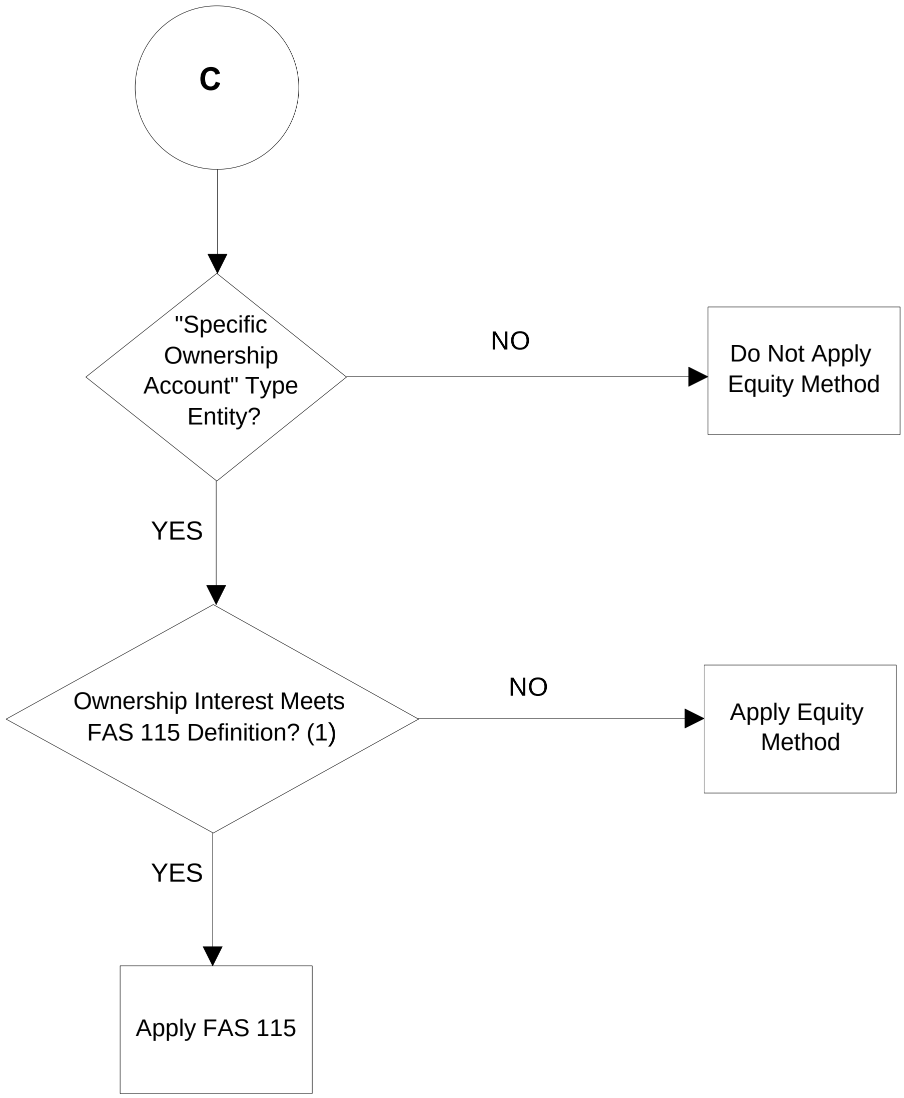


(1) A creditor interest includes redeemable preferred stock as defined in FASB Statement No. 115.



(1) Refers to definition in FASB Statement No. 115 of an equity security having a readily determinable fair value.


B
Investor Has Ability to Exercise Significant Influence?
NO
C
YES
Investor Has FAS 114 or 115 Investments in Investee?
NO
Apply Equity Method
YES
Apply Equity Method, Then FAS 114 or 115



(1) Refers to definition in FASB Statement No. 115 of an equity security having a readily determinable fair value.