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Accounting for income taxes : investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures); Opinions of the Accounting Principles Board 24; APB Opinion 24

American Institute of Certified Public Accountants. Accounting Principles Board

OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD

APRIL 1972

24

Accounting for Income Taxes

— Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)

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Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants

INTRODUCTION

1. In March 1971 the Accounting Principles Board issued APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* and stated that the guides in paragraph 16 of ARB No. 51, *Consolidated Financial Statements,* should apply in accounting for income taxes on income recognized by an investor in common stock of an investee company until the APB issued an Opinion on the special areas referred to in paragraphs 38 through 41 of Opinion APB No. 11, *Accounting for Income Taxes.* (See APB Opinion No. 23, *Accounting for Income Taxes — Special Areas.*)

2. The Board has examined the characteristics of the tax consequences of transactions in this area and sets forth in this Opinion its conclusion on appropriate accounting for taxes on income from investments in common stock accounted for by the equity method (other than subsidiaries and corporate joint ventures) in accordance with APB Opinion No. 18.

3. This Opinion applies to financial statements which purport to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. It does not apply to regulated industries in those circumstances meeting the standards described in the Addendum to APB Opinion No. 2, *Accounting for the "Investment Credit."*

DISCUSSION

4. The Board concluded in APB Opinion No. 18 that an investor should follow the equity method of accounting for an investment in common stock if the investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock.

5. Under the equity method of accounting for investments, an investor recognizes its share of the earnings or losses of an investee in the periods for which they are reported by the in-

vestee in its financial statements rather than in the period in which an investee declares a dividend or the period in which an investor liquidates its investment. A reasonable assumption is that a part or all of the earnings of an investee ultimately transferred to the investor or realized through the sale or liquidation of the investment will be taxable to the investor. Some believe that the assumed eventual tax consequences have the essential characteristics of a timing difference, and accordingly they would require interperiod tax allocation under the provisions of APB Opinion No. 11.

6. Others believe that the principles applicable to undistributed earnings of subsidiaries (paragraphs 9, 10, 11, 12 and 13) of APB Opinion No. 23 are equally applicable to undistributed earnings of investees (other than subsidiaries and corporate joint ventures) accounted for by the equity method and that income taxes should be provided only on the portion of undistributed earnings of an investee that represents a timing difference and not on the portion that available evidence indicates will be invested permanently or for an indefinite period. They emphasize that application of APB Opinion No. 18 is based on the presumption that the investor has the ability to exercise significant influence over the operating and financial policies of the investee, and accordingly they believe that the investor must necessarily be presumed to have the ability to exercise significant influence on the extent to which and manner in which the earnings of an investee will be remitted or invested. Under such circumstances, they believe that the investor is in a position to determine and substantiate the effect of probable future remittances which may require an accrual of income tax.

OPINION

7. The Board concludes that the tax effects of differences between taxable income and pretax accounting income attributable to an investor's share of earnings of investee companies (other than subsidiaries and corporate joint ventures) accounted for by the equity method in accordance with APB Opinion No. 18 are related either to probable future distributions of

dividends or to anticipated realization on disposal of the investment and therefore have the essential characteristics of timing differences. The Board believes that the ability of an investor to exercise significant influence over an investee differs significantly from the ability of a parent company to control investment policies of a subsidiary and that only control can justify the conclusion that undistributed earnings may be invested for indefinite periods.

8. The Board believes that the determination of whether an investor's equity in undistributed earnings of an investee will be realized in the form of dividends, will be realized by ultimate disposition of the investment, or a combination of both must be based on all facts and circumstances. If evidence indicates that an investor's equity in undistributed earnings of an investee will be realized in the form of dividends, an investor should recognize income taxes attributable to the timing difference as if the equity in earnings of the investee that the investor included in income were remitted as a dividend during the period, recognizing available dividend-received deductions and foreign tax credits. Income taxes of the investor company should also include taxes that would have been withheld if the undistributed earnings had been remitted as dividends. If evidence indicates that an investor's equity in undistributed earnings of an investee will be realized by ultimate disposition of the investment, an investor should accrue income taxes attributable to the timing difference at capital gains or other appropriate rates, recognizing all available deductions and credits.

9. The tax effect of a difference between taxable income and pretax accounting income attributable to losses of an investee should be accounted for in accordance with the Board's conclusions on operating losses in paragraphs 44 through 50 of APB Opinion No. 11.

10. *Change in Investment.* An investment in common stock of an investee (other than a subsidiary or corporate joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the in-

vestee acquires or retires common stock or other transactions affect the investment. Or, an investment in common stock of an investee may fall below the level of ownership necessary for the investor to have the ability to exercise significant influence over operating and financial policies of the investee because the investor sells a portion of the investment, the investee sells additional stock or other transactions affect the investment. If an investment in an investee increases so that it becomes a subsidiary, the deferred income taxes previously accrued by the investor in accordance with paragraphs 7 through 9 should be included in the income of the parent company only as dividends from the subsidiary are received in amounts which exceed the parent company's share of the earnings of the subsidiary subsequent to the date it became a subsidiary. Similarly, if an investment in the investee falls below the level of ownership necessary to enable the investor to follow the equity method of accounting, the deferred income taxes previously accrued by the investor should be included in the income of the former investor only as dividends from the former investee are received in amounts which exceed the former investor's allocable share of earnings of the former investee subsequent to the date it ceased to qualify as an investee. The amount of deferred income taxes of the investor attributable to its share of the equity in earnings of the investee company should be considered in accounting for a disposition through sale or other transaction that reduces the investment.

EFFECTIVE DATE

11. This Opinion shall be effective for all fiscal periods beginning after December 31, 1971. However, the Board encourages earlier application of the provisions of this Opinion.

12. The conclusions of the Board on accounting for income taxes on investments in common stock (other than subsidiaries and corporate joint ventures) represent a clarification of current practice. Accordingly, this Opinion should be applied retroactively to undistributed earnings applicable to investments (other than subsidiaries and corporate joint ventures) accounted

for by the equity method in accordance with APB Opinion No. 18. Adjustments resulting from a change in accounting method to comply with this Opinion should be treated as adjustments of prior periods, and financial statements presented for the periods affected should be restated.

The Opinion entitled "Accounting for Income Taxes — Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)" was adopted by the assenting votes of thirteen members of the Board, of whom one, Mr. Bevis, assented with qualification. Messrs. Hampton, Hayes, Hellerson, Horngren, and Watt dissented.

Mr. Bevis assents to the issuance of this Opinion because he believes that in most cases the results achieved are in substance equivalent to the application of the principles set forth in APB Opinion No. 11, *Accounting for Income Taxes.* However, he disagrees with the approach and the reasoning set forth in this Opinion because it implies the use of the "liability method" (see paragraph 8) of providing for deferred income taxes contrary to APB Opinion No. 11, and such implicit approval of the "liability method" is inappropriate in the absence of reconsideration of APB Opinion No. 11.

Messrs. Hampton, Hayes, Horngren, and Watt dissent to this Opinion because it requires provision for deferred taxes on undistributed earnings of investees (other than subsidiaries and corporate joint ventures) without regard to the circumstances and therefore in many cases will result in deferred tax credits that may never reverse and are mere contingencies. They concur with the view described in paragraph 6 that the principles applicable to undistributed earnings of subsidiary companies set forth in APB Opinion No. 23 are equally applicable to all companies accounted for by the equity method. They consider the distinction in paragraph 7 between significant influence and control, upon which the Board relies heavily for its major conclusion, to be illusory in this context, since an investor with significant influence would necessarily have knowledge of the plans of the investee company for investment of earnings and dividends.

Further, Mr. Watt believes that this Opinion should not have an effective date prior to its issuance but instead should have been effective for fiscal periods beginning after December 31, 1972 to allow a reasonable time for preparation of information necessary to implement the Opinion.

Mr. Hellerson dissents to this Opinion because he concurs with the view described in paragraph 6 that the principles applicable to undistributed earnings of subsidiaries and corporate joint ventures set forth in APB Opinion No. 23 are equally applicable to other companies accounted for by the equity method. In this connection reference is made to his qualified assent to APB Opinion No. 23.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

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