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Determining "Significant Influence" for Equity Method Investees
It's Not Just Owning 20% of the Stock

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Based on recent inquiries received by the CPEA related to equity-method investments, we have prepared this report covering how an investor determines whether it has the ability to exercise significant influence over the operating and financial policies of an investee and, therefore, apply the equity method of accounting. Too often, practitioners assume that significant influence automatically exists when an investor holds an investment of 20% or more of the voting stock of an investee. They fail to consider other factors that may indicate that significant influence does not exist. Similarly, practitioners automatically may assume that significant influence does not exist when an investor holds an investment of less than 20% of the voting stock on an investee. They fail to consider other factors that may indicate that significant influence does exist.

Practitioners are reminded to evaluate their client's equity method investments and consider if the client truly has the ability to exercise significant influence, beyond just a determination of whether the investor holds an investment of more or less than 20% of the voting stock of the investee. This report provides various sources of guidance to consider in making that evaluation.

Accounting Guidance on Significant Influence

FASB *Accounting Standards Codification* (FASB ASC) 323, *Investments--Equity Method and Joint Ventures*, requires that the equity method of accounting be used for an investment in common stock (and in-substance common stock) that gives the investor the *ability to exercise significant influence* over operating and financial policies of an investee even though the investor holds 50% or less of the common stock or in-substance common stock (or both common stock and in-substance common stock). FASB ASC 323-10-15-6 through FASB ASC 323-10-15-11 explains what significant influence means.

In particular, FASB ASC 323-10-15-8 indicates an investment (direct or indirect[1]) of 20% or more of the voting stock of an investee should lead to a presumption that, in the absence of predominant evidence to the contrary, an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.[2]

CPEA Observation: Some practitioners apply this "20% threshold" as the single factor in determining whether the equity method should or should not be applied and fail to consider evidence overcoming the 20% presumption. FASB ASC 323-10-15-7 indicates that determining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of each investment.

Partnerships, Unincorporated Joint Ventures, and Limited Liability Entities

In accordance with FASB ASC 323-30, investors in unincorporated entities such as partnerships and other unincorporated joint ventures generally should account for their investments using the equity method of accounting by analogy to FASB ASC 323-10 if the investor has the ability to exercise significant influence over the investee.

FASB ASC 970-323, *Real Estate – General, Investments – Equity Method and Joint Ventures*, specifically 970-323-25-3, indicates investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method.

FASB ASC 970-323-25-6 indicates the equity method of accounting for investments in general partnerships generally is appropriate for accounting by limited partners for their investments in limited partnerships. It also indicates that a limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation and, accordingly, the limited partner should account for its investment in accordance with FASB ASC 321, *Investments – Equity Securities*.

Practice Note: Although FASB ASC 970-323 applies to real estate ownership, in practice the guidance also is applied to investments that do not involve real estate ownership.

[1] Indirect investments can be held by an investor's other investees, such as investments through consolidated subsidiaries.
[2] FASB ASC 323-10-15-9 indicates that an investor's voting stock interest in an investee should be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges that may become available to holders of securities of an investee should be disregarded.

Equity Method for More Than 3-5% Ownership Investments in Limited Partnerships

Similar to the guidance in FASB ASC 970-323, SEC staff guidance, as provided in FASB ASC 323-30-S99-1, indicates the equity method of accounting should be used for investments in limited partnerships unless the investor's interest is so minor that the limited partner may have virtually no influence over partnership operating and financial policies. The SEC staff goes further and indicates that practice generally has viewed investments of more than 3-5% to be more than minor. Therefore, an investment in a limited partnership of more than 3-5% is considered to provide an investor with the ability to influence the operating and financial policies of the investee. This differs from the 20% threshold followed for applying the equity method to investments in the voting stock of an investee, as outlined in FASB ASC 323-10. SEC staff guidance is not applicable to nonpublic entities, however, in practice nonpublic entities look to this SEC staff guidance when determining whether the equity method is appropriate for investments in limited partnerships.

Limited Liability Companies (LLCs)

FASB ASC 323-30-35-3 indicates an investment in an LLC that maintains a specific ownership account for each investor—similar to a partnership capital account structure—should be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company should be accounted for in accordance with the guidance in FASB ASC 321 or the equity method.

Practice Note: LLCs are hybrid entities having characteristics of both partnerships and corporations. An investment in an LLC that maintains a specific ownership account for each investor would be viewed as an investment in a limited partnership when determining whether the investor has the ability to influence the operating and financial policies of the investee and whether the equity method should be applied (i.e., investors with investments of more than 3-5% would use the equity method). An investment in an LLC that does not maintain a specific ownership account for each investor would be viewed as an investment in a corporation when determining whether the investor has the ability to influence the operating and financial policies of the investee and whether the equity method should be applied (i.e., the 20% threshold would apply).

<u>Auditing Considerations Related to Significant Influence</u>[3]

Auditors have a responsibility to satisfy themselves with respect to the appropriateness of the equity method of accounting for investments. Inquiry should be made of the

[3] AU-C 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses auditing investments accounted for using the equity method of accounting. An investment accounted for under the equity method constitutes a component for purposes of AU-C 600.

investor's management as to (a) whether the investor has the ability to exercise significant influence over operating and financial policies of the investee under the criteria set forth in FASB ASC 323 and (b) the attendant circumstances which serve as a basis for management's conclusion. Auditors should consider the facts and circumstances of the investment, including the interaction of the investor with the investee, agreements between the investor and investee, and how much influence the investor has in the formulation of the agreements.

When an investor accounts for an investment in an investee contrary to the 20% threshold presumption, auditors should examine sufficient competent evidential matter to satisfy themselves that such presumption has been overcome.

Considerations Related to the Determination of Significant Influence

As indicated in FASB ASC 323-10-15-6, the ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

- Representation on the board of directors
- Participation in policy-making processes
- Material intra-entity transactions
- Interchange of managerial personnel
- Technological dependency
- Extent of ownership by an investor in relation to the concentration of other shareholdings (but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor)

Agreements, Relationships, Interests with the Investee

Considering the aforementioned guidance in FASB ASC 323 on determining significant influence, practitioners should consider the agreements (e.g., management/operating, licensing, supply) and relationships that exist between the investor and investee. Other interests, such as nonvoting interests, and cumulative dividends, that the investor has in the investee also should be considered. Those agreements, relationships, and interests may provide evidence about the existence or non-existence of significant influence over the investee.

Practice Note: Exercising significant influence over operating and financial policies of an investee does not mean that the investee will always follow the investor’s instructions. In addition, more than one investor can exercise significant influence over the operating and financial policies of an investee.

Indicators that an Investor may be Unable to Exercise Significant Influence

FASB ASC 323-10-15-10 indicates evidence that an investor owning 20% or more of the voting stock of an investee may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary. Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

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

Other Sources of Guidance for Determining Significant Influence

Below are some additional sources of guidance that help in the determination of whether significant influence over the operating and financial policies of an investee exists. Practitioners may find this guidance useful when making judgments in this area. Although SEC remarks are meant to apply to public company reporting, such guidance often can be informative when addressing non-public company financial reporting.

AICPA Technical Questions and Answers, Q&A Section 2220, *Long-Term Investments*

.01 Equity Method When Current Direct Ownership Less Than Twenty Percent

Inquiry — Company A purchased a 19% stock ownership interest in B. The company also made a loan to B that is convertible into stock of B and is secured by shares of C (B's subsidiary). For as long as the loan is outstanding, Company A will have several seats on B's board. The company also has options to purchase shares of C. Is the company required to report its investment in B under the equity method?

Reply — Paragraphs 6 and 8 of FASB Accounting Standards Codification (ASC) 323-10-15 state that the ability to exercise the type of influence contemplated in FASB ASC 323, *Investments — Equity Method and Joint Ventures*, may be indicated in several ways such as representation on the board of directors and investment (direct or indirect) of 20% or more in the voting stock of an investee.

The company would own only 19% of the outstanding voting stock. Although it is not indicated whether the conversion feature of the loan may result in ownership of 20% or more, or whether the board seats would allow A to significantly influence the voting at meetings of B's board of directors, the overall impact of the proposed transaction could demonstrate that the company has the ability to exercise significant influence over the investee. Therefore, the equity method should be followed in accounting for the investment.

Securities and Exchange Commission (SEC) 1999 Remarks[4]

When considering whether the application of the equity method of accounting is required for an investment in common stock, the staff has evaluated:

- The nature and significance of the investments, in any form, made in the investee. The staff does not consider the difference between a 20 percent common stock investment versus a 19.9 percent investment to be substantive...In addition, the staff will consider whether the investor has other forms of investments or advances, such as preferred or debt securities, in the investee in determining whether significant influence results.
- The capitalization structure of the investee. The analysis would consider whether the investee effectively is being funded by common or non-common stock investments and how critical the investments made by the investor are to the investee's capitalization structure (e.g., is the investor the sole funding source).
- Voting rights, veto rights, and other protective and participating rights held by the investor. The greater the ability of the investor to participate in the financial, operating, or governance decisions made by the investee, via any form of governance rights, the greater the likelihood that significant influence exists.
- Participation on the investee's board of directors (or equivalent), whether through contractual agreement or not. The staff will consider, in particular, whether any representation is disproportionate to the investment held. For example, an investor that is contractually granted 2 of 5 board seats, coupled with a 15 percent common stock investment, will likely be viewed to have significant influence over the investee.

[4] Remarks by Paul R. Kepple, Professional Accounting Fellow, Office of the Chief Accountant, SEC; AICPA Conference on Current SEC Developments, December 7, 1999

- Other factors as described in full in FASB ASC 323-10-15-10.

SEC Staff Remarks before the 2020 AICPA Conference on Current SEC and PCAOB Developments

Consider a fact pattern presented to SEC' Office of the Chief Accountant (OCA) staff:

Entity A evaluated whether it had significant influence over an investee in which it held less than 20% of the outstanding voting stock. Additional facts:

- Entity A was a party to a contractual agreement with certain other investors to vote in concert with respect to electing members to the board of directors.
- The aggregation of the voting stock among the group provided the group with the ability to directly appoint specified individuals to the board of directors, and the specified individuals comprised the majority of the board and included representatives from Entity A.
- Without Entity A's contribution or input, the aggregate vote encompassed by the contractual agreement would not have been sufficient to guarantee the appointment of the specified individuals to the board of directors.
- In addition to this contractual right that it shared with other parties, Entity A shared various at-will managerial personnel with the investee pursuant to separate employment agreements and had access to confidential information of the investee pursuant to certain informal arrangements.

Entity A evaluated the factors that could indicate the existence of significant influence and concluded that, because Entity A did not have a contractual right on its own to place representation on the board of directors or contractual rights related to any of the other indicators, it did not meet the requirements for applying the equity method of accounting.

Based on the total mix of information presented in this fact pattern, OCA staff objected to Entity A's conclusion that it did not have significant influence over the investee.

Correspondence Between the SEC Division of Corporate Finance and APPlife Digital Solutions Inc. (December 26, 2018)

SEC staff comment**:** We note that you entered into an agreement to purchase 21% of Smartrade for $450,000 in various tranches based on defined milestones and you agreed to purchase an additional 3% of the total common stock. We further note that you hold one of five seats on the Board of Directors and you are the exclusive marketing and development partner for Smartrade. These factors suggest that you have the ability to exercise significant influence over Smartrade. In this regard, tell us why this investment is being accounted for as a cost investment instead of applying the equity method.

APPlife Digital Solutions Inc. response: In connection with the Company's investment in Smartrade, the Company obtained a right to appoint one member to the board of Smartrade which is contemplated to consist of five board members. However, through the date of this letter, Smartrade has not established a formalized board of directors and the powers of the board of directors have not been defined. Smartrade is currently managed by its CEO, CFO and COO who collectively own approximately 56% of Smartrade and have the authority to make all decisions in the ordinary course of business. There is no legal agreement that specifies the role of the board in making decisions at Smartrade and there is no list of matters which require board approval that the Company can meaningfully participate in. Further, the other four board members include the CEO, CFO, COO and an investor but details such as timing, frequency, quorum and voting rights of members at board meetings have not been defined and no voting structures that have been determined. Therefore, it is unclear whether the Company will have the ability to vote and participate meaningfully at such meetings if they occur.

Based on these facts, the Company considered the guidance in ASC 323-10-15-6 to assess if it has the ability to exercise significant influence over the operating and financial policies of Smartrade. Absent a formalized governance document and structure that allows the Company to participate meaningfully in financial and operating matters of Smartrade, the Company does not have the ability to participate in or influence such decisions. Therefore, the Company concluded that merely by virtue of its board seat it does not have significant influence over Smartrade.

Further, as part of its investment, the Company also has the right to approve any material changes to Smartrade's branding and marketing strategy in the cryptocurrency mining and exchange procedures. The Company evaluated this right and determined that the right is akin to a protective right since only material changes outside the ordinary course of business require the Company's approval. The Company does not view this right to be participative in nature and therefore concluded that this right does not constitute significant influence over the financial and operating activities of Smartrade. The CPEA did not locate any further SEC correspondence on this matter.