A company can report unrealized gains and losses in one of two ways: (1) in net income of the period or (2) in net income for unrealized gains and losses on trading securities and as part of equity for “nontrading” securities. Note that the only significant difference between the provisions of IAS 39 and those of FASB Statement No. 115 is in the reporting of unrealized gains and losses. Under IAS 39, a company can choose the same treatment required under Statement No. 115, in which unrealized gains and losses on trading securities are recognized as part of net income but those on available-for-sale securities are recognized as part of stockholders’ equity, or a company can elect to recognize all unrealized gains and losses as part of net income. Thus, it appears that the provisions of Statement No. 115, adopted in the United States in 1993, have now become the accepted international benchmark.

In this section of the chapter, we deal with two variations of topics previously discussed. While changes in the classification of securities associated with FASB Statement No. 115 might be common, changes to and from the equity method are less common—and can be more complex. We discuss the complexities in this expanded material. In addition, to this point in the chapter we have talked about securities for which there is a tradeable market. In some instances, a company may invest in another firm in the form of a nonmarketable security. The most common example of this type of security would be a loan. In this expanded material we deal with the most complex issue associated with these nonmarketable securities—impairment.

### CHANGES IN CLASSIFICATION INVOLVING THE EQUITY METHOD

Variations in percentage of ownership caused by additional purchases or sales of stock by the investor or by the additional sale or retirement of stock by the investee may require a change in accounting method. For example, if the equity method has been used but subsequent events reduce the investment ownership below 20%, a change should be made to account for the security using the cost method, as either an available-for-sale or trading security, effective for the year when the reduced ownership occurs. Similarly, if the security had been accounted for as a trading or available-for-sale security, that is, the cost method is being used, but subsequent acquisitions increase the investment ownership to 20% or more, a change should be made to the equity method. The required accounting is different depending on whether the change is from or to the equity method.

#### A Change From the Equity Method

If an investment in equity securities has been accounted for under the equity method but circumstances dictate that a change in the security’s classification is necessary, no adjustment to the investment account is needed. At the time of change, the carrying amount of
the investment, as determined by the equity method for prior years, becomes the new basis when reclassifying the security. From that time forward, the investment account would not be adjusted for a proportionate share of investee earnings nor would any adjustments be made for additional depreciation or amortization of undervalued or unrecorded assets. Dividends received would be credited to a revenue account, not the investment account. Thus, once the equity method is no longer appropriate, the security is reclassified and accounted for using the cost method, as either a trading or available-for-sale security.

A Change to the Equity Method

Accounting for a change to the equity method is more complex. A retroactive adjustment is required for prior years to reflect the income that would have been reported using the equity method. This adjustment modifies the carrying value of the investment, in effect restating it on an equity basis, as if the equity method had been used during the previous periods that the investment was held. The offsetting entry for the adjustment is to Retained Earnings. From the date of change forward, the equity method is applied normally.

To illustrate, assume that MTI Corporation acquired stock of Excellcior Inc. over the three-year period 2000–2002 and originally accounted for the stock as available-for-sale. Purchase, dividend, and income information for these years are as follows (the purchases were made on the first day of each year):

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage Ownership Acquired</th>
<th>Purchase Price*</th>
<th>Excellcior Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Dividends Paid</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Dec. 31</td>
</tr>
<tr>
<td>2000</td>
<td>10</td>
<td>$ 50,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>2001</td>
<td>5</td>
<td>30,000</td>
<td>120,000</td>
</tr>
<tr>
<td>2002</td>
<td>15</td>
<td>117,000</td>
<td>180,000</td>
</tr>
</tbody>
</table>

*Purchase price is equal to underlying book value at date of purchase.

The following entries would be made on the books of MTI Corporation to reflect the securities being classified as available-for-sale for the years 2000 and 2001:

2000
Jan. 1 Investment in Available-for-Sale Securities ................................................. 50,000
Cash........................................................................................................ 50,000
To record purchase of 10% interest.

Dec. 31 Cash.............................................................................................................. 10,000
Dividend Revenue................................................................................... 10,000
To record receipt of dividends from Excellcior Inc. (10% × $100,000).

2001
Jan. 1 Investment in Available-for-Sale Securities ................................................. 30,000
Cash........................................................................................................ 30,000
To record purchase of 5% interest. (Total ownership interest is now 15%)

Dec. 31 Cash.............................................................................................................. 18,000
Dividend Revenue................................................................................... 18,000
To record receipt of dividends from Excellcior Inc. (15% × $120,000).

The additional acquisition of stock at the beginning of 2002 increases ownership to 30%, and a retroactive adjustment to change to the equity method must be made at the time of acquisition. The adjustment is for the difference between the revenue reported using the cost method and that which would have been reported if the equity method had been used. The adjustment would be computed as follows:
The following entries would be made on the books of MTI Corporation to reflect the equity method for 2002:

2002
Jan. 1  Investment in Excellcior Inc. Stock ....................................................... 197,000
       Cash ........................................................................................................ 117,000
Investment in Available-for-Sale Securities .............................................................. 80,000
       To record purchase of 15% interest and reclassify securities.
       (Total ownership interest is now 30%.)
Jan. 1  Investment in Excellcior Inc. Stock ............................................................... 37,000
       Retained Earnings .................................................................................. 37,000
       To retroactively reflect revenue for 2000 and 2001 for investment in Excellcior Inc. as if the equity method had been used.
Dec. 31 Investment in Excellcior Inc. Stock ............................................................... 120,000
       Income From Investment in Excellcior Inc. Stock ................................... 120,000
       To record 30% of income earned by Excellcior Inc. using equity method.
Dec. 31  Cash .............................................................................................................. 54,000
       Investment in Excellcior Inc. Stock ......................................................... 54,000
       To record receipt of dividend from Excellcior Inc. using equity method (30% × $180,000).

Note that in this example the retroactive adjustment restates the investment account to an equity basis. From that point on, the equity method is applied in a normal manner. For simplicity, the illustration assumed a purchase price equal to the underlying book value at date of purchase. If this were not the case, an adjustment to income for depreciation and amortization would be needed as discussed in an earlier section of this chapter.