



# The Equity Method of Accounting: How Minority Stakes in Other Companies Work on the Financial Statements

Net Income, Dividends, and Confusing Gains and Losses



**30%**

# Equity Investments: Say What?!

*“Can you explain how the accounting for Equity Investments or Associate Companies works?”*

*Where do Net Income and Dividends go? What happens if a company changes its ownership percentage? What about Unrealized Gains and Losses?”*

# Equity Method Accounting: The Short Answer

- **Why:** Used when one company has “significant influence,” but not control, over another company (e.g., 20-50% ownership stake)
- **Basic Idea:** Parent Co. records Sub Co. Ownership Percentage \* Sub Co.’s Net Income on its Income Statement under “Equity Investment Earnings” or a similar name
- **Then:** Parent Co. will reverse that item on its CFS and record Sub Co. Ownership Percentage \* Sub Co.’s Dividends as a positive on its CFS; both items link into Equity Investments on the BS
- **Changing Ownership Percentage:** This gets tricky to explain, so let’s start with the basics in Excel first...



# Part 1: Basic Minority-Stake Deal

- **Assumptions:** Need the Sub Co.'s Market Cap and the percentage we want to acquire, as well as both companies' statements
- **Cash Flow Statement:** Record this acquisition as a cash outflow in Cash Flow from Investing, with Debt Issued below it in CFF
- **Balance Sheet:** Link the Equity Investment line item to all the Equity Investment-related items on the CFS (Gains/Losses, Purchases/Sales, Net Income, and Dividends)
- **IS / CFS:** Record Sub Co. Ownership Percentage in Period \* Sub Co. Net Income on the IS, New Interest Expense, and Ownership Percentage \* Sub Co. Dividends on the CFS



# Part 2: Changing the Ownership Stake

- **Constraint:** We're going to **limit** the ownership percentage to 49%, at most, because above that, the accounting changes and gets much more complicated
- **Assumptions:** Need the Sub Co.'s Market Cap and the new Ownership Percentage in each year (end-of-year changes only)
- **Easy Part:** Percentage Change in Equity Investments and the Change in the Equity Investment Dollar Amount ( $\text{Market Cap} * \% \text{ Change}$ )
- **Harder:** If the Parent Co.'s stake in the Sub Co. *decreases*, it sold some of its stake... which means we need to calculate the Realized Gain or Loss on it (Unrealized Gains/Losses do not show up)



# Part 2: Changing the Ownership Stake

- **First:** Calculate the Cost Basis right before the change, i.e.,  
Old Equity Investments – Equity Investment Earnings – Equity Investment Dividends
- **Formula:**  $=IF(\text{Percentage Change is Negative}, (\text{Sub Co. Market Cap} * \text{Previous Ownership Percentage} - \text{Cost Basis}) * -\text{Percentage Change} / \text{Previous Ownership Percentage}, 0)$
- **Logic:** We cannot possibly have a Gain or Loss if the Ownership Percentage has *increased*, so check that part first; if the percentage change is  $\geq 0$ , set the Gain/Loss to 0



# Part 2: Changing the Ownership Stake

- **Logic, Continued:** Next part is easiest to understand with a specific example... let's say the Sub Co. Market Cap is \$150, Previous Ownership % is 30%, Cost Basis is \$30, and New Ownership % is 15%
- **So:**  $\$150 * 30\% = \$45$ , and, therefore, the Total Gain or Loss is  $\$45 - \$30 = \$15$
- **BUT** we don't necessarily sell the entire investment!
- **Last Part:** Adjusts for this, so if we're selling just 15%,  $15\% / 30\% = 50\%$ , so the Gain is  $\$15 * 50\% = \$7.5$  instead

# Part 2: Changing the Ownership Stake

- **Linking the Statements:** Realized Gains and Losses always appear on the IS and are reversed on the CFS
- **Cash Flow from Investing:** The Purchase / Sale of Equity Investments line item handles the rest – that, plus the Gain or Loss, equals the change in the Equity Investment line item
- **Testing:** Try different Ownership Percentages, Market Caps, Debt/Cash splits, etc., to test this model





# Recap and Summary

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- **Then:** Parent Co. reverses that item on its CFS and records Sub Co. Ownership Percentage \* Sub Co.’s Dividends as a positive; both items link into Equity Investments on the BS
- **Changing Ownership Percentage:** Calculate the Cost Basis...



# Recap and Summary

- **Gain or Loss Formula:** =IF(Percentage Change is Negative, (Sub Co. Market Cap \* Previous Ownership Percentage – Cost Basis) \* –Percentage Change / Previous Ownership Percentage, 0)
- **Why:** Adjusts for the fact that the company might sell only *part of* its stake, not the entire investment, and reduces the Gain or Loss proportionally

