Chapter 1

the equity method of accounting for investments

# Chapter Outline

1. Three methods are principally used to account for an investment in equity securities along with a fair value option.
2. Fair value method: applied by an investor when only a small percentage of a company’s voting stock is held.
3. Income is recognized when the investee declares a dividend.
4. Portfolios are reported at fair value. If fair values are unavailable, investment is reported at cost.
5. Consolidation: when one firm controls another (e.g., when a parent has a majority interest in the voting stock of a subsidiary or control through variable interests, their financial statements are consolidated and reported for the combined entity.
6. Equity method: applied when the investor has the ability to exercise significant influence over operating and financial policies of the investee.
7. Ability to significantly influence investee is indicated by several factors including representation on the board of directors, participation in policy-making, etc.
8. GAAP guidelines presume the equity method is applicable if 20 to 50 percent of the outstanding voting stock of the investee is held by the investor.

Current financial reporting standards allow firms to elect to use fair value for any new investment in equity shares including those where the equity method would otherwise apply. However, the option, once taken, is irrevocable. Investee dividends and changes in fair value over time are recognized as income.

On February 14, 2013, the FASB issued a Proposed Accounting Standards Update (ASU) entitled, Recognition and Measurement of Financial Assets and Financial Liabilities. The proposed ASU would eliminate the fair-value option for investments that qualify for equity method treatment. Fair-value accounting, however, would be extended to “equity method” investments that meet the criteria for classification as held for sale.

1. Accounting for an investment: the equity method
2. The investment account is adjusted by the investor to reflect all changes in the equity of the investee company.
3. Income is accrued by the investor as soon as it is earned by the investee.
4. Dividends declared by the investee create a reduction in the carrying amount of the Investment account. The text assumes all investee dividends are declared and paid in the same reporting period.
5. Special accounting procedures used in the application of the equity method
6. Reporting a change to the equity method when the ability to significantly influence an investee is achieved through a series of acquisitions.
7. Initial purchase(s) will be accounted for by means of the fair value method (or at cost) until the ability to significantly influence is attained.
8. At the point in time that the equity method becomes applicable, a retrospective adjustment is made by the investor to convert all previously reported figures to the equity method based on percentage of shares owned in those periods.
9. This restatement establishes financial statement comparability across years.
10. Investee income from other than continuing operations
11. The investor recognizes its share of investee reported other comprehensive income (OCI) through the investment account and the investor’s own OCI.
12. Income items such as extraordinary gains and losses and discontinued operations that are reported separately by the investee should be shown in the same manner by the investor. The materiality of these other investee income elements (as it affects the investor) continues to be a criterion for separate disclosure.
13. Investee losses
14. Losses reported by the investee create corresponding losses for the investor.
15. A permanent decline in the fair value of an investee’s stock should be recognized immediately by the investor as an impairment loss.
16. Investee losses can possibly reduce the carrying value of the investment account to a zero balance. At that point, the equity method ceases to be applicable and the fair-value method is subsequently used.

Reporting the sale of an equity investment

1. The investor applies the equity method until the disposal date to establish a proper book value.
2. Following the sale, the equity method continues to be appropriate if enough shares are still held to maintain the investor’s ability to significantly influence the investee. If that ability has been lost, the fair-value method is subsequently used.
3. Excess investment cost over book value acquired

A. The price an investor pays for equity securities often differs significantly from the investee’s underlying book value primarily because the historical cost based accounting model does not keep track of changes in a firm’s fair value.

B. Payments made in excess of underlying book value can sometimes be identified with specific investee accounts such as inventory or equipment.

C. An extra acquisition price can also be assigned to anticipated benefits that are expected to be derived from the investment. In accounting, these amounts are presumed to reflect an intangible asset referred to as goodwill. Goodwill is calculated as any excess payment that is not attributable to specific assets and liabilities of the investee. Because goodwill is an indefinite-lived asset, it is not amortized.

1. Deferral of unrealized gross profit in inventory
2. Profits derived from intra-entity transactions are not considered completely earned until the transferred goods are either consumed or resold to unrelated parties.
3. Downstream sales of inventory
4. “Downstream” refers to transfers made by the investor to the investee.
5. Intra-entity gross profits from sales are initially deferred under the equity method and then recognized as income at the time of the inventory’s eventual disposal.
6. The amount of gross profit to be deferred is the investor’s ownership percentage multiplied by the markup on the merchandise remaining at the end of the year.
7. Upstream sales of inventory
8. “Upstream” refers to transfers made by the investee to the investor.
9. Under the equity method, the deferral process for unrealized profits is identical for upstream and downstream transfers. The procedures are separately identified in Chapter One because the handling does vary within the consolidation process.

**Answers to Discussion Questions**

The textbook includes discussion questions to stimulate student thought and discussion. These questions are also designed to allow students to consider relevant issues that might otherwise be overlooked. Some of these questions may be addressed by the instructor in class to motivate student discussion. Students should be encouraged to begin by defining the issue(s) in each case. Next, authoritative accounting literature (FASB ASC) or other relevant literature can be consulted as a preliminary step in arriving at logical actions. Frequently, the FASB Accounting Standards Codification will provide the necessary support.

Unfortunately, in accounting, definitive resolutions to financial reporting questions are not always available. Students often seem to believe that all accounting issues have been resolved in the past so that accounting education is only a matter of learning to apply historically prescribed procedures. However, in actual practice, the only real answer is often the one that provides the fairest representation of the a firm’s transactions. If an authoritative solution is not available, students should be directed to list all of the issues involved and the consequences of possible alternative actions. The various factors presented can be weighed to produce a viable solution.

The discussion questions are designed to help students develop research and critical thinking skills in addressing issues that go beyond the purely mechanical elements of accounting.

***Did the Cost Method Invite Manipulation?***

The cost method of accounting for investments often caused a lack of objectivity in reported income figures. With a large block of the investee’s voting shares, an investor could influence the amount and timing of the investee’s dividend declarations. Thus, when enjoying a good earnings year, an investor might influence the investee to withhold declaring a dividend until needed in a subsequent year. Alternatively, if the investor judged that its current year earnings “needed a boost,” it might influence the investee to declare a current year dividend. The equity method effectively removes managers’ ability to increase current income (or defer income to future periods) through their influence over the timing and amounts of investee dividend declarations.

At first glance it may seem that the fair value method allows managers to manipulate income because investee dividends are recorded as income by the investor. However, dividends paid typically are accompanied by a decrease in fair value (also recognized in income), thus leaving reported net income unaffected.

***Does the Equity Method Really Apply Here?***

The discussion in the case between the two accountants is limited to the reason for the investment acquisition and the current percentage of ownership. Instead, they should be examining the actual interaction that currently exists between the two companies. Although the ability to exercise significant influence over operating and financial policies appears to be a rather vague criterion, ASC 323"Investments—Equity Method and Joint Ventures," clearly specifies actual events that indicate this level of authority (paragraph 323-10-15-6):

Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy‑making processes, material intra-entity transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the 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 company by another investor does not necessarily preclude the ability to exercise significant influence by the investor.

In this case, the accountants would be wise to determine whether Dennis Bostitch or any other member of the Highland Laboratories administration is participating in the management of Abraham, Inc. If any individual from Highland's organization is on Abraham’s board of directors or is participating in management decisions, the equity method would seem to be appropriate. Likewise, if significant transactions have occurred between the companies (such as loans by Highland to Abraham), the ability to apply significant influence becomes much more evident.

However, if James Abraham continues to operate Abraham, Inc., with little or no regard for Highland, the equity method should not be applied. This possibility seems especially likely in this case since one stockholder, James Abraham, continues to hold a majority (2/3) of the voting stock. Thus, evidence of the ability to apply significant influence must be present before the equity method is viewed as applicable. The mere holding of 1/3 of the stock is not conclusive.

**Answers to Questions**

1. The equity method should be applied if the ability to exercise significant influence over the operating and financial policies of the investee has been achieved by the investor. However, if actual control has been established, consolidating the financial information of the two companies will normally be the appropriate method for reporting the investment.
2. According to FASB ASC paragraph 323-10-15-6 "Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy‑making processes, material intra-entity transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the extent of ownership of other shareholdings." The most objective of the criteria established by the Board is that holding (either directly or indirectly) 20 percent or more of the outstanding voting stock is *presumed* to constitute the ability to hold significant influence over the decision‑making process of the investee.
3. The dividends are reported as a deduction from the investment account, not revenue, to avoid reporting the income from the investee twice. The equity method is appropriate when an investor has the ability to exercise significant influence over the operating and financing decisions of an investee. Because dividends represent financing decisions, the investor may have the ability to influence dividend timing. If dividends were recorded as income, managers could affect reported income in a way that does not reflect actual performance. Therefore, in reflecting the close relationship between the investor and investee, the equity method employs accrual accounting to record income as it is earned by the investee. The investment account is increased for the investee”s earned income and then decreased as the income is distributed, through dividends. From the investor’s view, the decrease in the investment asset (from investee dividends) is offset by an immediate increase in dividends receivable and an eventual increase in cash.
4. If Jones cannot significantly influence the operating and financial policies of Sandridge, the equity method should not be applied regardless of the ownership level. However, an owner of 25 percent of a company's outstanding voting stock is assumed to possess this ability. This presumption stands until overcome by predominant evidence to the contrary.

Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include (ASC 323-10-15-10):

1. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.
2. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.
3. 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.
4. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
5. The investor tries and fails to obtain representation on the investee's board of directors.

5. The following events necessitate changes in this investment account.

1. Net income earned by Watts would be reflected by an increase in the investment balance whereas a reported loss is shown as a reduction to that same account.
2. Dividends declared by the investee decrease its book value, thus requiring a corresponding reduction to be recorded in the investment balance.
3. If, in the initial acquisition price, Smith paid extra amounts because specific investee assets and liabilities had values differing from their book values, amortization of this portion of the investment account is subsequently required. As an exception, if the specific asset is land or goodwill, amortization is not appropriate.
4. Intra-entity gross profits created by sales between the investor and the investee must be deferred until earned through usage or resale to outside parties. The initial deferral entry made by the investor reduces the investment balance while the eventual recognition of the gross profit increases this account.

6. The equity method has been criticized because it allows the investor to recognize income that may not be received in any usable form during the foreseeable future. Income is being accrued based on the investee's reported earnings, not on the investor’s share of investee dividends. Frequently, equity income will exceed the investor’s share of investee cash dividends with no assurance that the difference will ever be forthcoming.

Many companies have contractual provisions (e.g., debt covenants, managerial compensation contracts) based on ratios in the main body of the financial statements. Relative to consolidation, a firm employing the equity method will report smaller values for assets and liabilities. Consequently, higher rates of return for its assets and sales, as well as lower debt-to-equity ratios may result. Meeting such contractual provisions of may provide managers incentives to maintain technical eligibility for the equity method rather than full consolidation.

*7.* FASB ASC Topic 323 requires that a change to the equity method be reflected by a retrospective adjustment. Although a different method may have been appropriate for the original investment, comparable balances will not be readily apparent if the equity method is now applied. For this reason, financial figures from all previous years presented are restated as *if* the equity method had been applied consistently since the date of initial acquisition.

8. In reporting equity earnings for the current year, Riggins must separate its accrual into two components: (1) net income and (2) other comprehensive income or loss. This handling enables the reader of the investor's financial statements to assess the nature of the change to the investment account.

9. Under the equity method, losses are recognized by an investor at the time that they are reported by the investee. However, because of the conservatism inherent in accounting, any permanent losses in value should also be recorded immediately. Because the investee's stock has suffered a permanent impairment in this question, the investor recognizes the loss applicable to its investment.

10. Following the guidelines established by the ASC, Wilson would recognize an equity loss of $120,000 (40 percent) stemming from Andrews' reported loss. However, since the book value of this investment is only $100,000, Wilson's loss is limited to that amount with the remaining $20,000 being omitted. Subsequent income will be recorded by the investor based on investee dividends. If Andrews is ever able to generate sufficient future profits to offset the total unrecognized losses, the investor will revert to the equity method.

11. In accounting, goodwill is derived as a residual figure. It is the investor's cost in excess of its share of the fair value of the investee assets and liabilities. Although a portion of the acquisition price may represent either goodwill or valuation adjustments to specific investee assets and liabilities, the investor records the entire cost in a single investment account. No separate identification of the cost components is made in the reporting process. Subsequently, the cost figures attributed to specific accounts (having a limited life), besides goodwill and other indefinite life assets, are amortized based on their anticipated lives. This amortization reduces the investment and the accrued income in future years.

12. On June 19, Princeton removes the portion of this investment account that has been sold and recognizes the resulting gross profit or loss. For proper valuation purposes, the equity method is applied (based on the 40 percent ownership) from the beginning of Princeton's fiscal year until June 19. Princeton's method of accounting for any remaining shares after June 19 will depend upon the degree of influence that is retained. If Princeton still has the ability to significantly influence the operating and financial policies of Yale, the equity method continues to be appropriate based on the reduced percentage of ownership. Conversely, if Princeton no longer holds this ability, the fair‑value method becomes applicable, based on the remaining equity value after the sale.

13. Downstream sales are made by the investor to the investee while upstream sales are from the investee to the investor. These titles have been derived from the traditional positions given to the two parties when presented on an organization‑type chart. Under the equity method, no accounting distinction is actually drawn between downstream and upstream sales. Separate presentation is made in this chapter only because the distinction does become significant in the consolidation process as will be demonstrated in Chapter Five.

14. The unrealized portion of an intra-entity gross profit is computed based on the markup on any transferred inventory retained by the buyer at year's end. The markup percentage (based on sales price) multiplied by the intra-entity ending inventory gives the seller’s profit remaining in the buyer’s ending inventory. The product of the ownership percentage and this profit figure is the unrealized gross profit from the intra-entity transaction. This profit is deferred in the recognition of equity earnings until subsequently earned through use or resale to an unrelated party.

15. Intra-entity transfers do not affect the financial reporting of the investee except that the related party transactions must be appropriately disclosed and labeled.

16. Under fair value accounting, firms report the investment’s fair value as an asset and changes in fair value as earnings. Dividends from an investee are included in earnings under the fair value accounting. Dividends are not recognized in income but instead reduce the investment account under the equity method. Also, under the equity method, firms recognize their ownership share of investee profits adjusted for excess cost amortizations and intra-entity profits.

# Answers to Problems

1. **D**
2. **B**
3. **C**
4. **B**
5. **D**
6. **A Acquisition price $1,600,000**

**Equity income ($560,000 × 40%) 224,000**

**Dividends (50,000 shares × $2.00) (100,000)**

**Investment in Harrison Corporation as of December 31 $1,724,000**

**7. A Acquisition price $700,000**

**Income accruals: 2014—$170,000 × 20% 34,000**

**2015—$210,000 × 20% 42,000**

**Amortization (see below): 2014 (10,000)**

**Amortization: 2015 (10,000)**

**Dividends: 2014—$70,000 × 20% (14,000)**

**2015—$70,000 × 20% (14,000)**

**Investment in Martes, December 31, 2015 $728,000**

**Acquisition price of Martes $700,000**

**Acquired net assets (book value) ($3,000,000 × 20%) (600,000)**

#### Excess cost over book value to patent $100,000

**Annual amortization (10 year remaining life) $10,000**

**8. B Purchase price of Johnson stock $500,000**

**Book value of Johnson ($900,000 × 40%) (360,000)**

**Cost in excess of book value $140,000**

***Remaining*  *Annual***

**Payment identified with undervalued *life amortization***

**Building ($140,000 × 40%) 56,000 7 yrs. $8,000**

**Trademark ($210,000 × 40%) 84,000 10 yrs. 8,400**

**Total $ -0- $16,400**

#### Investment purchase price $500,000

#### Basic income accrual ($90,000 × 40%) 36,000

**Amortization (above) (16,400)**

**Dividends declared ($30,000 × 40%) (12,000)**

**Investment in Johnson $507,600**

**9. D The 2014 purchase is reported using the equity method.**

**Purchase price of Evan stock $600,000**

**Book value of Evan stock ($1,200,000 × 40%) (480,000)**

#### Goodwill $120,000

**Life of goodwill indefinite**

**Annual amortization (-0-)**

**Cost on January 1, 2014 $600,000**

**2014 Income accrued ($140,000 x 40%) 56,000**

**2014 Dividend ($50,000 × 40%) (20,000)**

**2015 Income accrued ($140,000 × 40%) 56,000**

**2015 Dividend ($50,000 × 40%) (20,000)**

**2016 Income accrued ($140,000 × 40%) 56,000**

**2016 Dividend ($50,000 × 40%) (20,000)**

**Investment in Evan, 12/31/16 $708,000**

**10. D**

**11. A Gross profit rate (GPR): $36,000 ÷ $90,000 = 40%**

**Inventory remaining at year-end $20,000**

**GPR × 40%**

**Unrealized gross profit $8,000**

**Ownership × 30%**

**Intra-entity gross profit—deferred $ 2,400**

**12. B Purchase price of Steinbart shares $530,000**

**Book value of Steinbart shares ($1,200,000 × 40%) (480,000)**

#### Trade name $ 50,000

**Remaining life of trade name 20 years**

**Annual amortization $ 2,500**

**2014 Gross profit rate = $30,000 ÷ $100,000 = 30%**

**2015 Gross profit rate = $54,000 ÷ $150,000 = 36%**

**2015—Equity income in Steinbart:**

**Income accrual ($110,000 × 40%) $44,000**

**Amortization (above) (2,500)**

**Recognition of 2014 unrealized gross profit**

**($25,000 × 30% GPR × 40% ownership) 3,000**

**Deferral of 2015 unrealized gross profit**

**($45,000 × 36% GPR × 40% ownership (6,480)**

**Equity income in Steinbart—2015 $38,020**

**13. (6 minutes) (Investment account after one year)**

**Purchase price $1,160,000**

**Basic 2015 equity accrual ($260,000 × 40%) 104,000**

**Amortization of copyright:**

**Excess payment ($1,160,000 – $820,000 = $340,000)**

**to copyright allocated over 10 year remaining life (34,000)**

**Dividends (50,000 × 40%) (20,000)**

**Investment account balance at year end $1,210,000**

**14. (7 minutes)**

**a. Purchase price $ 2,290,000**

**Equity income accrual ($720,000 × 35%) 252,000**

**Other comprehensive loss accrual ($100,000 × 35%) (35,000)**

**Dividends (20,000 × 35%) (7,000)**

**Investment in Steel at December 31, 2015 $2,500,000**

**b. Equity income of Steel = $252,000 (does not include OCI share which is**

**reported separately).15. (15 minutes) (Investment account after 2 years)**

#### a. Acquisition price $2,700,000

**Book value acquired ($5,175,000 × 20%) 1,035,000**

**Excess payment $1,665,000**

**Excess fair value: Computing equipment ($700,000 × 20%) 140,000**

**Excess fair value: Patented technology ($3,900,000 × 20%) 780,000**

**Excess fair value: Trademark ($1,850,000 × 20%) 370,000**

**Goodwill $ 375,000**

**Amortization:**

**Computing equipment ($140,000 ÷ 7) $ 20,000**

**Patented technology ($780,000 ÷ 3) 260,000**

**Trademark (indefinite) -0-**

**Goodwill (indefinite) -0-**

**Annual amortization $280,000**

**b. Basic equity accrual 2014 ($1,800,000 × 20%) $360,000**

**Amortization—2014 (above) (280,000)**

**Equity in 2014 earnings of Sauk Trail $ 80,000**

**Basic equity accrual 2015 ($1,985,000 × 20%) $397,000**

**Amortization—2015 (above) (280,000)**

**Equity in 2015 earnings of Sauk Trail $117,000**

**c. Acquisition price $2,700,000**

**Equity in 2014 earnings of Sauk Trail (above) 80,000**

**Dividends—2014 ($150,000 × 20%) (30,000)**

**Investment in Sauk Trail, 12/31/14 $2,750,000**

**Investment in Sauk Trail, 12/31/14 $2,750,000**

**Equity in 2015 earnings of Sauk Trail (above) $117,000**

**Dividends—2015 ($160,000 × 20%) (32,000)**

**Investment in Sauk Trail, 12/31/15 $2,835,000**

**16. (10 minutes) (Investment account after 2 years with fair value accounting**

**included)**

#### a. Acquisition price $60,000

**Book value—assets minus liabilities ($125,000 × 40%) 50,000**

**Excess payment $10,000**

**Value of patent in excess of book value ($15,000 × 40%) 6,000**

**Goodwill $ 4,000**

**Amortization:**

**Patent ($6,000 ÷ 6) $1,000**

**Goodwill -0-**

**Annual amortization $1,000**

**Acquisition price $60,000**

**Basic equity accrual 2014 ($30,000 × 40%) 12,000**

**Dividends—2014 ($10,000 × 40%) (4,000)**

**Amortization—2014 (above) (1,000)**

**Investment in Holister, 12/31/14 $67,000**

**Basic equity accrual —2015 ($50,000 × 40%) 20,000**

**Dividends—2015 (6,000)**

**Amortization—2015 (above) (1,000)**

**Investment in Holister, 12/31/15 $80,000**

**b. Dividend income ($15,000 × 40%) $6,000**

**Increase in fair value ($75,000 ­– $68,000) 7,000**

**Investment income under fair value accounting—2015 $13,000**

**17. (10 minutes) (Equity entries for one year, includes intra-entity transfers but no unearned gross profit)**

**Purchase price of Burks stock $210,000**

**Book value of Burks stock ($360,000 × 40%) (144,000)**

**Unidentified asset (goodwill) $ 66,000**

**Life indefinite**

**Annual amortization $ -0-**

No unearned intra-entity profit exists at year’s end because all of the transferred merchandise was used during the period.

**17. *(continued)***

**Investment in Burks, Inc. 210,000**

**Cash (or a Liability) 210,000**

**To record acquisition of a 40 percent interest in Burks.**

**Investment in Burks, Inc. 32,000**

**Equity in Investee Income 32,000**

**To recognize 40 percent income earned during period by Burks, an equity method investment.**

**Dividend Receivable 10,000**

**Investment in Burks, Inc. 10,000**

**To record investee dividend declaration.**

**Cash 10,000**

**Dividend Receivable. 10,000**

**To record collection of dividend from investee.**

**18. (20 Minutes) (Equity entries for one year, includes conversion to equity method)**

**The 2014 purchase must be restated to the equity method.**

**FIRST PURCHASE—JANUARY 1, 2014**

#### Purchase price of McKenzie stock $210,000

#### Book value of McKenzie stock ($1,700,000 × 10%) (170,000)

#### Cost in excess of book value $40,000

#### Excess cost assigned to undervalued land ($100,000 × 10%) (10,000)

#### Trademark $30,000

#### Remaining life of trademark 10 years

#### Annual amortization $ 3,000

**BOOK VALUE—MCKENZIE—JANUARY 1, 2015 (before second purchase)**

#### January 1, 2014 book value (given) $1,700,000

#### 2014 Net income 240,000

#### 2014 Dividends (90,000)

#### January 1, 2015 book value $1,850,000