Fundamentals of Advanced Accounting

Eighth Edition

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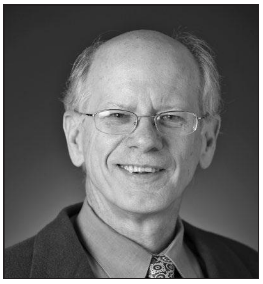
To our families

The real purpose of books is to trap the mind into doing its own thinking.

—Christopher Morley

About the Authors



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Joe B. Hoyle is associate professor of accounting at the Robins School of Business at the University of Richmond. He is also a Robins Teaching Fellow. In 2015, he was the first recipient of the J. Michael and Mary Anne Cook Prize for undergraduate teaching. The Cook Prize is awarded by the American Accounting Association and "is the foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting." In 2019, former students raised money to create an Accounting Teaching Fellowship, which will be renamed the "Joe Hoyle Accounting Teaching Fellowship" on his eventual retirement." He has authored a book of essays titled *Tips and Thoughts on Improving the Teaching Process in College,* which is available at https://facultystaff.richmond.edu/~jhoyle/documents/book-teaching-x.doc.pdf. His blog, *Teaching—Getting the Most from Your Students,* at http://joehoyle-teaching.blogspot.com/ was named the Accounting Education Innovation of the Year for 2013 by the American Accounting Association.

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Fundamentals of Advanced Accounting

Overall—this edition of the text provides relevant and up-to-date accounting standards references to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*® (ASC).

Chapter Changes for Fundamentals of *Advanced Accounting,* 8th Edition:

Chapter 1

Added a new section on business motivations for making equity method investments emphasizing economic benefits of significant influence.

Updated real-world references, with a new reference when an equity method investment is reduced to zero.

Chapter 2

Three new business combinations are discussed in terms of motivations to combine Amazon–Whole Foods, Salesforce.com–MuleSoft, and Tesla–Grohmann.

Updated real-world references.

Added a Discussion Question addressing situations where an acquired entity is not a business.

Added new end-of-chapter problems and three new cases.

Chapter 3

Updated material on goodwill impairment to reflect ASU updates for ASC Topic 350, *Intangibles—Goodwill and Other.*

Updated real-world references.

Revised and expanded section on accounting for contingent consideration in periods subsequent to acquisition.

Revised and added new end-of-chapter problems and cases.

Chapter 4

Introduced a table showing recent noncontrolling interest reported values by business entities.

Updated real-world references.

Revised and added new end-of-chapter problems and cases.

Provided additional ASC citations on valuing non-controlling interests and control premiums.

Revised the section covering control premiums to provide additional focus on goodwill implications.

Chapter 5

Streamlined and clarified the coverage for intra-entity gross profits in inventory and implications of the parent's investment accounting methods.

Revised and added new end-of-chapter problems and cases.

Chapter 6

Updated real-world references.

Revised and clarified the section on accounting for variable interest entities including additional ASC citations. Revised the consolidation examples for variable interest entities (acquisition date and post-acquisition) by incorporating a management fee paid by the variable interest entity to the primary beneficiary.

Revised several end-of-chapter problems.

Revised examples and end-of-chapter problems for changes in federal corporate income tax rates from the *Tax Cut and Jobs Act* enacted in December 2017.

Chapter 7

Updated the chapter to reflect *Accounting Standards Update* (ASU) No. 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities," which amends ASC Topic 815, Derivatives and Hedging.

This ASU requires an entity to present the income effect of the hedging instrument in the same income

8e Stays Current as the Accounting Profession Changes

statement line item in which the income effect of the hedged item is reported. If an entity excludes certain portions of a hedging instrument's change in fair value from the assessment of hedge effectiveness (a so-called excluded component), the ASU permits an entity to recognize the initial value of the excluded component in net income using (1) changes in the fair value of the excluded component or (2) a systematic and rational method (such as straight-line) over the life of the hedging instrument. Further, the ASU requires the income effect of an excluded component to be recognized in the same income statement line item in which the income effect of the hedged item is reported.

Introduced the concept of forward points in describing foreign currency forward contracts.

Added a timeline in "Hedges of Foreign Exchange Risk" to illustrate how the various hedges differ in terms of timing.

Added a subsection to the discussion on "Hedge Effectiveness" to cover issues relating to the "Exclusion of Components from Hedge Effectiveness Assessment."

Changed the hedge examples to exclude the forward points on a forward contract and the time value of an option from the assessment of hedge effectiveness whenever possible. In allocating the excluded components to net income, the examples consistently use a straight-line amortization approach for forward points on a forward contract and the change in fair value approach for the time value of an option.

Changed the name of the fictitious company in the hedge examples to Eximco and the example currency to British pounds to signal that examples have been changed.

Deleted reference to the effective interest method for allocating forward points to net income, as well as the comparison of the effective interest versus straight line methods of allocation.

Revised the hedges examples, for simplicity, to ignore discounting to present value in determining the fair value of forward contracts and firm commitments.

Changed the journal entries in the hedge examples so that all gains and losses related to foreign currency denominated assets and liabilities, firm commitments, forward contracts, and options are recognized in a single income statement line item titled "Foreign Exchange Gains and Losses."

Changed the journal entries in the hedge examples so that those entries that are ultimately reflected in accumulated other comprehensive income are first debited or credited to an "Other Comprehensive Income (OCI)" account rather than to "Accumulated Other Comprehensive Income (AOCI)."

Revised the facts and instructions in most of the end-of-chapter problems dealing with hedges to be consistent with changes made in the chapter. Also, changed company names in revised problems to signal that these problems have been changed.

Updated real-world references including examples of company practices, excerpts from annual reports, and foreign exchange rates.

Chapter 8

Updated information about countries currently meeting the definition of highly inflationary economy.

Changed the hypothetical exchange rates used in the Swissco example ("The Translation Process Illustrated") to be more consistent with the current U.S. dollar/Swiss franc exchange rate. Changed the hypothetical exchange rates and U.S. dollar amounts in Exhibits 8.4–8.9 accordingly.

Expanded the discussion related to hedging balance sheet exposure and added a numerical example demonstrating the accounting related to a hedge of a net investment.

Updated real-world references including examples of company practices and excerpts from annual reports.

Changed the foreign currency in several end-of-chapter problems to eliminate the use of nonexistent currency names.

Revised the facts in an end-of-chapter problem related to a hedge of a net investment.

Changed one of the companies included in the requirements for the second research case at the end of the chapter.

Chapter 9

Revised and updated coverage of the tax implications of partnership for changes from the *Tax Cut and Jobs Act.*

Updated real-world references.

Updated several end-of-chapter problems.

Chapter 10

Added two learning objectives related to (1) preparing a statement of partnership liquidation and (2) calculating safe payments.

Made "Partnership Liquidation Procedures," "Statement of Partnership Liquidation," and "Deficit Capital Balances" major headings.

Moved the "Two Partners with Deficit Capital Balances" example to the "Deficit Capital Balances" section.

Renamed "Statement of Liquidation" as "Statement of Partnership Liquidation."

Reorganized "Safe Payments to Partners" as a major section with a new, related learning objective.

Deleted the subsection on "Insolvent Partnership."

Relabeled the section on "Installment Liquidations" as "Preliminary Distribution of Partnership Assets."

Made "Predistribution Plan" a major heading.

Deleted an end-of-chapter question related to the Uniform Partnership Act and revised a question related to safe payments.

Revised requirements in several end-of-chapter problems to require preparation either of a statement of partnership liquidation, proposed schedule of liquidation, or predistribution plan.

Replaced a multi-part problem with a problem requiring preparation of a proposed schedule of liquidation.

Deleted the Research Case.

Replaced the previous Analysis Case with a new case.

Replaced the previous Communication Case with two new cases.

Chapter 11

Updated numerous references to the financial statements of a wide variety of state and local governments such as the City of Portland, the City of Phoenix, the City of Greensboro, and the City of Las Vegas.

Discussed the ongoing evolution of U.S. GAAP to highlight GASB's release of two Preliminary Views documents, *Financial Reporting Model Improvements* and *Recognition of Elements of Financial Statements* that could eventually create significant changes in state and local government accounting.

Chapter 12

Provided coverage of new pronouncement: *GASB Statement No. 87,* "Leases," including comparison with *FASB Accounting Standards Update No. 2016-02,* "Leases." The two authoritative groups take significantly different approaches to the reporting of lease contracts.

Rearranged chapter coverage to increase emphasis on the reporting of defined benefit pension plans to highlight the risk of such large government obligations.

Updated references to the financial statements of state and local governments such as the City of Los Angeles, the City of Chicago, the City of Orlando, the City of Cincinnati, and the City of Boston.

Students Solve the Accounting Puzzle with 8th Edition Features

The approach used by Hoyle, Schaefer, and Doupnik allows students to think critically about accounting, just as they will in their careers and as they prepare for the CPA exam. Read on to understand how students will succeed as accounting majors and as future CPAs by using Fundamentals of *Advanced Accounting, 8e.*

Thinking Critically

With this text, students gain a well-balanced appreciation of the accounting profession. As *Hoyle 8e* introduces them to the field's many aspects, it often focuses on past controversies and present resolutions. The text shows the development of financial reporting as a product of intense and considered debate that continues today and will in the future.

Readability

The writing style of the previous editions has been highly praised. **Students easily comprehend** chapter concepts because of the conversational tone used throughout the book. The authors have made every effort to ensure that the writing style remains engaging, lively, and consistent.

Real-World Examples

Students are better able to relate what they learn to what they will encounter in the business world after reading these frequent examples. Quotations, articles, and illustrations from *Forbes,* the *Wall Street Journal, Time,* and *Bloomberg BusinessWeek* are incorporated throughout the text. Data have been pulled from business, not-for-profit, and government financial statements as well as official pronouncements.

EXHIBIT 2.1
Recent Notable Business Combinations

Acquirer	Target	Deal Value
AT&T	Time-Warner	$79.4B
Walt Disney	21st Century Fox	$71.3B
CVS Health	Aetna	$69.0B
Cigna	Express Scripts	$52.0B
Walmart	Flipkart	$16.0B
Amazon	Whole Foods	$13.7B
Conagra	Pinnacle Foods	$10.9B
Celgene	Juno Therapeutics	$ 9.0B
Diamondback Energy	Energen	$ 8.4B
General Mills	Blue Buffalo	$ 8.0B
Microsoft	GitHub	$ 7.5B
Salesforce.com	Mulesoft	$ 6.5B
Verizon	Yahoo	$ 4.7B
Pepsico	SodaStream International	$ 3.2B
Tyson	Keystone Foods	$ 2.2B
Tesla	Grohmann Engineering	$109M

raw material purchases, manufacturing, and delivery, substantial savings can result. A
example, Oracle's acquisition of Sun Microsystems creates synergies by enabling Orac

Discussion Questions

This feature **facilitates student understanding** of the underlying accounting principles at work in particular reporting situations. Similar to minicases, these questions help explain the issues at hand in practical terms. Many times, these cases are designed to demonstrate to students why a topic is problematic and worth considering.

Discussion Question

DOES GAAP UNDERVALUE POST-CONTROL STOCK ACQUISITIONS?

In Berkshire Hathaway's 2012 annual report, Warren Buffett, in discussing the company's post-control step acquisitions of Marmon Holdings, Inc., observed the following:

> Marmon provides an example of a clear and substantial gap existing between book value and intrinsic value. Let me explain the odd origin of this differential.
>
> Last year I told you that we had purchased additional shares in Marmon, raising our ownership to 80% (up from the 64% we acquired in 2008). I also told you that GAAP accounting required us to immediately record the 2011 purchase on our books at far less than what we paid. I've now had a year to think about this weird accounting rule, but I've yet to find an explanation that makes any sense—nor can Charlie or Marc Hamburg, our CFO, come up with one. My confusion increases when I am told that if we hadn't already owned 64%, the 16% we purchased in 2011 would have been entered on our

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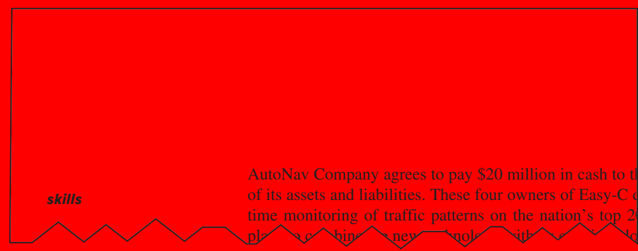
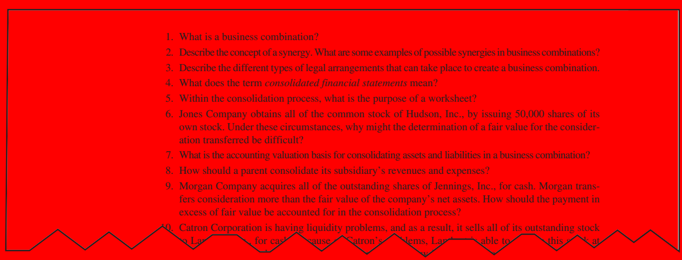
End-of-Chapter Materials

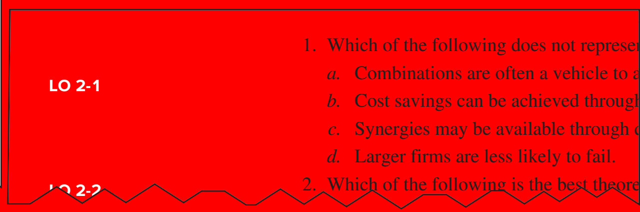
As in previous editions, the end-of-chapter material remains a strength of the text. The sheer number of questions, problems, and Internet assignments test and, therefore, **expand the students' knowledge** of chapter concepts.

Excel Spreadsheet Assignments extend specific problems and are located on the 14th edition Instructor Resources page, with template versions that can be provided to students for assignments. An Excel icon appears next to those problems that have corresponding spreadsheet assignments.

"Develop Your Skills" asks questions that address the four skills students need to master to pass the CPA exam: Research, Analysis, Spreadsheet, and Communication. An icon indicates when these skills are tested.







Connect Accounting for Fundamentals of *Advanced Accounting*, 8e

The 8th edition of *Advanced Accounting* has a full Connect package, with the following features available for instructors and students.

SmartBook® is the market-leading adaptive study resource that is proven to strengthen memory recall, increase retention, and boost grades. SmartBook 2.0 identifies and closes knowledge gaps through a continually adapting reading and questioning experience that helps students master the key concepts in the chapter. SmartBook 2.0 is the latest version of SmartBook, with key updates to: improve accessibility, provide mobile functionality, allow a more granular level of content selection, and provide the ability to assign Recharge activities.

The **End-of-Chapter Content** in Connect provides a robust offering of review and question material designed to aid and assess the student's retention of chapter content. The End-of-Chapter content is composed of both static and algorithmic versions of the problems in each chapter, which are designed to challenge students using McGraw-Hill Education's state-of-the-art online homework technology. Connect helps students learn more efficiently by providing feedback and practice material when and where they need it. Connect grades homework automatically, and students benefit from the immediate feedback that they receive, particularly on any questions they may have missed.

Example of Connect End-of-Chapter Problem

Prepare a consolidated balance sheet for Pratt and Spider as of December 31, 2021.

Auto-gradeable

PRATT COMPANY AND SUBSIDIARY
Consolidated Balance Sheet
December 31, 2021

Assets		Liabilities and Owners' Equity	
Cash			
Total assets		Total liabilities and equities	

The **Test Bank** for each chapter has been updated for the 8th edition to stay current with new and revised chapter material, with all questions available for assignment through Connect. Instructors can also create tests and quizzes with Test Builder, a cloud-based tool available within Connect that formats tests for printing or for administering within an LMS.

The **Instructor and Student Resources** have been updated for the 8th edition and are available in the Connect Instructor Resources page. Available resources include Instructor and Solutions Manuals, PowerPoint presentations, Test Bank files, Excel templates, and Chapter Check Figures. All applicable Student Resources will be available in a convenient file that can be distributed to students for classes either directly, through Connect, or via courseware.

Acknowledgments

We could not produce a textbook of the quality and scope of Fundamentals of *Advanced Accounting* without the help of a great number of people. Special thanks go to the following:

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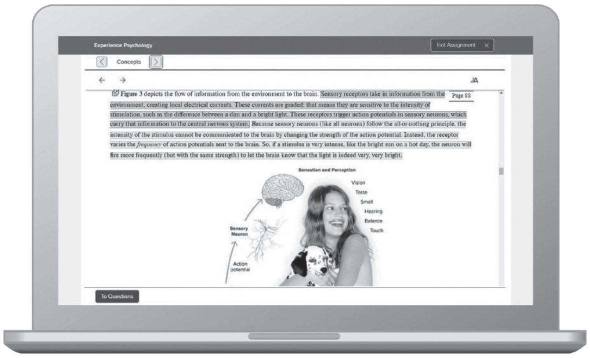

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- Jordan Cunningham,
Eastern Washington University

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chapter

The Equity Method of Accounting for Investments

After studying this chapter, you should be able to:

- Describe motivations for a firm to gain significant influence over another firm.
- Describe in general the various methods of accounting for an investment in equity shares of another company.
- Identify the sole criterion for applying the equity method of accounting and know the guidelines to assess whether the criterion is met.
- Describe the financial reporting for equity method investments and prepare basic equity method journal entries for an investor.
- Allocate the cost of an equity method investment and compute amortization expense to match revenues recognized from the investment to the excess of investor cost over investee book value.
- Understand the financial reporting consequences for:
  - a. A change to the equity method.
  - b. Investee's other comprehensive income.
  - c. Investee losses.
  - d. Sales of equity method investments.
- Describe the rationale and computations to defer the investor's share of gross profits on intra-entity inventory sales until the goods are either consumed by the owner or sold to outside parties.
- Explain the rationale and reporting implications of fair-value accounting for investments otherwise accounted for by the equity method.

The first several chapters of this text present the accounting and reporting for investment activities of businesses. The focus is on investments when one firm possesses either significant influence or control over another through ownership of voting shares. When one firm owns enough voting shares to be able to affect the decisions of another, accounting for the investment can become challenging and complex. The source of such complexities typically stems from the fact that transactions among the firms affiliated through ownership cannot be considered independent, arm's-length transactions. As in many matters relating to financial reporting, we look to transactions with *outside parties* to provide a basis for accounting valuation. When firms are affiliated through a common set of owners, measurements that recognize the relationships among the firms help provide objectivity in financial reporting.

Why Do Business Firms Invest in the Equity Shares of Other Business Firms?

We frequently see businesses buying equity shares (e.g., common stock) of other businesses. To understand the accounting for equity share acquisitions, it's helpful to understand two fundamental motivations for such investments. First, firms may temporarily invest in another firm's equity shares simply to earn a return on otherwise idle cash. Companies such as Microsoft, Google, and Starbucks each have large amounts of short-term investments in marketable equity securities that can produce both dividend income and share value appreciation.

Second, in sufficient quantity, equity shares can provide a powerful business tool to investors. Equity share ownership typically provides voting privileges to elect members to a firm's board of directors. Boards of directors are the highest authority in the management of a corporation. They make strategic decisions regarding how the firm will conduct its business. Boards set company policies and hire (and fire) management. Thus, the ability to vote for directors can be a powerful tool to influence the decisions of an investee corporation. Consequently, many firms will buy sufficient voting shares to enable the election of their representatives to another firm's board of directors. The range of ownership may result in the ability to influence the investee through the election of a single director all the way to complete control.

By exercising their voting rights over the investee, an investor firm can wield power over the strategic direction of the investee in ways that align with its own operating and financial interests. For example, an investee may be considering inventory purchase or sale contracts with several

LO 1-1

Describe motivations for a firm to gain significant influence over another firm.

outside firms. An investor firm, through its designated members on the investee board of directors, possesses the power to influence the selection of the outside firm—including the investor firm itself. Other examples abound, including cooperation between the investor and investee on research, technology, product development, licensing, advertising, distribution, market expansion, etc. Thus, we see businesses acquiring the equity shares of other businesses throughout the economy.

The Reporting of Investments in Corporate Equity Securities

In its 2018 annual report, The Coca-Cola Company describes its 28 percent investment in Coca-Cola FEMSA, a Mexican bottling company with operations throughout much of Latin America. The Coca-Cola Company uses the equity method to account for several of its bottling company investments, including Coca-Cola FEMSA. The annual report states,

> We use the equity method to account for investments in companies, if our investment provides us with the ability to exercise significant influence over operating and financial policies of the investee. Our consolidated net income includes our Company's proportionate share of the net income or loss of these companies.
>
> Our judgment regarding the level of influence over each equity method investment includes considering key factors such as our ownership interest, representation on the board of directors, participation in policy-making decisions and material intercompany transactions.

Such information is hardly unusual in the business world; corporate investors frequently acquire ownership shares of both domestic and foreign businesses. These investments can range from the purchase of a few shares to the acquisition of 100 percent control. Although purchases of corporate equity securities (such as the ones made by Coca-Cola) are not uncommon, they pose a considerable number of financial reporting issues because a close relationship has been established without the investor gaining actual control. These issues are currently addressed by the *equity method.* This chapter deals with accounting for stock investments that fall under the application of this method.

LO 1-2

Describe in general the various methods of accounting for an investment in equity shares of another company.

Generally accepted accounting principles (GAAP) recognize four different approaches to the financial reporting of investments in corporate equity securities:

1. Fair-value method.
2. Cost method for equity securities without readily determinable fair values.
3. Consolidation of financial statements.
4. Equity method.

The financial statement reporting for a particular investment depends primarily on the degree of influence that the investor (stockholder) has over the investee, a factor most often indicated by the relative size of ownership.[1] Because voting power typically accompanies ownership of equity shares, influence increases with the relative size of ownership. The resulting influence can be very little, a significant amount, or, in some cases, complete control.

Fair-Value Method

In many instances, an investor possesses only a small percentage of an investee company's outstanding stock, perhaps only a few shares. Because of the limited level of ownership, the investor cannot expect to significantly affect the investee's operations or decision making. These shares are bought in anticipation of cash dividends or appreciation of stock market values. Such investments are recorded at cost and periodically adjusted to fair value according to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*® (ASC) Topic 321, "Investments—Equity Securities."

[1] The relative size of ownership is most often the key factor in assessing one company's degree of influence over another. However, as discussed later in this chapter, other factors (e.g., contractual relationships between firms) can also provide influence or control over firms regardless of the percentage of shares owned.

Fair value is defined by the ASC (Master Glossary) as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." For most investments in equity securities, quoted stock market prices represent fair values.

Because a full coverage of limited ownership investments in equity securities is presented in intermediate accounting textbooks, only the following basic principles are noted here:

- Initial investments in equity securities are recorded at cost and subsequently adjusted to fair value if fair value is readily determinable (typically by reference to market value); otherwise, the investment remains at cost.
- Changes in the fair values of equity securities during a reporting period are recognized as income.[2]
- Dividends declared on the equity securities are recognized as income.

The preceding procedures are followed for equity security investments (with readily determinable fair values) when the owner possesses neither significant influence nor control.

Cost Method (Investments in Equity Securities without Readily Determinable Fair Values)

When the fair value of an investment in equity securities is not readily determinable, and the investment provides neither significant influence nor control, the investment may be measured at cost. Such investments sometimes can be found in ownership shares of firms that are not publicly traded or experience only infrequent trades.

Investments in equity securities that employ the cost method often continue to be reported at their original cost over time.[3] Income from cost method equity investments usually consists of the investor's share of dividends declared by the investee. However, despite its emphasis on cost measurements, GAAP allows for two fair value assessments that may affect cost method amounts reported on the balance sheet and the income statement.

- First, cost method equity investments periodically must be assessed for impairment to determine if the fair value of the investment is less than its carrying amount. The ASC allows a qualitative assessment to determine if impairment is likely.[4] Because the fair value of a cost method equity investment is not readily available (by definition), if impairment is deemed likely, an entity must estimate a fair value for the investment to measure the amount (if any) of the impairment loss.
- Second, ASC (321-10-35-2) allows for recognition of "observable price changes in orderly transactions for the identical or a similar investment of the same issuer." Any unrealized holding gains (or losses) from these observable price changes are included in earnings with a corresponding adjustment to the investment account. So even if equity shares are only infrequently traded (and thus fair value is not readily determinable), such trades can provide a basis for financial statement recognition under the cost method for equity investments.

Consolidation of Financial Statements

Many corporate investors acquire enough shares to gain actual control over an investee's operations. In financial accounting, such control may be achieved when a stockholder

[2] ASC 320, *Investments—Debt and Equity Securities,* requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, unless fair values are not readily determinable. Thus, the previous available-for-sale category with fair value changes recorded in other comprehensive income is no longer available.

[3] Dividends received in excess of earnings subsequent to the date of investment are considered returns of the investment and are recorded as reductions of cost of the investment.

[4] Impairment indicators include assessments of earnings performance, economic environment, going-concern ability, etc. If the qualitative assessment does not indicate impairment, no further testing is required. If an equity security without a readily determinable fair value is impaired, the investor recognizes the difference between the investment's fair value and carrying amount as an impairment loss in net income (ASC 321-10-35-3).

accumulates more than 50 percent of an organization's outstanding voting stock. At that point, rather than simply influencing the investee's decisions, the investor often can direct the entire decision-making process. A review of the financial statements of America's largest organizations indicates that legal control of one or more subsidiary companies is an almost universal practice. PepsiCo, Inc., as just one example, holds a majority interest in the voting stock of literally hundreds of corporations.

Investor control over an investee presents a special accounting challenge. Normally, when a majority of voting stock is held, the investor–investee relationship is so closely connected that the two corporations are viewed as a single entity for reporting purposes.[5] Consequently, an entirely different set of accounting procedures is applicable. Control generally requires the consolidation of the accounting information produced by the individual companies. Thus, a single set of financial statements is created for external reporting purposes with all assets, liabilities, revenues, and expenses brought together. The various procedures applied within this consolidation process are examined in subsequent chapters of this textbook.

The FASB ASC Section 810-10-05 on variable interest entities expands the use of consolidated financial statements to include entities that are financially controlled through special contractual arrangements rather than through voting stock interests. Prior to the accounting requirements for variable interest entities, many firms (e.g., Enron) avoided consolidation of entities that they owned little or no voting stock in but otherwise controlled through special contracts. These entities were frequently referred to as special purpose entities (SPEs) and provided vehicles for some firms to keep large amounts of assets and liabilities off their consolidated financial statements. Accounting for these entities is discussed in Chapters 2 and 6.

Equity Method

Another investment relationship is appropriately accounted for using the equity method. In many investments, although control is not achieved, the degree of ownership indicates the ability of the investor to exercise *significant influence* over the investee. If an investor holds between 20 and 50 percent of the voting stock of the investee, significant influence is normally assumed and the equity method is applied. Recall Coca-Cola's 28 percent investment in Coca-Cola FEMSA's voting stock. Through its ownership, Coca-Cola can undoubtedly influence Coca-Cola FEMSA's decisions and operations.

To provide objective reporting for investments with significant influence, FASB ASC Topic 323, "Investments—Equity Method and Joint Ventures," describes the use of the equity method. The equity method employs the accrual basis for recognizing the investor's share of investee income. Accordingly, the investor recognizes income as it is earned by the investee. As noted in FASB ASC (para. 323-10-05-5), because of its significant influence over the investee, the investor

> has a degree of responsibility for the return on its investment and it is appropriate to include in the results of operations of the investor its share of earnings or losses of the investee.

Furthermore, under the equity method, the investor records its share of investee dividends declared as a decrease in the investment account, not as income.

In today's business world, many corporations hold significant ownership interests in other companies without having actual control. The Coca-Cola Company, for example, owns between 20 and 50 percent of several bottling companies, both domestic and international. Many other investments represent joint ventures in which two or more companies form a new enterprise to carry out a specified operating purpose. For example, Ford Motor Company and Sollers formed FordSollers, a passenger and commercial vehicle manufacturing, import, and distribution company in Russia. Each partner owns 50 percent of the joint venture. For each of these investments, the investors do not possess absolute control because they hold less than a majority of the voting stock. Thus, the preparation of consolidated financial statements is inappropriate. However, the large percentage of ownership indicates that each investor possesses some ability to affect the investee's decision-making process.

[5] As discussed in Chapter 2, ownership of a majority voting interest in an investee does not always lead to consolidated financial statements.

Discussion Question

DID THE COST METHOD INVITE EARNINGS MANIPULATION?

Prior to GAAP for equity method investments, firms used the cost method to account for their unconsolidated investments in common stock regardless of the presence of significant influence. Under the cost method, when the investee declares a dividend, the investor records "dividend income." The investment account typically remains at its original cost—hence the term *cost method*.

Many firms' compensation plans reward managers based on reported annual income. How might the use of the cost method of accounting for significant influence investments have resulted in unintended wealth transfers from owners to managers? Do the equity or fair-value methods provide similar incentives?

Finally, as discussed at the end of this chapter, firms may elect a fair-value option in their financial reporting for certain financial assets and financial liabilities. Among the qualifying financial assets for fair-value reporting are significant influence investments otherwise accounted for by the equity method.

Application of the Equity Method

An understanding of the equity method is best gained by initially examining the FASB's treatment of two questions:

1. What factors indicate when the equity method should be used for an investment in another entity's ownership securities?
2. How should the investor report this investment, and the income generated by it, to reflect the relationship between the two entities?

Criteria for Utilizing the Equity Method

LO 1-3

Identify the sole criterion for applying the equity method of accounting and guidance in assessing whether the criterion is met.

The rationale underlying the equity method is that an investor begins to gain the ability to influence the decision-making process of an investee as the level of ownership rises. According to FASB ASC Topic 323 on equity method investments, achieving this "ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50 percent or less of the common stock" is the sole criterion for requiring application of the equity method (FASB ASC [para. 323-10-15-3]).

Clearly, a term such as *the ability to exercise significant influence* is nebulous and subject to a variety of judgments and interpretations in practice. At what point does the acquisition of one additional share of stock give an owner the ability to exercise significant influence? This decision becomes even more difficult in that only the *ability* to exercise significant influence need be present. There is no requirement that any actual influence must ever be applied.

FASB ASC Topic 323 provides guidance to the accountant by listing several conditions that indicate the presence of this degree of influence:

- Investor representation on the board of directors of the investee.
- Investor participation in the policy-making process of the investee.
- Material intra-entity transactions.

- Interchange of managerial personnel.
- Technological dependency.
- Extent of ownership by the investor in relation to the size and concentration of other ownership interests in the investee.

No single one of these guides should be used exclusively in assessing the applicability of the equity method. Instead, all are evaluated together to determine the presence or absence of the sole criterion: the ability to exercise significant influence over the investee.

These guidelines alone do not eliminate the leeway available to each investor when deciding whether the use of the equity method is appropriate. To provide a degree of consistency in applying this standard, the FASB provides a general ownership test: *If an investor holds between 20 and 50 percent of the voting stock of the investee, significant influence is normally assumed, and the equity method is applied.*

> An investment (direct or indirect) of 20 percent or more of the voting stock of an investee shall 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 percent of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.[6]

Limitations of Equity Method Applicability

At first, the 20 to 50 percent rule may appear to be an arbitrarily chosen boundary range established merely to provide a consistent method of reporting for investments. However, the essential criterion is still the ability to significantly influence (but not control) the investee, rather than 20 to 50 percent ownership. If the absence of this ability is proven (or control exists), the equity method should not be applied, regardless of the percentage of shares held.

For example, the equity method is not appropriate for investments that demonstrate any of the following characteristics, regardless of the investor's degree of ownership:[7]

- An agreement exists between investor and investee by which the investor surrenders significant rights as a shareholder.
- A concentration of ownership operates the investee without regard for the views of the investor.
- The investor attempts but fails to obtain representation on the investee's board of directors.

In each of these situations, because the investor is unable to exercise significant influence over its investee, the equity method is not applied.

Alternatively, if an entity can exercise *control* over its investee, regardless of its ownership level, consolidation (rather than the equity method) is appropriate. FASB ASC (para. 810-10-05-8) limits the use of the equity method by expanding the definition of a controlling financial interest and addresses situations in which financial control exists absent majority ownership interest. In these situations, control is achieved through contractual and other arrangements called *variable interests.*

To illustrate, one firm may create a separate legal entity in which it holds less than 50 percent of the voting interests but nonetheless controls that entity through governance document provisions and/or contracts that specify decision-making power and the distribution of profits and losses. Entities controlled in this fashion are typically designated as *variable interest entities,* and their sponsoring firm may be required to include them in consolidated financial reports despite the fact that ownership is less than 50 percent. For example, the Walt Disney Company reclassified several former equity method investees as variable interest entities and now consolidates these investments.[8]

[6] FASB ASC (para. 323-10-15-8).

[7] FASB ASC (para. 323-10-15-10). This paragraph deals specifically with limits to using the equity method for investments in which the owner holds 20 to 50 percent of the outstanding shares.

[8] Chapters 2 and 6 provide further discussions of variable interest entities.

Extensions of Equity Method Applicability

For some investments that either fall short of or exceed 20 to 50 percent ownership, the equity method is nonetheless appropriately used for financial reporting. As an example, The Coca-Cola Company owns a 19 percent investment in Monster Beverage Corporation. Coca-Cola notes in its recent financial statements that "Based on our equity ownership percentage, the significance that our expanded distribution and coordination agreements have on Monster's operations, and our representation on Monster's Board of Directors, the Company is accounting for its interest in Monster as an equity method investment."

Conditions can also exist where the equity method is appropriate despite a majority ownership interest. In some instances, rights granted to noncontrolling shareholders restrict the powers of the majority shareholder. Such rights may include approval over compensation, hiring, termination, and other critical operating and capital spending decisions of an entity. If the noncontrolling rights are so restrictive as to call into question whether control rests with the majority owner, the equity method is employed for financial reporting rather than consolidation. For example, prior to its acquisition of BellSouth, AT&T Inc., stated in its financial reports, "we account for our 60 percent economic investment in Cingular under the equity method of accounting because we share control equally with our 40 percent partner BellSouth."

To summarize, the following table indicates the method of accounting that is typically applicable to various stock investments:

Criterion	Normal Ownership Level	Applicable Accounting Method
Inability to significantly influence	Less than 20%	Fair value or cost method
Ability to significantly influence	20%–50%	Equity method or fair value
Control through voting interests	More than 50%	Consolidated financial statements
Control through variable interests (governance documents, contracts)	Primary beneficiary status (no ownership required)	Consolidated financial statements

LO 1-4

Describe the financial reporting for equity method investments and prepare basic equity method journal entries for an investor.

Accounting for an Investment—The Equity Method

Now that the criteria leading to the application of the equity method have been identified, a review of its reporting procedures is appropriate. Knowledge of this accounting process is especially important to users of the investor's financial statements because the equity method affects both the timing of income recognition and the carrying amount of the investment account.

In applying the equity method, the accounting objective is to report the investment and investment income to reflect the close relationship between the investor and investee. After recording the cost of the acquisition, two equity method entries periodically record the investment's impact:

1. The investor's investment account *increases as the investee recognizes and reports income.* Also, the investor recognizes investment income using the accrual method—that is, in the same period as reported by the investee in its financial statements. If an investee reports income of $100,000, a 30 percent owner should immediately increase its own income by $30,000. This earnings accrual reflects the essence of the equity method by emphasizing the connection between the two companies; as the owners' equity of the investee increases through the earnings process, the investment account also increases. Although the investor initially records the acquisition at cost, upward adjustments in the asset balance are recorded as soon as the investee makes a profit. The investor reduces the investment account if the investee reports a loss.

2. The investor decreases its investment account for its share of investee cash dividends. When the investee declares a cash dividend, its owners' equity decreases. The investor mirrors this change by recording a reduction in the carrying amount of the investment rather than recognizing the dividend as revenue. Furthermore, because the investor recognizes income when the investee recognizes it, double counting would occur if the investor also recorded its share of subsequent investee dividends as revenue. Importantly, a cash dividend declaration is not an appropriate point for income recognition. As stated in FASB ASC (para. 323-10-35-4),

> Under the equity method, an investor shall recognize its share of the earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements rather than in the period in which an investee declares a dividend.

Because the investor can influence their timing, investee dividends cannot objectively measure income generated from the investment.

Application of Equity Method

Investee Event	Investor Accounting
Income is recognized.	Proportionate share of income is recognized.
Dividends are declared.	Investor's share of investee dividends reduce the investment account.

Application of the equity method thus causes the investment account on the investor's balance sheet to vary directly with changes in the investee's equity.

In contrast, the fair-value method reports investments at fair value if it is readily determinable. Also, income is recognized both from changes in fair value and upon receipt of dividends. Consequently, financial reports can vary depending on whether the equity method or fair-value method is appropriate.

To illustrate, assume that Big Company owns a 20 percent interest in Little Company purchased on January 1, 2020, for $210,000. Little then reports net income of $200,000, $300,000, and $400,000, respectively, in the next three years while declaring dividends of $50,000, $100,000, and $200,000. The fair values of Big's investment in Little, as determined by market prices, were $245,000, $282,000, and $325,000 at the end of 2020, 2021, and 2022, respectively.

Exhibit 1.1 compares the accounting for Big's investment in Little across the two methods. The fair-value method carries the investment at its market values, presumed to be readily available in this example. Income is recognized both through changes in Little's fair value and as Little declares dividends.

In contrast, under the equity method, Big recognizes income as it is recorded by Little. As shown in Exhibit 1.1, Big recognizes $180,000 in income over the three years, and the

EXHIBIT 1.1 Comparison of Fair-Value Method (ASC 321) and Equity Method (ASC 323)

			Accounting by Big Company When Influence Is Not Significant (fair-value method)			Accounting by Big Company When Influence Is Significant (equity method)	
Year	Income of Little Company	Dividends Declared by Little Company	Dividend Income	Fair-Value Change to Income	Carrying Amount of Investment	Equity in Investee Income*	Carrying Amount of Investment†
2020	$200,000	$ 50,000	$10,000	$ 35,000	$245,000	$ 40,000	$240,000
2021	300,000	100,000	20,000	37,000	282,000	60,000	280,000
2022	400,000	200,000	40,000	43,000	325,000	80,000	320,000
Total income recognized			$70,000	$115,000		$180,000	

*Equity in investee income is 20 percent of the current year income reported by Little Company.
†The carrying amount of an investment under the equity method is the original cost plus income recognized less dividends. For 2020, as an example, the $240,000 reported balance is the $210,000 cost plus $40,000 equity income less $10,000 in dividends.

carrying amount of the investment is adjusted upward to $320,000. Dividends from Little are not an appropriate measure of income because of the assumed significant influence over the investee. Big's ability to influence Little's decisions applies to the timing of dividend distributions. Therefore, dividends from Little do not objectively measure Big's income from its investment in Little. As Little records income, however, under the equity method Big recognizes its share (20 percent) of the income and increases the investment account. Thus, the equity method reflects the accrual model: The investor recognizes income as it is recognized by the investee, not when the investee declares a cash dividend.

Exhibit 1.1 shows that the carrying amount of the investment fluctuates each year under the equity method. This recording parallels the changes occurring in the net asset figures reported by the investee. If the owners' equity of the investee rises through income, an increase is made in the investment account; decreases such as losses and dividends cause reductions to be recorded. Thus, the equity method conveys information that describes the relationship created by the investor's ability to significantly influence the investee.

Equity Method Accounting Procedures

Once guidelines for the application of the equity method have been established, the mechanical process necessary for recording basic transactions is straightforward. The investor accrues its percentage of the earnings reported by the investee each period. Investee dividend declarations reduce the investment balance to reflect the decrease in the investee's book value.[9]

Referring again to the information presented in Exhibit 1.1, Little Company reported a net income of $200,000 during 2020 and declared and paid cash dividends of $50,000. These figures indicate that Little's net assets have increased by $150,000 during the year. Therefore, in its financial records, Big Company records the following journal entries to apply the equity method:

Investment in Little Company	40,000	
Equity in Investee Income		40,000
To accrue earnings of a 20 percent owned investee ($200,000 × 20%)		
Dividend Receivable	10,000	
Investment in Little Company		10,000
To record a dividend declaration by Little Company ($50,000 × 20%)		
Cash	10,000	
Dividend Receivable		10,000
To record collection of the cash dividend.		

In the first entry, Big accrues income based on the investee's reported earnings. The second entry reflects the dividend declaration and the related reduction in Little's net assets followed then by the cash collection. The $30,000 net increment recorded here in Big's investment account ($40,000 – $10,000) represents 20 percent of the $150,000 increase in Little's book value that occurred during the year.

LO 1-5

Allocate the cost of an equity method investment and compute amortization expense to match revenues recognized from the investment to the excess of investor cost over investee book value.

Excess of Investment Cost over Book Value Acquired

After the basic concepts and procedures of the equity method are mastered, more complex accounting issues can be introduced. Surely one of the most common problems encountered in applying the equity method occurs when the investment cost exceeds the proportionate book value of the investee company.[10]

[9] In this text, the terms *book value* and *carrying amount* are used synonymously. Each refers to either an account balance, an amount appearing in a financial statement, or the amount of net assets (stockholders' equity) of a business entity.

[10] Although encountered less frequently, investments can be purchased at a cost that is less than the underlying book value of the investee. Accounting for this possibility is explored in later chapters.

Discussion Question

DOES THE EQUITY METHOD REALLY APPLY HERE?

Abraham, Inc., a New Jersey corporation, operates 57 bakeries throughout the northeastern section of the United States. In the past, its founder, James Abraham, owned all the company's outstanding common stock. However, during the early part of this year, the corporation suffered a severe cash flow problem brought on by rapid expansion. To avoid bankruptcy, Abraham sought additional investment capital from a friend, Dennis Bostitch, who owns Highland Laboratories. Subsequently, Highland paid $700,000 cash to Abraham, Inc., to acquire enough newly issued shares of common stock for a one-third ownership interest.

At the end of this year, the accountants for Highland Laboratories are discussing the proper method of reporting this investment. One argues for maintaining the asset at its original cost: "This purchase is no more than a loan to bail out the bakeries. Mr. Abraham will continue to run the organization with little or no attention paid to us. After all, what does anyone in our company know about baking bread? I would be surprised if Abraham does not reacquire these shares as soon as the bakery business is profitable again."

One of the other accountants disagrees, stating that the equity method is appropriate. "I realize that our company is not capable of running a bakery. However, the official rules state that we must have only the *ability* to exert significant influence. With one-third of the common stock in our possession, we certainly have that ability. Whether we use it or not, this ability means that we are required to apply the equity method."

How should Highland Laboratories account for its investment in Abraham, Inc.?

Unless the investor acquires its ownership at the time of the investee's conception, paying an amount equal to book value is rare. A number of possible reasons exist for a difference between the book value of a company and its fair value as reflected by the price of its stock. A company's fair value at any time is based on a multitude of factors such as company profitability, the introduction of a new product, expected dividend payments, projected operating results, and general economic conditions. Furthermore, stock prices are based, at least partially, on the perceived worth of a company's net assets, amounts that often vary dramatically from underlying book values. Many asset and liability accounts shown on a balance sheet tend to measure historical costs rather than current value. In addition, these reported figures are affected by the specific accounting methods adopted by a company. Inventory costing methods such as LIFO and FIFO, for example, obviously lead to different book values as does each of the acceptable depreciation methods.

If an investment is acquired at a price in excess of the investee's book value, logical reasons should explain the additional cost incurred by the investor. The source of the excess of cost over book value is important. Income recognition requires matching the income generated from the investment with its cost. Excess costs allocated to fixed assets will likely be expensed over longer periods than costs allocated to inventory. In applying the equity method, the cause of such an excess payment can be divided into two general categories:

1. Specifically identifiable investee assets and liabilities can have fair values that differ from their present book values. The excess payment can be identified directly with individual accounts such as inventory, equipment, franchise rights, and so on.
2. The investor may pay an extra amount because it expects future benefits to accrue from the investment. Such benefits could be anticipated as the result of factors such as the estimated profitability of the investee or the expected relationship between the two companies. When

the additional payment cannot be attributed to any specifically identifiable investee asset or liability, the investor recognizes an intangible asset called *goodwill.* For example, eBay Inc. once disclosed in its annual report that goodwill related to its equity method investments was approximately $27.4 million.

As an illustration, assume that Grande Company is negotiating the acquisition of 30 percent of the outstanding shares of Chico Company. Chico's balance sheet reports assets of $500,000 and liabilities of $300,000 for a net book value of $200,000. After investigation, Grande determines that Chico's equipment is undervalued in the company's financial records by $60,000. One of its patents is also undervalued, but only by $40,000. By adding these valuation adjustments to Chico's book value, Grande arrives at an estimated $300,000 worth for the company's net assets. Based on this computation, Grande offers $90,000 for a 30 percent share of the investee's outstanding stock.

Book value of Chico Company [assets minus liabilities (or stockholders' equity)]	$200,000
Undervaluation of equipment	60,000
Undervaluation of patent	40,000
Value of net assets	$300,000
Percentage acquired	30%
Purchase price	$ 90,000

Although Grande's purchase price is in excess of the proportionate share of Chico's book value, this additional amount can be attributed to two specific accounts: Equipment and Patents. No part of the extra payment is traceable to any other projected future benefit. Thus, the cost of Grande's investment is allocated as follows:

Payment by investor		$90,000
Percentage of book value acquired ($200,000 × 30%)		60,000
Payment in excess of book value		30,000
Excess payment identified with specific assets:		
Equipment ($60,000 undervaluation × 30%)	$18,000	
Patent ($40,000 undervaluation × 30%)	12,000	30,000
Excess payment not identified with specific assets—goodwill		$ –0–

Of the $30,000 excess payment made by the investor, $18,000 is assigned to the equipment whereas $12,000 is traced to a patent and its undervaluation. No amount of the purchase price is allocated to goodwill.

To take this example one step further, assume that Chico's owners reject Grande's proposed $90,000 price. They believe that the value of the company as a going concern is higher than the fair value of its net assets. Because the management of Grande believes that valuable synergies will be created through this purchase, the bid price is raised to $125,000 and accepted. This new acquisition price is allocated as follows:

Payment by investor		$125,000
Percentage of book value acquired ($200,000 × 30%)		60,000
Payment in excess of book value		65,000
Excess payment identified with specific assets:		
Equipment ($60,000 undervaluation × 30%)	$18,000	
Patent ($40,000 undervaluation × 30%)	12,000	30,000
Excess payment not identified with specific assets—goodwill		$ 35,000

As this example indicates, *any extra payment that cannot be attributed to a specific asset or liability is assigned to the intangible asset goodwill.* Although the actual purchase price can be computed by a number of different techniques or simply result from negotiations, goodwill is always the excess amount not allocated to identifiable asset or liability accounts.

Under the equity method, the investor enters total cost in a single investment account regardless of the allocation of any excess purchase price. If all parties accept Grande's bid of $125,000, the acquisition is initially recorded at that amount despite the internal assignments made to equipment, patents, and goodwill. The entire $125,000 was paid to acquire this investment, and it is recorded as such.

The Amortization Process

In the preceding transaction, the extra payment over Grande's book value was made for specific identifiable assets (equipment and patents), and goodwill. Even though the actual dollar amounts are recorded within the investment account, a definite historical cost can be attributed to these assets. With a cost to the investor as well as a specified life, the payment relating to each asset (except land, goodwill, and other indefinite life intangibles) should be amortized over an appropriate time period.[11] However, certain intangibles such as goodwill are considered to have indefinite lives and thus are not subject to amortization.[12]

Goodwill associated with equity method investments, for the most part, is measured in the same manner as goodwill arising from a business combination (see Chapters 2 through 6). One difference is that goodwill arising from a business combination is subject to annual impairment reviews, whereas goodwill implicit in equity method investments is not. Equity method investments are tested in their entirety for permanent declines in value.[13]

To show the amortization process for definite-lived assets, we continue with our Grande and Chico example. Assume that the equipment has a 10-year remaining life, the patent a 5-year life, and the goodwill an indefinite life. If the straight-line method is used with no salvage value, *the investor's cost* should be amortized initially as follows:[14]

Account	Cost Assigned	Remaining Useful Life	Annual Amortization
Equipment	$18,000	10 years	$1,800
Patent	12,000	5 years	2,400
Goodwill	35,000	Indefinite	–0–
Annual expense (for five years until patent cost is completely amortized)			$4,200

In recording this annual expense, Grande reduces the investment balance in the same way it would amortize the cost of any other asset that had a limited life. Therefore, at the end of the first year of holding the investment, the investor records the following journal entry under the equity method:

Equity in Investee Income	4,200	
Investment in Chico Company		4,200
To record amortization of excess payment allocated to equipment and patent.		

[11] A 2015 FASB *Proposed Accounting Standards Update,* "Simplifying the Equity Method of Accounting," recommended the elimination of the identification and amortization of excess cost over acquired investee book value. However, at a December 2015 meeting, the FASB did not affirm the proposed elimination of current accounting treatment for the excess cost over acquired investee book value and directed its staff to research additional alternatives for improving the equity method.

[12] Other intangibles (such as certain licenses, trademarks, etc.) also can be considered to have indefinite lives and thus are not amortized unless and until their lives are determined to be limited. Further discussion of intangibles with indefinite lives appears in Chapter 3.

[13] Because equity method goodwill is not separable from the related investment, goodwill should not be separately tested for impairment. See also FASB ASC (para. 350-20-35-59).

[14] Unless otherwise stated, all amortization computations are based on the straight-line method with no salvage value.

Because this amortization relates to investee assets, the investor does not establish a specific expense account. Instead, as in the previous entry, the expense is recognized by decreasing the the investor's equity income accruing from the investee company.

To illustrate this entire process, assume that Tall Company purchases 20 percent of Short Company for $200,000. Tall can exercise significant influence over the investee; thus, the equity method is appropriately applied. The acquisition is made on January 1, 2020, when Short holds net assets with a book value of $700,000. Tall believes that the investee's building (10-year remaining life) is undervalued within the financial records by $80,000 and equipment with a 5-year remaining life is undervalued by $120,000. Any goodwill established by this purchase is considered to have an indefinite life. During 2020, Short reports a net income of $150,000 and at year-end declares a cash dividend of $60,000.

Tall's three basic journal entries for 2020 pose little problem:

January 1, 2020		
Investment in Short Company	200,000	
Cash		200,000
To record acquisition of 20 percent of the outstanding shares of Short Company.		

December 31, 2020		
Investment in Short Company	30,000	
Equity in Investee Income		30,000
To accrue 20 percent of the 2020 reported earnings of investee ($150,000 × 20%).		
Dividend Receivable	12,000	
Investment in Short Company		12,000
To record a dividend declaration by Short Company ($60,000 × 20%).		

An allocation of Tall's $200,000 purchase price must be made to determine whether an additional adjusting entry is necessary to recognize annual amortization associated with the extra payment:

Payment by investor		$200,000
Percentage of 1/1/20 book value ($700,000 × 20%)		140,000
Payment in excess of book value		60,000
Excess payment identified with specific assets:		
Building ($80,000 × 20%)	$16,000	
Equipment ($120,000 × 20%)	24,000	40,000
Excess payment not identified with specific assets—goodwill		$ 20,000

As can be seen, $16,000 of the purchase price is assigned to a building and $24,000 to equipment, with the remaining $20,000 attributed to goodwill. For each asset with a definite useful life, periodic amortization is required.

Asset	**Attributed Cost**	**Remaining Useful Life**	**Annual Amortization**
Building	$16,000	10 years	$1,600
Equipment	24,000	5 years	4,800
Goodwill	20,000	Indefinite	–0–
Total for 2020			$6,400

At the end of 2020, Tall must also record the following adjustment in connection with these cost allocations:

Equity in Investee Income	6,400	
Investment in Short Company		6,400
To record 2020 amortization of excess payment allocated to building ($1,600) and equipment ($4,800).		

Although these entries are shown separately here for better explanation, Tall would probably net the income accrual for the year ($30,000) and the amortization ($6,400) to create a single entry increasing the investment and recognizing equity income of $23,600. Thus, the first-year return on Tall Company's beginning investment balance (defined as equity earnings/beginning investment balance) is equal to 11.80 percent ($23,600/$200,000).

International Accounting Standard 28—Investments in Associates

The International Accounting Standards Board (IASB), similar to the FASB, recognizes the need to take into account the significant influence that can occur when one firm holds a certain amount of voting shares of another. The IASB defines significant influence as the power to participate in the financial and operating policy decisions of the investee, but it is not control or joint control over those policies. The following describes the basics of the equity method in International Accounting Standard (IAS) 28:[15]

> If an investor holds, directly or indirectly (e.g., through subsidiaries), 20 percent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (e.g., through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.
>
> Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment.

As seen from the above excerpt from IAS 28, the equity method concepts and applications described are virtually identical to those prescribed by the FASB ASC. Nonetheless, some differences do exist. First, as described later in this chapter, the FASB allows a fair-value reporting option for investments that otherwise are accounted for under the equity method. IAS 28, however, does not provide for a fair-value reporting option. Second, if the investee employs accounting policies that differ from those of the investor, IAS 28 requires the financial statements of the investee to be adjusted to reflect the investor's accounting policies for the purpose of applying the equity method. U.S. GAAP does not have a similar conformity requirement.

Equity Method—Additional Issues

The previous sections on equity income accruals and excess cost amortizations provide the basics for applying the equity method. However, several other non-routine issues can arise during the life of an equity method investment. More specifically, special procedures are required in accounting for each of the following:

1. Reporting a change to the equity method.
2. Reporting investee income from sources other than continuing operations.
3. Reporting investee losses.
4. Reporting the sale of an equity investment.

[15] International Accounting Standards Board, IAS 28, "Investments in Associates," Technical Summary, www.iasb.org.

LO 1-6a

Understand the financial reporting consequences for a change to the equity method.

Reporting a Change to the Equity Method

In many instances, an investor's ability to significantly influence an investee is not achieved through a single stock acquisition. The investor could possess only a minor ownership for some years before purchasing enough additional shares to require conversion to the equity method. Before the investor achieves significant influence, any investment should be reported by either the fair-value method or, if the investment fair value is not readily determinable, the cost method. After the investment reaches the point at which the equity method becomes applicable, a technical question arises about the appropriate means of changing from one method to the other.[16]

FASB ASC (para. 323-10-35-33) addresses the issue of how to account for an investment in the common stock of an investee that, through additional stock acquisition or other means (e.g., increased degree of influence, reduction of investee's outstanding stock, etc.) becomes qualified for use of the equity method.

> If an investment qualifies for use of the equity method . . . , the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting.

Thus, the FASB requires a prospective approach by requiring that the cost of any new share acquired simply be added to the current investment carrying amount. By mandating prospective treatment, the FASB avoids the complexity of restating prior period amounts.[17]

To illustrate, assume that on January 1, 2020, Alpha Company exchanges $84,000 for a 10 percent ownership in Bailey Company. At the time of the transaction, officials of Alpha do not believe that their company gained the ability to exert significant influence over Bailey. Alpha properly accounts for the investment using the fair-value method and recognizes in net income its 10 percent ownership share of changes in Bailey's fair value. The fair and book values of Bailey's common stock appear in the following table:

Date	Fair Value	Book Value
January 1, 2020	$840,000	$670,000
December 31, 2020	890,000	715,000

At the end of 2020, Alpha recognizes the increase in its 10 percent share of Bailey's fair value and increases its investment account to $89,000. Because the fair-value method is used to account for the investment, Bailey's $670,000 book value balance at January 1, 2020 does not affect Alpha's accounting.

Then on January 1, 2021, Alpha purchases an additional 30 percent of Bailey's outstanding voting stock for $267,000 and achieves the ability to significantly influence the investee's decision making. Alpha will now apply the equity method to account for its investment in Bailey. To bring about the prospective change to the equity method, Alpha prepares the following journal entry on January 1, 2021:

Investment in Bailey Company	267,000	
Cash		267,000
To record an additional 30 percent investment in Bailey Company.		

On January 1, 2021, Bailey's carrying amounts for its assets and liabilities equaled their fair values except for a patent, which was undervalued by $175,000 and had a 10-year remaining useful life.

[16] A switch to the equity method also can be required if the investee purchases a portion of its own shares as treasury stock. This transaction can increase the investor's percentage of outstanding stock.

[17] Prior to 2017, the FASB required a retrospective adjustment to an investor's previous ownership shares upon achieving significant influence over an investee.

To determine the proper amount of excess fair-value amortization required in applying the equity method, Alpha prepares an investment allocation schedule. The fair value of Alpha's total (40 percent) investment serves as the valuation basis for the allocation schedule as of January 1, 2021, the date Alpha achieves the ability to exercise significant influence over Bailey. The following is the January 1, 2021 investment allocation schedule:

Investment Fair Value Allocation Schedule
Investment in Bailey Company
January 1, 2021

Current fair value of initial 10 percent ownership of Bailey	$ 89,000
Payment for additional 30 percent investment in Bailey	267,000
Total fair value of 40 percent investment in Bailey	$356,000
Alpha's share of Bailey's book value (40% × $715,000)	286,000
Investment fair value in excess of Bailey's book value	$ 70,000
Excess fair value attributable to Bailey's patent (40% × $175,000)	$ 70,000
	-0-

We next assume that Bailey reports net income of $130,000 and declares and pays a $50,000 dividend at the end of 2021. Accordingly, Alpha applies the equity method and records the following three journal entries at the end of 2021:

Investment in Bailey Company	45,000	
Equity in Investee Income		45,000
To accrue 40 percent of the year 2021 income reported by Bailey Company ($130,000 × 40%) – $7,000 excess patent amortization (10-year remaining life).		
Dividend Receivable	20,000	
Investment in Bailey Company		20,000
To record the 2021 dividend declaration by Bailey Company ($50,000 × 40%).		
Cash	20,000	
Dividend Receivable		20,000
To record collection of the cash dividend.		

Reporting Investee's Other Comprehensive Income and Irregular Items

LO 1-6b

Understand the financial reporting consequences for investee's other comprehensive income.

In many cases, reported net income and dividends sufficiently capture changes in an investee's owners' equity. By recording its share of investee income and dividends, an investor company typically ensures its investment account reflects its share of the underlying investee equity. However, when an investee company's activities require recognition of other comprehensive income (OCI), its owners' equity (and net assets) will reflect changes not captured in its reported net income.[18]

Equity method accounting requires that the investor record its share of investee OCI, which then is included in its balance sheet as Accumulated Other Comprehensive Income (AOCI). As noted by The Coca-Cola Company in its 2018 annual 10-K report,

> AOCI attributable to shareowners of The Coca-Cola Company is separately presented on our consolidated balance sheets as a component of The Coca-Cola Company's shareowners' equity, which also includes our proportionate share of equity method investees' AOCI.

Included in AOCI are items such as accumulated derivative net gains and losses, foreign currency translation adjustments, and certain pension adjustments.

[18] OCI is defined as revenues, expenses, gains, and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. OCI is accumulated and reported in stockholders' equity.

To examine this issue, assume that Charles Company applies the equity method in accounting for its 30 percent investment in the voting stock of Norris Company. No excess amortization resulted from this investment. In 2020, Norris reports net income of $500,000. Norris also reports $80,000 in OCI from pension and other postretirement adjustments. Charles Company accrues earnings of $150,000 based on 30 percent of the $500,000 net figure. However, for proper financial reporting, Charles must recognize an increase in its Investment in Norris account for its 30 percent share of its investee's OCI. This treatment is intended, once again, to mirror the close relationship between the two companies.

The journal entry by Charles Company to record its equity interest in the income and OCI of Norris follows:

Investment in Norris Company	174,000	
Equity in Investee Income		150,000
Other Comprehensive Income of Investee		24,000
To accrue the investee's operating income and other comprehensive income from equity investment.		

OCI thus represents a source of change in investee company net assets that is recognized under the equity method. In the preceding example, Charles Company includes $24,000 of other comprehensive income in its balance sheet AOCI total.

Other equity method recognition issues arise for irregular items traditionally included within net income. For example, an investee may report income (loss) from discontinued operations as components of its current net income. In such cases, the equity method requires the investor to record and report its share of these items in recognizing equity earnings of the investee.

LO 1-6c

Understand the financial reporting consequences for investee losses.

Reporting Investee Losses

Although most of the previous illustrations are based on the recording of profits, accounting for losses incurred by the investee is handled in a similar manner. The investor recognizes the appropriate percentage of each loss and reduces the carrying amount of the investment account. Even though these procedures are consistent with the concept of the equity method, they fail to take into account all possible loss situations.

Impairments of Equity Method Investments

Investments can suffer permanent losses in fair value that are not evident through equity method accounting. Such declines can be caused by the loss of major customers, changes in economic conditions, loss of a significant patent or other legal right, damage to the company's reputation, and the like. Permanent reductions in fair value resulting from such adverse events might not be reported immediately by the investor through the normal equity entries discussed previously. The FASB ASC (para. 323-10-35-32) provides the following guidance:

> A loss in value of an investment which is other than a temporary decline shall be recognized. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity that would justify the carrying amount of the investment.

Thus, when a permanent decline in an equity method investment's value occurs, the investor must recognize an impairment loss and reduce the asset to fair value.

However, this loss must be permanent before such recognition becomes necessary. Under the equity method, a temporary drop in the fair value of an investment is simply ignored.

Navistar International Corporation, a manufacturer of trucks and buses, for example, noted the following in its 2018 annual report:

> We assess the potential impairment of our equity method investments and determine fair value based on valuation methodologies, as appropriate, including the present value of estimated future cash flows, estimates of sales proceeds, and market multiples. If an investment is determined to be impaired and the decline in value is other than temporary, we record an appropriate write-down.

Investment Reduced to Zero

Through the recognition of reported losses as well as any permanent drops in fair value, the investment account can eventually be reduced to a zero balance. This condition is most likely to occur if the investee has suffered extreme losses or if the original purchase was made at a low, bargain price. Regardless of the reason, the carrying amount of the investment account is sometimes eliminated in total.

When an investment account is reduced to zero, the investor should discontinue using the equity method rather than establish a negative balance. The investment retains a zero balance until subsequent investee profits eliminate all unrecognized losses. Once the original cost of the investment has been eliminated, no additional losses can accrue to the investor (since the entire cost has been written off).

For example, Switch, Inc., a technology infrastructure company, explains in its 2018 annual 10-K report that

> The Company discontinues applying the equity method of accounting when the investment is reduced to zero. If the investee subsequently reports net income or other comprehensive income, the Company resumes applying the equity method of accounting only after its share of unrecognized net income and other comprehensive income, respectively, equals the share of losses not recognized during the period the equity method of accounting was suspended.

Reporting the Sale of an Equity Investment

LO 1-6d

Understand the financial reporting consequences for sales of equity method investments.

At any time, the investor can choose to sell part or all of its holdings in the investee company. If a sale occurs, the equity method continues to be applied until the transaction date, thus establishing an appropriate carrying amount for the investment. The investor then reduces this balance by the percentage of shares sold.

As an example, assume that Top Company owns 40 percent of the 100,000 outstanding shares of Bottom Company, an investment accounted for by the equity method. Any excess investment cost over Top's share of Bottom's book value is considered goodwill. Although these 40,000 shares were acquired some years ago for $200,000, application of the equity method has increased the asset balance to $320,000 as of January 1, 2021. On July 1, 2021, Top elects to sell 10,000 of these shares (one-fourth of its investment) for $110,000 in cash, thereby reducing ownership in Bottom from 40 percent to 30 percent. Bottom Company reports net income of $70,000 during the first six months of 2021 and declares and pays cash dividends of $30,000.

Top, as the investor, initially makes the following journal entries on July 1, 2021, to accrue the proper income and establish the correct investment balance:

Investment in Bottom Company	28,000	
Equity in Investee Income		28,000
To accrue equity income for first six months of 2021 ($70,000 × 40%).		
Dividend Receivable	12,000	
Investment in Bottom Company		12,000
To record a cash dividend declaration by Bottom Company ($30,000 × 40%).		
Cash	12,000	
Dividend Receivable		12,000
To record collection of the cash dividend.		

These two entries increase the carrying amount of Top's investment by $16,000, creating a balance of $336,000 as of July 1, 2021. The sale of one-fourth of these shares can then be recorded as follows:

Cash	110,000	
Investment in Bottom Company		84,000
Gain on Sale of Investment		26,000
To record sale of one-fourth of investment in Bottom Company (¼ × $336,000 = $84,000).		

After the sale is completed, Top continues to apply the equity method to this investment based on 30 percent ownership rather than 40 percent. However, if the sale had been of sufficient magnitude to cause Top to lose its ability to exercise significant influence over Bottom, the equity method would cease to be applicable. For example, if Top Company's holdings were reduced from 40 percent to 15 percent, the equity method might no longer be appropriate after the sale. The remaining shares held by the investor are reported according to the fair-value method with the remaining book value becoming the new *cost* figure for the investment rather than the amount originally paid.

If an investor is required to change from the equity method to the fair-value method, no retrospective adjustment is made. As previously demonstrated, a change to the equity method is also treated prospectively.

LO 1-7

Describe the rationale and computations to defer gross profits on intra-entity inventory sales until the goods are either consumed by the owner or sold to outside parties.

Deferral of Intra-Entity Gross Profits in Inventory[19]

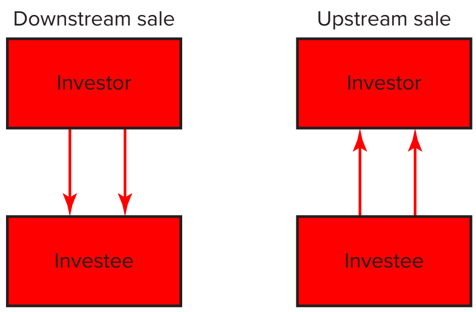
Many equity acquisitions establish ties between companies to facilitate the direct purchase and sale of inventory items. For example, The Coca-Cola Company recently disclosed net sales in excess of $14.1 billion to its equity method investees. The significant influence relationship between an investor and investee in many ways creates its own entity that works to achieve business objectives. Thus, we use the term *intra-entity* to describe sales between an investor and its equity method investee.

Intra-entity sales require special accounting to ensure proper timing for profit recognition. A fundamental accounting concept is that an entity cannot recognize profits through activities with itself. For example, when an investor company sells inventory to its 40 percent-owned investee at a profit, 40 percent of this sale effectively is with itself. Consequently, the investor company delays 40 percent of the gross profit recognition until the inventory is sold to an independent party or is consumed.[20]

Thus, in the presence of significant influence, the amount of profit deferred is limited to the investor's ownership share of the investee. In applying the equity method, the investor therefore defers only its share of the profit from intra-entity sales until the buyer's ultimate disposition of the goods. When the inventory is eventually consumed within operations or resold to an unrelated party, the investor recognizes the remaining gross profit. Accounting for both the profit deferral and subsequent recognition takes place through adjustments to the "Equity in Investee Income" and "Investment" accounts.

Intra-entity inventory sales are identified as either *downstream* or *upstream. Downstream sales* refer to the investor's sale of an item to the investee. Conversely, an *upstream sale* describes one that the investee makes to the investor (see Exhibit 1.2). *Although the direction of intra-entity sales does not affect reported equity method balances for investments when significant influence exists, it has definite consequences when financial control requires the consolidation of financial statements, as discussed in Chapter 5.* Therefore, these two types of intra-entity sales are examined separately even at this introductory stage.

EXHIBIT 1.2
Downstream and Upstream Sales



[19] Intra-entity transfers can involve the sale of items other than inventory. The intra-entity transfer of depreciable fixed assets and land is discussed in a later chapter.

[20] When inventory is consumed—for example, in a manufacturing process—sales of the resulting production are assumed to generate revenues from outside, unrelated parties.

Downstream Sales of Inventory

Assume that Major Company owns a 40 percent share of Minor Company and accounts for this investment through the equity method. In 2021, Major sells inventory to Minor at a price of $50,000. This figure includes a gross profit of 30 percent, or $15,000. By the end of 2021, Minor has sold $40,000 of these goods to outside parties while retaining $10,000 in inventory for sale during the subsequent year.

The investor has made downstream sales to the investee. In applying the equity method, recognition of the related profit must be delayed until the buyer disposes of these goods. Although total intra-entity inventory sales amounted to $50,000 in 2021, $40,000 of this merchandise has already been resold to outsiders, thereby justifying the normal reporting of profits. For the $10,000 still in the investee's inventory, the investor delays gross profit recognition. In computing equity income, the investor's portion of the intra-entity profit must be deferred until Minor disposes of the goods.

The gross profit on the original intra-entity sale was 30 percent of the sale price; therefore, Major's profit associated with these remaining items is $3,000 ($10,000 × 30%). *However, because only 40 percent of the investee's stock is held, just $1,200 ($3,000 × 40%) of this profit is deferred.* Major's ownership percentage reflects the intra-entity portion of the profit. The total $3,000 gross profit within the ending inventory balance is not the amount deferred. Rather, 40 percent of that gross profit is viewed as the currently deferred figure.

Remaining Ending Inventory	Gross Profit Percentage	Gross Profit in Ending Inventory	Investor Ownership Percentage	Deferred Intra-Entity Gross Profit
$10,000	30%	$3,000	40%	$1,200

After calculating the appropriate deferral, the investor decreases current equity income by $1,200 to reflect the deferred portion of the intra-entity profit. This procedure temporarily removes this portion of the profit from the investor's books in 2021 until the investee disposes of the inventory in 2022. Major accomplishes the actual deferral through the following year-end journal entry:

Intra-Entity Gross Profit Deferral		
Equity in Investee Income	1,200	
Investment in Minor Company		1,200
To defer gross profit on sale of inventory to Minor Company.		

In the subsequent year, when this inventory is eventually consumed by Minor or sold to unrelated parties, the deferral is no longer needed. Because a sale to an outside party has now occurred, Major should recognize the $1,200. By merely reversing the preceding deferral entry, the accountant succeeds in moving the investor's profit into the appropriate time period. Recognition shifts from the year of inventory transfer to the year in which the sale to customers outside of the affiliated entity takes place.

Subsequent Recognition of Intra-Entity Gross Profit		
Investment in Minor Company	1,200	
Equity in Investee Income		1,200
To recognize income on intra-entity sale that now can be recognized after sales to outsiders.		

Upstream Sales of Inventory

Unlike consolidated financial statements (see Chapter 5), the equity method reports upstream sales of inventory in the same manner as downstream sales. Hence, the investor's share of gross profits remaining in ending inventory is deferred until the items are used or sold to unrelated parties. To illustrate, assume that Major Company once again owns 40 percent of Minor Company. During the current year, Minor sells merchandise costing $40,000 to Major for $60,000. At the end of the fiscal period, Major still retains $15,000 of these goods. Minor reports net income of $120,000 for the year.

To reflect the basic accrual of the investee's earnings, Major records the following journal entry at the end of this year:

Income Accrual		
Investment in Minor Company	48,000	
Equity in Investee Income		48,000
To accrue income from 40 percent owned investee ($120,000 × 40%).		

The amount of the deferred intra-entity gross profit remaining at year-end is computed using the 33⅓ gross profit percentage of the sales price ($20,000/$60,000):

Remaining Ending Inventory	Gross Profit Percentage	Gross Profit in Ending Inventory	Investor Ownership Percentage	Deferred Intra-Entity Gross Profit
$15,000	33⅓%	$5,000	40%	$2,000

Based on this calculation, a second entry is required of the investor at year-end. Once again, a deferral of the gross profit created by the intra-entity sale is necessary for proper timing of income recognition. *Under the equity method for investments with significant influence, the direction of the sale between the investor and investee (upstream or downstream) has no effect on the final amounts reported in the financial statements.*

Intra-Entity Gross Profit Deferral		
Equity in Investee Income	2,000	
Investment in Minor Company		2,000
To defer recognition of intra-entity gross profit until inventory is used or sold to unrelated parties.		

After the adjustment, Major, the investor, reports earnings from this equity investment of $46,000 ($48,000 − $2,000). The income accrual is reduced because the investor defers its portion of the intra-entity gross profit. In an upstream sale, the investor's own inventory account contains the deferred gross profit. The previous entry, though, defers recognition of this profit by decreasing Major's investment account rather than the inventory balance. An alternative treatment would be the direct reduction of the investor's inventory balance as a means of accounting for this deferred amount. Although this alternative is acceptable, decreasing the investment account remains the traditional approach for deferring gross profits, even for upstream sales.

When the investor eventually consumes or sells the $15,000 in merchandise, the preceding journal entry is reversed as shown below. In this way, the effects of the inventory transfer are reported in the proper accounting period when sales to an outside party allow the recognition of the previously deferred intra-entity gross profit via the Equity in Investee Income account.

Subsequent Recognition of Intra-Entity Gross Profit		
Investment in Minor Company	2,000	
Equity in Investee Income		2,000
To recognize income on intra-entity sale that now can be recognized after sales to outsiders.		

Whether upstream or downstream, the investor's sales and purchases are still reported as if the transactions were conducted with outside parties. Only the investor's share of the gross profit is deferred, and that amount is adjusted solely through the equity income account. Furthermore, because the companies are not consolidated, the investee's reported balances are not altered at all to reflect the nature of these sales/purchases. Obviously, readers of the financial statements need to be made aware of the inclusion of these amounts in the income statement. Thus, reporting companies must disclose certain information about related-party transactions. These disclosures include the nature of the relationship, a description of the transactions, the dollar amounts of the transactions, and amounts due to or from any related parties at year-end.

Financial Reporting Effects and Equity Method Criticisms

Equity Method Reporting Effects

It is important to realize that business decisions, including equity investments, typically involve the assessment of a wide range of consequences. For example, managers frequently are very interested in how financial statements report the effects of their decisions. This attention to financial reporting effects of business decisions arises because measurements of financial performance often affect the following:

- The firm's ability to raise capital.
- Managerial compensation.
- The ability to meet debt covenants and future interest rates.
- Managers' reputations.

Managers are also keenly aware that measures of earnings per share can strongly affect investors' perceptions of the underlying value of their firms' publicly traded stock. Consequently, prior to making investment decisions, firms will study and assess the prospective effects of applying the equity method on the income reported in financial statements. Additionally, such analyses of prospective reported income effects can influence firms regarding the degree of influence they wish to have, or even on the decision of whether to invest. For example, managers could have a required projected rate of return on an initial investment. In such cases, an analysis of projected income will be made to assist in setting an offer price.

For example, Investmor Co. is examining a potential 25 percent equity investment in Marco, Inc., that will provide a significant level of influence. Marco projects an annual income of $300,000 for the near future. Marco's book value is $450,000, and it has an unrecorded newly developed technology appraised at $200,000 with an estimated useful life of 10 years. In considering offer prices for the 25 percent investment in Marco, Investmor projects equity earnings as follows:

Projected income (25% × $300,000)	$75,000
Excess unpatented technology amortization [(25% × 200,000) ÷ 10 years]	(5,000)
Annual expected equity in Marco earnings	$70,000

Investmor's required first-year rate of return (before tax) on these types of investments is 20 percent. Therefore, to meet the first-year rate of return requirement involves a maximum price of $350,000 ($70,000 ÷ 20% = $350,000). If the shares are publicly traded (leaving the firm a "price taker"), such income projections can assist the company in making a recommendation to wait for share prices to move to make the investment attractive.

Criticisms of the Equity Method

Over the past several decades, thousands of business firms have accounted for their investments using the equity method. Recently, however, the equity method has come under criticism for the following:

- Emphasizing the 20–50 percent of voting stock in determining significant influence versus control.
- Allowing off-balance-sheet financing.
- Potentially biasing performance ratios.

The guidelines for the equity method suggest that a 20–50 percent ownership of voting shares indicates significant influence that falls short of control. But can one firm exert "control" over another firm absent an interest of more than 50 percent? Clearly, if one firm controls another, consolidation is the appropriate financial reporting technique. However, over the years, firms have learned ways to control other firms despite owning less than 50 percent of voting shares. For example, contracts across companies can limit one firm's ability to act without permission of the other. Such contractual control can be seen in debt arrangements, long-term sales and purchase agreements, and agreements concerning board membership. As a result, control is exerted through a variety of contractual arrangements. For financial reporting purposes, however, if ownership is 50 percent or less, a firm can argue that control technically does not exist.

In contrast to consolidated financial reports, when applying the equity method, the investee's assets and liabilities are not combined with the investor's amounts. Instead, the investor's balance sheet reports a single amount for the investment, and the income statement reports a single amount for its equity in the earnings of the investee. If consolidated, the assets, liabilities, revenues, and expenses of the investee are combined and reported in the body of the investor's financial statements.

Thus, for those companies wishing to actively manage their reported balance sheet numbers, the equity method provides an effective means. By keeping its ownership of voting shares less than 50 percent, a company can technically meet the rules for applying the equity method for its investments and at the same time report investee assets and liabilities "off balance sheet." As a result, 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, could result.

On the surface, it appears that firms can avoid balance sheet disclosure of debts by maintaining investments at less than 50 percent ownership. However, the equity method requires summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements. Therefore, supplementary information could be available under the equity method that would not be separately identified in consolidation. Nonetheless, some companies have contractual provisions (e.g., debt covenants, managerial compensation agreements) based on ratios in the main body of the financial statements. Meeting the provisions of such contracts could provide managers strong incentives to maintain technical eligibility to use the equity method rather than full consolidation.

LO 1-8

Explain the rationale and reporting implications of fair-value accounting for investments otherwise accounted for by the equity method.

Fair-Value Reporting for Equity Method Investments

Financial reporting standards allow a fair-value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities. Under the fair-value option, changes in the fair value of the elected financial items are included in earnings. Among the many financial assets available for the fair-value option were investments otherwise accounted for under the equity method.

For example, Citigroup has reported at fair value certain of its investments that previously were reported using the equity method. In its 2018 annual report, Citigroup noted that "certain investments in non-marketable equity securities and certain investments that would otherwise have been accounted for using the equity method are carried at fair value, since the Company has elected to apply fair-value accounting. Changes in fair value of such investments are recorded in earnings." Many other firms, however, have been reluctant to elect the fair-value option for their equity method investments.

Firms using fair-value accounting simply report the investment's fair value as an asset and changes in fair value as earnings. As such, firms neither compute excess cost amortizations nor adjust earnings for intra-entity profits. Dividends from an investee are included in earnings under the fair-value option. Because dividends typically reduce an investment's fair value, an increase in earnings from investee dividends would be offset by a decrease in earnings from the decline in an investment's fair value.

To illustrate, on January 1, 2020, Westwind Co. pays $722,000 in exchange for 40,000 common shares of Armco, Inc., which has 100,000 common shares outstanding, the majority of which continue to trade on the New York Stock Exchange. During the next two years, Armco reports the following information:

Year	Net Income	Cash Dividends	Common Shares Total Fair Value at December 31
2020	$158,000	$25,000	$1,900,000
2021	125,000	25,000	1,870,000

Westwind elects to use fair-value accounting and accordingly makes the following journal entries for its investment in Armco over the next two years.

Investment in Armco, Inc.	722,000	
Cash		722,000
To record Westwind's initial 40 percent investment in Armco, Inc.		
Cash	10,000	
Dividend Income*		10,000
To recognize 2020 dividends received (40%) as Investment income.		
Investment in Armco, Inc.	38,000	
Investment Income		38,000
To recognize Westwind's 40 percent of the 2020 change in Armco's fair value [($1,900,000 × 40%) – $722,000].		
Cash	10,000	
Dividend Income*		10,000
To recognize 2021 dividends received (40%) as investment income.		
Investment Loss	12,000	
Investment in Armco, Inc.		12,000
To recognize Westwind's 40 percent of the 2021 change in Armco's fair value [40% × ($1,870,000 – $1,900,000)].		

*This example assumes dividend declaration and payment occur at the same time.

In its December 31, 2021, balance sheet, Westwind thus reports its Investment in Armco account at $748,000, equal to 40 percent of Armco's total fair value (or $722,000 initial cost adjusted for 2020–2021 fair value changes of $38,000 less $12,000).

In addition to the increasing emphasis on fair values in financial reporting, the fair-value option also was motivated by a perceived need for consistency across various balance sheet items. In particular, the fair-value option is designed to limit volatility in earnings that occurs when some financial items are measured using cost-based attributes and others at fair value.

As FASB ASC (para. 825-10-10-1) observes, the objective of the fair-value option is

> to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.

Thus, the fair-value option is designed to match asset valuation with fair-value reporting requirements for many liabilities.

Summary

1. The equity method of accounting for an investment reflects the close relationship that could exist between an investor and an investee. More specifically, this approach is available when the owner achieves the ability to apply significant influence to the investee's operating and financial decisions. Significant influence is presumed to exist at the 20 to 50 percent ownership level. However, the accountant must evaluate each situation, regardless of the percentage of ownership, to determine whether this ability is actually present.
2. To mirror the relationship between the companies, the equity method requires the investor to accrue income when the investee reports it in its financial statements. In recording this profit or loss, the investor separately reports items such as other comprehensive income and discontinued operations, to highlight their special nature. Dividend declarations decrease the owners' equity of the investee company; therefore, the investor reduces the investment account for its share of investee dividends.
3. When acquiring capital stock, an investor often pays an amount that exceeds the investee company's underlying book value. For accounting purposes, such excess payments must be either identified with specific assets and liabilities (such as land or buildings) or allocated to an intangible asset referred to as *goodwill.* The investor then amortizes each assigned cost (except for any amount attributed to land, goodwill, or other indefinite life assets) over the expected useful lives of the assets and liabilities. This amortization affects the amount of equity income recognized by the investor.
4. If the investor sells the entire investment or any portion of it, the equity method is applied until the date of disposal. A gain or loss is computed based on the adjusted book value at that time. Remaining shares are accounted for by means of either the equity method or the fair-value method, depending on the investor's subsequent ability to significantly influence the investee.
5. Inventory (or other assets) can be transferred between investor and investee. Because of the relationship between the two companies, the equity income accrual should be reduced to defer the portion of any gross profit included on these intra-entity sales until the items are either sold to outsiders or consumed. Thus, the amount of intra-entity gross profit in ending inventory decreases the amount of equity income recognized by the investor in the current period although this effect is subsequently reversed.
6. Firms may elect to report significant influence investments at fair value with changes in fair value as earnings. Under the fair-value option, firms simply report the investment's fair value as an asset and changes in fair value as earnings.

Comprehensive Illustration

(*Estimated Time: 30 to 50 Minutes*) Every chapter in this textbook concludes with an illustration designed to assist students in tying together the essential elements of the material presented. After a careful reading of each chapter, attempt to work through the comprehensive problem. Then review the solution that follows the problem, noting the handling of each significant accounting issue.

Problem

Part A

On January 1, 2019, Red Hawk Company pays $70,000 for a 10 percent interest in Wolf Company's common stock. Because market quotes for Wolf's stock are readily available on a continuing basis, the investment account has been appropriately maintained at fair value.

On January 1, 2020, Red Hawk acquires an additional 20 percent of Wolf Company for $176,000. This second purchase provides Red Hawk the ability to exert significant influence over Wolf, and Red Hawk will now apply the equity method. At the time of this transaction, Wolf had a January 1, 2020 book value of $650,000 although Wolf's equipment with a four-year remaining life was undervalued by $80,000 relative to its fair value.

During these two years, Wolf reported the following operational results (cash dividends are declared and paid in July each year):

Year	Net Income	Cash Dividends	Fair Value at January 1
2019	$210,000	$110,000	$700,000
2020	270,000	110,000	880,000

Required

a. What income did Red Hawk originally report for 2019 in connection with this investment?

b. On comparative financial statements for 2019 and 2020, what figures should Red Hawk report in connection with this investment?

Part B (Continuation of Part A)

In 2021, Wolf Company reports $400,000 in income and $60,000 in other comprehensive income from foreign currency translation adjustments. The company declares and pays a $120,000 cash dividend. During this fiscal year, Red Hawk sells inventory costing $80,000 to Wolf for $100,000. Wolf continues to hold 50 percent of this merchandise at the end of 2021. Red Hawk maintains 30 percent ownership of Wolf throughout the period.

Required

Prepare all necessary journal entries for Red Hawk for the year 2021.

Solution

Part A

a. Red Hawk Company accounts for its investment in Wolf Company at fair value during 2019. Because Red Hawk held only 10 percent of the outstanding shares, significant influence apparently was absent. Because stock quotes were readily available, the investment was periodically updated to fair value. Therefore, the investor recorded both dividends and changes in fair value in its 2019 financial statements as follows:

Dividend income (10% × $110,000)	$11,000
Increase in fair value [10% × ($880,000 – 700,000)]	18,000
Total income recognized from investment in Wolf in 2019	$29,000

b. Changes to the equity method are accounted for prospectively. Therefore, in comparative statements, Red Hawk's 2019 income from its investment in Wolf is $29,000, as reflected in the fair value method shown in (*a*).

Red Hawk's 2020 financial statements will reflect the equity method as a result of the January 1, 2020, share purchase that resulted in significant influence. To determine the 2020 equity method income, Red Hawk first evaluates its combined investments in Wolf to assess whether either goodwill or incremental asset values need to be reflected within the equity method procedures.

Fair Value Allocation of 30 Percent Ownership of Wolf Company on January 1, 2020

Fair value of initial 10 percent purchase	$ 88,000
Payment for 20 percent investment at January 1, 2020	176,000
Fair value of 30 percent ownership	264,000
Book value acquired ($650,000 × 30%)	195,000
Fair value in excess of book value	69,000
Excess fair value identified with specific assets:	
Equipment ($80,000 × 30%)	24,000
Excess fair value not identified with specific assets—goodwill	$ 45,000

In allocating Wolf's January 1, 2020, fair value, $24,000 of the payment is attributable to the undervalued equipment with $45,000 assigned to goodwill. Because the equipment now has only a four-year remaining life, annual amortization of $6,000 is appropriate ($24,000/4).

Financial Reporting—2020

Equity in Investee Income (income statement)	
Income reported by Wolf	$270,000
Red Hawk's ownership	30%
Red Hawk's share of Wolf's reported income	$ 81,000
Less: Amortization expense:	
Equipment ($24,000/4 years)	(6,000)
Equity in investee income—2020	$ 75,000
Investment in Wolf (balance sheet)	
Fair value—1/1/20 (above)	$264,000
Equity in investee income (above)	75,000
Less: Investee dividends ($110,000 × 30%)	(33,000)
Investment in Wolf—12/31/20	$306,000

Part B

In July 2021 Wolf declares and pays a $36,000 cash dividend to Red Hawk (30% × $120,000). According to the equity method, this dividend reduces the carrying amount of the investment account:

Dividend Receivable	36,000	
Investment in Wolf Company		36,000
To record the 2021 cash dividend declaration by Wolf Company.		
Cash	36,000	
Dividend Receivable		36,000
To record collection of the cash dividend.		

Red Hawk records no other journal entries in connection with this investment until the end of 2021. At that time, the annual accrual of income as well as the adjustment to record amortization is made (see Part A for computation of expense). The investee's net income is reported separately from its other comprehensive income.

Investment in Wolf Company	138,000	
Equity in Investee Income		120,000
Investee Other Comprehensive Income		18,000
To recognize reported income of investee based on a 30 percent ownership level of $400,000 net income and $60,000 other comprehensive income.		
Equity in Investee Income	6,000	
Investment in Wolf Company		6,000
To record annual amortization on excess payment made in relation to equipment ($24,000/4 years).		

Red Hawk needs to make only one other equity entry during 2021. Intra-entity sales have occurred, and Wolf continues to hold a portion of the inventory. Therefore, the investor's share of gross profit must be deferred. The gross profit rate from the sale was 20 percent ($20,000/$100,000). Because the investee still possesses $50,000 of this merchandise, the related gross profit is $10,000 ($50,000 × 20%). However, Red Hawk owns only 30 percent of Wolf's outstanding stock; thus, the intra-entity gross profit in inventory at year-end is $3,000 ($10,000 × 30%). That amount must be deferred until Wolf either consumes the inventory or sells it to unrelated parties.

Equity in Investee Company	3,000	
Investment in Wolf Company		3,000
To defer the investor's share of intra-entity gross profit in ending inventory.		

1. What advantages does a company achieve when it possesses significant influence over another company through voting stock ownership?
2. A company acquires a rather large investment in another corporation. What criteria determine whether the investor should apply the equity method of accounting to this investment?
3. What accounting treatments are appropriate for investments in equity securities without readily determinable fair values?
4. What indicates an investor's ability to significantly influence the decision-making process of an investee?
5. Why does the equity method record dividends from an investee as a reduction in the investment account, not as dividend income?
6. Jones Company owns a 25 percent interest in shares of Sandridge Company common stock. Under what circumstances might Jones decide that the equity method would not be appropriate to account for this investment?
7. Smith, Inc., has maintained an ownership interest in Watts Corporation for a number of years. This investment has been accounted for using the equity method. What transactions or events create changes in the Investment in Watts Corporation account as recorded by Smith?

8. Although the equity method is a generally accepted accounting principle (GAAP), recognition of equity income has been criticized. What theoretical problems can opponents of the equity method identify? What managerial incentives exist that could influence a firm's percentage ownership interest in another firm?
9. Because of the acquisition of additional investee shares, an investor will now change from the fair-value method to the equity method. Which procedures are applied to accomplish this accounting change?
10. Riggins Company accounts for its investment in Bostic Company using the equity method. During the past fiscal year, Bostic reported other comprehensive income from translation adjustments related to its foreign investments. How would this other comprehensive income affect the investor's financial records?
11. During the current year, Davis Company's common stock suffers a permanent drop in market value. In the past, Davis has made a significant portion of its sales to one customer. This buyer recently announced its decision to make no further purchases from Davis Company, an action that led to the loss of market value. Hawkins, Inc., owns 35 percent of the outstanding shares of Davis, an investment that is recorded according to the equity method. How would the loss in value affect this investor's financial reporting?
12. Wilson Company acquired 40 percent of Andrews Company at a bargain price because of losses expected to result from Andrews's failure in marketing several new products. Wilson paid only $100,000, although Andrews's corresponding book value was much higher. In the first year after acquisition, Andrews lost $300,000. In applying the equity method, how should Wilson account for this loss?
13. In a stock acquisition accounted for by the equity method, a portion of the purchase price often is attributed to goodwill or to specific assets or liabilities. How are these amounts determined at acquisition? How are these amounts accounted for in subsequent periods?
14. Princeton Company holds a 40 percent interest in shares of Yale Company common stock. On June 19 of the current year, Princeton sells part of this investment. What accounting should Princeton make on June 19? What accounting will Princeton make for the remainder of the current year?
15. What is the difference between downstream and upstream sales? How does this difference affect application of the equity method?
16. How is the investor's share of gross profit on intra-entity sales calculated? Under the equity method, how does the deferral of gross profit affect the recognition of equity income?
17. How are intra-entity transfers reported in an investee's separate financial statements if the investor is using the equity method?
18. What is the fair-value option for reporting equity method investments? How do the equity method and fair-value accounting differ in recognizing income from an investee?

1. When an investor uses the equity method to account for investments in common stock, the investor's share of cash dividends from the investee should be recorded as

LO 1-4

   a. A deduction from the investor's share of the investee's profits.
   b. Dividend income.
   c. A deduction from the stockholders' equity account, Dividends to Stockholders.
   d. A deduction from the investment account.
   (AICPA adapted)

LO 1-2

2. The equity method tends to be most appropriate if
   a. An investment represents 50 percent or more of the voting stock of an investee.
   b. An investment enables the investor to influence the operating and financial decisions of the investee.
   c. 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.
   d. The investor is unable to obtain representation on the investee's board of directors.

LO 1-6a

3. Hawkins Company has owned 10 percent of Larker, Inc., for the past several years. This ownership did not allow Hawkins to have significant influence over Larker. Recently, Hawkins acquired an additional 30 percent of Larker and now will use the equity method. How will the investor report change?
   a. A cumulative effect of an accounting change is shown in the current income statement.
   b. A retrospective adjustment is made to restate all prior years presented using the equity method.
   c. No change is recorded; the equity method is used from the date of the new acquisition.
   d. Hawkins will report the change as a component of accumulated other comprehensive income.

LO 1-8

4. Under fair-value accounting for an equity investment, which of the following affects the income the investor recognizes from its ownership of the investee?
   a. The investee's reported income adjusted for excess cost over book value amortizations.
   b. Changes in the fair value of the investor's ownership shares of the investee.
   c. Intra-entity profits from upstream sales.
   d. Other comprehensive income reported by the investee.

LO 1-6c

5. When an equity method investment account is reduced to a zero balance
   a. The investor should establish a negative investment account balance for any future losses reported by the investee.
   b. The investor should discontinue using the equity method until the investee begins paying dividends.
   c. Future losses are reported as unusual items in the investor's income statement.
   d. The investment retains a zero balance until subsequent investee profits eliminate all unrecognized losses.

LO 1-4

6. On January 1, Belleville Company paid $2,295,000 to acquire 90,000 shares of O'Fallon's voting common stock, which represents a 30 percent investment. No allocations to goodwill or other specific accounts were made. Significant influence over O'Fallon is achieved by this acquisition, and so Belleville applies the equity method. O'Fallon declared a $1 per share dividend during the year and reported net income of $750,000. What is the balance in the Investment in O'Fallon account found in Belleville's financial records as of December 31?
   a. $2,295,000
   b. $2,430,000
   c. $2,520,000
   d. $2,610,000

LO 1-4, 1-5

7. In January 2020, Domingo, Inc., acquired 20 percent of the outstanding common stock of Martes, Inc., for $700,000. This investment gave Domingo the ability to exercise significant influence over Martes, whose balance sheet on that date showed total assets of $3,900,000 with liabilities of $900,000. Any excess of cost over book value of the investment was attributed to a patent having a remaining useful life of 10 years.

   In 2020, Martes reported net income of $170,000. In 2021, Martes reported net income of $210,000. Dividends of $70,000 were declared in each of these two years. What is the equity method balance of Domingo's Investment in Martes, Inc., at December 31, 2021?
   a. $728,000
   b. $748,000
   c. $756,000
   d. $776,000

LO 1-4, 1-5

8. Franklin purchases 40 percent of Johnson Company on January 1 for $500,000. Although Franklin did not use it, this acquisition gave Franklin the ability to apply significant influence to Johnson's operating and financing policies. Johnson reports assets on that date of $1,400,000 with liabilities of $500,000. One building with a seven-year remaining life is undervalued on Johnson's books by $140,000. Also, Johnson's book value for its trademark (10-year remaining life) is undervalued by $210,000. During the year, Johnson reports net income of $90,000 while declaring dividends of $30,000. What is the Investment in Johnson Company balance (equity method) in Franklin's financial records as of December 31?
   a. $504,000
   b. $507,600
   c. $513,900
   d. $516,000

LO 1-4, 1-5

9. Evan Company reports net income of $140,000 each year and declares an annual cash dividend of $50,000. The company holds net assets of $1,200,000 on January 1, 2020. On that date, Shalina purchases 40 percent of Evan's outstanding common stock for $600,000, which gives it the ability to significantly influence Evan. At the purchase date, the excess of Shalina's cost over its proportionate share of Evan's book value was assigned to goodwill. On December 31, 2022, what is the Investment in Evan Company balance (equity method) in Shalina's financial records?
   a. $600,000
   b. $660,000
   c. $690,000
   d. $708,000

LO 1-7

10. Perez, Inc., applies the equity method for its 25 percent investment in Senior, Inc. During 2021, Perez sold goods with a 40 percent gross profit to Senior, which sold all of these goods in 2021. How should Perez report the effect of the intra-entity sale on its 2021 income statement?
   a. Sales and cost of goods sold should be reduced by the amount of intra-entity sales.
   b. Sales and cost of goods sold should be reduced by 25 percent of the amount of intra-entity sales.
   c. Investment income should be reduced by 25 percent of the gross profit on the amount of intra-entity sales.
   d. No adjustment is necessary.

LO 1-7

11. Jubilee, Inc., owns 35 percent of JPW Company and applies the equity method. During the current year, Jubilee buys inventory costing $60,000 and then sells it to JPW for $75,000. At the end of the year, JPW still holds only $30,000 of merchandise. What amount of gross profit must Jubilee defer in reporting this investment using the equity method?
   a. $2,100
   b. $2,625
   c. $6,000
   d. $10,500

LO 1-4, 1-5, 1-7

12. Alex, Inc., buys 40 percent of Steinbart Company on January 1, 2020, for $530,000. The equity method of accounting is to be used. Steinbart's net assets on that date were $1.2 million. Any excess of cost over book value is attributable to a trade name with a 20-year remaining life. Steinbart immediately begins supplying inventory to Alex as follows:

Year	Cost to Steinbart	Transfer Price	Amount Held by Alex at Year-End (at transfer price)
2020	$70,000	$100,000	$25,000
2021	96,000	150,000	45,000

   Inventory held at the end of one year by Alex is sold at the beginning of the next.
   Steinbart reports net income of $80,000 in 2020 and $110,000 in 2021 and declares $30,000 in dividends each year. What is the equity income in Steinbart to be reported by Alex in 2021?
   a. $34,050
   b. $38,020
   c. $46,230
   d. $51,450

LO 1-4, 1-5

13. On January 3, 2021, Matteson Corporation acquired 40 percent of the outstanding common stock of O'Toole Company for $1,160,000. This acquisition gave Matteson the ability to exercise significant influence over the investee. The book value of the acquired shares was $820,000. Any excess cost over the underlying book value was assigned to a copyright that was undervalued on its balance sheet. This copyright has a remaining useful life of 10 years. For the year ended December 31, 2021, O'Toole reported net income of $260,000 and declared cash dividends of $50,000. On December 31, 2021, what should Matteson report as its investment in O'Toole under the equity method?

LO 1-4

14. On January 1, 2021, Fisher Corporation paid $2,290,000 for 35 percent of the outstanding voting stock of Steel, Inc., and appropriately applied the equity method for its investment. Any excess of cost over Steel's book value was attributed to goodwill. During 2021, Steel reports $720,000 in net income and a $100,000 other comprehensive income loss. Steel also declares and pays $20,000 in dividends.
   a. What amount should Fisher report as its Investment in Steel on its December 31, 2021, balance sheet?
   b. What amount should Fisher report as Equity in Earnings of Steel on its 2021 income statement?

LO 1-4, 1-5

15. On January 1, 2020, Ridge Road Company acquired 20 percent of the voting shares of Sauk Trail, Inc., for $2,700,000 in cash. Both companies provide commercial Internet support services but serve markets in different industries. Ridge Road made the investment to gain access to Sauk Trail's board of directors and thus facilitate future cooperative agreements between the two firms. Ridge Road quickly obtained several seats on Sauk Trail's board, which gave it the ability to significantly influence Sauk Trail's operating and investing activities.

The January 1, 2020, carrying amounts and corresponding fair values for Sauk Trail's assets and liabilities follow:

	Carrying Amount	Fair Value
Cash and Receivables	$ 110,000	$ 110,000
Computing Equipment	5,000,000	5,700,000
Patented Technology	100,000	4,000,000
Trademark	150,000	2,000,000
Liabilities	(185,000)	(185,000)

Also, as of January 1, 2020, Sauk Trail's computing equipment had a seven-year remaining estimated useful life. The patented technology was estimated to have a three-year remaining useful life. The trademark's useful life was considered indefinite. Ridge Road attributed to goodwill any unidentified excess cost.

During the next two years, Sauk Trail reported the following net income and dividends:

	Net Income	Dividends Declared
2020	$1,800,000	$150,000
2021	1,985,000	160,000

a. How much of Ridge Road's $2,700,000 payment for Sauk Trail is attributable to goodwill?

b. What amount should Ridge Road report for its equity in Sauk Trail's earnings on its income statements for 2020 and 2021?

c. What amount should Ridge Road report for its investment in Sauk Trail on its balance sheets at the end of 2020 and 2021?

LO 1-4, 1-5, 1-8

16. On January 1, 2020, Alison, Inc., paid $60,000 for a 40 percent interest in Holister Corporation's common stock. This investee had assets with a book value of $200,000 and liabilities of $75,000. A patent held by Holister having a $5,000 book value was actually worth $20,000. This patent had a six-year remaining life. Any further excess cost associated with this acquisition was attributed to goodwill. During 2020, Holister earned income of $30,000 and declared and paid dividends of $10,000. In 2021, it had income of $50,000 and dividends of $15,000. During 2021, the fair value of Allison's investment in Holister had risen from $68,000 to $75,000.

    a. Assuming Alison uses the equity method, what balance should appear in the Investment in Holister account as of December 31, 2021?

    b. Assuming Alison uses fair-value accounting, what income from the investment in Holister should be reported for 2021?

LO 1-4, 1-7

17. On January 1, 2021, Alamar Corporation acquired a 40 percent interest in Burks, Inc., for $210,000. On that date, Burks's balance sheet disclosed net assets with both a fair and book value of $360,000. During 2021, Burks reported net income of $80,000 and declared and paid cash dividends of $25,000. Alamar sold inventory costing $30,000 to Burks during 2021 for $40,000. Burks used all of this merchandise in its operations during 2021. Prepare all of Alamar's 2021 journal entries to apply the equity method to this investment.

LO 1-2, 1-3, 1-4, 1-5, 1-6a

18. Milani, Inc., acquired 10 percent of Seida Corporation on January 1, 2020, for $190,000 and appropriately accounted for the investment using the fair-value method. On January 1, 2021, Milani purchased an additional 30 percent of Seida for $600,000 which resulted in significant influence over Seida. On that date, the fair value of Seida's common stock was $2,000,000 in total. Seida's January 1, 2021, book value equaled $1,850,000, although land was undervalued by $120,000. Any additional excess fair value over Seida's book value was attributable to a trademark with an eight-year remaining life. During 2021, Seida reported income of $300,000 and declared and paid dividends of $110,000. Prepare the 2021 journal entries for Milani related to its investment in Seida.

LO 1-7

19. Camille, Inc., sold $120,000 in inventory to Eckerle Company during 2020 for $200,000. Eckerle resold $85,000 of this merchandise in 2020 with the remainder to be disposed of during 2021. Assuming that Camille owns 30 percent of Eckerle and applies the equity method, what journal entry is recorded at the end of 2020 to defer the intra-entity gross profit?

LO 1-4, 1-5, 1-7

20. BuyCo, Inc., holds 25 percent of the outstanding shares of Marqueen Company and appropriately applies the equity method of accounting. Excess cost amortization (related to a patent) associated

with this investment amounts to $10,000 per year. For 2020, Marqueen reported earnings of $100,000 and declares cash dividends of $30,000. During that year, Marqueen acquired inventory for $50,000, which it then sold to BuyCo for $80,000. At the end of 2020, BuyCo continued to hold merchandise with a transfer price of $32,000.

a. What Equity in Investee Income should BuyCo report for 2020?

b. How will the intra-entity transfer affect BuyCo's reporting in 2021?

c. If BuyCo had sold the inventory to Marqueen, how would the answers to (*a*) and (*b*) have changed?

LO 1-2, 1-3, 1-4, 1-5, 1-6a

21. On January 1, 2019, Halstead, Inc., purchased 75,000 shares of Sedgwick Company common stock for $1,480,000, giving Halstead 25 percent ownership and the ability to apply significant influence over Sedgwick. Any excess of cost over book value acquired was attributed solely to goodwill.

Sedgwick reports net income and dividends as follows. These amounts are assumed to have occurred evenly throughout these years. Dividends are declared and paid in the same period.

	Net Income	Annual Cash Dividends (paid quarterly)
2019	$340,000	$120,000
2020	480,000	140,000
2021	600,000	160,000

On July 1, 2021, Halstead sells 12,000 shares of this investment for $25 per share, thus reducing its interest from 25 to 21 percent, but maintaining its significant influence.

Determine the amounts that would appear on Halstead's 2021 income statement relating to its ownership and partial sale of its investment in Sedgwick's common stock.

LO 1-2, 1-3, 1-4, 1-5, 1-6d

22. Echo, Inc., purchased 10 percent of ProForm Corporation on January 1, 2020, for $345,000 and accounted for the investment using the fair-value method. Echo acquires an additional 15 percent of ProForm on January 1, 2021, for $580,000. The equity method of accounting is now appropriate for this investment. No intra-entity sales have occurred.

a. How does Echo initially determine the income to be reported in 2020 in connection with its ownership of ProForm?

b. What factors should have influenced Echo in its decision to apply the equity method in 2021?

c. What factors could have prevented Echo from adopting the equity method after this second purchase?

d. What is the objective of the equity method of accounting?

e. What criticisms have been leveled at the equity method?

f. In comparative statements for 2020 and 2021, how would Echo determine the income to be reported in 2020 in connection with its ownership of ProForm? Why is this accounting appropriate?

g. How is the allocation of Echo's acquisition made?

h. If ProForm declares a cash dividend, what impact does it have on Echo's financial records under the equity method? Why is this accounting appropriate?

i. On financial statements for 2021, what amounts are included in Echo's Investment in ProForm account? What amounts are included in Echo's Equity in Income of ProForm account?

LO 1-4, 1-7

23. Parrot Corporation holds a 42 percent ownership of Sunrise, Inc., and applies the equity method to account for its investment. Parrot assigned the entire original excess purchase price over book value to goodwill. During 2020, the two companies made intra-entity inventory transfers. A portion of this merchandise was not resold until 2021. During 2021, additional transfers were made.

a. What is the difference between upstream transfers and downstream transfers?

b. How does the direction of an intra-entity transfer (upstream versus downstream) affect the application of the equity method?

c. How is the intra-entity gross profit deferral computed in applying the equity method?

d. How should Parrot compute the amount of equity income to be recognized in 2020? What entry is made to record this income?

e. How should Parrot compute the amount of equity income to be recognized in 2021?

f. If none of the transferred inventory had remained at the end of 2020, how would these transfers have affected the application of the equity method?

g. How do these intra-entity transfers affect Sunrise's financial reporting?

LO 1-2, 1-6d

24. Several years ago, Einstein, Inc., bought 40 percent of the outstanding voting stock of Brooks Company. The equity method is appropriately applied. On August 1 of the current year, Einstein sold a portion of these shares.

a. How does Einstein compute the book value of this investment on August 1 to determine its gain or loss on the sale?

b. How should Einstein account for this investment after August 1?

c. If Einstein retains only a 2 percent interest in Brooks so that it holds virtually no influence over Brooks, what figures appear in the investor's income statement for the current year?

d. If Einstein retains only a 2 percent interest in Brooks so that virtually no influence is held, does the investor have to retroactively adjust any previously reported figures?

LO 1-4, 1-5, 1-7

25. Matthew, Inc., owns 30 percent of the outstanding stock of Lindman Company and has the ability to significantly influence the investee's operations and decision making. On January 1, 2021, the balance in the Investment in Lindman account is $335,000. Amortization associated with this acquisition is $9,000 per year. In 2021, Lindman earns an income of $90,000 and declares cash dividends of $30,000. Previously, in 2020, Lindman had sold inventory costing $24,000 to Matthew for $40,000. Matthew consumed all but 25 percent of this merchandise during 2020 and used the rest during 2021. Lindman sold additional inventory costing $28,000 to Matthew for $50,000 in 2021. Matthew did not consume 40 percent of these 2021 purchases from Lindman until 2022.

a. What amount of equity method income would Matthew recognize in 2021 from its ownership interest in Lindman?

b. What is the equity method balance in the Investment in Lindman account at the end of 2021?

LO 1-2, 1-4, 1-5

26. On December 31, 2019, Akron, Inc., purchased 5 percent of Zip Company's common shares on the open market in exchange for $16,000. On December 31, 2020, Akron, Inc., acquires an additional 25 percent of Zip Company's outstanding common stock for $95,000. During the next two years, the following information is available for Zip Company:

	Income	Dividends Declared	Common Stock Fair Value (12/31)
2019			$320,000
2020	$75,000	$ 7,000	380,000
2021	88,000	15,000	480,000

At December 31, 2020, Zip reports a net book value of $290,000. Akron attributed any excess of its 30 percent share of Zip's fair over book value to its share of Zip's franchise agreements. The franchise agreements had a remaining life of 10 years at December 31, 2020.

a. Assume Akron applies the equity method to its Investment in Zip account:

What amount of equity income should Akron report for 2021?

On Akron's December 31, 2021, balance sheet, what amount is reported for the Investment in Zip account?

b. Assume Akron uses fair-value accounting for its Investment in Zip account:

What amount of income from its investment in Zip should Akron report for 2021?

On Akron's December 31, 2021, balance sheet, what amount is reported for the Investment in Zip account?

LO 1-4, 1-5, 1-6d, 1-7

27. Belden, Inc., acquires 30 percent of the outstanding voting shares of Sheffield, Inc., on January 1, 2020, for $312,000, which gives Belden the ability to significantly influence Sheffield. Sheffield has a net book value of $800,000 at January 1, 2020. Sheffield's asset and liability accounts showed carrying amounts considered equal to fair values, except for a copyright whose value accounted for Belden's excess cost over book value in its 30 percent purchase. The copyright had a remaining life of 16 years at January 1, 2020. No goodwill resulted from Belden's share purchase.

Sheffield reported net income of $180,000 in 2020 and $230,000 of net income during 2021. Dividends of $70,000 and $80,000 are declared and paid in 2020 and 2021, respectively. Belden uses the equity method.