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Accounting for Intercorporate Investments

In 1982, **AT&T Corporation** (“Ma Bell”), the sole provider of local and long-distance phone service in the U.S., was declared to be a monopoly and was forced to divest and break up its local phone service operations into seven regional companies known as the “Baby Bells.” In return, AT&T received

the right to enter the computer business. During the next two decades, the market methodically recombined the Baby Bells into three surviving companies: AT&T (formed by the merger of **Southwestern Bell**, **BellSouth**, **Ameritech**, and **Pacific Telesis**), **Verizon** (formed by the merger of **Nynex** and **Bell Atlantic**), and **Qwest** (originally **USWest**).

AT&T

Prior to the merger of AT&T and BellSouth in 2006, these two companies formed a joint venture known as **Cingular Wireless**. Cingular is now the largest wireless provider in the U.S., with over 70 million subscribers and revenues in excess of \$38 billion. AT&T and BellSouth managed the Cingular Wireless joint venture equally, sharing voting rights and representatives on Cingular’s board of directors. Each of these companies could exert “significant influence” over the operations of Cingular, but could not “control” the joint venture. As a result, both AT&T and BellSouth accounted for their respective investments in Cingular using the *equity method* of accounting.

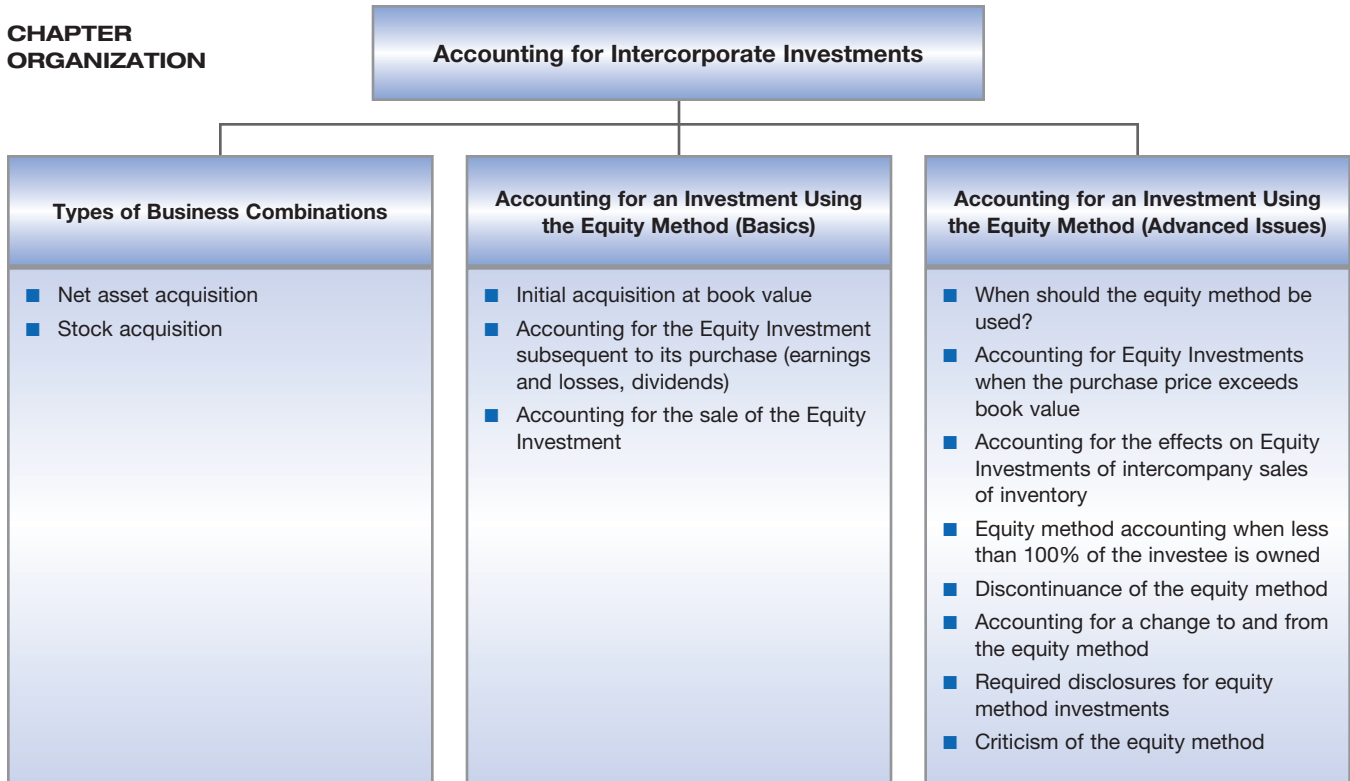
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Under the equity method of accounting, AT&T and BellSouth recorded their investments in Cingular on their respective balance sheets as an asset. AT&T, for example, referred to this asset as “Investments in and Advances to Cingular Wireless,” with a reported carrying amount of over \$31 billion, representing over 20% of AT&T’s total assets. The Equity Investment portion of this asset was equal to one-half of Cingular’s Stockholders’ Equity, the percentage owned by AT&T (the advances portion represents loans that AT&T made to the Cingular joint venture). And, as Cingular’s Stockholders’ Equity increased or decreased, so did the investment account on AT&T’s balance sheet. That is the nature of the equity method of accounting for intercorporate investments. The basic idea is that each company reports as an asset the percentage of the Stockholders’ Equity of the business that it owns, not its market value, as is the case with passive investments, which you learned in your intermediate accounting class.

This chapter illustrates the equity method of accounting for intercorporate investments. Although a valuable topic in its own right, understanding the equity method of accounting is critical to an understanding of the consolidation process that comprises the next five chapters of this text. To give you a sneak peek, the consolidation process basically replaces this investment account with the assets and liabilities of the business represented by that investment (we make similar changes to the income statement). That is, instead of reporting the equity of the business, we report its assets and liabilities. We will tell you how this is done in Chapter 2. For now, just concentrate on learning the equity method of accounting thoroughly. The more time you spend on this chapter, the easier you will find the consolidation process that follows.

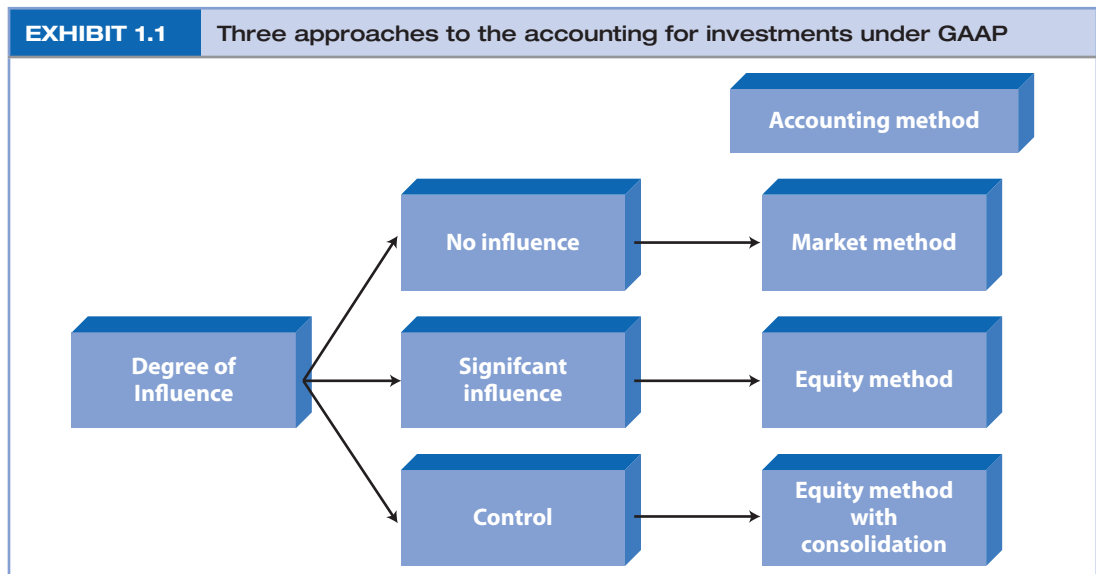
Sources: AT&T 10-K 2005–2007

CHAPTER ORGANIZATION



Companies can invest in other companies just like you can, and they purchase these investments for a variety of reasons. Sometimes companies purchase an investment as an alternative to holding excess cash, and they earn a return on this equity investment in the form of dividends and appreciation in the value of the investment. Or, they may invest for strategic reasons, such as to solidify relations with suppliers or to gain entry into a new market. These investments are typically larger in amount and represent a significant percentage ownership in the other company.

The accounting for investments in the voting shares of other companies depends on the degree to which the company making the investment (the *investor*) can influence the operating activities of the company in which it is investing (the *investee*). These approaches are illustrated in Exhibit 1.1.



No influence (market method)—the investment account is reported on the balance sheet at its current market value at each statement date. Dividends received are recognized as income, and increases in the market value of the investment are reported in current income or other comprehensive income (OCI) depending on whether the investment is accounted for as a *trading* security or an *available-for-sale* security. This method is required if the investment is passive in nature (i.e., the investor *cannot* exert significant influence over or control the investee company).¹

Significant influence (equity method)—the investment account is not reported at market value, but at an amount that is equal to the proportion of the stockholders' equity of the investee company that the investor owns (and typically also includes fair value adjustments which we discuss later in the chapter).

Control (consolidation)—the equity method continues to be used by the investor company to account for its investment in the investee company, but, once the investor company is deemed to “control” the investee, the financial statements of the two companies must be consolidated, that is, combined (we discuss the consolidation process beginning in Chapter 2).

The degree of influence or control that the investor company can exert over the investee company's operating activities determines the method that the investor must use to account for its equity investment. Intermediate accounting textbooks typically include a discussion of the market method of accounting for passive investments and a brief introduction to the equity method and to the consolidation process. Our focus in this chapter is on investments involving significant influence and the equity method of accounting for these investments. In Chapter 2, we begin our discussion of the consolidation process relating to investments in which the investor has control over the investee.

Our experience suggests that you will be much better prepared to learn the consolidation process if you first understand well the accounting for investments using the equity method. Consolidation is just an expanded form of the equity method. So, if you invest the time now to thoroughly understand the equity method of accounting, you will find the consolidation process much easier to learn.

Let us now turn to a discussion of the ways in which one company can acquire another.

REVIEW OF ASSET ACQUISITION ACCOUNTING

In previous courses, you have learned that the accounting for the purchase of a single asset requires you to first determine the amount paid for the asset and, then, to assign that amount to the acquired asset. When a company acquires more than one asset in a single transaction, however, the appropriate accounting is determined by whether the group of assets qualifies as a *business*.²

If more than one asset is purchased for a single lump-sum payment (“basket purchase”) and the group of assets does *not* qualify as a business, the purchaser should proportionately allocate the lump-sum payment to the individual acquired assets on the basis of the *relative fair values* of the acquired assets.³

To illustrate, assume that an investor company acquires the following net assets of an investee company for a single lump sum cash payment of \$880 and that the bundle of net assets does *not* meet the definition of a business in FASB ASC 805. The allocation of the \$880 purchase price to the individual assets acquired is based on the relative fair values of the assets as follows:

LO1 Identify the types of business combinations and the accounting for each

¹ If no readily determinable fair value exists for the securities owned, the investor accounts for the investment using the cost method as indicated by FASB ASC 325-20. Under the cost method, the investment is recorded at its cost (i.e., purchase price) and is not subsequently adjusted for changes in its market value. Further, dividends received are recorded as income.

² FASB ASC Master Glossary defines a **business** as follows: “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. A business consists of inputs and processes applied to those inputs that have the ability to create outputs.” Additional guidance on what a business consists of is presented in FASB ASC 805-10-55-4 through 55-9.

³ As noted in FASB ASC 805-50-30-3, the cost of a group of assets acquired in an asset acquisition is allocated to the individual assets acquired or liabilities assumed based on their relative fair values and does *not* give rise to goodwill. This is one important difference between basket purchases of assets and the business combination transactions discussed in this chapter.

Debit (Credit)	Fair Value (assumed)*	Fair Value Proportion (Fair Value / \$800)	Allocated Cost
Accounts receivable, net	\$100	12.5%	\$110
Inventories	300	37.5%	330
Building	600	75.0%	660
Mortgage liability	(200)	(25.0%)	(220)
Total	<u>\$800</u>	<u>100.0%</u>	<u>\$880</u>

* It is important to note that the values assigned to the assets and liabilities are the investor's estimates of fair values. These fair values will be different from both the book values at which these assets are reported on the seller's balance sheet on the date of sale and, possibly, the seller's estimates of their fair values.

Given these allocated costs, the investor records the transaction as follows:⁴

Accounts receivable	110
Inventories	330
Building	660
Mortgage liability	220
Cash	880

The investor records the assets purchased and liabilities assumed at their *allocated costs* on the date of purchase, and cash is credited for the payment. A basket purchase of net assets that does *not* qualify as a business combination is accounted for just like the purchase of any other asset; each asset is recorded at the allocated cost that we compute in the table above.

Types of Business Combinations

When the acquisition of net assets qualifies as the purchase of a “*business*,” a specialized set of accounting principles, called the *Acquisition Method*, applies. This method applies only to *business combinations*, which are most commonly executed via two general types of transaction structures: asset acquisitions and stock acquisitions. In a *net asset acquisition*, the acquirer directly purchases the individual net assets that constitute a business.⁵ In a *stock acquisition*, the acquirer purchases the business by acquiring its voting shares. We discuss both of these acquisition structures in this section.

Net Asset Acquisition In a net asset acquisition, the acquirer purchases some or all of the assets of the acquiree, and may assume selected liabilities, like a mortgage on a building it is acquiring. For the most part, this type of purchase is accounted for like any asset purchase: the net assets are recorded on the balance sheet with an offsetting reduction of cash and/or an increase in liabilities or common stock.

An important feature of *business combinations* is that the acquiring company must apply *Acquisition Method* accounting (as defined in SFAS ASC 805) which requires that the acquired net assets are recorded on the balance sheet at *fair value*, regardless of the amount paid by the acquirer. This means that the purchase price for the acquired net assets is *not allocated* to those net assets as in our previous example; instead, the assets are recorded at their respective fair values with any difference between the fair value of those net assets and the purchase price paid for them recorded as Goodwill.⁶ Goodwill is an intangible asset that is only recorded in transactions that qualify as *business combinations*.

To illustrate, let's return to the facts from the previous basket purchase example. Let's now assume that the asset acquisition qualifies as a business combination under FASB ASC 805. In this

⁴ Intermediate Accounting textbooks typically confine their discussion of the relative fair value method to PPE assets. FASB ASC 805-50-30-3, however, applies to all assets acquired, including current assets. Given the initial values as computed in this example, each of the assets acquired would be subsequently tested for impairment and written down, if necessary.

⁵ The *acquiree* is defined as “the business or businesses that the acquirer obtains control of in a business combination.” The *acquirer* is defined as “the entity that obtains control of the acquiree” (FASB ASC Master Glossary).

⁶ In Chapter 2 we more fully discuss the Acquisition Method, accounting for Goodwill, including the case where Goodwill appears to be negative.

case we will also modify the composition of the consideration paid in exchange for the net assets so that the acquirer pays the \$880 purchase price with cash of \$380 and by issuing 100 shares of \$1 par value common stock with a market value of \$5 per share.⁷ The fair values of the net assets are the same amounts that we report in our previous example (note: we are using the fair values, not the allocated cost as we did previously), and the investor records the purchase of these assets as follows:

Accounts receivable	100	
Inventories	300	
Building	600	
Goodwill	80	
Cash		380
Mortgage liability		200
Common stock (100 shares @ \$1 par value)		100
Additional paid-in capital		400

The investor records the assets purchased and (mortgage) liability assumed at their fair values on the date of purchase, and cash is credited for the payment. The issuance of common stock is recorded by a credit to Common Stock for the par value of the shares issued, with the remainder recorded as an increase in Additional Paid-in Capital.

In many ways, the purchase of net assets that comprise a business is recorded much like the purchase of any asset. However, one important difference is that acquired net assets in a business combination are recorded at their *fair values*, not at the *allocated cost* of the acquired net assets as in our previous example. And, a second difference is that the acquisition may involve the recognition of a Goodwill asset at an amount that is equal to the difference between the amount paid for an acquisition and the fair value of the net assets acquired. We discuss the determination of Goodwill in Chapter 2. For now, you can view the Goodwill asset as the difference between the amount paid and the fair value of the net assets received in a business combination.

Stock Acquisition In our previous example, the investor purchased selected *net assets* of the investee with a value of \$880. Let us now assume that the investor purchases all of the investee's outstanding *common stock* from its shareholders, rather than specific assets. The investor funds the purchase price of \$880 by a cash payment of \$380 and issuance of 100 shares of \$1 par value common stock with a market value of \$500, like before. The investor records the purchase of the investee's common stock as follows:

Equity investment	880	
Cash		380
Common stock (100 shares @ \$1)		100
Additional paid-in capital		400

The Equity Investment account is an asset that is reported on the investor's balance sheet just like any other asset, and, our use of the term "investment" in this journal entry implies that the acquired company will remain in existence after the purchase.⁸

Notice that the Equity Investment account of \$880 represents the *implied* Stockholders' Equity of the investee's business that the investor has acquired. In our previous example, the investor acquired specific assets (accounts receivable in the amount of \$100, inventories of \$300, the building in the amount of \$600, and \$80 of goodwill, less the mortgage assumed of \$200). Now, we are acquiring the investee's common stock rather than its specific assets, and the Equity Investment account represents the investee's business in one account on our balance sheet at a reported amount

⁷ If noncash assets (like land and building) are given as consideration, those assets are first adjusted to their market values before removal from the investor's balance sheet. This adjustment results in a gain or loss that is reflected in the investor's income statement (FASB ASC 805-50-30-1). In addition, transaction costs, such as professional fees, are included in the purchase price (and, thus, recorded as an asset rather than recognized as expenses in the income statement). Transaction costs are expensed, however, in the purchase of a business as we discuss later in this chapter.

⁸ If the acquired company ceases to exist after the acquisition, we would record the assets purchased and liabilities assumed as in our asset purchase above. The dissolution of the acquired company following the sale is called a *statutory merger*.

of \$880 that is equal to the fair value of the investee's Stockholders' Equity (assets of \$100 + \$300 + \$600 + \$80 – liabilities of \$200 = Stockholders' Equity of \$880) on the acquisition date.

In future years, the Equity Investment account on the investor's balance sheet will increase or decrease as the Stockholders' Equity of the investee's business grows or shrinks. In the next section of this chapter, we discuss the mechanics by which the Equity Investment account increases and decreases following the acquisition.

TOPIC REVIEW 1

Accounting for Asset and Stock Purchases

Assume that an investor purchases an investee's business for \$500. The investee reports the following assets and liabilities on the date of purchase:

Accounts receivable	\$ 50	Mortgage payable	\$ 50
Inventories	100		
Building	400	Stockholders' equity	500
Total assets	<u>\$550</u>	Total liabilities and equity	<u>\$550</u>

The investor purchases the investee with a cash payment of \$200 and the issuance of 50 shares of \$1 par value common stock with a current market value of \$6 per share.

1. Provide the journal entry on the investor's books for the purchase of selected assets (and not the business) of the investee and assumption of its mortgage liability.
2. Provide the journal entry on the investor's books for the purchase of the investee's business, assuming that it purchases the investee's net assets as a stock purchase.

The solution to this review problem can be found on page 35.

ACCOUNTING FOR AN INVESTMENT USING THE EQUITY METHOD (BASICS)

LO2 Explain the mechanics of the accounting for investments using the equity method of accounting

In the previous section, the investor acquires the business of an investee by either purchasing its assets or purchasing its common stock, and recognizes the investee company on its balance sheet either as individual assets and liabilities (asset purchase) or with an account called Equity Investment (stock purchase). In this section, we focus only on the stock purchase and we discuss the accounting for this Equity Investment from its purchase through its ultimate sale.

Accounting for the Purchase of an Equity Investment

This Equity Investment account represents the proportion of the equity of the acquired business that we own. To introduce the concept of equity-method accounting, we first assume that the market values of the acquired company's net assets equal their reported amounts (i.e., their "book value") on the balance sheet (we will relax this assumption later). That is, the market value of the company's business is initially assumed to be \$800, rather than the \$880 we used in the previous example, and this amount is equal to the Stockholders' Equity of the acquired company on the date of purchase.

The investor records the Equity Investment as follows:

Equity investment	800	
Cash		300
Common stock (100 shares @ \$1)		100
Additional paid-in capital		400

The purchase of the \$800 Equity Investment is funded by a \$300 decrease in Cash and a \$500 increase in Stockholders' Equity. The investee's business is now represented on the investor's balance sheet as an asset (Equity Investment) that is equal to the Stockholders' Equity of the acquired company on the date of purchase.

Since, in this example, the investor owns 100% of the investee company and the market value of the business is equal to its Stockholders' Equity, the investor's Equity Investment account in the amount of \$800 is equal to the proportion of the investee's Stockholders' Equity that it owns, namely 100% of \$800 = \$800. Illustration 1.1 depicts this relation.

Investee Company Balance Sheet		Investor Company Balance Sheet			
Accounts receivable... \$ 100	Mortgage payable ... \$ 200	Cash \$ 300	Payables..... \$ 200		
Inventories 300		Receivables 500	Accruals 300		
Building 600		Inventories 900	L-T Liabs 1,000		
		PPE, net 2,500			
	S-H Equity 800	Investment 800	Equity 3,500		
Total <u>\$1,000</u>	Total <u>\$1,000</u>	Total <u>\$5,000</u>	Total <u>\$5,000</u>		

In this example, the investor acquires the Equity Investment at “book value,” that is, in an amount equal to the book value of the investee's Stockholders' Equity. There will always be an important relation between the amount at which the Equity Investment is reported on the investor's balance sheet and the Stockholders' Equity of the investee company: **provided that the acquisition is made at book value, the balance reported in the Equity Investment account will always be equal to the proportion of the investee company equity that we own.**⁹ And, as the investee's Stockholders' Equity increases or decreases, so does the Equity Investment on the investor's balance sheet. In our next section, we discuss the process by which these increases or decreases are recognized.

Accounting for the Equity Investment Subsequent to Its Purchase

We divide our discussion of the accounting treatment for an Equity Investment subsequent to purchase into two parts: accounting for changes in its reported amount during the holding period of the Equity Investment and accounting for its ultimate sale.

Accounting for Changes in the Reported Amount of the Equity Investment Subsequent to Its Purchase

Let us now assume that the investee earns a profit of \$300 and pays a dividend of \$100 to the investor. The investee's Stockholders' Equity has, therefore, increased by \$200 (\$300 profit – \$100 dividend) to \$1,000. To maintain the equivalence between the Equity Investment account on the investor's balance sheet and the investee's Stockholders' Equity, the Equity Investment must likewise increase by \$200 to a balance of \$1,000. This is accomplished by recording two changes to that account:

1. A \$300 *increase* to recognize the investor's share of the increase in the investee's Stockholders' Equity resulting from the profit of \$300,¹⁰ and
2. A \$100 *decrease* to recognize the investor's share of the decrease in the investee's Stockholders' Equity resulting from the payment of dividends (reduction of Retained Earnings) of \$100.

⁹ Even when the investment is at an amount different from book value, there will be a similar relation to the Stockholders' Equity of the investee as we discuss later in the chapter.

¹⁰ According to FASB ASC 323-10-45-2, if the investee company's net income includes extraordinary items, the investor must also segregate its equity income into ordinary and extraordinary items in the same proportion, unless the amount of extraordinary items is deemed *not* to be *material* with respect to the investor's net income (an item is material if its omission or misstatement could influence the economic decision of users). In addition, the investment account will change for all sources of recognized income, including “other comprehensive income.” The investor also must segregate ordinary income from the individual sources of other comprehensive income (FASB ASC 323-10-35-18 and 323-10-45-3).

The journal entries that an investor must make to accomplish these changes are as follows:

1. Equity investment	300	
Equity income		300
<i>(to record the recognition of Equity Income)</i>		
2. Cash	100	
Equity investment		100
<i>(to record the receipt of dividends)</i>		

A T-account for the investor’s Equity Investment illustrates these changes:

Equity Investment		
Beginning balance	800	
Equity income	300	100 Dividends received
Ending balance	<u>1,000</u>	

As the investee earns a profit of \$300, its Stockholders’ Equity (Retained Earnings) increases by that amount and the Equity Investment account on the investor’s balance sheet must increase accordingly. Likewise, the payment of dividends to the investor results in a decrease in the investee’s Stockholder’s Equity (Retained Earnings) and a consequent decrease in the Equity Investment on the investor’s balance sheet. The equity method of accounting, then, results in an Equity Investment account that increases and decreases together with the Stockholders’ Equity of the investee company.¹¹

We conclude this section of our chapter with three observations relating to the investor’s accounting for its Equity Investment under the equity method:

- First, the investor does not report the receipt of dividends as income like it does under the market method of accounting for passive investments that you learned in previous financial accounting courses. Dividends are treated as a return of investment and the Equity Investment account is reduced accordingly. Instead, the investor reports income from the investment equal to the percentage of the investee’s net income that it owns. In this case, the investor owns 100% of the investee. So, it reports 100% of the investee’s net income as Equity Income in its own income statement.
- Second, the investor only reports Equity Income commencing with the date on which it purchases the Equity Investment. For example, if the investor purchases the Equity Investment on March 1, it can only include in its income statement the percentage of the investee’s profit that it earns subsequent to March 1.
- And third, under the equity method, the investor does not adjust the Equity Investment account for changes in its market value, as is the case with the market method of accounting for investments in which the investor can exert no influence over the investee’s operating activities. Consequently, there may be substantial unrealized gains that are not reported on the balance sheet, and the investor does not report these gains in its income statement. Instead, all unrealized gains are recognized in full when the investment is sold.

Accounting for the Sale of the Equity Investment We account for the sale of an Equity Investment in the same way as we do for the sale of any other asset that we own:

- Record the receipt of cash (or other assets, such as a note receivable).
- Remove the Equity Investment from the balance sheet.
- Recognize the difference between cash received and the reported amount (book value) of the Equity Investment as a gain or loss on the sale.

¹¹ FASB ASC 825-10-25 allows companies to *irrevocably* elect to measure Equity Investments at fair value, with changes in market value reflected in income. Should a company elect to measure Equity Investments under this standard, the reported amount may differ from the Stockholders’ Equity of the investee company that the investor owns. However, an Equity Investment that represents subsidiaries to be *consolidated* cannot be valued at fair value.

To illustrate, assume that the investor sells its Equity Investment (which it currently reports on its balance sheet at \$1,000) for cash proceeds of \$1,250. The journal entry to record this sale is as follows:

Cash	1,250	
Equity investment		1,000
Gain on sale		250
<i>(to record the sale of the Equity Investment)</i>		

The investor recognizes a gain on the sale of the Equity Investment because the proceeds (\$1,250) exceed the reported amount (book value) of the investment (\$1,000) on its balance sheet. Had it sold the Equity Investment for \$700, however, it would record a loss as follows:

Cash	700	
Loss on sale	300	
Equity investment		1,000
<i>(to record the sale of the Equity Investment)</i>		

Finally, we provide a summary of the basic accounting for Equity Investments in Exhibit 1.2.

EXHIBIT 1.2	Summary of the Equity Method of Accounting (basics)
<ol style="list-style-type: none"> 1. The Equity Investment is initially recorded at its purchase price. 2. Dividends received are treated as a recovery of the investment and, as a result, reduce the Equity Investment account. 3. The investor reports income equal to its percentage share of the investee’s reported income. 4. As a result of #2 and #3, the Equity Investment account on the investor’s balance sheet increases and decreases to reflect corresponding increases and decreases in the investee’s Stockholders’ Equity. 5. Changes in market value of the Equity Investment are not reflected as adjustments to the reported amount of the Equity Investment and, thus, are not recognized in income until the Equity Investment is sold. 	

TOPIC REVIEW 2

Accounting for Equity Investments (basic)

In our previous topic review (part 2), the investor purchases all of the stock of the investee (and, thus, its business) in a stock purchase for \$500. The investee’s balance sheet on the date of purchase is as follows:

Accounts receivable.....	\$ 50	Mortgage payable	\$ 50
Inventories	100		
Building	<u>400</u>	Stockholders’ equity	<u>500</u>
Total assets	<u>\$550</u>	Total liabilities and equity.....	<u>\$550</u>

Now, assume that, subsequent to the purchase, the investee reports net income of \$100 and pays \$25 in dividends to the investor.

1. At what amount will the investee’s Stockholders’ Equity be reported after income and dividends have been closed to Retained Earnings (assume no other changes to Stockholders’ Equity)?
2. Provide the following journal entries:
 - a. Record the recognition of Equity Income by the investor
 - b. Record the receipt of the \$25 dividend
3. At what amount is the Equity Investment reported on the investor’s balance sheet? How does this compare to the investee’s Stockholders’ Equity?

The solution to this review problem can be found on page 35.

ACCOUNTING FOR AN INVESTMENT USING THE EQUITY METHOD (ADVANCED TOPICS)

LO3 Explain when the equity method should be used

In the previous section, we discuss the purchase of the Equity Investment, the recognition of income and dividends subsequent to purchase, and the sale of the Equity Investment. These topics are the basics of the equity method of accounting. We now introduce a number of more advanced issues, such as the rules governing the use of the equity method, how we account for Equity Investments purchased at a price that exceeds book value, accounting issues that arise when the investor and investee companies sell assets to one another, the purchase of less than 100% ownership of the investee company equity, the circumstances under which we discontinue use of the equity method altogether, the reporting of changes to and from the equity method and other methods of accounting for intercorporate investments, and related disclosures to equity method investments. We begin with a discussion of when to use the equity method of accounting.

When Should the Equity Method Be Used?

GAAP prescribes that the equity method should be used to account for Equity Investments when the investor has the ability to exercise “significant influence” over operating and financial policies of an investee (FASB ASC 323).¹² Traditionally, accountants *presumed* the ability to exercise significant influence over the investee company when the investor owned more than 20% of the investee’s outstanding voting stock. The FASB is now moving away from quantitative measures such as this, however, and is placing more reliance on the judgment of accountants in making that determination.

So, how should you decide if the investor has the ability to exercise significant influence over the investee’s operating and financial policies? The ability to exercise significant influence may be indicated in a number of ways (FASB ASC 323-10-15-6):

- Investor representation on the board of directors of the investee
- Investor participation in policy making processes of the investee
- The extent of ownership of investee voting shares by the investor in relation to the concentration of other shareholdings.
- Material intercompany transactions between the investor and the investee
- Interchange of managerial personnel between the investor and the investee
- Technological dependency of the investee on the investor

The first three criteria relate to the investor’s participation in executive decision making bodies of the investee company and its ability to influence the board of directors and, thus, the operating policies of the investee. The last three criteria relate to direct involvement in the operating activities of the investee company. All of these criteria do not have to be met in order to conclude that the investor has the ability to exert significant influence. Any of them can provide sufficient evidence to conclude that the ability to exercise significant influence is present, even if the investor owns less than 20% of the outstanding voting stock of the investee.

The converse might also be true: the investor might not have significant influence even though it owns more than 20% of the outstanding voting stock of the investee. Examples of indications that an investor may be *unable* to exercise significant influence over the operating and financial policies of an investee include (FASB ASC 323-10-15-10):

- The investee challenges the investor’s ability to exercise significant influence, such as by litigation or complaints to governmental regulatory authorities.

¹² FASB ASC 323 also requires the use of the equity method to account for investments in corporate *joint ventures*. A joint venture is a non-stock entity that is managed by more than one “owner.” The AT&T and BellSouth **Cingular Wireless** joint venture is an example. Until their merger in 2006, both AT&T and BellSouth were required to account for the **Cingular** joint venture using the equity method of accounting for the Equity Investment since each company had an equal voice in the management of the business. We discuss the accounting implications of their merger in Chapter 2.

- The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.
- Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.
- The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
- The investor tries and fails to obtain representation on the investee's board of directors.

When any of these conditions are present, the investor company may be justified in *not* employing the equity method in accounting for the investment despite ownership of more than 20% of the outstanding voting stock of the investee.

The investor must account for the Equity Investment using the equity method when it can exert significant influence over the investee company, and it can continue to account for this Equity Investment using the equity method even after it gains “control” over the activities of the investee (say, at ownership levels of 100% as in our example).¹³ When the investor obtains control of the investee, however, it must *consolidate* the financial statements of both companies when reporting to *external* parties such as shareholders or the SEC. For *internal* reporting, however, the investor can use the equity method to account for its Equity Investment in the investee company.

BUSINESS INSIGHT

Can AT&T account for its investment in Cingular using the equity method?

Cingular Wireless (now known as AT&T Mobility) began as a joint venture between, what are now, AT&T and BellSouth, two of the original Baby Bells. A joint venture is an agreement between two or more companies to form a business. The joint venture agreement spells out how the company will be run and how the profits will be split. The Cingular joint venture agreement provides that AT&T has a 60% *economic interest* in Cingular, with BellSouth owning a 40% economic interest. That means that AT&T receives 60% of the profit and BellSouth 40%. How should AT&T account for its investment in the Cingular joint venture given its 60% economic interest?

Following is a quote from the footnotes to AT&T's annual report that discusses this issue:

We account for our 60% economic interest in Cingular under the equity method of accounting in our consolidated financial statements since we share control equally (i.e., 50/50) with our 40% economic partner in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular.

AT&T contends that the equity method is appropriate since it shares voting control equally with its joint venture partner. As a result, it can exert significant influence over Cingular's operating activities, but cannot *control* that company. Accounting for the Equity Investment using the equity method is, therefore, appropriate in this instance.

We discuss the consolidation process beginning in Chapter 2. As you will see, consolidation is basically the replacement of the Equity Investment account with the assets and liabilities of the investee company to which that account relates. So, don't be surprised when we account for the parent company's investment in a wholly-owned subsidiary (investee) using the equity method. As long as the two companies are ultimately consolidated prior to issuance of the financial statements to shareholders and the SEC, that is perfectly acceptable.

¹³ Control is typically defined as legal control, that is, ownership of more than 50% of the outstanding voting stock of the investee company. As is the case with *significant influence*, however, accountants must look to all of the available evidence in order to determine when *control* is present. We discuss the determination of control in the next chapter.

TOPIC REVIEW 3

Criteria for Using the Equity Method

In its 10-K, **Anheuser-Busch** discloses that it owns a 35.12% direct interest in Grupo Modelo, S.A.B. de C.V. (Modelo), Mexico's largest brewer and producer of the Corona brand, and a 23.25% direct interest in Modelo's operating subsidiary Diblo, S.A. de C.V. (Diblo). The company's direct investments in Modelo and Diblo give Anheuser-Busch an effective (direct and indirect) 50.2% equity interest in Diblo. Anheuser-Busch holds 9 of 19 positions on Modelo's board of directors (with the Controlling Shareholders Trust holding the other 10 positions) and also has membership on the audit committee.

Does Anheuser-Busch's representation on the Modelo board of directors allow it to exert significant influence or to control the company? That is, should Anheuser-Busch account for its investment using the equity method, or should it consolidate Modelo's financial statements with its own?

The solution to this review problem can be found on page 35.

Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO4 Explain the amortization of excess assets, and the deferral of unrealized income

When we introduced the basics of equity-method accounting, the investor acquired all of the investee's outstanding stock for a purchase price of \$800, equal to the investee's Stockholders' Equity on the date of acquisition. In this initial case, the purchase is said to be made at "book value."

Acquisitions are rarely made at book value, however. The reason is twofold: financial statements are prepared using historical costing and, for the most part, do not reflect current market values (one exception is the investment in marketable securities accounted for using the market method); and, second, there may be unrecorded assets, such as an internally developed patent, for example, that will be factored into the purchase price but are not reported on the investee's balance sheet.

When the price of the Equity Investment exceeds the book value of the company acquired, the investor has, essentially, purchased two groups of assets: the net assets (assets less liabilities) that are reported on the balance sheet of the investee company (these net assets are equal to its reported Stockholders' Equity) *plus* some additional previously unrecorded assets. In order to account for these additional assets following the acquisition, the investor must first decide what they are. They could be tangible assets, such as PPE, or intangible assets, such as recorded Patent assets or the more general Goodwill asset. Once the investor determines the nature of these additional assets, it must subsequently account for these assets just like any other assets that it purchases. That is, tangible assets must be depreciated and definite-lived intangible assets (i.e., intangible assets other than Goodwill and other indefinite-lived intangibles) must be amortized over their useful lives.

To illustrate, assume that the investor purchases all of the stock of the investee for a purchase price of \$1,100 (instead of \$800), with a cash payment of \$600 and issuance of 100 shares of \$1 par value common stock with a market value of \$500 (\$5 per share). Assume that the investor is willing to pay the increased purchase price because it feels that a building, reported on the investee's balance sheet at a net book value (cost less accumulated depreciation) of \$600, has a current market value of \$900. The purchase price of \$1,100, then, is comprised of two assets: the book value of the Stockholders' Equity of the investee company *plus* the portion of the building's value not reported on the investee's balance sheet:

Purchase price	Assets acquired
\$1,100	<div style="display: flex; align-items: center;"> <div style="font-size: 2em; margin-right: 10px;">{</div> <div style="display: flex; flex-direction: column; gap: 5px;"> <div style="display: flex; align-items: center;"> \$800 Book value of Stockholders' Equity of the investee company </div> <div style="display: flex; align-items: center;"> \$300 Building value not reported on investee company's balance sheet </div> </div> </div>

If the investor had purchased just the building for \$900, it would depreciate it over its useful life. Acquiring the building as part of a stock purchase is no different. The investor and investee will

still depreciate the full purchase price of the building. The only difference is that the depreciation will be done in two places:

1. The *investee* will continue to depreciate the \$600 book value of the building it reports on its balance sheet, and
2. The *investor* will depreciate the additional \$300 building asset that it purchased in the acquisition.

To illustrate, assume that the building has a remaining life of 20 years and is depreciated on a straight-line basis with no salvage value. The *total* depreciation expense is \$45 per year (\$900/20). The \$45 depreciation expense, however, is recorded in two different income statements:

Total Depreciation expense	Where recorded
\$45	{ \$30 (\$600/20) Investee's income statement { \$15 (\$300/20) Investor's income statement

The investee continues to depreciate the book value of the building as it has been doing all along. This means that the \$30 of depreciation expense that the investee (acquired) company recognizes will reduce its reported income (and this expense will ultimately affect the investor's income statement via the Equity Income adjustment under the equity method). In addition, the investor recognizes the additional \$15 of depreciation expense in its own income statement. How? By reducing the Equity Income it is recognizing on its Equity Investment.

Let's see how this is accomplished. The investor's Equity Investment, reflecting the new purchase price, is recorded as follows:

Equity investment	1,100	
Cash		600
Common stock (100 shares @ \$1)		100
Additional paid-in capital		400

Let us continue to assume that the investee earns a profit (all in cash) of \$300 and pays a dividend of \$100 to the investor, just like before. The investee's Stockholders' Equity, therefore, increases by \$200 to a balance of \$1,000. Notice that the higher purchase price for the Equity Investment has not affected the investee at all. That additional investment is on the *investor's* balance sheet, not the investee's balance sheet.

The investor makes the following journal entries to recognize the Equity Income earned and dividends received as before:

1. Equity investment	300	
Equity income		300
<i>(to record the recognition of Equity Income)</i>		
2. Cash	100	
Equity investment		100
<i>(to record the receipt of dividends)</i>		

These are the same journal entries that we recorded earlier. However, given the additional facts in the present example, one additional journal entry is required on the investor's books to record the depreciation of the new building asset. This is accomplished by the following journal entry:

Equity income	15	
Equity investment		15
<i>(to record the depreciation of the building asset)</i>		

Equity Income is reduced by the depreciation of the additional building asset, and the Equity Investment account is reduced likewise.

As a result of these three journal entries, the investor reports a balance in the Equity Investment account on its balance sheet of \$1,285, consisting of the beginning balance of \$1,100, the recognition of equity income of \$300, and a reduction of \$115 relating to the \$100 in dividends received and \$15 depreciation of the additional building asset. The T-account for the Equity Investment illustrates these changes:

Equity Investment		
Beginning balance	1,100	
Equity income	300	100 Dividends received 15 Depreciation of building asset
Ending balance	<u>1,285</u>	

Given that most acquisitions are made at a price that is greater than the investee’s book value of Stockholders’ Equity, we now need to modify the general rule about the relation between the Equity Investment account and the Stockholders’ Equity of the investee company that we discussed earlier: **the balance reported in the Equity Investment account will always be equal to the proportion of the investee company Stockholders’ Equity that we own plus the book value of additional assets purchased.** In this case, our Equity Investment of \$1,285 is comprised of the following assets:

Equity Investment	Composition						
\$1,285	<table style="border: none;"> <tr> <td style="font-size: 3em; vertical-align: middle;">{</td> <td style="padding-left: 10px;">\$1,000</td> <td>Proportion of the book value of the investee company that we own (100% in this case)</td> </tr> <tr> <td></td> <td style="padding-left: 10px;">\$ 285</td> <td>Remaining book value of the additional building asset that we purchased (\$300 – \$15)</td> </tr> </table>	{	\$1,000	Proportion of the book value of the investee company that we own (100% in this case)		\$ 285	Remaining book value of the additional building asset that we purchased (\$300 – \$15)
{	\$1,000	Proportion of the book value of the investee company that we own (100% in this case)					
	\$ 285	Remaining book value of the additional building asset that we purchased (\$300 – \$15)					

The additional assets purchased by the investor can relate to any of the reported assets (and even liabilities) of the investee and to a variety of unrecorded intangible assets. Each of these additional assets must be depreciated (*amortized* is the name we use to describe depreciation of intangible assets) over their respective useful lives. One exception to this relates to any Goodwill the investor recognizes in the purchase. We do not amortize Goodwill. Instead, we test it annually for impairment and write it down if it is impaired. We discuss all intangible assets, including Goodwill and its impairment test, in Chapters 2 and 3. For now, just appreciate the fact that these additional assets that are included in the Equity Investment account are real assets of the investor and should be accounted for just like any other assets that the investor owns.

We next consider intercompany sales of assets, such as inventories, and the ways in which these sales affect our accounting for the Equity Investment.

TOPIC REVIEW 4

Accounting for the Equity Investment When Price Exceeds Book Value

In our previous topic review (part 2), the investor purchases all of the stock of the investee in a stock purchase for \$500. The investee’s balance sheet on the date of purchase is as follows:

Accounts receivable	\$ 50	Mortgage payable	\$ 50
Inventories	100	Stockholders’ equity	500
Building	400	Total liabilities and equity	<u>550</u>
Total assets	<u>\$550</u>		

We also assume that, subsequent to the purchase, the investee reports net income of \$100 and pays \$25 in dividends to the investor. Now, let's assume that, instead of purchasing the stock of the investee for \$500, the investor pays \$600, and assigns the additional \$100 of the purchase price to a patent that the investee owns that has a useful life of 10 years.

1. Provide the journal entry to recognize the Equity Income by the investor.
2. Provide the journal entry to record the receipt of the \$25 dividend.
3. Provide the journal entry to record the amortization of the patent asset.

The solution to this review problem can be found on page 35.

Accounting for the Effects on Equity Investments of Intercompany Sales of Inventory

Many companies acquire suppliers or customers in order to capture value in other portions of the supply chain (i.e., they are “vertically integrated”), and it is not uncommon for the investor and investee to sell products among themselves. A manufacturing investee company, for example, might sell completed or partially completed inventories to the investor who, subsequently, resells them to the end customer.

To begin our discussion of the accounting for the effects of intercompany sales of inventories between the investee and the investor, let's assume that the investee sells goods that cost \$100 to the investor for \$130 on account. When the intercompany (i.e., between investor and investee) sale occurs, the investee and investor companies make the following journal entries (assuming perpetual inventory costing) in their respective books:

LOS Explain the process for deferral of unrealized income

Investee		Investor	
1. Accounts receivable	130	Inventories	130
Sales	130	Accounts payable	130
<i>(to record the sale of product on account)</i>		<i>(to record the purchase of inventory)</i>	
2. Cost of goods sold	100		
Inventories	100		
<i>(to record the cost of goods sold)</i>			

The investee records a gross profit on the sale of \$30 (\$130 – \$100), and the investor records the inventory on its books at the purchase price of \$130.

More importantly, the \$30 gross profit has increased the investee's net income by \$30, and that increase in profit results in a \$30 increase in Equity Income that is reported by the investor (the investor owns 100% of the investee company and, thus, reports 100% of the investee's profit as Equity Income). Thus, *both* the investor and investee companies have reported the same \$30 of profit. Now, if we think of the investor and investee companies as one organization, that organization has just written up its inventories by \$30 and recorded the write-up as profit!

With very limited exceptions (e.g., trading securities under FASB ASC 320), GAAP does not permit the recognition of profit on appreciated assets until those assets are sold (i.e., when the profit is *realized*). And, because the investor has the ability to significantly influence the investee's operating activities (or possibly control those operations), GAAP views these two companies as one reporting group. If separate companies under one reporting group were allowed to recognize a profit on transfers of inventories within the reporting group, they could increase profit without limit without ever selling a good or service to an outside party. This would clearly be unacceptable. Consequently, **the gross profit on the intercompany sale must be deferred and cannot be recognized until those inventories are sold outside of the reporting group.** (By the way, it doesn't matter in which direction the sale occurs; we also would be required to defer the gross profit on the sale if the investor had sold inventory to the investee.)

The deferral of gross profit on intercompany inventory sales is accomplished by the following journal entry:¹⁴

Equity income.	30	
Equity investment		30
<i>(to record the deferral of gross profit on inventory sale in the period of sale)</i>		

Equity income has, thus, been reduced by the profit on the intercompany sale that we cannot recognize until the inventories are re-sold outside by the investor. The reduction in Equity Income has also reduced the Equity Investment account. And, in the subsequent year, when the investor sells the inventory to outside parties, we reverse the entry to recognize in the current period the deferred profit from the prior period:

Equity investment.	30	
Equity income		30
<i>(to record the recognition of gross profit on inventory sale in the following period)</i>		

The example we provide above assumes that *all* of the inventories sold by the investee to the investor remain on the investor’s balance sheet at the end of the period. If some, but not all, of those inventories have been sold to independent companies by the end of the accounting period in the year of the intercompany sale, the gross profit on the sale relating to the inventories sold can be recognized in that year, and only the gross profit on the inventories that remain on the investor’s balance sheet must be deferred.

To illustrate, suppose that 60% of the inventories have been re-sold by the investor and that 40% of the inventories still remain on the investor’s balance sheet at the end of the year of the intercompany sale. In this case, only 40% of the \$30 gross profit on the intercompany inventory sale must be deferred, and the deferral of gross profit on the intercompany inventory sale is accomplished by the following journal entry:

Equity income.	12	
Equity investment		12
<i>(to record the deferral of 40% of the gross profit on inventory sale in the period of sale)</i>		

TOPIC REVIEW 5

Accounting for the Effects on Equity Investments of Intercompany Sales of Inventory

Continuing with our previous topic review, assume that the investor sells parts inventories to the investee that cost \$50 for a sale price of \$75. Also assume that 60% of the parts inventories remain on the investee’s balance sheet at the end of the period. Provide the journal entry to defer the recognition of gross profit on the inventories that remain on the investee’s balance sheet.

The solution to this review problem can be found on page 35.

¹⁴ When we consolidate these two companies in Chapter 3, we will also need to eliminate the intercompany sale and Account Receivable of \$130.

Equity Method Accounting When Less Than 100% of the Investee Is Owned

In our discussion thus far, the investor owns 100% of the investor. We now relax that assumption to consider ownership levels of less than 100%. We begin this section with a discussion of the equity method mechanics when we own less than 100% of the investee, and conclude with a further discussion of when the equity method can be used.

LO6 Explain the equity method of accounting for less than 100% ownership

Equity Method Mechanics With Less Than 100% Ownership We continue with our previous example in which the investor is purchasing stock in the investee whose book value of Stockholders' Equity on the date of the acquisition is \$800. Now, let's assume that, instead of purchasing 100% of the company for \$800, the investor purchases a 30% interest in the investee for \$240 ($\$800 \times 30\%$), in cash, and has significant influence over the investee company. As before, assume that the investee earns a profit of \$300 and pays a total dividend of \$100, with \$30 (30%) paid to the investor and the remainder paid to other shareholders. The investee's Stockholders' Equity at the end of the year increases by \$200, as before, to a balance of \$1,000.

Following are the required journal entries by the investor to record the initial investment and the subsequent recognition of equity income and dividends received:

1. Equity investment	240	
Cash		240
<i>(to record the purchase of the Equity Investment)</i>		
2. Equity investment	90	
Equity income		90
<i>(to record the equity income – 30% of \$300)</i>		
3. Cash	30	
Equity investment		30
<i>(to record the receipt of dividends of \$30)</i>		

We have multiplied all of the previous journal entry amounts by 30%, the proportion of the investee that the investor owns in this example. The investor initially records the Equity Investment at its purchase price of \$240, and subsequently recognizes the dividends received of \$30 as a reduction of that account. For the income recognition, when the investor owns less than 100% of the investee, it can only record equity income equal to the proportion of the investee's income that it owns. Since the investee is reporting \$300 of income in this case, the investor recognizes 30% of that amount (\$90) in its income statement as Equity Income.

The T-account for the Equity Investment illustrates these changes:

Equity Investment		
Beginning balance	240	
Equity income	90	30 Dividends received
Ending balance	<u>300</u>	

The relation between the Equity Investment account on the investor's balance sheet and the investee's Stockholders' Equity still holds. The investee reports Stockholders' Equity of \$1,000 at the end of the year, and, since the 30% investment was acquired at book value, the investor reports an Equity Investment of \$300, representing the 30% of the investee's Stockholders' Equity that it owns.

One final note: in the previous section we discuss the deferral of unrealized profit on intercompany inventory sales. In that example, the investee sold inventory with a gross profit of \$30 that the investor deferred at the end of the year. The deferral of that profit *when the investor owns less than 100% of the investee* is handled in one of two ways:

1. **Investor controls the investee**—when the investor owns less than 100%, but still controls the investee (say, for ownership levels in excess of 51% of the outstanding common stock), the investor defers *all* of the intercompany profit as described above, or

2. **Investor has a significant interest in the investee**—when the investor has a significant interest in the investee (say for ownership levels less than or equal to 50%), it defers only the proportion of the gross profit that it owns. For example, if the investor owns 30% of the investee, and the gross profit on the intercompany sale is \$30, the investor defers \$9 ($\$30 \times 30\%$) in the following journal entry:¹⁵

Equity income.	9	
Equity investment		9
<i>(to record the deferral of gross profit on inventory sale in the period of sale)</i>		

The reason we draw the distinction between the two cases above is this: for an entity that is controlled (and ultimately consolidated), the equity method of accounting should yield equity income for the investor equal to that which it would report if the investee is consolidated. We begin our discussion of the consolidation process in Chapter 2, and discuss intercompany asset sales more thoroughly in Chapter 4. Then, we will see that *all* intercompany sales are eliminated in the consolidation process. Thus, we draw a distinction between the first case above in which the two companies will be consolidated (and *all* intercompany sales will be eliminated), and the second case in which they will not (thus, the investor might only eliminate the investor’s proportionate interest in the profit on the intercompany sale).

When Can the Equity Method be Used? As we discuss earlier in this chapter, the equity method is required when the investor can exercise significant influence over the investee’s operating activities. Further, at the point when the investor can “control” the operating activities of the investee, the investor is required to consolidate its financial statements with those of the investee company. In this section, we discuss what that means.

There are two important points to keep in mind: first, both the investor and investee companies are separate legal entities, each with their own financial statements. We need to account for the operations of both companies separately. That does not change even though one company owns another. And second, the investor will continue to report the investee on the investor’s balance sheet using the same Equity Investment account that we have described throughout this chapter. This will be true whether the investor has significant influence over or controls the investee company.

The consolidation process that we describe in Chapter 2 involves a combining of the financial statements of the two companies for external reporting purposes. In its most basic form, consolidation involves replacing the Equity Investment account with the assets and liabilities of the investee company to which the Equity Investment relates. Likewise, we replace the Equity Income account in the income statement with the revenues and expenses of the investee company.¹⁶

Bottom line: the investor accounts for its Equity Investment using the equity method from the time it acquires significant influence and, for *internal* reporting purposes, can continue to account for the investee using the equity method even after it gains control. However, when the investor gains control over the investee, the investor must issue consolidated financial statements for *external* financial reporting purposes. We begin our discussion of the consolidation process in Chapter 2.¹⁷

¹⁵ FASB ASC 323-10-35-9 through 35-11 indicates that proportionate elimination is only allowed if both of the following conditions are met: (1) the investor does not control the investee and (2) the intercompany transactions are considered arm’s length. Otherwise, all of the intercompany transaction must be eliminated.

¹⁶ We account for the investment in the subsidiary using the equity method in the first five chapters of this text because the consolidation process is easier to understand when the parent uses the equity method. The parent can, however, use any method it wants to account for its investment in the subsidiary provided that it does not issue parent-company-only financial statements, in which case, it must use the equity method. In Chapter 3, we discuss the consolidation process when the parent uses the cost method or a hybrid equity method to account for its Equity Investment.

¹⁷ Even when issuing consolidated financial statements once control is reached, the parent is permitted to supplement its consolidated financial statements with “parent only” financial statements that reflect the subsidiary as an equity method investment.

TOPIC REVIEW 6

Accounting for the Effects on Equity Investments of Intercompany Sales of Inventory When Less Than 100% of the Investee Is Owned

In our previous topic review, we assume that the investor sells parts inventories to the investee that cost \$50 for a sale price of \$75. We also assume that 60% of the parts inventories remain on the investee's balance sheet at the end of the period. Now, let's also assume that the investor only owns 1/3 (33.3%) of the investee. Provide the journal entry to defer the recognition of gross profit on the inventories that remain on the investee's balance sheet.

The solution to this review problem can be found on page 36.

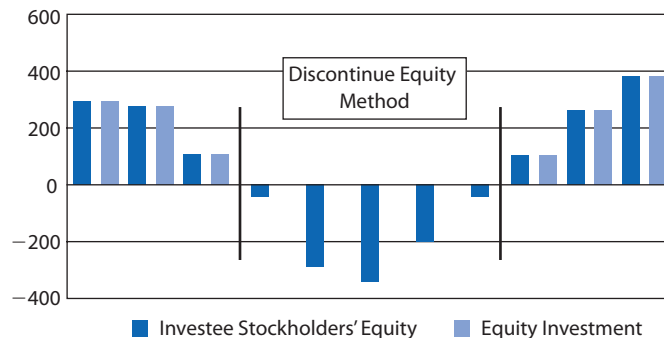
Discontinuance of the Equity Method

It is possible that the reported amount of the Equity Investment might be reduced to zero on the investor's balance sheet. This can occur because of any or all of the following:

1. Investee company losses
2. Payment of dividends by the investee to the investor in excess of the amount of cumulative Equity Income reported by the investor
3. Write-down of the Equity Investment by the investor as a result of its determination that the market value of the investment has permanently declined.¹⁸

When the reported amount of the Equity Investment is reduced to zero, the investor ceases to use the equity method to account for its Equity Investment. Instead, the investment is carried on the investor's balance sheet at a zero amount until the investee earns sufficient profit such that the unrealized loss is eliminated.

To illustrate, assume that the investee company reports a number of years of losses followed by a number of profitable years as illustrated in the following graphic:



We assume that the investor owns 100% of the investee and that the Equity Investment was acquired at book value to simplify the example. The reported amount of the Equity Investment, therefore, equals the Stockholders' Equity of the investee. As the investee reports losses, the investor reduces the reported amount of its Equity Investment until the Stockholders' Equity of the investee company reaches zero. At that point, the investor ceases to recognize equity losses until the investee resumes profitability and the deficit Stockholders' Equity has been eliminated. At that point, the investor resumes accounting for its Equity Investment using the equity method.¹⁹

¹⁸ Equity Investments are treated just like any other asset. If they decline in market value, and that decline is deemed to be other than temporary, the investor must write down the reported amount of the Equity Investment to its lower market value and report the write-down as a loss in the period it is recognized.

¹⁹ An exception to this rule arises if the investor has guaranteed the debts of the investee company. In that case, the investor reports the negative balance of the Equity Investment as a liability.

LO7 Explain when the equity method should be discontinued

Accounting for a Change to and from the Equity Method

LOB Explain the accounting for changes to and from the equity method

As we discuss in our introduction to this chapter, GAAP specifies different accounting methods for investments in securities that depend on the level of influence that the investor has over the investee. Sometimes, that level of influence can change over time, say, by the investor purchasing additional shares of the investee, the investee repurchasing its own shares from other parties, thereby increasing the percentage owned by the investor, or by other events, such as the investor gaining representation on the board of directors of the investee company or engaging in material intercompany transactions, and so forth. All of these events and transactions would suggest that the level of influence of the investor over the investee has increased.

Prior to gaining significant influence, investments will have been accounted for by the market or cost methods. We first discuss the accounting procedures required for a change from both of these methods to the equity method, followed by a discussion of the change from the equity method to another method.

Change from the Market Method to the Equity Method If the investment had been accounted for by the market method, the investment account will consist of the original cost plus (minus) the fair value adjustment (the difference between market value and cost). The adoption of equity method accounting for this investment involves two steps:

1. Removing the Fair Value Adjustment from the investment account and the associated Unrealized Holding Gain (Loss) from the Accumulated Other Comprehensive Income (AOCI) account of Stockholders' Equity, and
2. Adjusting the Equity Investment account for the cumulative profit that the investor would have recorded had the equity method been in use, less the reduction for any dividends received. The offset to this adjustment is to the beginning balance of Retained Earnings (prior period adjustment).

The objective of these adjustments is to adjust the Equity Investment account (and the investor's Retained Earnings) to what it would have been had the equity method been followed from the initial purchase of the investment.

To illustrate, assume that the investor has accounted for a \$10,000 cost, 10% investment in the investee using the market method (available-for-sale designation). The following additional information is available:

Cumulative dividends received from investee	Cumulative profits recorded by investee	Cumulative fair value adjustment
\$10,000	\$30,000	\$25,000

Now, assume that the investor acquires an additional 20% interest in the investee and concludes that it can now exert significant influence over the investee. We must now account for the investment using the equity method instead of the market method. The required journal entries to account for the change from the market method to the equity method for the original investment are as follows:

1. Unrealized holding gain (AOCI)	25,000	
Fair value adjustment		25,000
<i>(to remove the unrealized gain from stockholders' equity and the fair value adjustment from the investment account)</i>		
2. Equity investment	20,000	
Retained earnings (prior period adjustment)		20,000
<i>(to adjust the Equity Investment to its correct amount at the beginning of the year and to increase the beginning of the year Retained Earnings for the cumulative equity income that would have been recognized)</i>		

The Unrealized Holding Gain is reversed from both Stockholders' Equity and the investment account, and Retained Earnings is adjusted for the net effect of the equity income less the receipt of dividends (\$30,000 – \$10,000).

The effect of these adjusting entries is to report the Equity Investment at the balance that would have been reported as of the beginning of the year had the equity method been in use from the acquisition of the investment and to correct the beginning balance of Retained Earnings for the cumulative differences between the equity and market methods of accounting for this investment. In subsequent periods, then, the investor accounts for its Equity Investment using the equity method of accounting as we describe earlier in the chapter.

Change from the Cost Method to the Equity Method The cost method is used for investments in which the investor cannot exercise significant influence and for which a reliable market price does not exist. An example might be an investment in a privately held (non-public) company. The accounting for these investments is relatively simple: the investment is always reported on the balance sheet at its original cost and any dividends that the investor receives are treated as dividend income, thus increasing Retained Earnings.

As in our previous example, we assume that the investor has acquired additional shares of the investee company and concludes that it can now exert significant influence over the investee. Since the original investment is reported at its original cost of \$10,000, to change from the cost method to the equity method for this investment, we need to increase the investment by the \$20,000 difference between the cumulative profits and the dividends paid by the investee:

Equity investment	20,000	
Retained earnings		20,000
<i>(prior period adjustment)</i>		

In subsequent periods, then, the investor accounts for its Equity Investment using the equity method of accounting as we describe earlier in the chapter.

Change from the Equity Method to the Market or Cost Methods When the level of influence changes, such that the investor can no longer exert significant influence over the investee company's operating activities, use of the equity method is no longer appropriate and either the market or cost method must be used. The change from the equity method to one of these two methods is simple: the amount at which the Equity Investment is reported (i.e., its book value) on the date of change becomes the cost of the security. The accounting for the security using either the cost or market methods proceeds as usual from that point forward.

To illustrate, assume that the investor reports an Equity Investment on its balance sheet in the amount of \$20,000 and that it can no longer exert significant influence over the investee company (possibly due to the issuance of additional shares to outside parties, thus diluting the investor's ownership percentage). Assume that the investor will account for this investment using the market method (available-for-sale designation) and that the fair value of the shares owned has increased to \$25,000 at the next reporting period. The investor will treat the investment as though it has a cost of \$20,000 and a market value of \$25,000, and the required journal entry to record the increase in fair value is as follows:

Fair value adjustment	5,000	
Net unrealized holding gains and losses – OCI . .		5,000
<i>(to record the increase in fair value of the AFS security)</i>		

TOPIC REVIEW 7

Reporting a Change to and from the Equity Method

To illustrate, assume that the investor has accounted for a \$20,000 cost, 10% investment in the investee using the market method (available-for-sale designation). The following additional information is available:

Cumulative dividends received from investee	Cumulative profits recorded by investee	Cumulative fair value adjustment
\$20,000	\$60,000	\$50,000

Now, assume that the investor acquires an additional 20% interest in the investee and concludes that it can now exert significant influence over the investee. We must account for the original investment using the equity method instead of the market method. Provide the required journal entries to account for the change from the market method to the equity method for the original investment.

The solution to this review problem can be found on page 36.

Required Disclosures for Equity Method Investments

FASB ASC 323-10-50 identifies required disclosures relating to investments accounted for under the equity method:

- The name of each investee and percentage of ownership of common stock, the accounting policies of the investor with respect to investments in common stock, and the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.
- For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price usually should be disclosed. This disclosure is not required for investments in common stock of subsidiaries.
- When investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate.
- Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances should be disclosed in notes to the financial statements of an investor.

Criticism of the Equity Method

Two final points about equity method accounting: First, there can be a substantial difference between the book value of an equity method investment and its market value. An increase in value is not recognized until the investment is sold. If the market value of the investment has permanently declined, however, the investment is deemed impaired and it is written down to that lower market value. Second, if the investee company reports income, the investor company reports its share. Recognition of equity income by the investor, however, does not mean that it has received that income in *cash*. Cash is only received if the investee pays a dividend.²⁰

The investor company reports equity method investments on the balance sheet at an amount equal to the percentage owned of the investee company's equity when that investment is acquired at book value. To illustrate, consider the case of **Abbott Laboratories, Inc.**, which owns 50% of **TAP Pharmaceutical Products Inc. (TAP)** (a joint venture between Abbott Laboratories and Takeda Pharmaceutical Company, Limited of Japan). TAP develops and markets pharmaceuti-

LO9 Explain the required disclosures for equity method investments

LO10 Explain the criticisms of the equity method of accounting

²⁰ To highlight this, the investor's statement of cash flows will include a reconciling item (a deduction from net income in computing operating cash flow) for its percentage share of the investee's net income. This is typically reported net of any cash dividends received.

cal products mainly for the U.S. and Canada. Abbott accounts for its investment in TAP using the equity method as described in the following footnote to its 2007 10-K report:

Equity Method Investments (\$ millions) Abbott's 50 percent-owned joint venture, TAP Pharmaceutical Products Inc. (TAP), is accounted for under the equity method of accounting. The investment in TAP was \$159, \$162 and \$167 at December 31, 2007, 2006 and 2005, respectively, and dividends received from TAP were \$502, \$487 and \$343 in 2007, 2006 and 2005, respectively. Abbott performs certain administrative and manufacturing services for TAP at negotiated rates that approximate fair value.

At the end of 2007, the TAP joint venture reported stockholders' equity of \$317.6 million and net income of \$996.0 million. (TAP's financial statements are included in an exhibit to Abbott's 2007 10-K; not reproduced here.) In the footnote above, Abbott reports an investment balance at December 31, 2005, of \$159 million (TAP equity of \$317.6 million \times 50%). In its income statement, Abbott reports income of \$498.0 million (TAP net income of \$996.0 million \times 50%). Provided the investment is originally acquired at book value these relations will always hold.

Let's look a bit closer at TAP. TAP's balance sheet reports assets of \$1,354.2 million, liabilities of \$1,036.6 million, and stockholders' equity of \$317.6 million. TAP is a highly leveraged company with considerable assets. The \$159 million investment balance on Abbott's balance sheet does not provide investors with any clue about the level of TAP's total assets. It reflects only Abbott's share of TAP's net assets (assets less liabilities, or equity).

Another area of concern with equity method accounting relates to unreported liabilities. As described above, TAP reports total liabilities of \$1,036.6 million as of 2007, none of which appear on Abbott's balance sheet (Abbott only reports its investment in TAP's equity as an asset). Pharmaceutical companies face large potential liabilities arising from drug sales. (For example, TAP reports a loss of \$150 million relating to litigation that it settled in 2004.) Although Abbott might have no direct legal obligation for TAP's liabilities, it might need to fund settlement costs via additional investment or advances to maintain TAP's viability if the company is important to Abbott's strategic plan. Further, companies that routinely fund R&D activities through equity investments in other companies, a common practice in the pharmaceutical and software industries, can find themselves supporting underperforming equity investments to assure continued capital market funding for these entities.

The cooperative experience of **Dow Chemical Company** and **Corning, Incorporated** provides an illustration of the flexibility afforded by joint venture arrangements and the appropriateness of equity method accounting for those arrangements. The Dow Corning joint venture was formed in 1943 by Corning Glass Works (now Corning, Inc.) and Dow Chemical Company. The purpose of the joint venture is to develop silicone-based technologies and to pursue business opportunities related to those technologies. An extremely popular technology developed and sold by Dow Corning was silicone breast implants. Unfortunately, those implants caused serious health problems for thousands of consumers. According to Corning, Inc.'s December 31, 2008 SEC Form 10-K, "In May 1995, Dow Corning filed for bankruptcy protection to address pending and claimed liabilities arising from many thousands of breast implant product lawsuits. On June 1, 2004, Dow Corning emerged from Chapter 11 with a Plan of Reorganization (the Plan) which provided for the settlement or other resolution of implant claims. The Plan also includes releases for Corning and Dow Chemical as shareholders in exchange for contributions to the Plan." Dow Corning's history suggests that the joint venture arrangement allowed both Dow Chemical and Corning, Inc. to significantly reduce their potential liability related to the breast-implant lawsuits.

CHAPTER SUMMARY

The accounting for these investments depends on the degree to which the investor can influence the activities of the investee. Exhibit 1.3 summarizes the three levels of influence or control for publicly traded securities and the cost method for investments in companies for which a reliable

market for their stock does not exist (private companies, for example) and the prescribed accounting method for each:

EXHIBIT 1.3 Investment Type, Accounting Treatment, and Financial Statement Effects				
	Accounting	Balance Sheet Effects	Income Statement Effects	Cash Flow Effects
Passive	Market method	Investment account is reported at current market value	Dividends and capital gains included in income Interim changes in fair value may or may not affect income depending on whether the investor actively trades the securities Sale of investment yields capital gain or loss	Dividends and sale proceeds are cash inflows Purchases are cash outflows
No reliable market	Cost	Investment account is reported at original cost (purchase price)	Dividends and capital gains included in income Interim changes in market value not recognized	Dividends and sale proceeds are cash inflows Purchases are cash outflows
Significant influence	Equity method	Investment account equals percent owned of investee company's equity*	Dividends reduce investment account Investor reports income equal to percent owned of investee income Sale of investment yields capital gain or loss	Dividends and sale proceeds are cash inflows Purchases are cash outflows
Control	Consolidation	Balance sheets of investor and investee are combined	Income statements of investor and investee are combined (and sale of investee yields capital gain or loss)	Cash flows of investor and investee are combined (and sale/purchase of investee yields cash inflow/outflow)

*Investments are often acquired at purchase prices in excess of book value (on average, market prices are 1.5 times book value for public companies). In this case the investment account exceeds the proportionate ownership of the investee's equity by the amount of the unamortized excess.

Use of the equity method is prescribed when the investor can exert significant influence over the investee company's operating activities. Significant influence is presumed when the investor owns in excess of 20% of the outstanding voting stock of the investee, but can arise with ownership levels less than that if it gains significant representation on the board of directors, participates actively in the investee's operating decisions, provides investee with significant technology, and so forth.

There are a number of important points relating to the use of the equity method:

1. The investor can only recognize equity income subsequent to the date it purchases the Equity Investment.
2. The investor can only recognize equity income equal to the proportion of the investee that it owns.
3. The investor must defer unrealized gains on intercompany sales.
4. The investor must discontinue the use of the equity method if the investee becomes insolvent (i.e., reports negative stockholders' equity) or if the investment is written down to a zero balance.
5. Reporting Equity Income does not imply that cash dividends have been received.
6. Reporting the Equity Investment potentially omits a significant amount of assets and liabilities from the investor's balance sheet and a significant amount of sales and expenses from the investor's income statement (this objection is overcome if the investee is consolidated with the investor).
7. The investor may have practical liability for the investee company's liabilities even if no actual liability exists.

COMPREHENSIVE REVIEW

Assume that in 20X1 the investor purchases a 10% investment in the investee for \$100,000 and accounts for that investment using the market method (available-for-sale designation). In 20X4, the investor acquires an additional 25% of the outstanding common stock of the investee for \$250,000. The following additional information is available on the date of purchase:

Cumulative dividends paid by investee	Cumulative profits recorded by the investee	Cumulative fair value adjustment on investors balance sheet
\$150,000	\$400,000	\$35,000

The investee's balance sheet on the date of the additional purchase is as follows:

Accounts receivable	\$100,000	Mortgage payable	\$200,000
Inventories	200,000	Stockholders' equity	500,000
Building	400,000	Total liabilities and equity	<u>\$700,000</u>
Total assets	<u>\$700,000</u>		

The investor is willing to pay \$250,000 for 25% of the stock of the investee (implying a fair value of the investee of $\$250,000 / 25\% = \$1,000,000$) because the investee has a patent that the investor estimates is worth \$500,000. That patent will expire in 10 years.

Subsequent to the purchase, the investee reports net income of \$200,000 and pays \$90,000 in dividends. In addition, the investor sells inventories to the investee that cost \$50,000 for a sale price of \$80,000. At the end of the year, 60% of the parts inventories remain on the investee's balance sheet.

1. Provide the journal entry to account for the change from the market method to the equity method for the original investment.
2. Provide the journal entry to recognize the Equity Income by the investor.
3. Provide the journal entry to record the receipt of the \$20 dividend.
4. Provide the journal entry to record the amortization of the Patent asset.
5. Provide the journal entry to record the deferral of gross profit on the intercompany inventory sale.

The solution to this review problem can be found on page 36.

QUESTIONS

1. Equity Investments are sometimes referred to as "one-line consolidations." That means that the balance sheets of the investor and investee companies are combined and that the Stockholders' Equity of the investor company is equal to that which would be obtained had the investor and the investee's balance sheets been combined. It also means that the investor's income statement reports the same net income as would have been reported by a combination of the income statements of the investor and investee companies.
 - a. How is the reporting of an Equity Investment like a consolidation (i.e., yielding the same Stockholders' Equity for the Parent company that would result from a consolidation)? How is it different?
 - b. How is the reporting of equity income in the investor's income statement a consolidation (i.e., yielding the same net income for the parent company that would result from a consolidation)? How is it different?

2. In applying the equity method of accounting for Equity Investments, dividends are treated as a reduction of the Equity Investment rather than as dividend income. Why?
3. Equity Income is recognized based on the net income of the investee company rather than from dividends. While this approach may have theoretical merit, what potential problems might this cause for your evaluation of the cash-flow-generating ability of the investor?
4. **CBS Corp.** owns approximately 18% of Westwood One, Inc. which manages the CBS Radio Network. CBS, in turn, manages Westwood under a management agreement. Further, one employee of CBS is a member of Westwood's board of directors. CBS does not control the board of directors, however. How should CBS account for its investment in Westwood One?

**FASB ASC
Review**

5. **CBS** wrote down the carrying amount of its investment in Westwood One (see question #4). This write-down was unrelated to any net loss reported by Westwood in its income statement. FASB ASC 323 governs the accounting for equity method investments. FASB ASC 323-10-35-32 provides the following guidance: "A loss in value of an investment which is other than a temporary decline should 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 which would justify the carrying amount of the investment. A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors to be evaluated."
 - a. What must CBS have concluded about the market value of its investment in Westwood One to justify the write-down of this investment?
 - b. How much judgment is involved in the decision to write down an investment and how might a company use that judgment to manage the level of net income that it reports?

**FASB ASC
Review**

6. In applying the equity method of accounting for an Equity Investment, profits on intercompany sales of assets are eliminated (FASB ASC 323-10-35-5). Why?
7. Consider the following scenario: an investor owns 10% of an investee company with publically traded stock, and licenses technology to the investee for the production of its sole product. None of the investor's employees serve in the management of the investee company, nor sit on its board of directors. The license agreement prohibits the investee from certain business activities, such as entering into business arrangements with other companies without the investor's consent, using the technology to develop products except as authorized by the investor, and expanding the business into new lines of business without the investor's approval. How should the investor account for its investment in the investee company?
8. Consider the following scenario: an investor owns 30% of an investee company. The remaining 70% is owned by the investee's founder who has managed the company since its inception and takes no direction from "outsiders." How should the investor account for its investment?

**FASB ASC
Review**

9. FASB ASC 323-10-35-19 provides the following: "An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended."
 - a. **Enron**, the infamous energy company that failed in the early 2000s, disclosed that it invested in companies that reported substantial losses and were technically insolvent (i.e., deficit Stockholders' Equity). Enron used the equity method to account for these investments, had not made any advances to them, and did not guarantee their debts. How did the losses by its investee companies affect Enron's income statement?
 - b. What is meant by this phrase in FASB ASC 323-10-35-22: "only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended."
10. What disclosures are required for equity method investments under FASB ASC 323?

EXERCISES

11. Asset acquisition vs. stock purchase (market value equals book value)

Assume that an investor purchases the business of an investee. The investee company reports the following balance sheet on the acquisition date:

Cash	\$ 1,000	Accounts payable	\$ 2,000
Accounts receivable	2,000	Accrued liabilities	3,000
Inventories	4,000		
Current assets	\$ 7,000	Current liabilities	\$ 5,000
PPE, net	10,000	Long-term liabilities	4,000
Total assets	\$17,000	Stockholders' equity	8,000
		Total liabilities and equity	\$17,000

Required

- Provide the journal entry if the investor purchases the assets and assumes the liabilities of the investee company (assume that the market value of the assets is equal to their book values).
- Provide the journal entry if the investor purchases all of the stock of the investee's shareholders.

12. Asset acquisition vs. stock purchase (market value is greater than book value)

Assume the investor purchases the same assets in #11, but now assume that the cash purchase price is \$15,000 rather than \$8,000. The investor is willing to purchase the investee's business for \$15,000 because it appraises its PPE, net at \$14,000, and because it values the investee's customer list at \$3,000 (the fair values of all other assets and liabilities are equal to their book values).

Required

- Provide the journal entry if the investor purchases the assets and assumes the liabilities of the investee company (assume that the market value of the assets is equal to their book values).
- Provide the journal entry if the investor purchases all of the stock of the investee's shareholders.

13. Equity method mechanics

An investor owns 30% of the outstanding common stock of an investee company. The Equity Investment was reported at \$500,000 as of the end of the previous year. During the year, the investee pays dividends of \$50,000 to the investor. The investee reports the following income statement for the year:

Revenues	\$2,000,000
Expenses	1,570,000
Net income	\$ 430,000

Required

- How much equity income should the investor report in its income statement?
- What amount should the investor report in its balance sheet at the end of the year for the Equity Investment?
- Assume that the market value of the investee company is \$4.3 million at the end of the year (ten times reported earnings). How should the market value of the investee company be reflected in the investor's financial statements?
- Assume that the net income of the investee company included an extraordinary item. Does the presence of an extraordinary item affect the reporting of equity income by the investor?

14. Equity method journal entries (price equals book value)

Prepare journal entries for the transactions below relating to an Equity Investment accounted for using the equity method.

Required

- An investor purchases 12,000 common shares of an investee at \$9 per share; the shares represent 30% ownership in the investee and the investor concludes that it can exert significant influence over the investee.

- b. The investee reports net income of \$80,000.
- c. The investor receives a cash dividend of \$1.25 per common share from the investee.
- d. The investor sells all 12,000 common shares of the investee for \$120,500.

15. Equity method journal entries with intercompany sales of inventory

Assume that an investor owns 30% of an investee, and accounts for its investment using the equity method. At the beginning of the year, the Equity Investment was reported on the investor’s balance sheet at \$300,000. During the year, the investee reported net income of \$100,000 and paid dividends of \$20,000 to the investor. In addition, the investor sold inventory to the investee, realizing a gross profit of \$40,000 on the sale. At the end of the year, 20% of the inventory remained unsold by the investee.

Required

- a. How much equity income should the investor report for the year?
- b. What is the balance of the Equity Investment at the end of the year?
- c. Assume that the inventories are all sold in the following year, that the investee reports \$150,000 of net income. How much equity income will the investor report for the following year?

16. Equity method journal entries (price greater than book value)

An investor purchases a 40% interest in an investee company, and the investor concludes that it can exert significant influence over the investee. The book value of the investee’s Stockholders’ Equity on the acquisition date is \$400,000, and the investor purchases its 40% interest for \$200,000. The investor is willing to pay the purchase price because it believes that the investee owns an unrecorded patent that is worth \$100,000. The patent has a remaining useful life of 10 years. Subsequent to the acquisition, the investee reports net income of \$100,000, and pays a cash dividend to the investor of \$15,000. At the end of the first year, the investor sells the Equity Investment for \$230,000. Prepare all of the required journal entries to account for this Equity Investment during the year.

17. Change from the market method to the equity method

Assume that an investor has accounted for a \$300,000 cost, 5% investment in the investee using the market method (available-for-sale designation). The following additional information is available:

Cumulative dividends received from investee	Cumulative profits recorded by investee	Cumulative fair value adjustment
\$40,000	\$90,000	\$125,000

Now, assume that the investor acquires an additional 20% interest in the investee and concludes that it can now exert significant influence over the investee.

Required

- a. Provide the required journal entries to account for the change from the market method to the equity method for the original investment.
- b. Now, assume that the investor has accounted for its investment using the cost method. Provide the required journal entries to account for the change from the cost method to the equity method for the original investment.

18. Equity method computations from footnote

Dow Chemical

Dow Chemical reports Equity Investments of \$3,089 million (6% of total assets) and equity income on those investments of \$1,122 million (39% of net income) in a recent 10-K report. The company provides the following summary financial information in the footnotes to that report:

Summarized Balance Sheet Information at December 31 In millions	
Current assets	\$ 6,943
Noncurrent assets	9,669
Total assets	<u>\$16,612</u>
Current liabilities	\$ 3,165
Noncurrent liabilities	6,700
Total liabilities	<u>\$ 9,865</u>

Summarized Income Statement Information In millions	
Sales.....	\$13,884
Gross profit.....	\$ 3,492
Net income.....	\$ 2,464

Required

- a. Approximately what percent of the investee companies does **Dow Chemical** own?
- b. Do the investee total liabilities of \$9,865 million appear on **Dow Chemical**'s balance sheet? How might these liabilities affect **Dow Chemical**'s cash flow?

19. Equity method computations from footnote

In a recent annual report, **Abbott Laboratories** reports an Equity Investment of \$159 million and equity income of \$498 million relating to its Equity Investment in its TAP Pharmaceutical Products Inc. joint venture. Abbott provides the following information about Tap in the footnotes relating to this Equity Investment:

**Abbott
Laboratories**

Net sales.....	\$3,002
Cost of sales.....	720
Income before taxes.....	1,564
Net income.....	996

Current assets.....	\$1,101
Total assets.....	1,354
Current liabilities.....	914
Total liabilities.....	1,037

Required

- a. Confirm that the equity income that **Abbott Laboratories** reports is equal to its 50% proportionate share of the net income of TAP.
- b. Confirm that the Equity Investment on **Abbott Laboratories**' balance sheet is equal to its proportionate share of the Stockholders' Equity of TAP.

20. Equity method computations from footnote

Cummins, Inc., a manufacturer of large engines and electric power generation systems, among other products, reports the following Equity Investments in the footnotes to a recent annual report:

Cummins, Inc.

Dongfeng Cummins Engine Co. Ltd.....	50%	\$121
North American distributors.....	30%–50%	80
European Engine Alliance.....	33%	62
Tata Cummins Ltd.....	50%	43
Beijing Foton Cummins Engine Company Limited.....	50%	35
Chongqing Cummins Engine Company Limited.....	50%	33
Komatsu alliances.....	20%–50%	27
Cummins-Scania XPI Manufacturing, LLC.....	50%	22
Shanghai Fleetguard Filter Co., Ltd.....	50%	15
Other.....	Various	76
Total.....		\$514

In addition, **Cummins** provides the following information about these Equity Investments:

Net sales.....	\$5,716
Gross margin.....	1,320
Net earnings.....	451
Cummins share of net earnings.....	\$ 192

Current assets	\$2,279
Noncurrent assets	1,071
Current liabilities	(1,726)
Noncurrent liabilities	(442)
Net assets	\$1,182

Approximately what percentage of these investee companies does Cummins own, on average?

PROBLEMS

Corning, Inc.

21. Interpreting equity method footnote

Corning Inc. reports \$931 million on a recent balance sheet relating to its Equity Investment in Dow Corning. Corning owns 50% of Dow Corning (the other 50% is owned by Dow Chemical). Excerpts from its footnote relating to this Equity Investment follow:

Dow Corning Corporation (Dow Corning)

Dow Corning is a U.S.-based manufacturer of silicone products. In 1995, Corning fully impaired its investment of Dow Corning upon its entry into bankruptcy proceedings and did not recognize net equity earnings from the second quarter of 1995 through the end of 2002. Corning began recognizing equity earnings in the first quarter of 2003 when management concluded that Dow Corning's emergence from bankruptcy protection was probable. Dow Corning emerged from bankruptcy in 2004. Corning considers the \$249 million difference between the carrying value of its investment in Dow Corning and its 50% share of Dow Corning's equity to be permanent.

Dow Corning's financial position and results of operations follow (in millions):

Statement of Operations:	
Net sales	\$4,943
Gross profit	\$1,747
Net income	\$ 690
Corning's equity in earnings of Dow Corning	\$ 345
Related Party Transactions:	
Corning purchases from Dow Corning	\$ 13
Dividends received from Dow Corning	\$ 130
Balance Sheet:	
Current assets	\$3,511
Noncurrent assets	\$3,688
Short-term borrowings, including current portion of long-term debt	\$ 24
Other current liabilities	\$1,243
Long-term debt	\$ 43
Other long-term liabilities	\$3,145
Misc. liabilities	\$ 383

Corning and **Dow Chemical** each own 50% of the common stock of **Dow Corning**. In May 1995, Dow Corning filed for bankruptcy protection to address pending and claimed liabilities arising from many thousands of breast implant product lawsuits. On June 1, 2004, Dow Corning emerged from Chapter 11 with a Plan of Reorganization (the Plan) which provided for the settlement or other resolution of implant claims. The Plan also includes releases for Corning and **Dow Chemical** as shareholders in exchange for contributions to the Plan.

Required

- Does the amount that **Corning** reports as equity income seem consistent with its ownership percentage of the investee given the summary income statement data that **Corning** provides in this footnote?
- Does the carrying amount of the Equity Investments appear to be consistent with the summary balance sheet information that **Corning** provides in this footnote?

- c. Why did **Corning** discontinue the recognition of equity losses on this investment? Why did it resume the recognition of equity income?
- d. What is the significance of the following statement in this footnote: “The Plan also includes releases for **Corning** and **Dow Chemical** as shareholders in exchange for contributions to the Plan.”

22. Interpreting equity method footnote

AT&T reports the following footnote to its 2005 10-K report.

AT&T, Inc.

Equity Method Investments We account for our nationwide wireless joint venture, **Cingular**, and our investments in equity affiliates under the equity method of accounting. The following table is a reconciliation of our investments in and advances to Cingular as presented on our Consolidated Balance Sheets.

	2005	2004
Beginning of year	\$33,687	\$11,003
Contributions	—	21,688
Equity in net income	200	30
Other adjustments	(2,483)	966
End of year	<u>\$31,404</u>	<u>\$33,687</u>

Undistributed earnings from Cingular were \$2,711 and \$2,511 at December 31, 2005 and 2004. “Other adjustments” in 2005 included the net activity of \$2,442 under our revolving credit agreement with Cingular, consisting of a reduction of \$1,747 (reflecting Cingular’s repayment of their shareholder loan during 2005) and a decrease of \$695 (reflecting Cingular’s net repayment of their revolving credit balance during 2005). During 2004, we made an equity contribution to Cingular in connection with its acquisition of AT&T Wireless. “Other adjustments” in 2004 included the net activity of \$972 under our revolving credit agreement with Cingular, consisting of a reduction of \$30 (reflecting Cingular’s repayment of advances during 2004) and an increase of \$1,002 (reflecting the December 31, 2004 balance of advances to Cingular under this revolving credit agreement).

We account for our 60% economic interest in Cingular under the equity method of accounting in our consolidated financial statements since we share control equally (i.e., 50/50) with our 40% economic partner in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular. The following table presents summarized financial information for Cingular at December 31, or for the year then ended.

	2005	2004	2003
Income Statements			
Operating revenues	\$34,433	\$19,565	\$15,577
Operating income	1,824	1,528	2,254
Net income	333	201	977
Balance Sheets			
Current assets	\$ 6,049	\$ 5,570	
Noncurrent assets	73,270	76,668	
Current liabilities	10,008	7,983	
Noncurrent liabilities	24,333	29,719	

We have made a subordinated loan to Cingular that totaled \$4,108 and \$5,855 at December 31, 2005 and 2004, which matures in June 2008. This loan bears interest at an annual rate of 6.0%. During 2005, Cingular repaid \$1,747 to reduce the balance of this loan in accordance with the terms of a revolving credit agreement. We earned interest income on this loan of \$311 during 2005, \$354 in 2004 and \$397 in 2003. This interest income does not have a material impact on our net income as it is mostly offset when we record our share of equity income in Cingular.

Required

- a. At what amount is the equity investment in **Cingular** reported on **AT&T**’s balance sheet? (*Hint:* The table in the footnote reports **AT&T**’s equity investment plus its “advances” of \$4,108 to

Cingular plus \$311 of interest accrued on the advances.) Confirm that this amount is equal to its proportionate share of **Cingular**'s equity.

- b. Did **Cingular** pay out any of its earnings as dividends in 2005? How do you know?
- c. How much income did **AT&T** report in 2005 relating to this investment in **Cingular**?
- d. Interpret the **AT&T** statement that "undistributed earnings from **Cingular** were \$2,711 and \$2,511 at December 31, 2005 and 2004."

23. Interpreting equity method footnote

General Mills

General Mills invests in a number of joint ventures to manufacture and distribute its food products as discussed in the following footnote to a recent 10-K:

We have a 50 percent equity interest in CPW that manufactures and markets ready-to-eat cereal products in more than 130 countries and republics outside the United States and Canada... We have 50 percent equity interests in **Häagen-Dazs** Japan, Inc. and Häagen-Dazs Korea Company Limited. We also had a 49 percent equity interest in HD Distributors (Thailand) Company Limited... These joint ventures manufacture, distribute and market Häagen-Dazs frozen ice cream products and novelties.

Our cumulative investment in these joint ventures was \$295 million at the end of fiscal 2007 and \$186 million at the end of fiscal 2006. Our investments in these joint ventures include aggregate advances of \$158 million as of May 27, 2007 and \$48 million as of May 28, 2006. Our sales to these joint ventures were \$32 million in fiscal 2007, \$35 million in fiscal 2006, and \$47 million in fiscal 2005. We made net investments in the joint ventures of \$103 million in fiscal 2007, \$7 million in fiscal 2006, and \$15 million in fiscal 2005. We received dividends from the joint ventures of \$45 million in fiscal 2007, \$77 million in fiscal 2006, and \$83 million in fiscal 2005.

Summary combined financial information for the joint ventures (including income statement information for SVE through the date of its termination on February 28, 2005) on a 100 percent basis follows:

In Millions, Fiscal Year	2007	2006	2005
Net sales	\$2,016	\$1,796	\$2,652
Gross margin	835	770	1,184
Earnings before income taxes	167	157	231
Earnings after income taxes	132	120	184

In Millions	May 27, 2007	May 28, 2006
Current assets	\$ 815	\$ 634
Noncurrent assets	898	578
Current liabilities	1,228	756
Noncurrent liabilities	82	6

- a. How does **General Mills** account for its investments in joint ventures? How are these investments reflected on **General Mills**' balance sheet, and how generally is income recognized on these investments?
- b. Does the \$295 million investment reported on **General Mills**' balance sheet sufficiently reflect the assets and liabilities required to conduct these operations? Explain.
- c. Do you believe that the liabilities of these joint venture entities represent actual obligations of **General Mills**? Explain.
- d. What potential problem(s) does equity method accounting present for analysis purposes?

TOPIC REVIEW

Solution 1

1.	Accounts receivable	50	
	Inventories	100	
	Building	400	
	Cash		200
	Mortgage liability		50
	Common stock (50 shares @ \$1)		50
	Additional paid-in capital		250
2.	Equity investment	500	
	Cash		200
	Common stock (100 shares @ \$1)		50
	Additional paid-in capital		250

Solution 2

1. The investee’s stockholders’ equity will be reported at \$575 (\$500 + \$100 – \$25).
2. a.

Equity investment		100	
	Equity income		100
	<i>(to record equity income of \$100 representing 100% of the investee’s net income)</i>		

b.

Cash		25	
	Equity investment		25
	<i>(to record the receipt of \$25 dividend from the investee)</i>		

3. The Equity investment account on the investor’s balance sheet has a current balance of \$575 (\$500 + \$100 – \$25), the same as the investee’s stockholders’ equity. This is so because the investor owns 100% of the investee’s equity.

Solution 3

Anheuser-Busch does not have voting control of Modelo. Further, it controls only 9 of 19 seats on the board of directors and, therefore, does not control the board. We cannot conclude, therefore, that **Anheuser-Busch** controls Modelo. As a result, **Anheuser-Busch** should account for its investments using the equity method.

Solution 4

1.	Equity investment	100	
	Equity income		100
	<i>(to record equity income of \$100 representing 100% of the investee’s net income)</i>		
2.	Cash	25	
	Equity investment		25
	<i>(to record the receipt of \$25 dividend from the investee)</i>		
3.	Equity income	10	
	Equity investment		10
	<i>(to record the amortization of the patent asset)</i>		

Solution 5

Equity income		15	
	Equity investment		15
	<i>(to record the deferral of 60% of the \$25 of gross profit on inventory sale in the period of sale)</i>		

Solution 6

Equity income	5	
Equity investment		5
<i>(to record the deferral of 60% of the gross profit on inventory sale in the period of sale when the investor owns 1/3 of the investee – \$25 × 60% × 1/3 = \$5)</i>		

Solution 7

1. Unrealized holding gain (AOCI)	50,000	
Fair value adjustment		50,000
<i>(to remove the unrealized gain from stockholders' equity and the fair value adjustment from the investment account)</i>		
2. Equity investment	40,000	
Retained earnings (prior period adjustment)		40,000
<i>(to adjust the Equity Investment to its correct amount at the beginning of the year and to increase the beginning of the year retained earnings for the cumulative equity income that would have been recognized)</i>		

COMPREHENSIVE REVIEW

Solution

1. Unrealized holding gain (AOCI)	35,000	
Fair value adjustment		35,000
<i>(to remove the unrealized gain from stockholders' equity and the fair value adjustment from the investment account)</i>		
Equity investment	87,500	
Retained earnings (prior period adjustment)		87,500
<i>(to increase the Equity Investment by \$87,500 ((\$400,000 – \$150,000) × 35%) at the beginning of the year and to increase the beginning of the year retained earnings for the cumulative equity income that would have been recognized less cumulative dividends received)</i>		
2. Equity investment	70,000	
Equity income		70,000
<i>(to record equity income of \$70,000 representing 35% of the investee's net income of \$200,000)</i>		
3. Cash	31,500	
Equity investment		31,500
<i>(to record the receipt of a \$31,500 (\$90,000 × 35%) dividend from the investee)</i>		
4. Equity income	17,500	
Equity investment		17,500
<i>(to record the amortization of the Patent asset of \$17,500 ((\$500,000/10) × 35%)</i>		
5. Equity income	6,300	
Equity investment		6,300
<i>(to record the deferral of 60% of the gross profit on inventory sale in the period of sale when the investor owns 35% of the investee – (\$80,000 – \$50,000) × 60% × 35% = \$6,300)</i>		

