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# Intercorporate Investments: An Overview

## LEARNING OBJECTIVES

- LO1** Identify and discuss the major motivations for intercorporate investments. (p. 3)
- LO2** Describe the reporting for trading, available-for-sale, and held-to-maturity intercorporate investments. (p. 6)
- LO3** Explain the reporting for equity method intercorporate investments. (p. 10)
- LO4** Describe the reporting for controlling interests in other companies. (p. 15)
- LO5** Discuss International Financial Reporting Standards (IFRS) for intercorporate investments. (p. 18)

## THE COCA-COLA COMPANY

[www.coca-cola.com](http://www.coca-cola.com)

**THE COCA-COLA COMPANY** is the world's largest producer of nonalcoholic beverages. In addition to Coca-Cola, its brands include Sprite, Fruitopia, Minute Maid and Nestea. Coca-Cola's balance sheet reports many types of intercorporate investments.

Coca-Cola produces beverage syrup in concentrated form, and sells it to franchised bottlers. The bottlers mix the syrup with water and sweeteners, add carbonation, and bottle or can the finished beverages for delivery to retailers, restaurants, and food distributors. Although many bottlers are independently owned, Coca-Cola owns a **significant interest** in several bottlers. Note 3 of Coca-Cola's 2008 annual report discusses its relationship with Coca-Cola Enterprises Inc. (CCE):

CCE is a marketer, producer and distributor of bottle and can nonalcoholic beverages, operating in eight countries. As of December 31, 2008, our Company owned approximately 35 percent of the outstanding common stock of CCE. We account for our investment by the equity method of accounting and, therefore, our net income includes our proportionate share of CCE's net income or loss.

In 2007 Coca-Cola entered into an agreement with Coca-Cola FEMSA to jointly acquire Jugos del Valle, S.A.B. de C.V., a producer of juices and fruit-flavored beverages for Mexican and Brazilian markets. Ownership of Jugos del Valle is split equally between Coca-Cola and Coca-Cola FEMSA. Coca-Cola uses the equity method to account for this **joint venture**.

Also in 2007, Coca-Cola acquired 18 German bottling and distribution operations for a total purchase price of \$660 million. These companies are **subsidiaries** of Coca-Cola, and their accounts are included in Coca-Cola’s consolidated financial statements.

Coca-Cola also holds **marketable debt and equity investments**, categorized as trading, available-for-sale, or held-to-maturity. These accounts appear as current and noncurrent assets on Coca-Cola’s balance sheet. This chapter presents an overview of reporting for investments in other companies. *Source:* The Coca-Cola Company annual report, 2008.

## CHAPTER ORGANIZATION

Introduction	Marketable debt and equity investments	Investments with significant influence	Controlling investments	International Financial Reporting Standards
<ul style="list-style-type: none"> <li>• Motivations for intercorporate investments</li> <li>• Types of investments</li> </ul>	<ul style="list-style-type: none"> <li>• Trading investments</li> <li>• Available-for-sale investments</li> <li>• Held-to-maturity investments</li> </ul>	<ul style="list-style-type: none"> <li>• Equity method investments</li> <li>• Joint ventures</li> </ul>	<ul style="list-style-type: none"> <li>• Statutory mergers, statutory consolidations, and asset acquisitions</li> <li>• Stock acquisitions</li> <li>• Variable interest entities</li> </ul>	<ul style="list-style-type: none"> <li>• Marketable debt and equity investments</li> <li>• Investments with significant influence</li> <li>• Joint ventures</li> <li>• Controlling investments</li> </ul>

## INTRODUCTION

Companies invest in other companies for many reasons, using a variety of financing arrangements, operating relationships and legal structures. Intercorporate investments are pervasive business activities and affect financial performance in profound ways, and the reporting requirements are detailed and complex. Requirements on valuing investments and reporting gains and losses depend on the purpose of the investment and whether the investor has significant influence or control over the investee.

### Motivations for Intercorporate Investments

Intercorporate investments achieve a variety of business purposes.

- A company purchases debt or equity securities of another company as a temporary investment of excess cash or as part of a longer-term risk-adjusted portfolio, with the expectation of dividends and capital gains.
- A company makes strategic investments to develop relationships with suppliers or customers or to gain access to new product or geographic markets.
- A company takes a controlling interest in another company to facilitate activity along its supply chain.

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**LO1** Identify and discuss the major motivations for investments in other companies.

The current assets and investments sections of **THE COCA-COLA COMPANY**’s December 31, 2008, balance sheet below illustrate the variety of intercorporate investments.

The Coca-Cola Company, Balance Sheet, Current Assets and Investments Only		
December 31 (in millions)	2008	2007
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents . . . . .	\$ 4,701	\$ 4,093
Marketable securities . . . . .	278	215
Trade accounts receivable, less allowances of \$51 and \$56, respectively . . . . .	3,090	3,317
Inventories . . . . .	2,187	2,220
Prepaid expenses and other assets . . . . .	1,920	2,260
Total Current Assets . . . . .	<u>\$12,176</u>	<u>\$12,105</u>
<b>Investments</b>		
Equity method investments:		
Coca-Cola Hellenic Bottling Company S.A. . . . .	\$ 1,487	\$ 1,549
Coca-Cola FEMSA, S.A.B. de C.V. . . . .	877	996
Coca-Cola Amatil Limited . . . . .	638	806
Coca-Cola Enterprises Inc. . . . .	—	1,637
Other, principally bottling companies and joint ventures . . . . .	2,314	2,301
Other investments, principally bottling companies . . . . .	463	488
Total Investments . . . . .	<u>\$ 5,779</u>	<u>\$ 7,777</u>

Short- and long-term portfolios of investments provide investment income and gains in value. Footnote 10 to Coca-Cola's 2008 annual report lists its investments in trading, available-for-sale, and held-to-maturity securities. These investments are reported as cash and cash equivalents, marketable securities, and cost method investments on Coca-Cola's balance sheet.

The Coca-Cola Company, Footnote 10, 2008 Annual Report				
2008 (in millions)	Cost	Gross Unrealized		Estimated Fair Value
		Gains	Losses	
Trading securities <sup>1</sup> :				
Equity securities . . . . .	\$ 74	\$ —	\$(30)	\$ 44
Other securities . . . . .	7	—	(2)	5
	<u>\$ 81</u>	<u>\$ —</u>	<u>\$(32)</u>	<u>\$ 49</u>
Available-for-sale securities <sup>1</sup> :				
Equity securities . . . . .	\$329	\$193	\$ (7)	\$515
Other securities . . . . .	12	—	(5)	7
	<u>\$341</u>	<u>\$193</u>	<u>\$(12)</u>	<u>\$522</u>
Held-to-maturity securities:				
Bank and corporate debt . . . . .	\$ 74	\$ —	\$ —	\$ 74

<sup>1</sup> The fair value of trading and available-for-sale securities included in the table were determined in accordance with SFAS No. 157.

Companies that invest in other companies with the intention of exerting **significant influence** over their operations generally do so for strategic reasons. Coca-Cola reports these types of investments as "equity method investments." Coca-Cola owns a 35 percent interest in Coca-Cola Enterprises Inc. (CCE), a 23 percent interest in Coca-Cola Hellenic, a 32 percent interest in Coca-Cola FEMSA, and a 30 percent interest in Coca-Cola Amatil. Coca-Cola's business relationships with CCE are discussed in its 2008 annual report:

Syrup and finished product purchases from CCE represent purchases of fountain syrup in certain territories that have been resold by our Company to major customers and purchasers of bottle and can products. Marketing payments made by us directly to CCE ... promote the sale of Company trademark products within CCE territories... Payments made to CCE for dispensing equipment repair

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services represent reimbursement to CCE for its costs of parts and labor for repairs on ... equipment owned by us or our customers... Our Company ... paid CCE for a portion of the cost of developing the infrastructure necessary to support accelerated placements of cold-drink equipment. These payments support a common objective of increased sales of Company trademarked beverages from increased availability and consumption in the cold-drink channel.

Coca-Cola's December 31, 2008, investment balance for CCE is zero, a reduction of \$1,637 million from 2007. This reduction is the result of heavy losses reported by CCE.

Companies also invest in **joint ventures**, where two or more companies share ownership interests in and jointly control a new entity, to engage in a short-term project or continuing business arrangement. In 2007 Coca-Cola and Coca-Cola FEMSA acquired Jugos del Valle as a joint venture, giving Coca-Cola a 50 percent ownership in Jugos del Valle. In 2005 the company joined with Coca-Cola Hellenic to acquire 50 percent ownership of Multon, which produces and distributes juice products in Russia, Ukraine and Belarus. These joint ventures expand Coca-Cola's international markets.

A company may acquire a **controlling interest** in another company for strategic reasons. The following excerpt from Coca-Cola's 2008 financial statements describes two such acquisitions.

In order to increase the efficiency of our bottling and distribution operations in the German market, the Company, through its consolidated German bottling operation Coca-Cola Erfrischungsgetraenke AG ("CCEAG"), acquired 18 German bottling and distribution operations on September 1, 2007 for a total purchase price of approximately \$547 million plus transaction costs. Following the acquisition, the Company owns the franchise rights for all of the German market. On June 7, 2007, in an effort to expand our still beverage offerings, our Company acquired Energy Brands Inc., also known as glacéau, the maker of enhanced water brands, such as vitaminwater and smartwater, for approximately \$4.1 billion.

Coca-Cola also has legal arrangements with other companies that make it the beneficiary of the majority of the risks and rewards of these companies, even though it does not own their stock.

Our Company holds interests in certain entities, primarily bottlers, that are considered variable interest entities. These variable interests relate to profit guarantees or subordinated financial support for these entities.

Each type of investment described above is reported differently.

## Types of Investments

For reporting purposes, intercorporate investments are divided into the following categories:

- **Trading** debt or equity securities are held on a short-term basis to generate profits through realized gains. Investors typically buy and sell these securities frequently.
- **Held-to-maturity** investments are *debt* securities intended to be held to maturity. There are only limited circumstances where the investor may sell the security before maturity, such as financial distress on the part of the issuer, or if the investor reorganizes through acquisition or disposal of a unit and must rebalance its portfolio to maintain its current credit rating.
- **Available-for-sale** investments are debt or equity securities held for income or gains in value that are not classified as trading or held-to-maturity.
- **Equity method** investments are stock investments that provide the investor with a significant influence over the investee, typically by holding 20 to 50 percent of the investee's voting stock. This category includes *joint ventures*, where the investor shares joint control of an entity.
- Debt or equity securities can be held as *hedges* of the investor's financial risk. For example, a U.S. company with payables denominated in euros may neutralize the risk of a weakening U.S. dollar by

investing in euro-denominated debt securities, which gain in value to offset the loss on the payables if the U.S. dollar weakens.

- A company can acquire the assets and liabilities of another company; the acquired company is usually absorbed into the acquiring company and loses its separate legal identity. These transactions are called *statutory mergers*, *statutory consolidations*, or *asset acquisitions*, depending on the acquisition structure.
- A company can gain a *controlling interest* in another legally separate company, either through ownership of all or the majority of its voting stock—termed a *stock acquisition*—or through a legal agreement that gives the investor the right to the majority of the investee’s risks and rewards. These acquired companies are called *subsidiaries*. Entities controlled through a legal agreement rather than equity ownership are also known as *variable interest entities*.

Exhibit 1.1 summarizes the sources of major U.S. reporting requirements for intercorporate investments.

EXHIBIT 1.1 Reporting Guidance for Intercorporate Investments		
Statement	Title	Application
APBO 18	The Equity Method of Accounting for Investments in Common Stock	Ownership of an investee’s voting stock giving the investor significant influence but not control
SFAS 115	Accounting for Certain Investments in Debt and Equity Securities	Debt or equity investments giving the investor no significant influence or control
SFAS 133	Accounting for Derivative Instruments and Hedging Activities	Derivative investments and qualified hedges of financial risk
SFAS 141(R)	Business Combinations	Acquisition of the assets and liabilities of a company or most or all of the voting stock of a separate legal entity
SFAS 142	Goodwill and Other Intangible Assets	Postacquisition reporting of goodwill and other intangible assets acquired in a business combination
SFAS 159	The Fair Value Option for Financial Assets and Financial Liabilities	Applying fair value to marketable debt and equity securities and equity method investments
SFAS 160	Noncontrolling Interests in Consolidated Financial Statements	Noncontrolling interests in the acquiree resulting from business combinations
FIN 46(R)	Consolidation of Variable Interest Entities	Entities controlled by legal agreement rather than stock acquisition

*SFAS 159* allows companies to elect fair value reporting (the “fair value option”) for eligible intercorporate investments, including those currently covered by the requirements of *SFAS 115* and *APBO 18*. When a company chooses the fair value option, investments are reported at fair value and value changes appear in income. The discussion below assumes the investor does *not* elect the fair value option. Controlling equity investments are not eligible for the fair value option.

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**LO2** Describe the reporting for trading, available-for-sale, and held-to-maturity investments in other companies.

## MARKETABLE DEBT AND EQUITY INVESTMENTS

A business may invest in the debt and equity securities of other companies to generate investment income and capital gains. Examples of debt securities include commercial paper, corporate bonds, and redeemable preferred stock. Equity investments typically take the form of shares of a company’s common or preferred stock, but also can be put or call options on the shares, allowing the investor to sell or buy shares at a fixed price. Such investors have no significant influence over the investee, either because the investments are debt securities, or the equity investment is a small fraction of total ownership, generally less than 20 percent.

*SFAS 115* divides investments with readily determinable market values into three categories or portfolios: trading, available-for-sale, and held-to-maturity investments. However, if market value is not determinable, investments are reported at cost. Because intermediate accounting courses detail the reporting for these investments, the discussion below is purposefully brief.

## Trading Investments

Trading investments can be in the form of debt or equity securities. These investments appear on the balance sheet as current assets reported at fair value, with unrealized gains and losses reported on the income statement as market prices change. Investment income, in the form of interest or dividends, is reported in income as earned. An illustration is based on the information in Exhibit 1.2.

EXHIBIT 1.2 Securities Portfolio					
Security	Date Acquired	Cost	Dec. 31, 2010 Fair Value	Date Sold	Selling Price
A.....	10/15/10	\$100,000	\$125,000	1/15/11	\$120,000
B.....	10/15/10	500,000	485,000	1/15/11	496,000
C.....	10/15/10	200,000	N/A	12/5/10	214,000

When these securities are classified as trading securities, the journal entries related to these securities are as follows:

2010	Oct. 15	Investment in trading securities .....	800,000	
		Cash .....		800,000
		<i>To record investment in trading securities costing a total of \$800,000 in cash.</i>		
2010	Dec. 5	Cash .....	214,000	
		Investment in trading securities .....		200,000
		Gain on sale of trading securities .....		14,000
		<i>To record sale of trading security C.</i>		
2010	Dec. 31	Investment in trading securities .....	10,000	
		Unrealized gain on trading securities .....		10,000
		<i>To record unrealized value change in securities A and B; unrealized gain of \$25,000 on security A and unrealized loss of \$15,000 on security B.</i>		
2011	Jan. 15	Cash .....	616,000	
		Investment in trading securities .....		610,000
		Gain on sale of trading securities .....		6,000
		<i>To record sale of trading securities A and B; cash received = \$120,000 + \$496,000, credit to Investment = \$125,000 + \$485,000.</i>		

All unrealized and realized gains and losses on trading securities are reported on the income statement.

## Available-for-Sale Investments

Investments in available-for-sale (AFS) securities may also be debt or equity securities that are reported at fair value as current or noncurrent assets on the balance sheet. As market prices change, unrealized gains and losses on AFS securities are reported in other comprehensive income (OCI), which is closed to accumulated other comprehensive income (AOCI) in the equity section of the balance sheet. When AFS securities are sold, the investor transfers the unrealized gain or loss from AOCI to the income statement. Interest or dividend income is reported in income as earned.

Assume that the securities in Exhibit 1.2 are classified as AFS securities. Journal entries are as follows:

2010				
Oct. 15	Investment in AFS securities . . . . .	800,000		
	Cash . . . . .		800,000	
	<i>To record investment in AFS securities A, B and C.</i>			
2010				
Dec. 5	Cash . . . . .	214,000		
	Investment in AFS securities . . . . .		200,000	
	Gain on sale of AFS securities (income) . . . . .		14,000	
	<i>To record the sale of AFS security C. When AFS securities are purchased and sold in the same reporting period, gains and losses can be reported directly in income without going through OCI.</i>			
2010				
Dec. 31	Investment in AFS securities . . . . .	10,000		
	Unrealized gains on AFS securities (OCI) . . . . .		10,000	
	<i>To record unrealized value changes for AFS securities A and B in OCI; OCI is closed to AOCI on the balance sheet.</i>			
2011				
Jan. 15	Cash . . . . .	616,000		
	Investment in AFS securities . . . . .		610,000	
	Gain on sale of AFS securities (income) . . . . .		6,000	
	<i>To record sale of AFS securities A and B.</i>			
Jan. 15	Unrealized gains on AFS securities (AOCI) . . . . .	10,000		
	Gain on sale of AFS securities (income) . . . . .		10,000	
	<i>To reclassify unrealized gains on sales of AFS securities from AOCI to income.</i>			

The principal difference in reporting for trading and available-for-sale investments is the timing of gain and loss recognition on the income statement. For trading securities, gains and losses affect net income *as prices change*. For AFS securities, gains and losses affect net income *when they are sold*.

## Held-to-Maturity Investments

Investments in held-to-maturity (HTM) securities can only be debt securities, since equity securities have no maturity date. They appear on the balance sheet at amortized cost, as noncurrent assets until the year of maturity. No gains or losses are reported unless the securities are not held to maturity as intended, and this only occurs under special circumstances, discussed above. When debt securities are purchased above or below face value, the premium or discount is amortized over time as interest income is reported.

Assume investment in a \$1,000,000 face value corporate bond on January 1, 2010, for \$965,349, a price producing a 6 percent yield to maturity. The bond pays 5 percent interest annually on December 31, matures on December 31, 2013, and is classified as an HTM security. We use the effective interest method to amortize the discount. Journal entries to maturity are as follows:

2010				
Jan. 1	Investment in HTM securities . . . . .	965,349		
	Cash . . . . .		965,349	
	<i>To record investment in HTM securities.</i>			
2010				
Dec. 31	Cash . . . . .	50,000		
	Investment in HTM securities . . . . .	7,921		
	Interest income . . . . .		57,921	
	<i>To record interest income for 2010; \$50,000 = 5% × \$1,000,000; \$57,921 = 6% × \$965,349.</i>			

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2011			
Dec. 31	Cash .....	50,000	
	Investment in HTM securities .....	8,396	
	Interest income .....		58,396
	<i>To record interest income for 2011; \$58,396 = 6% × \$973,270 (= \$965,349 + \$7,921).</i>		
2012			
Dec. 31	Cash .....	50,000	
	Investment in HTM securities .....	8,900	
	Interest income .....		58,900
	<i>To record interest income for 2012; \$58,900 = 6% × \$981,666 (= \$973,270 + \$8,396).</i>		
2013			
Dec. 31	Cash .....	50,000	
	Investment in HTM securities .....	9,434	
	Interest income .....		59,434
	<i>To record interest income for 2013; \$59,434 = 6% × \$990,566 (= \$981,666 + \$8,900).</i>		
Dec. 31	Cash .....	1,000,000	
	Investment in HTM securities .....		1,000,000
	<i>To record receipt of the face value of the matured bond; \$1,000,000 = \$990,566 + \$9,434.</i>		

**Impairment Testing for HTM Investments** Although companies normally report HTM securities at amortized cost, *SFAS 115* requires that they be evaluated for impairment. If the fair value of the security declines below amortized cost, and the decline is judged to be “**other than temporary**,” we write the security down to fair value and report the impairment loss on the income statement. Any subsequent increases in fair value are not reported. *SFAS 115* offers one example indicating other-than-temporary impairment:

For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. (para 16)

In the illustration above, assume that a significant decrease in the bond issuer’s profit and analysts’ severe downgrade of company prospects reduced the December 31, 2011, fair value of the corporate bond to \$200,000 when the amortized cost of the bond is \$981,666. If the decline in fair value is attributed to other-than-temporary impairment, the investor reports the impairment loss in income, as follows:

2011			
Dec. 31	Impairment loss on HTM securities .....	781,666	
	Investment in HTM securities .....		781,666
	<i>To record other-than-temporary impairment of HTM securities; \$781,666 = \$200,000 – \$981,666.</i>		

## REVIEW 1 • Trading, AFS, and HTM Investments

Assume **THE COCA-COLA COMPANY** makes the following intercorporate investments on January 2, 2011:

Security	Type	Cost
A.....	Trading	\$ 300,000
B.....	AFS	1,000,000
C.....	HTM	486,384

Security C is a 3-year \$500,000 face value corporate bond paying 4% interest annually on December 31 and yielding 5% to maturity. Coca-Cola sells Security A for \$265,000 on June 15, 2011, and acquires Security D on October 15, 2011, for \$250,000. Security D is classified as a trading security.

December 31, 2011, fair values are as follows:

Security	Type	Fair Value
B.....	AFS	\$920,000
C.....	HTM	495,000
D.....	Trading	260,000

Cash dividends of \$12,000 are received on the investments in Securities B and D on December 1, 2011. Interest of \$20,000 is received on Security C on December 31, 2011.

*Required:* Prepare all entries related to the above investments for 2011.

**Solutions are located after the chapter assignments.**

## INVESTMENTS WITH SIGNIFICANT INFLUENCE

**LO3** Explain the reporting for equity method intercorporate investments.

Unless a company elects the *SFAS 159* fair value option, *APBO 18* requires that the **equity method** be used to account for large equity investments that allow the investor to exercise *significant influence* over the operating and financial decisions of the investee. **Significant influence** is assumed to be present if the investor owns between 20 and 50 percent of the investee’s voting stock. Ownership of less than 20 percent of the investee’s voting stock implies no significant influence, unless influence can be demonstrated. *APBO 18* offers guidelines that indicate the investor’s ability to exert significant influence, including:

- representation on the investee’s board of directors
- involvement in the development of investee operating and financial policies
- significant transactions between investor and investee

The 20 to 50 percent ownership test is a guideline; the *key issue* is whether the investor in fact *exerts significant influence* over the investee’s operations. Significant influence may exist with less than 20 percent ownership of the investee’s voting shares, or there may be circumstances where a large minority ownership does not indicate significant influence. *FASB Interpretation 35* provides guidance on this point. For example, if the investor has given up significant shareholder rights, has tried but failed to gain representation on the investee’s board, or if other owners not influenced by the investor control the investee’s operations, the equity method is not appropriate even if the investor holds 20 to 50 percent of the voting stock.

### Accounting Using the Equity Method

When the investor can influence the investee’s operating and financial decisions and the amount and timing of dividends the investee pays, performance of the investment is not accurately measured by dividend payout. Instead, investment performance should parallel the investee’s performance. The equity method achieves this goal with the following procedures:

- The investment account increases (decreases) by the investor’s share of the investee’s income (loss).
- The investor reports its share of the investee’s income (loss) in income.
- Dividends from the investee reduce the carrying value of the investment.

The investment balance therefore changes in proportion to the retained earnings of the investee.

Assume that on January 2, 2011, The Coca-Cola Company acquires 300,000 voting shares of Rocky Mountain Bottlers for \$40 per share, or a total investment of \$12 million in cash. Because Rocky Mountain has one million voting shares, Coca-Cola's 30 percent ownership indicates significant influence and the equity method is appropriate. Rocky Mountain reports net income of \$2 million for the year ended December 31, 2011. It declares a cash dividend of \$0.50 per share on November 1, 2011, and pays the dividend on December 2, 2011. Coca-Cola records the following entries for 2011 relative to its equity method investment in Rocky Mountain:

2011	Jan. 2	Investment in Rocky Mountain Bottlers . . . . .	12,000,000	
		Cash . . . . .		12,000,000
		<i>To record the investment.</i>		
2011	Nov. 1	Dividends receivable . . . . .	150,000	
		Investment in Rocky Mountain Bottlers . . . . .		150,000
		<i>To record the declared dividend; \$150,000 = \$0.50 × 300,000.</i>		
2011	Dec. 2	Cash . . . . .	150,000	
		Dividends receivable . . . . .		150,000
		<i>To record receipt of the declared dividend.</i>		
2011	Dec. 31	Investment in Rocky Mountain Bottlers . . . . .	600,000	
		Equity in income of Rocky Mountain Bottlers . . . . .		600,000
		<i>To accrue the earnings of the investee; \$600,000 = 30% × \$2,000,000.</i>		

The December 31, 2011, investment balance, reported on Coca-Cola's balance sheet in noncurrent assets, is \$12,450,000 (= \$12,000,000 - \$150,000 + \$600,000). Equity in income of Rocky Mountain Bottlers of \$600,000 appears as a component of Coca-Cola's income for 2011.

## Equity in Net Income Calculation

The discussion above computed equity in net income as the investor's share of the investee's reported net income, based on the assumption that the investee's reported net income accurately measures the performance of the investment. When investment cost differs from the investee's book value, or the investor and investee transact business with each other, the investor must make adjustments to the investee's reported income.

At the date of acquisition, investment cost usually exceeds the book value of the investee, calculated as its reported assets less liabilities. The investee reports its noncurrent assets such as plant and equipment at cost less accumulated depreciation, not current fair value. Internally developed intangible assets, such as favorable contractual agreements, customer base, technology and reputation do not appear as assets on the investee's balance sheet. Reported liabilities may also not reflect fair values—the investee may have unrecorded contingent liabilities such as lawsuits—but these differences are typically not as significant. For these reasons an investee's shares almost always sell at a price in excess of book value.

Companies usually take large noncontrolling interests in other entities for strategic reasons that facilitate business activities between the companies. Common transactions involve intercompany sales of raw materials or finished goods inventories. For example, Coca-Cola sells syrup and bottle and can products to its 35-percent-owned bottler, Coca-Cola Enterprises, Inc. When related entities sell merchandise to each other, the profit on these transactions is not considered to be earned until the merchandise is sold to an unrelated outside party.

**Amortization of Investment Cost in Excess of Book Value Acquired** To accurately measure investment performance, we must consider any investment cost in excess of investee book value. The investee's reported income reflects appropriate write-offs of its reported assets, in the form of depreciation, amortization, and impairment losses. If investment cost reflects additional assets not recorded on the investee's books, equity in net income should in turn reflect write-offs of these additional assets. In the above discussion, we calculated Coca-Cola's share of Rocky Mountain Bottlers'

income as a proportion of Rocky Mountain's reported net income. If Coca-Cola's investment cost at the date of investment differs from Rocky Mountain's underlying book value, we must make adjustments to accurately measure investment performance.

Suppose that on January 2, 2011, Rocky Mountain reports total assets of \$80 million and total liabilities of \$50 million, for a net book value of \$30 million. Coca-Cola therefore paid \$3 million (= \$12 million – 30% × \$30 million) more for its 30 percent investment than its share of Rocky Mountain's underlying book value. Analysis of Rocky Mountain's assets and liabilities reveals undervaluation of its plant and equipment by \$1 million and unreported technology valued at \$5 million. We can explain the \$3 million excess over acquired book value as follows:

Price paid . . . . .		\$12,000,000
Share of Rocky Mountain's net assets acquired:		
Book value (30% × \$30,000,000) . . . . .	\$9,000,000	
Revaluation of plant and equipment (30% × \$1,000,000) . . . . .	300,000	
Unreported technology (30% × \$5,000,000). . . . .	1,500,000	10,800,000
Additional investment cost (goodwill). . . . .		<u>\$ 1,200,000</u>

Of the total \$3 million excess cost, \$1,800,000 (= \$300,000 + \$1,500,000) is explained by specific asset undervaluations. The remaining unexplained cost is attributed to goodwill, representing the additional cost not explained by underreported or unreported identifiable assets.

Rocky Mountain does not report depreciation, amortization and impairment losses on the additional assets embedded in Coca-Cola's investment cost, because these assets do not appear on its books. Coca-Cola therefore adjusts its equity in the net income of Rocky Mountain by these additional yearly write-offs. Write-offs of revaluations of tangible assets such as plant and equipment follow existing reporting policies for the tangible assets. Write-offs of previously unrecorded intangibles and goodwill follow the requirements of *SFAS 142* and *SFAS 144*. Chapter 4 in this text covers these requirements in detail; we abbreviate that discussion here.

*SFAS 142* requires that previously unreported intangible assets be identified as having limited lives or indefinite lives. Examples of previously unreported limited life intangibles include favorable lease agreements and customer lists. Examples of indefinite life intangibles include brand names, franchises, and in-process research and development. Limited life intangibles are amortized over their estimated lives, generally on a straight-line basis. Both limited and indefinite life intangibles are tested at least annually for impairment, following the requirements of *SFAS 144*, and losses recognized in income as appropriate. Goodwill is also an indefinite life intangible asset, but it is tested for impairment using a different procedure, explained in *SFAS 142*.

For investments reported using the equity method, equity in net income is adjusted for depreciation and amortization on revaluations of *tangible assets* and *limited life intangible assets*—*SFAS 142 prohibits* any adjustment for goodwill impairment. *SFAS 142* does not specifically address the question of whether equity in net income should be adjusted for impairment of indefinite life intangibles. In *EITF Issue 08-06*, the Emerging Issues Task Force concluded that indefinite life intangibles connected with equity method investments should *not* be tested for impairment.

Continuing Coca-Cola's investment in 30 percent of Rocky Mountain Bottlers' voting stock, assume that the revalued plant and equipment has a remaining life of 10 years as of January 2, 2011, straight-line, and the previously unreported technology is a limited life intangible asset with a five-year life. Coca-Cola's 2011 equity in the income of Rocky Mountain Bottlers is reduced by the implied depreciation on the plant and equipment revaluation of \$30,000 (= \$300,000/10) and amortization of previously unreported technology of \$300,000 (= \$1,500,000/5).

**Unconfirmed Inventory Profits** An investor may sell inventory to its investee, termed **downstream** sales, or an investee may sell merchandise to the investor, termed **upstream** sales. Both companies record the sales as if they are selling to outside customers. If both companies sell the merchandise at a markup over cost, they will report a gross margin on these intercompany sales as part of their income. However, if the inventories are not yet sold to an unrelated outside party at year-end, this gross margin is not yet earned and must be removed when calculating equity in the net income of the investee.

Suppose that during 2011 Rocky Mountain Bottlers sells canned beverages to Coca-Cola (upstream) for \$800,000, an average markup of 20 percent on cost. Coca-Cola still holds \$210,000 of this inventory at year-end. During 2011 Coca-Cola sells finished products to Rocky Mountain (downstream) for \$500,000, an average markup of 25 percent on cost. Rocky Mountain holds \$100,000 of this inventory at year-end. The total unconfirmed profit on the ending inventories is as follows:

Unconfirmed gross profit on \$210,000 upstream sales:	
	$\$210,000 - \$210,000/1.20 = \$35,000$
Unconfirmed gross profit on \$100,000 downstream sales:	
	$\$100,000 - \$100,000/1.25 = \$20,000$

Coca-Cola's 2011 equity in the income of Rocky Mountain Bottlers is reduced by \$10,500 ( $= 30\% \times \$35,000$ ) and \$6,000 ( $= 30\% \times \$20,000$ ). In 2012, when the beginning inventories are sold to outside customers, the profit is confirmed and equity in net income is increased by \$10,500 and \$6,000.

To summarize, Coca-Cola's equity in the 2011 income of Rocky Mountain is calculated as follows:

Coca-Cola's share of Rocky Mountain's reported net income ( $30\% \times \$2,000,000$ ) . . . . .	\$600,000
Adjustments for revaluation write-offs:	
Plant and equipment . . . . .	(30,000)
Previously unreported technology . . . . .	(300,000)
Adjustments for unconfirmed inventory profits:	
Upstream sales . . . . .	(10,500)
Downstream sales . . . . .	(6,000)
Equity in net income of Rocky Mountain . . . . .	<u>\$253,500</u>

Coca-Cola's end-of-year entry to recognize its share of Rocky Mountain's income is:

2011			
Dec. 31	Investment in Rocky Mountain Bottlers . . . . .	253,500	
	Equity in income of Rocky Mountain Bottlers . . . . .		253,500
	<i>To accrue the earnings of the investee.</i>		

The investment balance at year-end is \$12,103,500 ( $= \$12,000,000 - \$150,000 + \$253,500$ ).

The equity method required for *external* reporting of *significant influence investments* differs from the complete equity method used *internally* by a *controlling* parent company to facilitate consolidation procedures. Chapters 4 through 6 provide further discussion of these differences.

## Other Comprehensive Income and the Equity Method

Using the equity method, the investor reports its share of the investee's performance each year on its own books. A company's performance is measured by its income, which accumulates in retained earnings, but other elements of performance are reflected in accumulated other comprehensive income, an equity account on its balance sheet. To fully report the investee's performance, the investor adjusts its investment and other comprehensive income for its share of the investee's yearly OCI.

Assume that in 2011 Rocky Mountain reported \$200,000 in unrealized gains on AFS securities. In addition to the entries above, Coca-Cola makes the following entry to reflect these gains:

2011			
Dec. 31	Investment in Rocky Mountain Bottlers . . . . .	60,000	
	Unrealized gains on equity method investments (OCI) . . . . .		60,000
	<i>To report 30% share of Rocky Mountain's unrealized gains on AFS securities.</i>		

Coca-Cola reports the \$60,000 in unrealized gains in AOCI, one of the accounts in the equity section of its balance sheet.

## Impairment Testing

*APBO 18* requires impairment testing of equity method investments. If the fair value of the investment declines below its carrying value, and the decline is judged to be other than temporary, the investment is written down and the loss appears on the investor's income statement. Any subsequent increases in fair value are not reported.

### BUSINESS APPLICATION IMPAIRMENT TESTING

Note 1 to **COCA-COLA**'s 2008 financial statements describes its impairment testing for investments:

**Recoverability of Investments in Equity and Debt Securities** We review our investments in equity and debt securities that are accounted for using the equity method or cost method or that are classified as available-for-sale or held-to-maturity each reporting period to determine whether a significant event or change in circumstances has occurred that may have an adverse effect on the fair value of each investment. In the event the fair value of an investment declines below our cost basis, management is required to determine if the decline in fair value is other than temporary. If management determines the decline is other than temporary, an impairment charge is recorded.

Coca-Cola uses a variety of methods to measure the fair value of its investments, including market prices, appraisals, and discounted cash flows. *Source:* The Coca-Cola Company annual report, 2008.

### Reporting Perspective

Typically the cost of equity method investments is greater than the underlying book value of the investee, because the investee has assets that are valued by the market but are not reported on its balance sheet. When using the equity method, the investor identifies the specific assets that are undervalued or not reported on the investee's books. The investor then reports equity in the net income of the investee as its share of the investee's reported net income, adjusted for write-offs of those undervalued or unreported assets with limited lives. Equity in net income is *not* adjusted for impairments of indefinite life intangibles, including goodwill.

Why are impairments in indefinite life intangibles ignored in computing equity in net income? Although not specifically stated in authoritative pronouncements, a logical conclusion is that the impairment test currently required by *APBO 18* already accounts for such declines in value. If the investment is subject to other-than-temporary impairment, expectations concerning the investee's future performance have significantly declined. A financially distressed investee's intangible assets, including goodwill, are therefore impaired. There is also a practical argument for not reporting impairments of the investee's specific indefinite life intangibles as adjustments to equity in net income. The investor may not have enough information to assess impairment losses on the investee's intangible assets. The investor has a significant influence over the investee's operations, but may not have access to the detailed information on future cash flows that is necessary to properly test for impairment.

## Joint Ventures

A **joint venture** is an entity formed by a small group of individuals or firms that contribute resources and jointly share in managing and controlling the venture. Joint ventures are traditionally established to carry out a single business transaction or activity, often over a limited period of time. Frequently, the owners of a joint venture are themselves large firms, either partnerships or corporations. A **corporate joint venture** exists when the venture is organized as a corporation. Participants form joint ventures for activities where it is mutually desirable to combine expertise, special technology, capital, or access to certain markets. Examples include research projects or development of new products, in which two

areas of technology must be joined, and large-scale construction projects, in which the capital and facilities of two or more contractors are needed. Although joint ventures are frequently short-lived, they can last several years and their initial projects may lead to ongoing business activities.

Coca-Cola's joint ventures with Coca-Cola FEMSA and Coca-Cola Hellenic are discussed earlier in this chapter. These joint ventures give Coca-Cola 50 percent ownership of Jugos del Valle and Multon, respectively; both investments expand Coca-Cola's markets internationally. U.S. companies follow the guidelines of *APBO 18* for joint ventures. *APBO 18* states that investments of 20 to 50 percent interest in an investee are presumed to give the investor significant influence and require use of the equity method.

### Reporting Perspective

If two companies form a joint venture with equal interests, U.S. GAAP allows both companies to report the venture using the equity method. As a result, the separate assets and liabilities of the joint venture do not appear on *any* balance sheet. Each investor reports its interest as a one-line equity investment in the asset section of its balance sheet. Similarly, the separate revenues and expenses of the joint venture do not appear on *any* income statement. Each investor reports its equity in the net income of the joint venture on one line in its income statement.

In 2007 **PEPSICO** formed a joint venture with **PEPSI BOTTLING GROUP (PBG)**, to combine PepsiCo's concentrate with PBG's bottling operations in Russia. PepsiCo owns a 40 percent interest in the joint venture, and accounts for its investment using the equity method. PBG, on the other hand, owns a 60 percent majority interest and *consolidates* the joint venture on its financial statements. PBG combines the separate assets, liabilities, revenues and expenses of the joint venture with its own accounts on its financial statements. The next section introduces reporting for majority-owned equity investments.

## REVIEW 2 • Reporting for Equity Method Investments

On January 5, 2012, Fizzy Cola Corporation, headquartered in Minneapolis, MN, acquires 25 percent of the voting stock of Armadillo Bottlers, located in Austin, TX, to support expansion in southwestern U.S. markets. Fizzy Cola pays \$15 million in cash for the stock. Armadillo's book value is \$20 million at the acquisition date, and its assets and liabilities are fairly stated except for unreported customer-related intangible assets valued at \$10 million, with average expected lives of five years. In 2012, Armadillo reports net income of \$3 million.

Armadillo sells canned and bottled beverages to Fizzy Cola at a markup of 30 percent on cost. Fizzy Cola sells syrup to Armadillo at a markup of 20 percent on cost. At December 31, 2012, Fizzy Cola's inventory includes \$325,000 in merchandise acquired from Armadillo. Armadillo's inventory includes \$480,000 in merchandise purchased from Fizzy Cola. Armadillo pays total cash dividends of \$500,000 on December 1, 2012. Fizzy Cola accounts for its investment in Armadillo using the equity method.

*Required:* Prepare Fizzy Cola's entries to record the above information for 2012.

**Solutions are located after the chapter assignments.**

## CONTROLLING INVESTMENTS

Investments in other companies may give the investor control over the operating and financial decisions of the investee. The investment structures may take different forms, as follows:

- **Statutory merger, statutory consolidation, or asset acquisition**, where the investor directly acquires the assets and liabilities of the investee. Statutory mergers occur when the investor acquires the investee and becomes the remaining legal entity. In a statutory consolidation, a new entity is formed to acquire both the investor and investee. In asset acquisitions, the investor acquires a subset of the investee's assets.

**LO4** Describe the reporting for controlling interests in other companies.

- **Stock acquisition**, where the investor acquires a controlling interest in the voting equity stock of the investee.
- **Variable interest entity**, where the investor does not hold the investee’s stock, but legal agreements give it the right to the majority of the investee’s risks and rewards. The investee’s actual equity holders do not have the usual rights and responsibilities pertaining to equity ownership.

Investors should be able to evaluate the complete financial performance of a company by looking at its financial statements. If the company controls the resources of another company, investors should see the results of decisions affecting these resources in the controlling company’s financial statements. Therefore, regardless of the investment structure used to obtain control, reporting policies are generally the same—the assets, liabilities, revenues and expenses of the controlled investee are combined with those of the investor for presentation in its financial statements.

### Statutory Mergers, Statutory Consolidations, and Asset Acquisitions

When the investor acquires the assets and liabilities of the investee, it records these assets and liabilities directly on its books at fair value. Consider again Coca-Cola’s acquisition of Rocky Mountain Bottlers, but assume Coca-Cola acquires *all* of Rocky Mountain’s assets and liabilities, in a statutory merger. Information on this acquisition is in Exhibit 1.3 below.

EXHIBIT 1.3 Coca-Cola’s Acquisition of Rocky Mountain Bottlers	
Coca-Cola pays \$40,000,000 in cash to acquire the assets and liabilities of Rocky Mountain Bottlers on January 2, 2011. Fair values of Rocky Mountain’s reported assets and liabilities are as follows on that date:	
Rocky Mountain Bottlers	Fair value
Current assets . . . . .	\$20,000,000
Plant and equipment . . . . .	61,000,000
Current liabilities . . . . .	15,000,000
Long-term liabilities . . . . .	35,000,000
Coca-Cola identified and valued Rocky Mountain’s previously unreported intangible assets as follows:	
Technology . . . . .	\$ 5,000,000

The acquisition price is analyzed as follows:

Price paid . . . . .		\$40,000,000
Fair value of identifiable net assets acquired:		
Current assets . . . . .	\$20,000,000	
Plant and equipment . . . . .	61,000,000	
Technology . . . . .	5,000,000	
Current liabilities . . . . .	(15,000,000)	
Long-term debt . . . . .	(35,000,000)	
		<u>36,000,000</u>
Goodwill . . . . .		<u>\$ 4,000,000</u>

Coca-Cola makes the following January 2 entry on its books:

Current assets . . . . .	20,000,000	
Plant and equipment . . . . .	61,000,000	
Technology . . . . .	5,000,000	
Goodwill . . . . .	4,000,000	
Current liabilities . . . . .		15,000,000
Long-term debt . . . . .		35,000,000
Cash . . . . .		40,000,000
<i>To record the acquisition of Rocky Mountain Bottlers for \$40,000,000 in cash.</i>		

Coca-Cola records Rocky Mountain's assets and liabilities directly on its books. Rocky Mountain ceases to exist as a separate entity, and Coca-Cola reports Rocky Mountain's subsequent activities directly in its own financial records. Coca-Cola reports its acquisition of Rocky Mountain's assets and liabilities the same way it reports any other acquisition of property.

## Stock Acquisitions

When an investor obtains control over another company by investing in its *voting stock*, the investee remains a separate legal entity. U.S. GAAP states that generally the investor has control over an investee when it owns the *majority* of its voting stock. Control may be obtained with a large minority ownership, but under U.S. GAAP this reporting option is almost never used.

When the investor has a controlling interest in the voting stock of an investee, the investor is known as the **parent**, the acquired company is the **subsidiary**, and the two companies remain as separate legal entities, recording transactions on their own books. At the end of each reporting period, the accountant **consolidates** the separate financial records of the parent and subsidiary for presentation in the annual report.

Assume Coca-Cola acquires and holds all of the *voting stock* of Rocky Mountain Bottlers, paying the former stockholders of Rocky Mountain \$40,000,000 cash. Coca-Cola makes the following entry on its own books:

Investment in Rocky Mountain Bottlers . . . . .	40,000,000	
Cash . . . . .		40,000,000
<i>To record acquisition of all Rocky Mountain's stock for \$40,000,000 cash.</i>		

Rocky Mountain Bottlers continues to exist as a separate entity, and reports its financial activities on its own books. At the end of each reporting period, a *consolidation working paper* is used to combine the financial results of Coca-Cola and Rocky Mountain, as if Coca-Cola had reported Rocky Mountain's acquired assets and liabilities, and subsequent activities, directly on its books. Chapters 3 through 6 discuss this process.

## Variable Interest Entities

Variable interest entities (VIEs) are similar to stock acquisitions, in that the investee is a separate legal entity, but is controlled by another company. However, control occurs through legal relationships rather than stock ownership. Two reporting questions arise: (1) Is the entity a variable interest entity, and (2) must the investor consolidate the entity with its own financial statements? While the answers to these questions are discussed in detail in Chapter 3, the discussion below is a brief introduction.

According to *FIN 46(R)*, if the entity must obtain guarantees from other parties in order to obtain financing, or if the equity holders do not have the usual rights and responsibilities pertaining to equity ownership, such as voting rights and the right to residual returns, the entity is a VIE. A common example is a leasing arrangement where a company creates a separate legal entity to purchase long-term assets, funded by loans guaranteed by the company. That entity leases the assets to the company, and uses the lease payments to pay interest and principal on the debt. The entity has a small equity ownership, but rights to dividends or returns in liquidation may be contractually guaranteed or limited, leaving the equity owners with rights similar to debtholders. The question is whether the entity is able to finance its activities without additional support, such as guaranteed loans or future funding commitments, from affiliated entities. If not, the entity is a VIE.

Because voting rights are not an indicator of who controls a VIE, the FASB looks to the *consequences* of control—who absorbs the majority of the VIE's risks and rewards. *FIN 46(R)* requires the entity that absorbs the majority of the VIE's expected losses and/or receives a majority of the VIE's residual gains to consolidate the VIE. Consolidation procedures are the same as for stock investments.



**LO5** Discuss International Financial Reporting Standards (IFRS) for intercorporate investments.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR INTERCORPORATE INVESTMENTS

International financial reporting standards (IFRS) for intercorporate investments are found in the following pronouncements:

- *IAS 27*, Consolidated and Separate Financial Statements
- *IAS 28*, Investments in Associates
- *IAS 31* Interests in Joint Ventures
- *IAS 39*, Financial Instruments: Recognition and Measurement
- *IFRS 3(R)*, Business Combinations
- *SIC 12*, Consolidation—Special Purpose Entities

### Marketable Debt and Equity Investments

IFRS for marketable investments in debt and equity securities, found in *IAS 39*, generally parallel U.S. GAAP. Investments are classified as trading, available-for-sale, and held-to-maturity. Trading and available-for-sale securities are reported at fair value, with unrealized gains and losses on trading securities reported in income, and unrealized gains and losses on available-for-sale securities reported in equity until the securities are sold. Held-to-maturity debt securities are carried at amortized cost.

IFRS for impairment losses focuses on specific objective evidence of the decline in fair value, citing observance of particular “*loss events*,” such as a decline in credit rating or if the investee misses scheduled debt payments. U.S. GAAP requires loss recognition when the decline is “*other than temporary*,” which may involve more judgment. Unlike U.S. GAAP, IFRS allows impairment losses on held-to-maturity debt investments to be *reversed*, thereby increasing income, if a subsequent event reduces the previously recognized impairment loss. Like U.S. GAAP, IFRS does not allow reversal of impairment losses on equity investments.

### Investments With Significant Influence

IFRS for investments providing the investor with a significant influence over the investee are found in *IAS 28*. The investee in this case is defined as an **associate**. While U.S. GAAP focuses on ownership in voting shares, IFRS takes a more principles-oriented view. Ownership of 20 percent or more of the voting shares presumes significant influence, but there are other circumstances that indicate significant influence, taking one of the following forms (*para 7*):

- representation on the board of directors or equivalent governing body of the investee;
- participation in the policy-making process;
- material transactions between the investor and the investee;
- interchange of managerial personnel; or
- provision of essential technical information.

For example, suppose an investor that holds less than 20 percent of an investee’s voting stock is the sole provider of technical support necessary to the investee’s operations. While U.S. GAAP could conclude there is no significant influence, IFRS would likely disagree.

IFRS requires the equity method for significant influence investments, using procedures very similar to U.S. GAAP. Impairment testing requires comparing the investment carrying value with the *higher of its market value or value-in-use*. **Value-in-use** is the present value of the investment’s future expected cash flows while held by the investor. U.S. GAAP requires impairment recognition if the decline in value is *other than temporary*. This difference in criteria is likely to result in differences in impairment loss recognition between IFRS and U.S. GAAP.

### Joint Ventures

Unlike U.S. GAAP, *IAS 31* allows two methods to report business ventures where two or more investors have joint control over an investee. The investor may report the joint venture using the equity method,

as required under U.S. GAAP. More commonly, companies following IFRS report joint ventures using **proportionate consolidation**, where the investor includes its share of the individual assets, liabilities, revenues and expenses of the joint venture in its financial statements. The joint venture accounts may be presented separately or aggregated with those of the investor.

Although proportionate consolidation is prohibited in the primary financial statements for U.S. companies, it is popular in other countries. The choice between the equity method and proportionate consolidation does not affect the bottom line on the income statement. However, other financial ratios may be affected. For example, suppose Clearly Canadian Beverage Corporation enters a joint venture with two other companies, giving it 40 percent ownership and joint control over the venture. Acquisition cost is \$3.2 million, 40 percent of the \$8 million book value of the venture's net assets at the acquisition date. Information on the separate financial results of Clearly Canadian and the joint venture at the end of the first year appear in Exhibit 1.4, panel A. Panel B shows Clearly Canadian's financial statements using alternative methods to account for its investment in the joint venture.

The equity method carrying value of the joint venture is \$5.6 million, which is the original acquisition cost of \$3.2 million plus Clearly Canadian's share of the joint venture's income for the year, \$2.4 million ( $= 40\% \times \$6$  million). Proportionate consolidation aggregates 40 percent of each of the joint venture's assets, liabilities, revenues and expenses with Clearly Canadian's separate account balances.

<b>EXHIBIT 1.4 Proportionate Versus Equity Method Reporting</b>		
<b>Panel A: Separate Financial Results (in millions)</b>	<b>(1) Clearly Canadian</b>	<b>(2) Joint Venture</b>
Current assets . . . . .	\$ 40	\$ 2
Plant and equipment, net . . . . .	120	46
Current liabilities . . . . .	20	4
Long-term debt . . . . .	60	30
Equity . . . . .	80	14
Revenues . . . . .	96	32
Expenses . . . . .	64	26
<b>Panel B: Clearly Canadian Financial Statements (in millions)</b>	<b>(3) Equity Method</b>	<b>(4) = (1) + [40% × (2)] Proportionate Consolidation</b>
<b>Balance Sheet</b>		
Current assets . . . . .	\$ 40.0	\$ 40.8
Plant and equipment, net . . . . .	120.0	138.4
Investment in joint venture . . . . .	5.6	—
Total assets . . . . .	<u>\$165.6</u>	<u>\$179.2</u>
Current liabilities . . . . .	\$ 20.0	\$ 21.6
Long-term debt . . . . .	60.0	72.0
Equity . . . . .	<u>85.6</u>	<u>85.6</u>
Total liabilities and equity . . . . .	<u>\$165.6</u>	<u>\$179.2</u>
<b>Income Statement</b>		
Revenues . . . . .	\$ 96.0	\$108.8
Income from joint venture . . . . .	2.4	—
Expenses . . . . .	<u>(64.0)</u>	<u>(74.4)</u>
Net income . . . . .	<u>\$ 34.4</u>	<u>\$ 34.4</u>

Although reported income and equity are the same, proportionate consolidation allows the joint venture's financial condition to more significantly affect Clearly Canadian's financial ratios. For example, Clearly Canadian's separate leverage (debt to equity) is 100 percent ( $= (\$20 + \$60)/\$80$ ). The joint venture's leverage is 243 percent ( $= (\$4 + \$30)/\$14$ ). The equity method reports Clearly Canadian's leverage at 93 percent ( $= (\$20 + \$60)/\$85.6$ ), while proportionate consolidation reports its leverage at 109 percent ( $= (\$21.6 + \$72.0)/\$85.6$ ). The equity method implies greater solvency than proportionate consolidation. Other ratios, such as asset turnover and profit margin, are similarly affected.

### Reporting Perspective

A study of 78 Canadian firms compares the usefulness of equity method versus proportionate consolidation information for joint ventures for the period 1995 - 2001. The Canadian firms report joint ventures using proportionate consolidation. The authors restate the results to the equity method and then compare the usefulness of each alternative in predicting future company returns. Return on common shareholders' equity is regressed on the prior year's return, profit margin, asset turnover and leverage. The study finds a higher regression R<sup>2</sup> when using proportionate consolidation data. The results of this study support the view that proportionate consolidation allows more detailed assessment of the financial health of the joint venture and its investors. The equity method summarizes the net assets and income of the joint venture on two lines in the investor's financial statements, while proportionate consolidation includes the investor's share of the joint venture's individual assets, liabilities, revenues and expenses with the investor's accounts. *Source: R. Graham, R. King, and C. Morrill, "Decision Usefulness of Alternative Joint Venture Reporting Methods," Accounting Horizons, June 2003.*

### BUSINESS APPLICATION FRANCE TELECOM GROUP'S EQUITY INVESTMENTS

Note 34 to **FRANCE TELECOM**'s 2008 financial statements lists the following investments related to their Personal Communications Services business:

Associates consolidated by the equity method	% interest	Country
One (PASR 24) . . . . .	35.00%	Austria
Safelayer . . . . .	13.23%	Spain
GIE Preventel . . . . .	27.90%	France
Sonaecom . . . . .	20.00%	Portugal
<b>Proportionally consolidated companies</b>		
Irisnet . . . . .	26.45%	Belgium
Mobinil for Telecommunications . . . . .	71.25%	Egypt
Egyptian Company for Mobile Services . . . . .	36.36%	Egypt
Mobinil Invest . . . . .	37.06%	Egypt
Mobinil Services Company . . . . .	36.33%	Egypt
Darty France Telecom . . . . .	50.00%	France
Getesa . . . . .	40.00%	Equatorial Guinea
Cellplus Mobile Communications Ltd . . . . .	40.00%	Mauritius

Although France Telecom holds only 13 percent of Safelayer, it is reported as an equity method investment, presumably because France Telecom significantly influences the company through other means, such as business relationships. France Telecom proportionally consolidates Mobinil for Telecommunications because it does not control Mobinil's operations, even though it has 71 percent ownership. Orascom Telecom owns the other 29 percent interest, and all major decisions must have the joint approval of France Telecom and Orascom Telecom. *Source: France Telecom Group annual report, 2008.*

### Controlling Investments

*IFRS 3(R)*, "Business Combinations," describes IFRS for assets and liabilities acquired in statutory mergers, consolidations, and asset acquisitions, and consolidation of controlling stock investments. These standards are similar to U.S. GAAP. IFRS for determining *when* an entity should be consolidated are in *IAS 27*, "Consolidated and Separate Financial Statements," and are also very similar to U.S. GAAP. Application of these requirements, however, is more principles-based under IFRS. While IFRS

emphasizes governance and control, U.S. GAAP focuses on the “bright line” of majority equity ownership. These standards are discussed in detail in Chapter 3.

*SIC 12* states conditions for consolidation of **special purpose entities**, the IFRS term for variable interest entities. A “beneficial interest” test determines whether the entity should be consolidated. Whereas U.S. GAAP focuses on whether the investor absorbs the majority of the entity’s risks and rewards, the IFRS focus is the same as for stock investments—whether or not the investor has *control* over the entity. Indicators of control include decision-making power as well as the investor’s right to the majority of the entity’s benefits and risks. Because the criteria are different, some entities consolidated under IFRS are not consolidated under U.S. GAAP, and vice versa. Chapter 3 discusses in detail IFRS consolidation of special purpose entities.

## REVIEW OF KEY CONCEPTS . . . . .

**Identify and discuss the major motivations for intercorporate investments. (p. 3)** Companies hold **intercorporate investments** for many reasons, and through a variety of investment vehicles. Major categories are investments held for income and increases in value, strategic investments with significant influence over the investee, and controlling investments. **LO 1**

**Describe the reporting for trading, available-for-sale, and held-to-maturity intercorporate investments. (p. 6)** Investments in securities held for income and value increases are grouped into **trading, available-for-sale, and held-to-maturity** portfolios. Trading and available-for-sale investments in debt and equity securities appear on the balance sheet at fair value. Unrealized gains and losses on trading securities are reported in income. Unrealized gains and losses on AFS debt and equity securities are reported outside the income statement in accumulated other comprehensive income, and are reclassified to income when the securities are sold. Held-to-maturity debt securities are reported at amortized cost and are regularly tested for impairment. **LO 2**

**Explain the reporting for equity method intercorporate investments. (p. 10)** The **equity method** is used to report equity investments that enable the investor to significantly influence the investee’s operating and financial decisions. Significant influence is generally present when the investor owns between 20 and 50 percent of the investee’s voting stock. The investor’s equity in the investee’s income appears on the investor’s income statement, adjusting the investment balance, and dividends received reduce the balance. Equity in the investee’s income is the investor’s share of the investee’s reported income, adjusted for amortization of the excess of investment cost over the investee’s book value and unconfirmed profits on intercompany transactions. Other-than-temporary impairment losses are reported in income. Some companies pool resources and create a business enterprise to complete a particular project or expand into new markets. This enterprise is a **joint venture** if control is shared by the participating companies. U.S. investors typically use the equity method to report joint ventures. **LO 3**

**Describe the reporting for controlling interests in other companies. (p. 15)** Controlling investments in other companies take the form of **statutory mergers, statutory consolidations, asset acquisitions, majority stock investments, and variable interest entities**. The acquisition structures of statutory mergers, consolidations and asset acquisitions differ, but they all involve investors acquiring the assets and liabilities of another company. The investor reports each acquired asset and liability at fair value. With controlling stock investments and variable interest entities “controlled” through legal financial agreements, the investor and investee remain legal entities with separate books, and the investor accounts for its investment as a noncurrent asset on its own books. **Consolidation procedures** bring the financial statements of the investor and investee together at the end of each reporting period for external reporting purposes. **LO 4**

**Discuss International Financial Reporting Standards (IFRS) for intercorporate investments. (p. 18)** **International Financial Reporting Standards (IFRS)** for intercorporate investments parallel U.S. GAAP on many dimensions. Criteria for impairment loss recognition differ, and in some cases IFRS allows reversal of impairment losses. Joint ventures may be reported using **proportionate consolidation**, prohibited under U.S. GAAP. The decision to use the equity method of reporting focuses on whether the investor has significant influence, rather than assuming that influence when the investor holds 20 percent or more of the investee’s stock. Similarly, the decision to consolidate the investee under IFRS depends on whether the investor controls the investee, rather than whether the investor owns the majority of the investee’s stock. **LO 5**

## EXERCISES . . . . .

**E1.1 Investment in Trading Securities** **THE COCA-COLA COMPANY**’s December 31, 2008, balance sheet reports investments in trading securities at \$49 million, with gross unrealized losses of \$32 million. **LO 2**

*Required*

- How much did Coca-Cola pay for the trading securities reported on its 2008 balance sheet?
- How are unrealized gains and losses on trading securities reported in Coca-Cola's financial statements?
- Assume the trading securities on hand at the end of 2008 were acquired during 2008. Prepare the summary journal entries made by Coca-Cola to record events related to these trading securities.
- Assume the securities are sold for \$60 million in 2009. Prepare the journal entry to record the sale.

**LO 2 COCA-COLA [KO]** **E1.2 Investment in Available-for-Sale Securities** **THE COCA-COLA COMPANY**'s December 31, 2008, balance sheet reports investments in available-for-sale securities at \$522 million, with gross unrealized gains of \$193 million and gross unrealized losses of \$12 million. Coca-Cola's 2008 statement of shareowners' equity reports a net change in unrealized gains on available-for-sale securities as a debit to accumulated other comprehensive income of \$44 million.

*Required*

- Based on the above data, it is apparent that Coca-Cola acquired at least some of its AFS securities prior to 2008. How do we know this?
- Assume that in 2009 Coca-Cola sells AFS securities carried at \$40 million on December 31, 2008, for \$35 million. Unrealized gains related to these securities at December 31, 2008, are \$8 million. Prepare the journal entries to record the sale of the securities and update accumulated other comprehensive income as appropriate.

**LO 2 E1.3 Held-to-Maturity Investments** On January 1, 2010, a company pays \$5,222,591 for a 5-year corporate bond with a face value of \$5 million. The bond pays interest at 5 percent on December 31 of each year, and the principal is due on December 31, 2014. The investment yields a 4 percent compound annual return to maturity. The company classifies the bond as a held-to-maturity investment.

*Required*

Prepare the journal entries to record the investment on January 1, 2010, receipt of the interest payments on December 31 of each year 2010 through 2014, and receipt of the bond principal on December 31, 2014, using the effective interest method.

**LO 2 E1.4 Investment in Trading, AFS and HTM Securities** Zygy Corporation has the following investment activity during 2010, 2011, and 2012:

**WebAssign.**

- Purchased trading investment of \$200,000 in the stock of Allen Corporation on February 3, 2010. The investment was sold on June 18, 2010, for \$210,000.
- Purchased trading investment of \$400,000 in the stock of Becker Corporation on October 29, 2010. The investment had a December 31, 2010, fair value of \$380,000 and was sold on March 1, 2011, for \$405,000.
- Purchased AFS investment of \$600,000 in the stock of Corey Corporation on November 1, 2010. Its fair value on December 31, 2010, and 2011 was \$640,000 and \$510,000, respectively. The investment was sold on February 15, 2012 for \$560,000.
- Purchased AFS investment of \$500,000 in the stock of Donata Corporation on April 4, 2012. Its fair value on December 31, 2012, was \$535,000.
- Purchased HTM investment on January 2, 2011, of \$194,449 in Eiffel Corporation's \$200,000 face value, 3 percent bond, yielding 4 percent to maturity, interest paid annually on December 31.

*Required*

For each of the above investments, determine the accounts and balances reported on Zygy's December 31, 2010, 2011, and 2012 balance sheets and its 2010, 2011, and 2012 income statements.

**LO 3 COCA-COLA [KO]** **E1.5 Equity Method Investment with Intercompany Sales and Profits** **THE COCA-COLA COMPANY** owns 35 percent of the voting stock of **Coca-Cola Enterprises, Inc. (CCE)**, acquired at book value. Assume that CCE reports income of \$1 million for 2010. CCE regularly sells canned beverages to Coca-Cola at a markup of 25 percent on cost. During 2010 CCE's sales to Coca-Cola totaled \$5 million. Coca-Cola's January 1, 2010, inventories include \$700,000 purchased from CCE. Coca-Cola's December 31, 2010, inventories include \$775,000 purchased from CCE.

**WebAssign.***Required*

Prepare the journal entry on Coca-Cola's books to recognize its income from CCE under the equity method.

- E1.6 Equity Method Investment with Cost in Excess of Book Value** Revco Corporation purchases 40 percent of the voting stock of Ronco Pharmaceuticals on January 1, 2011, for \$5 million in cash. Ronco's book value at the date of acquisition is \$6 million. Investigation reveals that Ronco's reported patents (10-year life) are undervalued by \$4 million and it has unreported technology (5-year life) valued at \$1 million. Ronco pays dividends of \$250,000 and reports net income of \$900,000 for 2011. Any unallocated excess of Revco's cost over Ronco's book value is attributed to goodwill. **LO 3**

*Required*

Prepare the journal entries on Revco's books to report the above information assuming Revco accounts for its investment in Ronco using the equity method.

- E1.7 Equity Method and Other Comprehensive Income** Mitchell Corporation pays \$6 million to acquire a 25 percent interest in Turner Corporation's stock on January 1, 2012, and reports the investment using the equity method. Turner's net assets are fairly reported, except for \$2 million of unreported intangibles (4-year life). During 2012, Turner reports net income of \$900,000, which includes \$25,000 in realized and unrealized gains on trading securities and \$40,000 in realized gains on sales of AFS securities. Turner also reports \$30,000 in unrealized losses on AFS securities and pays dividends of \$240,000 in 2012. **LO 3**

*Required*

Prepare Mitchell's journal entries to record the above events for 2012.

- E1.8 Equity Method Investment Cost Computation** Traynor Corporation reports its 40 percent investment in Victor Company on its December 31, 2012, balance sheet at \$14,608,000. Traynor acquired its interest in Victor on January 2, 2010, and uses the equity method to account for the investment. Victor's assets and liabilities were fairly stated on January 2, 2010, except for unreported intangibles (5-year life) of \$4 million. Victor reported net income of \$1.2 million, \$1.5 million, and \$1.4 million, and paid dividends of \$200,000, \$250,000, and \$230,000 in 2010, 2011, and 2012, respectively. **LO 3**

*Required*

How much did Traynor Corporation pay for its investment in Victor Company on January 2, 2010?

- E1.9 Joint Venture** On January 2, 2012, Akron Corporation and Dayton Company form a joint venture to develop a new product. Each contributes \$2 million and has a 50 percent interest in the venture. At December 31, 2012, the joint venture's balance sheet is as follows (*in millions*): **LO 3**

Cash . . . . .	\$ 1.0	Debt . . . . .	\$ 6.5
Equipment . . . . .	10.0	Equity . . . . .	4.5
Total . . . . .	<u>\$11.0</u>	Total . . . . .	<u>\$11.0</u>

The joint venture reported net income of \$500,000 during 2012. Each investor uses the equity method to report its interest in the joint venture.

*Required*

Show how the joint venture is reported on each investor's financial statements for 2012. Where are the joint venture's individual assets and liabilities reported by the venturers?

- E1.10 Equity Method Investment with Indefinite Life Intangibles Several Years Later** Saxton Corporation purchased 25 percent of Taylor Company's voting stock on January 1, 2008, for \$3 million in cash. At the date of acquisition, Taylor reported its total assets at \$60 million and its total liabilities at \$56 million. Investigation revealed that Taylor's plant and equipment (15-year life) was undervalued by \$1.8 million, it had an unreported customer database (2-year life) valued at \$500,000, and unreported indefinite-life brand names valued at \$1.5 million. Taylor pays \$100,000 in dividends and reports net income of \$250,000 in 2011. Impairment losses on the brand names for 2011 are \$200,000. **LO 3**

*Required*

Prepare the necessary journal entries on Saxton's books to report the above information for 2011 assuming Saxton uses the equity method to report its investment.

- E1.11 Statutory Merger and Stock Investment (see related E1.10)** Saxton Corporation purchases all of Taylor Company's assets and liabilities on January 1, 2008, for \$12 million in cash. At the date of acquisition, Taylor's reported assets consist of current assets of \$10 million and plant and equipment of \$50 million. It reports current liabilities of \$16 million and long-term debt of \$40 million. Investigation reveals **LO 4**

that Taylor’s plant and equipment is undervalued by \$1.8 million, it has an unreported customer database valued at \$500,000, and unreported indefinite life brand names valued at \$1.5 million.

*Required*

- a. Prepare the necessary journal entry on Saxton’s books to record its acquisition of Taylor on January 1, 2008.
- b. Assume that Saxton purchases all of Taylor’s voting stock on January 1, 2008, for \$12 million in cash. Prepare the necessary journal entry on Saxton’s books to record the acquisition.

**LO 4 E1.12 Statutory Merger** Organic Juices, Inc. acquires Healthy Snax Corporation for \$50 million in cash, in a statutory merger. Healthy Snax’ balance sheet at the date of acquisition is as follows (*in millions*):

**WebAssign.**

Current assets . . . . .	\$10	Current liabilities . . . . .	\$12
Plant and equipment . . . . .	65	Long-term debt . . . . .	36
Intangible assets . . . . .	5	Capital stock . . . . .	18
		Retained earnings . . . . .	24
		Treasury stock . . . . .	(10)
Total assets . . . . .	<u>\$80</u>	Total liabilities and equity . . . . .	<u>\$80</u>

A consulting firm values Healthy Snax’ plant and equipment at \$40 million and its intangibles at \$25 million. There are no unreported identifiable intangibles, and all other assets and liabilities are fairly reported.

*Required*

Prepare the journal entry Organic Juices makes to record its acquisition of Healthy Snax.

**PROBLEMS** . . . . .

**LO 2 P1.1 Investments in Marketable Securities** A company has the following investment activity during 2010 and 2011:

Security	Type	Date of Acquisition	Cost	Fair value at 12/31/10	Date of Sale	Selling Price	Fair value at 12/31/11
A . . . . .	Trading	3/5/10	\$350,000	N/A	6/3/10	\$325,000	N/A
B . . . . .	Trading	7/14/10	225,000	\$252,000	1/15/11	235,000	N/A
C . . . . .	Trading	9/1/11	400,000	N/A	N/A	N/A	\$410,000
D . . . . .	AFS	8/2/10	175,000	190,000	4/2/11	213,000	N/A
E . . . . .	AFS	11/20/10	300,000	250,000	N/A	N/A	215,000
F . . . . .	AFS	4/6/11	710,000	N/A	N/A	N/A	690,000

*Required*

- a. Prepare the journal entries to record the above information for 2010 and 2011, including appropriate adjustments to other comprehensive income, assuming the company’s reporting year ends December 31.
- b. Show how this information is presented in the company’s financial statements for 2010 and 2011.
- c. If the company designated all the securities as trading securities, how would your answer to part *b* change? Comment on the income effect of classifying the AFS securities as trading securities.

**LO 2 P1.2 Held-to-Maturity Intercorporate Debt Investments** On January 2, 2010, a company invests in the following corporate debt securities, classified as held-to-maturity per *SFAS 115*:

1. 5-year \$1,000,000 face value corporate bond paying 6 percent interest annually on December 31. The bond is priced to yield 5 percent to maturity.
2. 4-year \$500,000 face value corporate bond paying 4 percent interest annually on December 31. The bond is priced to yield 5 percent to maturity.

*Required*

- a. Calculate the cost of each investment.
- b. Calculate interest income for 2010 and 2011.

- c. At what value are these investments reported on the company's December 31, 2012, balance sheet?
- d. On December 31, 2013, the company determines that an impairment loss should be reported on the \$1,000,000 bond. What factors indicate impairment loss? If the bond is estimated to have a value of \$500,000 on December 31, 2013, what is the amount of the impairment loss, and where will it be reported on the 2013 financial statements?

**P1.3 Held-to-Maturity Intercorporate Debt Investment, Impairment Losses** **HANSEN NATURAL CORPORATION** is a public U.S. company that produces and distributes sodas, fruit and energy drinks, ready-to-drink iced teas, and other beverages. Its 2007 balance sheet includes \$3.5 million in held-to-maturity bonds. Hansen reports its HTM securities as follows:

LO 2

**HANSEN  
NATURAL  
CORPORATION**  
[HANS]

Held-to-maturity securities are recorded at amortized cost which approximates fair market value. A decline in the market value of any held-to-maturity security below cost that is deemed other than temporary results in a reduction in its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related held-to-maturity security as an adjustment to yield using the effective-interest method. The Company evaluates whether the decline in fair value of its investments is other-than temporary at each quarter-end. (*Note 1 to 2007 financial statements*)

Assume that the HTM bonds on Hansen's 2007 balance sheet have a 3-year remaining life, were acquired at par, and pay interest each December 31 at 5 percent. Hansen determines that due to an other-than-temporary decline in the issuer's liquidity, the fair value of the bonds is \$2.4 million.

*Required*

- a. Prepare Hansen's journal entry to record the impairment loss for 2007. Where is the loss reported in Hansen's financial statements?
- b. What is Hansen's new yield on the bonds? Round to the nearest percent.
- c. Assume Hansen receives its interest payment on December 31, 2008, as usual. Calculate reported interest revenue, and prepare Hansen's journal entry to record receipt of the interest. At what value does the investment appear on Hansen's December 31, 2008, balance sheet?
- d. Assume that on December 31, 2008, the issuer's financial health has improved and the bond's fair value is now \$3.5 million. How does Hansen report this information?

**P1.4 Equity Method Investment Several Years after Acquisition** On January 2, 2009, Best Beverages acquired 45 percent of the stock of Better Bottlers for \$30 million in cash. Best Beverages accounts for its investment using the equity method. At the time of acquisition, Better Bottlers' balance sheet was as follows (*in millions*):

LO 3

WebAssign

**Better Bottlers Balance Sheet, January 2, 2009**

<b>Assets</b>	
Current assets . . . . .	\$ 20
Property and equipment, net . . . . .	415
Patents and trademarks . . . . .	150
Total assets . . . . .	<u>\$585</u>
<b>Liabilities and equity</b>	
Current liabilities . . . . .	\$ 42
Long-term debt . . . . .	518
Total liabilities . . . . .	<u>560</u>
Capital stock . . . . .	12
Retained earnings . . . . .	13
Total equity . . . . .	<u>25</u>
Total liabilities and equity . . . . .	<u>\$585</u>

Valuation of Better Bottlers’ assets and liabilities revealed that its reported patents and trademarks (10-year life) had a fair value of \$160 million and it had unrecognized brand names (15-year life) worth \$9 million. Better Bottlers’ December 31, 2012, retained earnings balance is \$25 million. For 2012, it reported net income of \$2.5 million and paid \$650,000 in dividends.

*Required*

- a. Prepare the 2012 entries to report the above information on Best Beverages’ books.
- b. Calculate the Investment in Better Bottlers balance, reported on Best Beverages’ December 31, 2012 balance sheet.

**LO 3 P1.5 Equity Method Investment Several Years after Acquisition** Rance Corporation paid \$10 million in cash to acquire 30 percent of the voting stock of Seaway Company on January 2, 2010. Rance uses the equity method to report its investment. Seaway’s book value at date of acquisition was \$25 million. Analysis of Seaway’s assets and liabilities reveals that Seaway’s property and equipment (10-year life) was overvalued by \$4 million, and its reported intangibles (2-year life) were undervalued by \$6 million.

During the years 2010 and 2011, Seaway reported total income of \$14 million, paid dividends of \$5 million, and reported net unrealized gains on AFS securities of \$1 million. During 2012, Seaway reported income of \$4 million, paid dividends of \$1.5 million, and reported net unrealized losses on AFS securities of \$800,000.

Rance sells merchandise to Seaway at a markup of 20 percent on cost. Seaway sells merchandise to Rance at a markup of 25 percent on cost. Below are the inventories on hand at each balance sheet date, related to these sales.

December 31	2010	2011	2012
Ending inventory held by Rance Corporation . . . . .	\$750,000	\$925,000	\$625,000
Ending inventory held by Seaway Company . . . . .	480,000	420,000	696,000

*Required*

- a. Calculate Rance’s equity in net income of Seaway for 2012.
- b. Prepare Rance’s journal entries to report its investment in Seaway for 2012.
- c. Calculate the investment balance at December 31, 2012.

**LO 3 P1.6 Equity Method Investment with Several Assets in Excess of Book Value** Birmingham Corporation acquired 40 percent of the voting stock of Cambridge Corporation on January 2, 2011, for \$3.2 million in cash. Cambridge’s balance sheet and estimated fair values of its assets and liabilities on January 2, 2011, are as follows:

<b>CAMBRIDGE CORPORATION</b>		
<b>Balance Sheet</b>		
<b>January 2, 2011</b>		
<i>(in thousands)</i>	<b>Book Value</b>	<b>Fair Value</b>
<b>Assets</b>		
Cash and receivables . . . . .	\$ 400	\$ 400
Inventory (FIFO) . . . . .	1,200	1,500
Investments . . . . .	300	300
Land . . . . .	800	2,000
Property and equipment . . . . .	4,200	2,500
Less: Accumulated depreciation . . . . .	(1,300)	
Total assets . . . . .	<u>\$5,600</u>	
<b>Liabilities and Equity</b>		
Current liabilities . . . . .	\$ 900	\$ 900
Long-term liabilities . . . . .	3,000	3,000
Common stock, \$0.50 par . . . . .	500	
Additional paid-in capital . . . . .	1,000	
Retained earnings . . . . .	800	
Accumulated other comprehensive income . . . . .	(600)	
Total liabilities and equity . . . . .	<u>\$5,600</u>	

In addition to its reported assets, Cambridge has unreported franchise agreements (5-year life) valued at \$1.3 million and brand names (indefinite life) valued at \$2.2 million. Its property and equipment has a 20 year average remaining life. Cambridge reported income of \$1 million for 2011.

*Required*

- How many shares of Cambridge stock did Birmingham acquire?
- Compute Birmingham's equity in Cambridge's net income for 2011.

**P1.7 Equity Method Investment, Intercompany Sales** Harcker Corporation acquires 40 percent of Jackson Corporation's voting stock on January 3, 2012, for \$40 million in cash. Jackson's net assets were fairly reported at \$100 million at the date of acquisition. During 2012, Harcker sells \$65 million in merchandise to Jackson at a markup of 30 percent on cost. Jackson still holds all of this merchandise in its ending inventory. Also during 2012, Jackson sells \$54 million in merchandise to Harcker at a markup of 35 percent on cost. Harcker still holds all of this merchandise in its ending inventory. Jackson reports 2012 net income of \$30 million. **LO 3**

*Required*

- Calculate Harcker's equity in Jackson's net income for 2012.
- Assume Harcker reports total 2012 sales revenue and cost of sales of \$131 million and \$110 million, respectively, while Jackson reports total 2012 sales revenue and cost of sales of \$264 million and \$229 million, respectively. Compute each company's gross margin on sales as reported following U.S. GAAP. Now compute gross margin on sales again, excluding intercompany transactions. Comment on the results.

**P1.8 Equity Investments, Various Reporting Methods** On January 2, 2010, Parker Corporation invests in the stock of Quarry Corporation. Quarry's book value is \$4 million and its assets and liabilities are fairly reported. Quarry reports income of \$3 million and pays dividends of \$1 million in 2010. Parker's December 31, 2010, balance sheet and 2010 income statement, ignoring its investment in Quarry's stock, follow. **LO 3, 4**

<b>PARKER CORPORATION</b> <b>Balance Sheet (in thousands)</b> <b>December 31, 2010</b>			
Current assets	\$ 40,000	Current liabilities	\$ 20,000
Property, net	450,000	Long-term liabilities	200,000
Identifiable intangibles	5,000	Capital stock	90,000
		Retained earnings	185,000
Total assets	<u>\$495,000</u>	Total liabilities and equity	<u>\$495,000</u>

<b>PARKER CORPORATION</b> <b>Income Statement (in thousands)</b> <b>Year ended December 31, 2010</b>	
Sales revenue	\$900,000
Cost of sales	(750,000)
Operating expenses	(140,000)
Net income	<u>\$ 10,000</u>

Quarry Corporation's financial statements for 2010 are as follows:

<b>QUARRY CORPORATION</b> <b>Balance Sheet (in thousands)</b> <b>December 31, 2010</b>			
Current assets	\$ 5,000	Current liabilities	\$ 3,000
Property, net	85,000	Long-term liabilities	81,000
		Capital stock, \$1 par	1,000
		Retained earnings	5,000
Total assets	<u>\$90,000</u>	Total liabilities and equity	<u>\$90,000</u>

<b>QUARRY CORPORATION</b>	
<b>Income Statement (in thousands)</b>	
<b>Year ended December 31, 2010</b>	
Sales revenue . . . . .	\$60,000
Cost of sales . . . . .	(20,000)
Operating expenses . . . . .	<u>(37,000)</u>
Net income . . . . .	<u>\$ 3,000</u>

*Required*

Prepare Parker’s December 31, 2010, balance sheet and 2010 income statement under each of the following circumstances:

- Parker’s investment consists of 100,000 shares costing \$15/share, and Parker classifies it as an AFS investment. The shares have a market value of \$12/share on December 31, 2010.
- Parker’s investment consists of 400,000 shares costing \$15/share, and Parker accounts for it using the equity method.
- Parker acquires all of Quarry’s shares for \$15 million, retires the shares and merges with Quarry. Goodwill is unimpaired in 2010.

**LO 3, 5 P1.9 Joint Venture, Various Reporting Methods** On January 3, 2012, Allen Corporation, Barkely Corporation, and Collins Corporation invested \$5 million, \$3.5 million, and \$1.5 million in cash, respectively, to form Albarcol Enterprises, a joint venture that develops new products benefitting all three corporations. Each corporation holds an ownership interest equal to its proportionate initial investment. Albarcol Enterprises’ balance sheet on December 31, 2012, follows (*in millions*):

Cash . . . . .	\$ 0.5	Current payables . . . . .	\$ 20.5
Merchandise . . . . .	12.0	Noncurrent debt . . . . .	150.0
Equipment . . . . .	120.0	Equity . . . . .	12.0
Patents . . . . .	<u>50.0</u>		
Total . . . . .	<u>\$182.5</u>	Total . . . . .	<u>\$182.5</u>

The joint venture did not make any distributions to its owners during the year.

December 31, 2012, balance sheets for each of the three corporations are below. Each shows its investment in Albarcol Enterprises at original cost.

<b>Balance Sheet (in millions)</b>	<b>Allen Corp.</b>	<b>Barkely Corp.</b>	<b>Collins Corp.</b>
Current assets . . . . .	\$ 1.0	\$ 0.4	\$ 0.6
Plant and equipment, net . . . . .	150.0	65.0	42.0
Investment in Albarcol Enterprises . . . . .	5.0	3.5	1.5
Intangibles . . . . .	200.0	5.0	—
Total assets . . . . .	<u>\$356.0</u>	<u>\$73.9</u>	<u>\$44.1</u>
Current liabilities . . . . .	\$ 14.0	\$ 0.2	\$ 0.8
Noncurrent liabilities . . . . .	265.0	55.0	30.0
Capital stock . . . . .	10.0	1.0	5.0
Retained earnings . . . . .	67.0	17.7	8.3
Total liabilities and equity . . . . .	<u>\$356.0</u>	<u>\$73.9</u>	<u>\$44.1</u>

Allen Corporation follows IFRS and uses proportionate consolidation to report its investment in the joint venture. Barkely Corporation uses the equity method, and Collins Corporation reports its investment at cost, because its interest in the joint venture has no readily determinable market value.

*Required*

Present the December 31, 2012, balance sheets of the three corporations, after appropriate adjustments for their joint venture investment.

**P1.10 Balance Sheet after Business Acquisition** Wilson Corporation acquires Greatbatch Company for \$45 million cash in a statutory merger. The balance sheets of both companies at the date of acquisition are as follows:

LO 4

WebAssign.

Balance Sheet (in millions)	Wilson	Greatbatch
Current assets . . . . .	\$ 60	\$ 5
Property and equipment . . . . .	500	90
Intangibles . . . . .	20	3
Total assets . . . . .	<u>\$580</u>	<u>\$98</u>
Current liabilities . . . . .	\$ 25	\$ 2
Long-term debt . . . . .	400	65
Capital stock . . . . .	50	12
Retained earnings . . . . .	120	15
Accumulated other comprehensive income . . . . .	(15)	4
Total liabilities and equity . . . . .	<u>\$580</u>	<u>\$98</u>

Greatbatch's property and equipment is overvalued by \$25 million, its reported intangibles are undervalued by \$17 million, and it has unreported intangibles, in the form of customer databases and marketing agreements, valued at \$9 million.

*Required*

Prepare Wilson's balance sheet immediately following the statutory merger.

**P1.11 Business Acquisition** In 2007 **CLEARLY CANADIAN BEVERAGE CORPORATION** acquired **MY ORGANIC BABY INC.** (MOB), a leading Canadian producer of organic baby food. The total purchase price was \$4,913,000, consisting of \$369,000 in cash, and new no-par common stock with a market value of \$4,544,000. The fair values of MOB's acquired assets and liabilities are as follows (in thousands):

LO 4

**CLEARLY  
CANADIAN  
BEVERAGE**  
[CCBEF]  
**MY ORGANIC  
BABY INC.**

Net assets reported on MOB's books	
Cash and receivables . . . . .	\$ 466
Inventory . . . . .	142
Plant and equipment . . . . .	21
Other tangible assets . . . . .	131
Accounts payable . . . . .	686
Identifiable intangible assets not reported on MOB's books	
Distribution relationships . . . . .	715
Trademarks, copyrights and brands . . . . .	834
Other intangible assets . . . . .	1,961

*Required*

Assuming Clearly Canadian records this acquisition as a statutory merger, prepare the journal entry it made in 2007 to record its acquisition of My Organic Baby, Inc.

**P1.12 Joint Venture Reporting, IFRS** **PEPSICO, INC.** owns a significant percentage of the outstanding voting stock of **THE PEPSI BOTTLING GROUP** (PBG). It reports its investment using the equity method, following U.S. GAAP. PepsiCo acquired its interest in PBG several years ago at a cost that was \$1,107 million in excess of its share of PBG's book value. This excess was attributed to goodwill. The separate 2007 financial statements of PepsiCo and PBG appear below.

LO 5

**THE PEPSI  
BOTTLING  
GROUP**  
[PBG]

(in millions)	PepsiCo	PBG
<b>Balance Sheet</b>		
Current assets . . . . .	\$10,151	\$ 3,086
Investment in PBG . . . . .	2,022	—
Other noncurrent assets . . . . .	22,455	10,029
Total assets . . . . .	<u>\$34,628</u>	<u>\$13,115</u>

WebAssign.

continued

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<i>(in millions)</i>	PepsiCo	PBG
Liabilities . . . . .	\$17,394	\$10,500
Equity . . . . .	17,234	2,615
Total liabilities and equity . . . . .	<u>\$34,628</u>	<u>\$13,115</u>
<b>Income Statement</b>		
Sales revenue . . . . .	\$39,474	\$13,591
Equity in net income of PBG . . . . .	186	—
Cost of goods sold . . . . .	(18,038)	(7,370)
Operating expenses . . . . .	<u>(15,964)</u>	<u>(5,689)</u>
Net income . . . . .	<u>\$ 5,658</u>	<u>\$ 532</u>

*Required*

- a. What percentage of PBG’s voting stock does PepsiCo own? Round your answer to the nearest whole percentage.
- b. Assume PepsiCo follows IFRS and uses proportionate consolidation to report its investment in PBG. Prepare PepsiCo’s 2007 financial statements, using the ownership percentage calculated in part a. Round dollar amounts to the nearest million.
- c. Compare PepsiCo’s liabilities to assets and liabilities to equity using the equity method financial statements and the proportionate consolidation financial statements. Why are these ratios different?

## REVIEW SOLUTIONS

### Review #1 Solution

2011	Jan. 2	Investment in trading securities . . . . .	300,000	
		Investment in AFS securities . . . . .	1,000,000	
		Investment in HTM securities . . . . .	486,384	
		Cash . . . . .		1,786,384
2011	June 15	Cash . . . . .	265,000	
		Loss on sale of trading securities (income) . . . . .	35,000	
		Investment in trading securities . . . . .		300,000
2011	Oct. 15	Investment in trading securities . . . . .	250,000	
		Cash . . . . .		250,000
2011	Dec. 1	Cash . . . . .	12,000	
		Dividend income . . . . .		12,000
2011	Dec. 31	Investment in trading securities . . . . .	10,000	
		Unrealized loss on AFS securities (OCI) . . . . .	80,000	
		Unrealized gain on trading securities (income) . . . . .		10,000
		Investment in AFS securities . . . . .		80,000
Dec. 31		Cash . . . . .	20,000	
		Investment in HTM securities . . . . .	4,319	
		Interest income . . . . .		24,319
		\$20,000 = 4% × \$500,000; \$24,319 = 5% × \$486,384.		

**Review #2 Solution**

2012			
Jan. 5	Investment in Armadillo Bottlers .....	15,000,000	
	Cash .....		15,000,000
	<i>To record investment in Armadillo.</i>		
2012			
Dec. 1	Cash .....	125,000	
	Investment in Armadillo Bottlers .....		125,000
	<i>To record dividends received; \$125,000 = 25% × \$500,000.</i>		
2012			
Dec. 31	Investment in Armadillo Bottlers .....	211,250	
	Equity in income of Armadillo Bottlers .....		211,250
	<i>To record equity in Armadillo's income for 2012.</i>		

Equity in net income for 2012 is calculated as follows:

Fizzy Cola's share of Armadillo's reported net income (25% × \$3 million) .....	\$750,000
Amortization of previously unreported intangibles (25% × \$10 million/5) .....	(500,000)
Unconfirmed profit on downstream sales (25% × (\$480,000 - (\$480,000/1.2))) .....	(20,000)
Unconfirmed profit on upstream sales (25% × (\$325,000 - (\$325,000/1.3))) .....	(18,750)
Equity in net income .....	<u>\$211,250</u>