

CHAPTER 1

THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS

Chapter Outline

- I. Four methods are principally used to account for an investment in equity securities along with a fair value option.
 - A. Fair value method: applied by an investor when only a small percentage of a company's voting stock is held.
 1. The investor recognizes income when the investee declares a dividend.
 2. Portfolios are reported at fair value. If fair values are unavailable, investment is reported at cost.
 - B. Cost Method: applied to investments without a readily determinable fair value. When the fair value of an investment in equity securities is not readily determinable, and the investment provides neither significant influence nor control, the investment may be measured at cost. The investment remains at cost unless
 1. A demonstrable impairment occurs for the investment, or
 2. An observable price change occurs for identical or similar investments of the same issuer.The investor typically recognizes its share of investee dividends declared as dividend income.
 - C. Consolidation: when one firm controls another (e.g., when a parent has a majority interest in the voting stock of a subsidiary or control through variable interests, their financial statements are consolidated and reported for the combined entity.
 - D. Equity method: applied when the investor has the ability to exercise significant influence over operating and financial policies of the investee.
 3. Ability to significantly influence investee is indicated by several factors including representation on the board of directors, participation in policy-making, etc.
 4. GAAP guidelines presume the equity method is applicable if 20 to 50 percent of the outstanding voting stock of the investee is held by the investor.

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

- II. Accounting for an investment: the equity method
 - A. The investor adjusts the investment account to reflect all changes in the equity of the investee company.
 - B. The investor accrues investee income when it is reported in the investee's financial statements.
 - C. Dividends declared by the investee create a reduction in the carrying amount of the Investment account. This book assumes all investee dividends are declared and paid in the same reporting period.

- III. Special accounting procedures used in the application of the equity method
 - A. Reporting a change to the equity method when the ability to significantly influence an investee is achieved through a series of acquisitions.
 - 1. Initial purchase(s) will be accounted for by means of the fair value method (or at cost) until the ability to significantly influence is attained.
 - 2. When the ability to exercise significant influence occurs following a series of stock purchases, the investor applies the equity method prospectively. The total fair value at the date significant influence is attained is compared to the investee's book value to determine future excess fair value amortizations.
 - B. Investee income from other than continuing operations
 - 1. The investor recognizes its share of investee reported other comprehensive income (OCI) through the investment account and the investor's own OCI.
 - 2. Income items such as discontinued operations that are reported separately by the investee should be shown in the same manner by the investor. The materiality of these other investee income elements (as it affects the investor) continues to be a criterion for separate disclosure.
 - C. Investee losses
 - 1. Losses reported by the investee create corresponding losses for the investor.
 - 2. A permanent decline in the fair value of an investee's stock should be recognized immediately by the investor as an impairment loss.
 - 3. Investee losses can possibly reduce the carrying value of the investment account to a zero balance. At that point, the equity method ceases to be applicable and the fair-value method is subsequently used.
 - D. Reporting the sale of an equity investment
 - 1. The investor applies the equity method until the disposal date to establish a proper book value.
 - 2. Following the sale, the equity method continues to be appropriate if enough shares are still held to maintain the investor's ability to significantly influence the investee. If that ability has been lost, the fair-value method is subsequently used.
- IV. Excess investment cost over book value acquired
 - A. The price an investor pays for equity securities often differs significantly from the investee's underlying book value primarily because the historical cost based accounting model does not keep track of changes in a firm's fair value.
 - B. Payments made in excess of underlying book value can sometimes be identified with specific investee accounts such as inventory or equipment.
 - C. An extra acquisition price can also be assigned to anticipated benefits that are expected to be derived from the investment. In accounting, these amounts are presumed to reflect an intangible asset referred to as goodwill. Goodwill is calculated as any excess payment that is not attributable to specific identifiable assets and liabilities of the investee. Because goodwill is an indefinite-lived asset, it is not amortized.

- V. Deferral of intra-entity gross profit in inventory
 - A. The investor's share of intra-entity profits in ending inventory are not recognized until the transferred goods are either consumed or until they are resold to unrelated parties.
 - B. Downstream sales of inventory
 - 1. "Downstream" refers to transfers made by the investor to the investee.
 - 2. Intra-entity gross profits from sales are initially deferred under the equity method and then recognized as income at the time of the inventory's eventual disposal.
 - 3. The amount of gross profit to be deferred is the investor's ownership percentage multiplied by the markup on the merchandise remaining at the end of the year.
 - C. Upstream sales of inventory
 - 1. "Upstream" refers to transfers made by the investee to the investor.
 - 2. Under the equity method, the deferral process for intra-entity gross profits is identical for upstream and downstream transfers. The procedures are separately identified in Chapter One because the handling does vary within the consolidation process.

Answers to Discussion Questions

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

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

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

Did the Cost Method Invite Manipulation?

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

At first glance it may seem that the fair value method allows managers to manipulate income because investee dividends are recorded as income by the investor. However, dividends paid

typically are accompanied by a decrease in fair value (also recognized in income), thus leaving reported net income unaffected.

Does the Equity Method Really Apply Here?

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

Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy-making processes, material intra-entity transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee company by another investor does not necessarily preclude the ability to exercise significant influence by the investor.

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

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

Answers to Questions

1. Through its voting rights over an investee, an investor firm can elect members to the investee's board of directors and thus exercise power over the strategic direction of the investee in ways that align with the investor's own operating and financial interests.
2. An investor should apply the equity method when it has the ability to exercise significant influence over the operating and financial policies of the investee. However, if the investor controls the investee, consolidating the financial information of the two companies will normally be the appropriate method for reporting the investment.
3. For equity securities without readily determinable fair values, ASC 321 allows the cost method for the investment asset. The investor recognizes dividend income for its share of investee dividends declared. Under the cost method, the investment account remains at cost unless there is (a) a demonstrable impairment or (b) observable price changes for identical or similar investments of the same issuer.
4. According to FASB ASC paragraph 323-10-15-6 "Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy-making processes, material intra-entity transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the extent of ownership of other shareholdings." The most objective of the criteria established by the Board is that holding (either directly or indirectly) 20 percent or more of the outstanding voting stock is *presumed* to constitute the ability to hold significant influence over the decision-making process of the investee.
5. Dividends received from an investee reduce the investment account. The investor does not record such dividends as revenue, to avoid reporting the income from the investee twice. The equity method is appropriate when an investor has the ability to exercise significant influence over the operating and financing decisions of an investee. Because dividends represent financing decisions, the investor may have the ability to influence dividend timing. If investors recorded dividends received as income, managers could affect reported income in a way that does not reflect actual performance. Therefore, in reflecting the close relationship between the investor and investee, the equity method employs accrual accounting to record income when reported by the investee. The investor increases its investment account for the investor's share of the investee's net income and then decreases the investment accounts as the investee distributes its net income through dividends. From the investor's view, the decrease in the investment asset (from investee dividends) is offset by an immediate increase in dividends receivable and an eventual increase in cash.
6. If Jones cannot significantly influence the operating and financial policies of Sandridge, the equity method should not be applied regardless of the ownership level. However, an owner of 25 percent of a company's outstanding common stock is assumed to possess this ability. This presumption stands until overcome by predominant evidence to the contrary.

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

- a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.
- b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.

- c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.
 - d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
 - e. The investor tries and fails to obtain representation on the investee's board of directors.
7. The following events necessitate changes in this investment account.
 - a. Net income earned by Watts would be reflected by an increase in the investment balance whereas a reported loss is shown as a reduction to that same account.
 - b. Dividends declared by the investee decrease its book value, thus requiring a corresponding reduction to be recorded in the investment balance.
 - c. If, in the initial acquisition price, Smith paid extra amounts because specific investee assets and liabilities had values differing from their book values, amortization of this portion of the investment account is subsequently required. As an exception, if the specific asset is land or goodwill, amortization is not appropriate.
 - d. Intra-entity gross profits created by sales between the investor and the investee must be deferred until resale to outside parties or consumed by the purchasing affiliate. The initial deferral entry made by the investor reduces the investment balance while the eventual recognition of the gross profit increases this account.
 8. The equity method has been criticized because it allows the investor to recognize income that may not be received in any usable form in the foreseeable future. The investor accrues income based on the investee's reported earnings, not on the investor's share of investee dividends. Frequently, equity income will exceed the investor's share of investee cash dividends with no assurance that the difference will ever be forthcoming.

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

9. Accounting standards require that an investor treat a change to the equity method prospectively. Any new investment (or other investor or investee activity) that provides significant influence requires application of the equity method. At the date the investor's influence becomes significant, the investor prepares an investment fair value allocation schedule. The resulting excess fair over book value amortizations serve to compute future equity in investee earnings.
10. In reporting equity earnings for the current year, Riggins must separate its accrual into two components: (1) net income and (2) other comprehensive income or loss. This handling enables the reader of the investor's financial statements to assess the nature of the change to the investment account.
11. Under the equity method, losses are recognized by an investor at the time that they are reported by the investee. However, because of the conservatism inherent in accounting, any permanent losses in value should also be recorded immediately. Because the investee's stock

has suffered a permanent impairment in this question, the investor recognizes the loss applicable to its investment.

12. Following the guidelines established by the ASC, Wilson would recognize an equity loss of \$120,000 (40 percent) stemming from Andrews' reported loss. However, since the book value of this investment is only \$100,000, Wilson's loss is limited to that amount with the remaining \$20,000 omitted. The investor will record subsequent income based on investee dividends. If Andrews is ever able to generate sufficient future profits to offset the total unrecognized losses, the investor will revert to the equity method.
13. In accounting, goodwill is derived as a residual figure. It is the investor's cost in excess of its share of the fair value of the investee assets and liabilities. Although a portion of the acquisition price may represent either goodwill or valuation adjustments to specific identifiable investee assets and liabilities, the investor records the entire cost in a single investment account. No separate identification of the cost components is made in the reporting process. Subsequently, the cost figures attributed to specific accounts (having a limited life), besides goodwill and other indefinite life assets, are amortized based on their anticipated lives. This amortization reduces the investment and the accrued income in future years.
14. On June 19, Princeton removes the portion of this investment account that has been sold and recognizes the resulting gross profit or loss. For proper valuation purposes, the equity method is applied (based on the 40 percent ownership) from the beginning of Princeton's fiscal year until June 19. Princeton's method of accounting for any remaining shares after June 19 will depend upon the degree of influence that is retained. If Princeton still has the ability to significantly influence the operating and financial policies of Yale, the equity method continues to be appropriate based on the reduced percentage of ownership. Conversely, if Princeton no longer holds this ability, the fair-value method becomes applicable, based on the remaining equity value after the sale.
15. Downstream sales occur when an investor sells to the investee while upstream sales are from the investee to the investor. These titles reflect the traditional positions given to the two parties when presented on an organization-type chart. Under the equity method, no accounting distinction exists between downstream and upstream sales. Separate presentation is made in this chapter only because the distinction becomes significant in the consolidation process as demonstrated in Chapter Five.
16. The portion of an intra-entity gross profit is computed based on the markup on any transferred inventory retained by the buyer at year's end. The markup percentage (based on sales price) multiplied by the intra-entity ending inventory gives the seller's profit remaining in the buyer's ending inventory. The product of the ownership percentage and this profit figure is the investor's share of gross profit from the intra-entity transaction. The investor defers this gross profit in the recognition of equity earnings until subsequently recognized following use or resale to an unrelated party.
17. Intra-entity transfers do not affect the financial reporting of the investee except that the related party transactions must be appropriately disclosed and labeled.
18. Under fair value accounting, firms report the investment's fair value as an asset and changes in fair value as earnings. Dividends from an investee are included in earnings under the fair value accounting. Dividends are not recognized in income but instead reduce the investment account under the equity method. Also, under the equity method, firms recognize their

ownership share of investee profits adjusted for excess cost amortizations and intra-entity profits.