Hoyle • Schaefer • Doupnik

Fundamentals of Advanced Accounting

6e

Fundamentals of Advanced Accounting

Sixth Edition

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To our families

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

—Christopher Morley

About the Authors

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Joe B. Hoyle is associate professor of accounting at the Robins School of Business at the University of Richmond, where he teaches intermediate accounting and advanced accounting. In 2009, he was named one of the 100 most influential people in the accounting profession by *Accounting Today.* He was named the 2007 Virginia Professor of the Year by the Carnegie Foundation for the Advancement of Teaching and the Center for Advancement and Support of Education. He has been named a Distinguished Educator five times at the University of Richmond and Professor of the Year on two occasions. Joe recently authored a book of essays titled *Tips and Thoughts on Improving the Teaching Process in College,* which is available without charge at http://oncampus.richmond.edu/~jhoyle/. His blog, *Teaching—Getting the Most from Your Students* at http://joehoyle-teaching.blogspot.com/ was named the Accounting Education Innovation of the Year for 2013 by the American Accounting Association.

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Students Solve the Accounting Puzzle

The approach used by Hoyle, Schaefer, and Doupnik allows students to think critically about accounting, just as they will in their careers and as they prepare for the CPA exam. Read on to understand how students will succeed as accounting majors and as future CPAs by using *Fundamentals of Advanced Accounting, 6e.*

Thinking Critically

With this text, students gain a well-balanced appreciation of the accounting profession. As *Hoyle 6e* introduces them to the field's many aspects, it often focuses on past controversies and present resolutions. The text shows the development of financial reporting as a product of intense and considered debate that continues today and will in the future.

Readability

The writing style of the 5 previous editions has been highly praised. **Students easily comprehend** chapter concepts because of the conversational tone used throughout the book. The authors have made every effort to ensure that the writing style remains engaging, lively, and consistent.

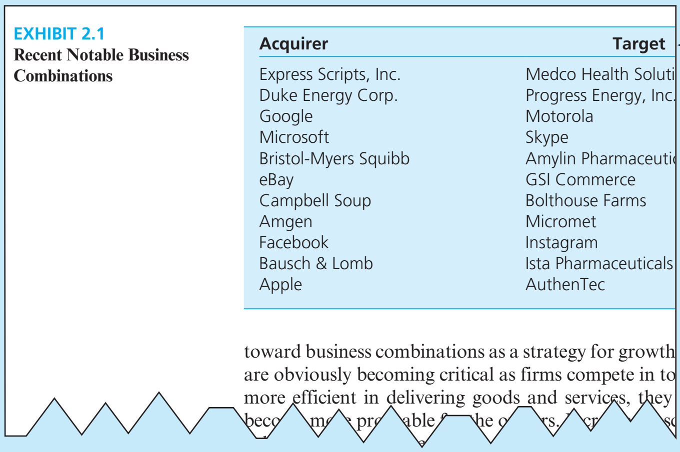


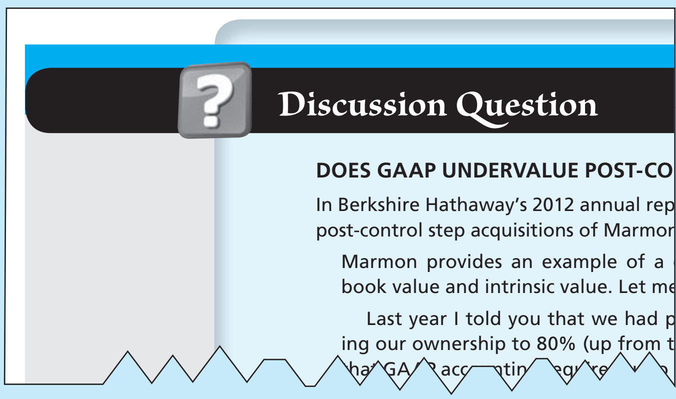
EXHIBIT 2.1
Recent Notable Business Combinations

Acquirer	Target
Express Scripts, Inc.	Medco Health Soluti
Duke Energy Corp.	Progress Energy, Inc.
Google	Motorola
Microsoft	Skype
Bristol-Myers Squibb	Amylin Pharmaceuti
eBay	GSI Commerce
Campbell Soup	Bolthouse Farms
Amgen	Micromet
Facebook	Instagram
Bausch & Lomb	Ista Pharmaceuticals
Apple	AuthenTec

toward business combinations as a strategy for growth
are obviously becoming critical as firms compete in to
more efficient in delivering goods and services, they

Real-World Examples

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



Discussion Question

DOES GAAP UNDERVALUE POST-CO

In Berkshire Hathaway's 2012 annual rep
post-control step acquisitions of Marmon

Marmon provides an example of a
book value and intrinsic value. Let me

Last year I told you that we had p
ing our ownership to 80% (up from t

Discussion Questions

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

with 6th Edition Features

CPA Simulations

Hoyle et al.'s CPA Simulations, powered by Kaplan, are found in Chapters 1, 2, 5, 8, and 11 of the 6th edition and have been updated in this edition to reflect the task-based approach of the CPA exam. Simulations are set up in the text and completed online at the 6th edition website (mhhe.com/hoyle6e). This allows students to practice advanced accounting concepts in a web-based interface identical to that used in the actual CPA exam. There will be no hesitation or confusion when students sit for the real exam; they will know exactly how to maneuver through the computerized test.

KAPLAN CPA REVIEW

Please visit the text website for the online Kaplan CPA simula

Scotch City
Situation: Scotch City uses encumbrance accounting to control spending throug
year. The following events occurred during the year:

- October 1: Purchase order #101 was placed for goods as assigned by Scotch Cit total cost was $75,000 for 100 units.
- October 31: $50,000 in goods was received on account re: PO #101. The goods estimated to cost $55,000.
- November 30: $50,000 was paid in cash on PO #101 by Scotch City.
- At year-end, the remaining goods have not yet been received.

Topic to be covered:

- Encumbrance Accounting

KAPLAN CPA REVIEW

Nowhere City
Situation: Nowhere City is in the process of adopting its annual budget. The legisla
tified the following sources of revenue for the upcoming year:

Property taxes $3,000,000

End-of-Chapter Materials

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

Excel Spreadsheet Assignments extend specific problems and are located on the 6th edition website at mhhe.com/hoyle6e. An Excel icon appears next to those problems that have corresponding spreadsheet assignments.

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

Comprehensive Illustration

(*Estimated Time: 45 to 65 Minutes*) Following
Richmond Company as of December 31. Th
liabilities are also listed.

Problem

Develop Your Skills

FASB ASC RESEARCH AND ANALYSIS CASE—CONSID OR COMPENSATION?

CPA skills

NaviNow Company agrees to pay $20 million in cash
all of its assets and liabilities. These four owners of T
ogy for real-time monitoring of traffic patterns on th

assumed in a business combination.

Questions

1. What is a business combination?
2. Describe the different types of legal arrangements that can take place to create a business combination.
3. What does the term *consolidated financial statements* mean?
4. Within the consolidation process, what is the purpose of a worksheet?
5. Jones Company obtains all of the common stock of Hudson, Inc., by issuing 50,000 shares of its own stock. Under these circumstances, why might the determination of a fair value for the consideration transferred be difficult?
6. What is the accounting valuation basis for consolidating assets and liabilities in a business combination?
7. How should a parent consolidate its subsidiary's revenues and expenses?
8. Morgan Company acquires all of the outstanding shares of Jennings, Inc., for cash. Morgan transfers consideration more than the fair value of the company's net assets. How should the

Problems

LO 2-1

1. Which of the following does not represe
   a. Combinations as a vehicle for achiev
   b. Cost savings through elimination of
   c. Quick entry for new and existing pro
   d. Larger firms being less likely to fail.

LO 2-2

2. Which of the following is the best theoreti

Supplements

The text's Online Learning Center (www.mhhe.com/hoyle6e) includes electronic files for all of the Instructor Supplements

For the Instructor

- **Instructor's Resource and Solutions Manual,** revised by the text authors, includes the solutions to all discussion questions, end-of-chapter questions, and problems. It provides chapter outlines to assist instructors in preparing for class.
- **Test Bank,** revised by Stephen Shanklin, University of Southern Indiana, has been significantly updated.
- **EZ Test Computerized Test Bank** can be used to make different versions of the same test, change the answer order, edit and add questions, and conduct online testing. Technical support for this software is available at (800) 331-5094 or visit www.mhhe.com/eztest.
- **PowerPoint® Presentations,** revised by Anna Lusher, Slippery Rock University, deliver a complete set of slides covering many of the key concepts presented in each chapter.
- **Excel Template Problems and Solutions,** revised by Jack Terry of ComSource Associates, Inc., allow students to develop important spreadsheet skills by using Excel templates to solve selected assignments.
- ***Connect® Accounting***
  ISBN 9780077632212; MHID 0077632214.
- ***Connect® Plus Accounting***
  ISBN 9780077632236; MHID 0077632230.

For the Student

- **Self-Grading Multiple-Choice Quizzes** (mhhe.com/hoyle6e) for each chapter are available on the Student Center of the text's Online Learning Center.
- **Excel Template Problems** (mhhe.com/hoyle6e) are available on the Student Center of the text's Online Learning Center. The software includes innovatively designed Excel templates that may be used to solve many complicated problems found in the book. These problems are identified by a logo in the margin.
- **PowerPoint Presentations** (mhhe.com/hoyle6e) are available on the Student Center of the text's Online Learning Center. These presentations accompany each chapter of the text and contain the same slides that are available to the instructor.

Assurance of Learning Ready

Many educational institutions today are focused on the notion of assurance of learning, an important element of some accreditation standards. Hoyle 6e is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for Hoyle 6e maps to a specific chapter learning outcome/objective listed in the text. You can use our test bank software, EZ Test, to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of EZ Test to aggregate student results in a similar fashion, making the collection and presentation of assurance of learning data simple and easy.

AACSB Statement

The McGraw-Hill Companies is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, Hoyle 6e recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the test bank to the general knowledge and skill guidelines found in the AACSB standards.

The statements contained in Hoyle 6e are provided only as a guide for the users of this text. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While Hoyle 6e and the teaching package make no claim of any specific AACSB qualification or evaluation, we have, within the test bank, labeled selected questions according to the six general knowledge and skills areas.

Technology

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New for the 6th edition!

Intelligent Response Technology (IRT) is a redesigned student interface for our end-of-chapter assessment content. The benefits include

- Improved answer acceptance to reduce students' frustration with formatting issues such as rounding.
- Selected redesigned questions to test students' knowledge more fully; they now include tables for students to work through rather than requiring all calculations to be done off-line.

Simple assignment management

With McGraw-Hill's *Connect Accounting,* creating assignments is easier than ever so that you can spend more time teaching and less time managing. *Connect Accounting* enables you to

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Smart grading

When it comes to studying, time is precious. *Connect Accounting* helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. The grading function enables you to

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For more information about *Connect,* go to www.mcgrawhillconnect.com, or contact your local McGraw-Hill sales representative.

CPA Simulations

The McGraw-Hill Companies and Kaplan have teamed up to bring students CPA simulations to test their knowledge of the concepts discussed in various chapters, practice critical professional skills necessary for career success, and prepare for the computer-based CPA exam. Kaplan CPA Review provides a broad selection of web-based simulations that were modeled after the AICPA format. Exam candidates become familiar with the item format, the research database, and the spreadsheet and word processing software used exclusively on the CPA exam (not Excel or Word), as well as the functionality of the simulations, including the tabs, icons, screens, and tools used on the exam. CPA simulations are found in the end-of-chapter material after the very last cases in Chapters 1, 2, 5, 8, and 11 and have been updated in this edition to reflect the task-based approach of the CPA exam.

Online Learning Center

www.mhhe.com/hoyle6e For instructors, the book's website contains the Instructor's Resource and Solutions Manual, PowerPoint slides, Excel templates and solutions, Interactive Activities, Text and Supplement Updates, and links to professional resources. The student section of the site features online multiple-choice quizzes, PowerPoint presentations, Check Figures, and Excel template exercises.

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"Students using ALEKS performed significantly better than those who had not on the exams that tested the underlying financial accounting material. Furthermore . . . **I spent far less office-hour time tutoring students** on the fundamental financial accounting material."

— Ryan J. Baxter and Jay C. Thibodeau, Bentley University, MA
Issues in Accounting Education: Nov 2011, Vol. 26, No. 4

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In addition to Blackboard integration, course cartridges for whatever online course management system you use (e.g., WebCT or eCollege) are available for Hoyle 6e. Our cartridges are specifically designed to make it easy to navigate and access content online. They are easier than ever to install on the latest version of the course management system available today.

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Advanced Accounting 6e Stays Current

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

Chapter Changes for *Advanced Accounting,* 6th Edition:

Chapter 1

- Changed the focus to the date investee dividends are declared rather than paid in accounting for investments. Past editions used the investee's dividend payment date to reduce the investor's investment account (equity method) or to recognize dividend income (initial value method). The previous treatment implicitly assumed that investee dividends were declared and paid in the same accounting period. The current edition uses the date that an investee declares a dividend to trigger a reduction in the investment account (or to recognize dividend income under the initial value method) to better reflect current accounting practice.
- Provided greater coverage of equity method applications where the investee reports other comprehensive income or loss.
- Reduced coverage of investee extraordinary items to reflect the fact that extraordinary items have become almost nonexistent over the past decade. The text's new emphasis on comprehensive income thus is in keeping with the times.
- Updated real-world references.
- Discussed proposed FASB standard would eliminate the fair-value option for investments that otherwise require equity method accounting.
- Added and revised several end-of-chapter problems.

Chapter 2

- Added new descriptive coverage of three recent real-world business combinations—Campbell Soup and Bolthouse Farms, Microsoft and Skype, and Duke Energy and Progress Energy.
- Enhanced the discussion of the nature of control and the difficulty standard setters have in defining control situations.
- Used a Dividends Declared account (rather than Dividends Paid) in all text illustrations and end-of-chapter problems to better reflect current accounting practice.
- Updated real-world references.
- In addition to several new and revised end-of-chapter problems, added a new research case on Celgene's acquisition of Avila Therapeutics that provides students with a real-world application of business combination financial reporting.

Chapter 3

- Used a Dividends Declared account (rather than Dividends Paid) in all text illustrations and end-of-chapter problems to better reflect current accounting practice.
- Provided updated coverage of impairment for intangible assets with indefinite lives (other than goodwill). The chapter discusses the option to first perform qualitative assessments prior to quantitative tests.
- Updated real-world references.
- Added two new equity method end-of-chapter problems requiring the preparation of consolidated financial statements subsequent to acquisition. In addition, several other end-of-chapter problems have been revised.
- Added a new research and analysis case on Microsoft's 2012 goodwill impairment loss.

Chapter 4

- Replaced the term *noncontrolling interest in subsidiary income with net income attributable to noncontrolling interest* to better align with financial reporting practice.
- Used a Dividends Declared account (rather than Dividends Paid) in all text illustrations and end-of-chapter problems to better reflect current accounting practice.
- Added a discussion question on step acquisitions using observations from Berkshire Hathaway's 2012 annual report. The question addresses the

counterintuitive aspects of GAAP accounting for post-control step acquisitions as equity transactions. The question also provides an opportunity for students to explain, and agree or disagree with, the rationale for the accounting practice.

- Updated real-world references.
- Revised the end-of-chapter *Charging Ahead* FASB ASC and IFRS research case. The new case, entitled *InstaPower,* changes the fact pattern for valuing the noncontrolling interest to explicitly allow for alternative goodwill measurement under IFRS. In addition, several other end-of-chapter problems have been revised.

Chapter 5

- Updated Kaplan CPA Simulation in the end-of-chapter material.
- Updated real-world references.
- Revised and streamlined the discussion on downstream intra-entity beginning inventory profit worksheet adjustments to the investment account when the parent uses the equity method.
- Used a Dividends Declared account (rather than Dividends Paid) in all text illustrations and end-of-chapter problems to better reflect current accounting practice.
- Revised several end-of-chapter problems.

Chapter 6

- Updated real-world references.
- Used a Dividends Declared account (rather than Dividends Paid) in all text illustrations and end-of-chapter problems to better reflect current accounting practice.
- Revised several end-of-chapter problems.

Chapter 7

- Updated examples of company practices, excerpts from annual reports, and foreign exchange rates.
- Added language to emphasize that speculative derivatives, derivatives not designated as hedges, and derivatives designated as fair value hedges of foreign currency denominated assets and liabilities are all accounted for similarly; that is, changes in fair value are recognized immediately in net income.
- Updated the discussion of a proposed change in hedge accounting made by the IASB.
- Changed the facts in several end-of-chapter problems.

Chapter 8

- Updated references to actual company practice and related excerpts from annual reports.
- Added discussion of why stockholders' equity accounts are translated at historical exchange rates.
- Made note of the fact that the comprehensive illustration at the end of this chapter further demonstrates how nonlocal currency balances of a foreign entity are treated in the preparation of consolidated financial statements.
- Changed the requirements in the comprehensive illustration from preparation and translation of financial statements to preparation and translation of a trial balance.
- Created two new end-of-chapter problems that focus on the translation of nonlocal currency balances of a foreign entity.
- Changed facts in several existing end-of-chapter problems.
- Changed the use of indirect exchange rate quotes to direct quotes in several end-of-chapter problems.
- Added new Kaplan CPA Simulation to the end-of-chapter material.

Chapter 9

- Updated discussion for changes in the tax code, in particular 2012 "fiscal cliff" legislation, and other real-world references.
- Revised several end-of-chapter problems.

Chapter 10

- Removed much of the historical material in the first two sections of the chapter.
- Added an outline of the important steps involved in a partnership liquidation to the introductory section.
- Renamed "schedule" of liquidation as "statement" of liquidation.
- Replaced the notion of "making distributions based on safe capital balances" with "distributing safe payments."

- Changed or added several second and third headings to assist in chapter organization.
- Placed emphasis on the preparation of a statement of partnership liquidation.
- Streamlined discussion of how a partner's loan balance is handled in a partnership liquidation.
- Added a new end-of-chapter problem related to learning objectives LO 10-2 and LO 10-4.
- Changed the facts and requirements in several end-of-chapter problems.

Chapter 11

- Provided coverage of new pronouncement: *GASB Statement No. 63,* "Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position."
- Provided coverage of new pronouncement: *GASB Statement No. 65.* "Items Previously Reported as Assets and Liabilities."
- Updated numerous references to the financial statements of a wide variety of state and local governments.
- Added new Kaplan CPA Simulations to the end-of-chapter material.

Chapter 12

- Provided coverage of new pronouncement: *GASB Statement No. 67,* "Financial Reporting for Pension Plans" (an amendment of GASB Statement No. 25).
- Provided coverage of new pronouncement: *GASB Statement No. 68,* "Accounting and Financial Reporting for Pensions" (an amendment of GASB Statement No. 27).
- Provided coverage of new pronouncement: *GASB Statement No. 69,* "Combinations and Disposals of Government Operations."

Acknowledgments

We could not produce a textbook of the quality and scope of *Fundamentals of Advanced Accounting* without the help of a great number of people. Special thanks goes to Gregory Schaefer for his Chapter 2 descriptions of recent business combinations. Additionally, we would like to thank Steve Shanklin of Tennessee State University for revising and adding new material to the Test Bank and online student quizzes; Anna Lusher of Slippery Rock University, for updating and revising the PowerPoint presentations; Jack Terry of ComSource Associates for updating the Excel Template Exercises for students to use as they work the select end-of-chapter material; Ilene Leopold Persoff of Long Island University (LIU Post) and Beth Woods of Accuracy Counts for checking the text and Solutions Manual for accuracy; Beth Woods for checking the Test Bank for accuracy; and Barbara Gershman of Northern Virginia Community College for checking the PowerPoints.

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William Paterson University

Ronald Zhao
Monmouth University

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Brief Contents

Contents

Fundamentals of Advanced Accounting

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chapter 1

The Equity Method of Accounting for Investments

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

Learning Objectives

After studying this chapter, you should be able to:

- **LO 1-1** Describe in general the various methods of accounting for an investment in equity shares of another company.
- **LO 1-2** Identify the sole criterion for applying the equity method of accounting and guidance in assessing whether the criterion is met.
- **LO 1-3** Prepare basic equity method journal entries for an investor and describe the financial reporting for equity method investments.
- **LO 1-4** Allocate the cost of an equity method investment and compute amortization expense to match revenues recognized from the investment to the excess of investor cost over investee book value.
- **LO 1-5** Understand the financial reporting consequences for:
  - a. A change to the equity method.
  - b. Investee other comprehensive income.
  - c. Investee losses.
  - d. Sales of equity method investments.
- **LO 1-6** Describe the rationale and computations to defer unrealized gross profits on intra-entity inventory transfers until the goods are either consumed or sold to outside parties.
- **LO 1-7** Explain the rationale and reporting implications of fair-value accounting for investments otherwise accounted for by the equity method.

The Reporting of Investments in Corporate Equity Securities

In its recent annual report, The Coca-Cola Company describes its 29 percent investment in Coca-Cola FEMSA, a Mexican bottling company with operations throughout much of Latin America. The Coca-Cola Company uses the equity method to account for several of its bottling company investments, including Coca-Cola FEMSA. The Coca-Cola Company states,

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

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

LO 1-1

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

At present, generally accepted accounting principles (GAAP) recognize three different approaches to the financial reporting of investments in corporate equity securities:

1. The fair-value method.
2. The consolidation of financial statements.
3. The equity method.

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

Fair-Value Method

In many instances, an investor possesses only a small percentage of an investee company's outstanding stock, perhaps only a few shares. Because of the limited level of ownership, the investor cannot expect to significantly affect the investee's operations or decision making. These shares are bought in anticipation of cash dividends or in appreciation of stock market values. Such investments are recorded at cost and periodically adjusted to fair value according to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) Topic 320, "Investments—Debt and Equity Securities."

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

- Initial investments in equity securities are recorded at cost and subsequently adjusted to fair value if fair value is readily determinable (typically by reference to market value); otherwise, the investment remains at cost.[2]
- Equity securities held for sale in the short term are classified as *trading securities* and reported at fair value, with unrealized gains and losses included in earnings.
- Equity securities not classified as trading securities are classified as *available-for-sale securities* and reported at fair value with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity as part of *other comprehensive income.*
- Dividends from the investments are recognized as income for both trading and available-for-sale securities.

The above procedures are followed for equity security investments when neither significant influence nor control is present. However, as observed at the end of this chapter, FASB ASC Topic 825, "Financial Instruments," allows a special fair-value reporting option for available-for-sale securities. Although the balance sheet amounts for the investments remain at fair value under this option, changes in fair values over time are recognized in the income statement (as opposed to other comprehensive income) as they occur.

Consolidation of Financial Statements

Many corporate investors acquire enough shares to gain actual control over an investee's operation. In financial accounting, such control is often achieved when a stockholder accumulates more than 50 percent of an organization's outstanding voting stock. At that

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

[2] ASC (para. 325-20-35-1 and 2) notes two exceptions to the cost basis for reporting investments:

1. Dividends received in excess of earnings subsequent to the date of investment are considered returns of the investment and are recorded as reductions of cost of the investment.
2. A series of an investee's operating losses or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and shall be recognized.

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

Investor control over an investee presents a special accounting challenge. Normally, when a majority of voting stock is held, the investor-investee relationship is so closely connected that the two corporations are viewed as a single entity for reporting purposes. Hence, an entirely different set of accounting procedures is applicable. Control generally requires the consolidation of the accounting information produced by the individual companies. Thus, a single set of financial statements is created for external reporting purposes with all assets, liabilities, revenues, and expenses brought together.[3] The various procedures applied within this consolidation process are examined in subsequent chapters of this textbook.

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

Equity Method

Another investment relationship is appropriately accounted for using the equity method. In many investments, although control is not achieved, the degree of ownership indicates the ability of the investor to exercise *significant influence* over the investee. Recall Coca-Cola's 29 percent investment in Coca-Cola FEMSA's voting stock. Through its ownership, Coca-Cola can undoubtedly influence Coca-Cola FEMSA's decisions and operations.

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

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

Furthermore, under the equity method, the investor's share of investee dividends declared are recorded as decreases in the investment account, not as income.

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

[3] As is discussed in the next chapter, owning a majority of the voting shares of an investee does not always lead to consolidated financial statements.

Discussion Question

DID THE COST METHOD INVITE EARNINGS MANIPULATION?

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

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

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

International Accounting Standard 28—Investments in Associates

The International Accounting Standards Board (IASB), similar to the FASB, recognizes the need to take into account the significant influence that can occur when one firm holds a certain amount of voting shares of another. The IASB defines significant influence as the power to participate in the financial and operating policy decisions of the investee, but it is not control or joint control over those policies. The following describes the basics of the equity method in International Accounting Standard (IAS) 28:[4]

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

As seen from the above excerpt from *IAS 28,* the equity method concepts and applications described are virtually identical to those prescribed by the FASB ASC.

[4] International Accounting Standards Board, *IAS 28*, "Investments in Associates," Technical Summary (www.iasb.org).

Application of the Equity Method

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

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

LO 1-2

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

Criteria for Utilizing the Equity Method

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

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

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

- Investor representation on the board of directors of the investee.
- Investor participation in the policy-making process of the investee.
- Material intra-entity transactions.
- Interchange of managerial personnel.
- Technological dependency.
- Extent of ownership by the investor in relation to the size and concentration of other ownership interests in the investee.

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

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

> An investment (direct or indirect) of 20 percent or more of the voting stock of an investee shall lead to a presumption that in the absence of predominant evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.[5]

Limitations of Equity Method Applicability

At first, the 20 to 50 percent rule may appear to be an arbitrarily chosen boundary range established merely to provide a consistent method of reporting for investments. However, the essential criterion is still the ability to significantly influence (but not control)

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

the investee, rather than 20 to 50 percent ownership. If the absence of this ability is proven (or control exists), the equity method should not be applied regardless of the percentage of shares held.

For example, the equity method is not appropriate for investments that demonstrate any of the following characteristics regardless of the investor's degree of ownership:[6]

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

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

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

To illustrate, one firm may create a separate legal entity in which it holds less than 50 percent of the voting interests but nonetheless controls that entity through governance document provisions and/or contracts that specify decision-making power and the distribution of profits and losses. Entities controlled in this fashion are typically designated as *variable interest entities,* and their sponsoring firm may be required to include them in consolidated financial reports despite the fact that ownership is less than 50 percent. Many firms (e.g., The Walt Disney Company and Mills Corporation) reclassified former equity method investees as variable interest entities and now consolidate these investments.[7]

Extensions of Equity Method Applicability

For some investments that either fall short of or exceed 20 to 50 percent ownership, the equity method is nonetheless appropriately used for financial reporting. As an example, AT&T, Inc., disclosed that it uses the equity method to account for its 9.55 percent investment in América Móvil, a wireless provider in Mexico with telecommunications investments in the United States and Latin America. In its annual report, AT&T notes that it is a member of a consortium that holds voting control of the company, thus providing it significant influence.

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

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

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

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

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

Accounting for an Investment—The Equity Method

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

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

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

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

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

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

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

Application of the equity method causes the investment account on the investor's balance sheet to vary directly with changes in the investee's equity. As an illustration, assume that an investor acquires a 40 percent interest in a business enterprise. If the investor has the ability to significantly influence the investee, the equity method may

EXHIBIT 1.1 Comparison of Fair-Value Method (ASC 320) and Equity Method (ASC 323)

			Accounting by Big Company When Influence Is Not Significant (available-for-sale security)			Accounting by Big Company When Influence Is Significant (equity method)	
Year	Income of Little Company	Dividends Declared by Little Company	Dividend Income	Carrying Amount of Investment	Fair-Value Adjustment to Stockholders' Equity	Equity in Investee Income	Carrying Amount of Investment
2014	$200,000	$ 50,000	$10,000	$235,000	$ 35,000	$ 40,000*	$230,000†
2015	300,000	100,000	20,000	255,000	55,000	60,000*	270,000†
2016	400,000	200,000	40,000	320,000	120,000	80,000*	310,000†
Total income recognized			$70,000			$180,000	

*Equity in investee income is 20 percent of the current year income reported by Little Company.
†The carrying amount of an investment under the equity method is the original cost plus income recognized less dividends. For 2014, as an example, the $230,000 reported balance is the $200,000 cost plus $40,000 equity income less $10,000 in dividends.

be utilized. If the investee subsequently reports net income of $50,000, the investor increases the investment account (and its own net income) by $20,000 in recognition of a 40 percent share of these earnings. Conversely, a $20,000 investee dividend necessitates a reduction of $8,000 in this same asset account (40 percent of the total payout).

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

To illustrate, assume that Big Company owns a 20 percent interest in Little Company purchased on January 1, 2014, for $200,000. Little then reports net income of $200,000, $300,000, and $400,000, respectively, in the next three years while declaring dividends of $50,000, $100,000, and $200,000. The fair values of Big's investment in Little, as determined by market prices, were $235,000, $255,000, and $320,000 at the end of 2014, 2015, and 2016, respectively.

Exhibit 1.1 compares the accounting for Big's investment in Little across the two methods. The fair-value method carries the investment at its market values, presumed to be readily available in this example. Because the investment is classified as an *available-for-sale security,* the excess of fair value over cost is reported as a separate component of stockholders' equity.[8] Income is recognized as dividends are declared.

In contrast, under the equity method, Big recognizes income as it is earned by Little. As shown in Exhibit 1.1, Big recognizes $180,000 in income over the three years, and the carrying amount of the investment is adjusted upward to $310,000. Dividends from Little are not an appropriate measure of income because of the assumed significant influence over the investee. Big's ability to influence Little's decisions applies to the timing of dividend distributions. Therefore, dividends from Little do not objectively measure Big's income from its investment in Little. As Little earns income, however, under the equity method Big recognizes its share (20 percent) of the income and increases the investment account. Thus the equity method reflects the accrual model: The investor recognizes income as it is earned by the investee, not when the investee declares a cash dividend.

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

[8] Fluctuations in the market values of *trading securities* are recognized in income in the period in which they occur.

LO 1-3

Prepare basic equity method journal entries for an investor and describe the financial reporting for equity method investments.

Equity Method Accounting Procedures

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

Referring again to the information presented in Exhibit 1.1, Little Company reported a net income of $200,000 during 2014 and declared and paid cash dividends of $50,000. These figures indicate that Little's net assets have increased by $150,000 during the year. Therefore, in its financial records, Big Company records the following journal entries to apply the equity method:

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

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

LO 1-4

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

Excess of Investment Cost Over Book Value Acquired

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

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

If an investment is acquired at a price in excess of book value, logical reasons should explain the additional cost incurred by the investor. The source of the excess of cost over book value is important. Income recognition requires matching the income generated

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

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