

Investments

THE EQUITY METHOD

Investments in Equity Securities

Equity securities are normally common stock, preferred stock or the rights to acquire such stock. If an investor company holds equity securities in an investee company the accounting for the investment is determined by the amount of *influence* or *control* attributed to the investor company. For all practical purposes the level of influence or control is determined by the percentage of ownership unless there are other factors that might override such consideration.

Holdings of Less Than 20%

If an investor company holds less than 20% of the stock of an investee company it is considered to be a passive investor. The investment is for the purpose of earning capital gains from appreciation on the stock and/or dividends if the stock pays dividends. Depending on management's intent the stock will be accounted for as either a trading security or an available-for-sale security.

Holdings Between 20% and 50%

If an investor company owns 20% to 50% of the stock in an investee company there is a good chance that it can exercise *significant influence* over the financial and operating policies of the investee company. Factors that indicate significant influence may include one or more of the following:

- (1) Representation on the board of directors
- (2) Participation in policy-making decisions
- (3) There are material intercompany transactions
- (4) There is an interchange of management personnel
- (5) There is technical dependency between the two entities
- (6) The extent of ownership in relation to other voting blocks of ownership

Professional judgment is required to determine if an investor company exercises significant control. If it does the investor company must use the equity method in accounting for this investment.

Equity Method

There is a substantial economic relationship between the investor and the investee. Therefore, the investor will reflect its proportionate share of the economic transactions that take place in the investee corporation at the end of each accounting period.

Example: Spencer Company purchased a 40% interest in Fido Chow on January 1, 2000 for \$600,000. During the year Fido Chow had the following transactions.

- Net income for year-ended December 31, 2000 was \$250,000
- Dividends of \$50,000 were declared and paid on November 1, 2000

Spencer Company will record the original investment at cost. As the investor, Spencer Company will record 40% of the net income at the end of the year as an increase in the investment account and 40% of the dividends as a decrease in the investment account. The following is a T-account of the investment in Fido Chow.

Investments

T-Account: Investment in Fido Chow

Date	Description	Debit	Credit
1/1/00	Investment in Fido Chow	600,000	
11/1/00	Dividends received (40% * \$50,000)		20,000
12/31/00	Proportionate share of net income (40% * \$250,000)	100,000	
	Balance at 12/31/00	680,000	

The three journal entries that Spencer Company would record would be as follows:

DATE	ACCOUNT	DEBIT	CREDIT
1/1/00	Investment-Fido Chow	600,000	
	Cash		600,000
	To record investment in Fido Chow		
11/1/00	Cash	20,000	
	Investment-Fido Chow		20,000
	To record the receipt of dividends from investment in Fido Chow		
12/31/00	Investment-Fido Chow	100,000	
	Investment income-Fido Chow		100,000
	To record proportionate share of new income fro investment in Fido Chow		

In most situations the investor company will pay more for the stock than book value. The difference reflects the difference between market value and book value of the plant, property, and equipment, identifiable intangible assets, and goodwill. To the extent that some or all of the excess of the purchase price is allocated to depreciable assets an additional charge for depreciation needs to be made on the investor company's books at the end of each accounting period.

It is highly unlikely that an investment would be made at the beginning of the year. If the investment is made during the year the allocated share of net income and dividends and the additional depreciation must be prorated to reflect the number of months that the investor company held the investment during the current year.

Exercise: On September 1, 2002, Spencer Company, a calendar year corporation, purchased for \$300,000 a 25% interest in Alexander Company. This investment enables Spencer Company to exert significant influence over Alexander Company. The book value of Alexander Company at the date of the purchase was \$600,000. It is estimated that 60% of the excess of market value over book value should be allocated to property, plant and equipment. The remaining service life of the property, plant, and equipment is 10 years. Spencer Company will allocate depreciation using the straight-line method. During the calendar year of 2002, Alexander Company earned net income of \$180,000 and paid dividends of \$60,000. The dividends were declared and paid at the end of each quarter.

In the format provided, prepare the journal entry to record the purchase of this equity investment.

Investments

Date	Account	Debit	Credit
9/1/02	Investment-Alexander Company		
	Cash		
	To record the purchase of the investment in Alexander Company		

Solution:

Date	Account	Debit	Credit
9/1/02	Investment-Alexander Company	300,000	
	Cash		300,000
	To record the purchase of the investment in Alexander Company		

In the format provided, prepare the journal entry to record the receipt of the September 30, 2002 dividend.

Date	Account	Debit	Credit
9/30/02	Cash		
	Investment-Alexander Company		
	To record the receipt of the third quarter dividend from the investment in Alexander Company		

Solution:

Date	Account	Debit	Credit
9/30/02	Cash	15,000	
	Investment-Alexander Company		15,000
	To record the receipt of the third quarter dividend from the investment in Alexander Company		

In the format provided, prepare the journal entry to record the receipt of the December 31, 2002 dividend.

Date	Account	Debit	Credit
12/31/02	Cash		
	Investment-Alexander Company		
	To record the receipt of the fourth quarter dividend from the investment in Alexander Company		

Solution:

Investments

Date	Account	Debit	Credit
9/30/02	Cash	15,000	
	Investment-Alexander Company		15,000
	To record the receipt of the fourth quarter dividend from the investment in Alexander Company		

In the format provided, prepare the journal entry to record the proportionate share of net income that Spencer Company earned on this investment.

Date	Account	Debit	Credit
12/31/02	Investment-Alexander Company		
	Investment income-Alexander Company		
	To record the proportionate share of net income from the investment in Alexander Company for the year ended December 31, 2002.		

Solution:

Date	Account	Debit	Credit
12/31/02	Investment-Alexander Company	15,000	
	Investment income-Alexander Company		15,000
	To record the proportionate share of net income from the investment in Alexander Company for the year ended December 31, 2002.		

Analysis of proportionate share of net income:			
Net income-Alexander Company		180,000	
Proportionate share		25%	
Subtotal		<u>45,000</u>	
Months investment was held		<u>4/12</u>	
Proportionate share			15,000

In the format provided, prepare the journal entry to record Spencer Company's extra depreciation as a result of paying more than book value for this investment.

Date	Account	Debit	Credit
12/31/02	Investment income-Alexander Company		
	Investment-Alexander Company		
	To record the additional depreciation of the excess of market value over book value on property, plant and equipment.		

Solution:

Investments

Date	Account	Debit	Credit
12/31/02	Investment income-Alexander Company	3,000	
	Investment-Alexander Company		3,000
	To record the additional depreciation of the excess of market value over book value on property, plant and equipment.		

Analysis of additional depreciation:			
FMV of Alexander Company		1,200,000	
Book value of Alexander Company		<u>600,000</u>	
Excess of FMV over book		600,000	
Allocated to property, plant, and equipment		<u>60%</u>	
Depreciable assets		360,000	
Percentage ownership by Spencer Company		<u>25%</u>	
Depreciable assets allocated to investor		90,000	
Service life (SL depreciation)		<u>10</u>	
Annual depreciation		9,000	
Months investment was held		<u>4/12</u>	
Extra depreciation expense			3,000

Holdings of More Than 50%

If a investor company owns more than a 50% equity interest in an investee company, the investor is considered to have a *controlling interest*. The investor is called the *parent* company and the investee is called the *subsidiary*. The investment is accounted for using the equity method explained above but the financial statements must be consolidated. This means that there is only one set of financial statements for the combined companies. You will learn how to consolidate financial statements in Advanced Accounting.