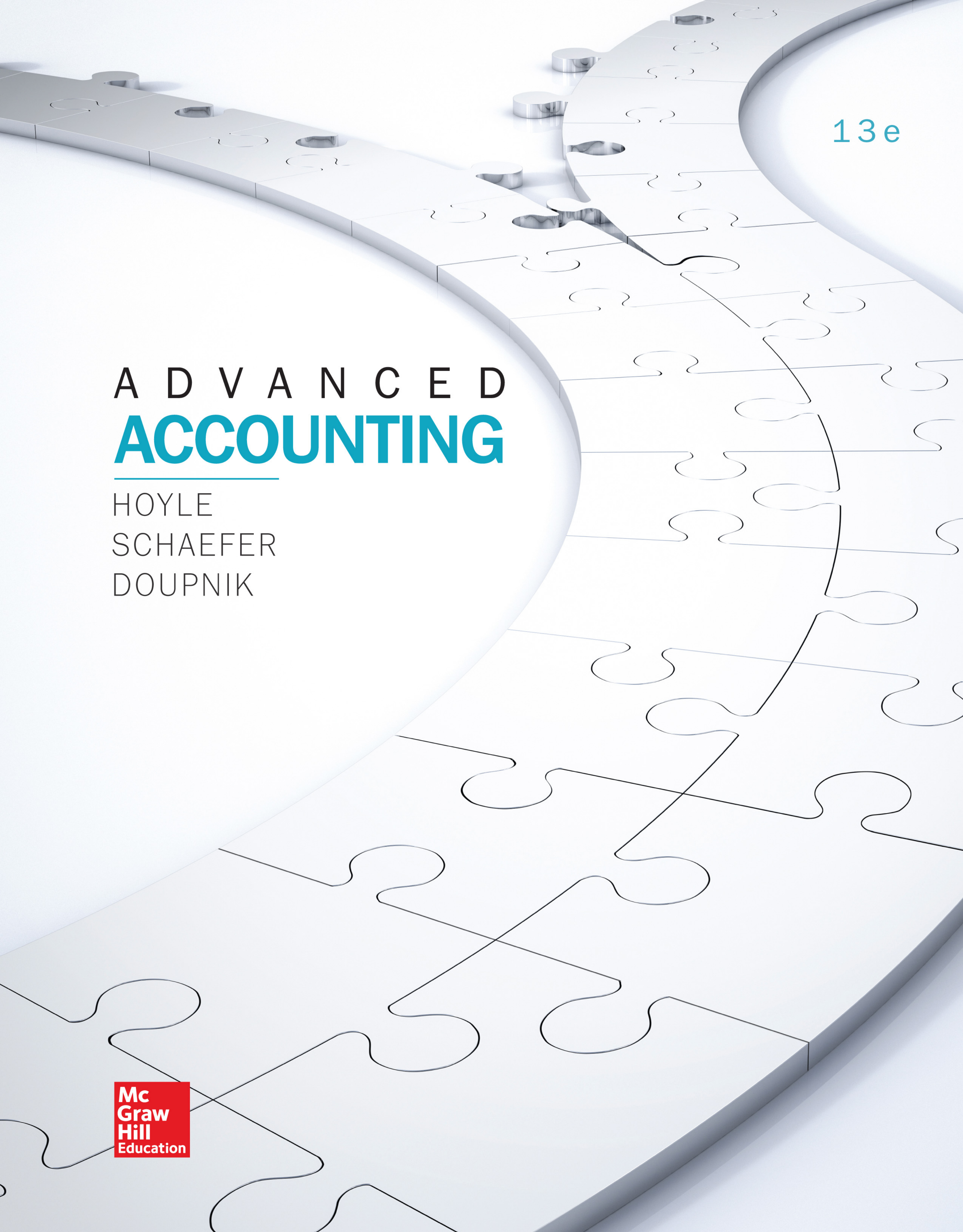

13e

ADVANCED ACCOUNTING

HOYLE
SCHAEFER
DOUPNIK

McGraw Hill Education

Advanced Accounting

Thirteenth Edition

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Robins School of Business
University of Richmond

Thomas F. Schaefer

KPMG Professor of Accountancy
Mendoza College of Business
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Mc Graw Hill Education

ADVANCED ACCOUNTING, THIRTEENTH 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

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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, financial accounting, and advanced accounting. In 2015, he was the first recipient of the J. Michael and Mary Anne Cook Prize for undergraduate teaching. The Cook Prize is awarded by the American Accounting Association and "is the foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting." Professor Hoyle has also been named (in 2007) as the 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 selected as a Distinguished Educator five times at the University of Richmond and Professor of the Year on two occasions. He has authored a book of essays titled *Tips and Thoughts on Improving the Teaching Process in College,* which is available 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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Advanced Accounting 13e 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,* 13th Edition:

Chapter 1

- Updated the chapter to reflect *Accounting Standards Update* (ASU) No. 2016-07 to ASC Topic 323, Investments—Equity Method and Joint Ventures, entitled "Simplifying the Transition to the Equity Method of Accounting." The ASU is effective for fiscal years beginning after December 15, 2016.

  The ASU eliminates the requirement to retrospectively apply the equity method to previously held ownership interests in an investee when an increase in ownership results in significant influence and thus qualifies for use of the equity method.
- Updated coverage for *Accounting Standards Update* (ASU) No. 2016-01, Financial Instruments—Overall, which requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, unless fair values are not readily determinable. Thus, the previously available-for-sale category with fair value changes recorded in other comprehensive income will no longer be available. The ASU is effective for fiscal years beginning after December 15, 2017, with early adoption permitted.
- Eliminate coverage of investee extraordinary items to align the text coverage with *Accounting Standards Update* No. 2015-01 which eliminates the concept of extraordinary items.
- Updated terminology in discussion of intra-entity gross profits to reflect the new revenue recognition standards (ASC 606).
- Updated real-world references.
- Added and revised several end-of-chapter problems.

Chapter 2

- Added new descriptive coverage of three recent real-world business combinations—Facebook and WhatsApp, AT&T and DirecTV, and MeadwestVaco and Rock-Tenn.
- Revised chapter learning objectives to focus on combinations when the acquired firm is dissolved vs. continued existence. The chapter also newly recognizes a learning objective on the related costs that typically accompany business combinations.
- Added an updated appendix on pushdown accounting based on *Accounting Standards Update* (ASU) No.2014-17, Business Combinations: Pushdown Accounting. The ASU allows companies an option to apply pushdown accounting for newly acquired subsidiaries.
- Updated real-world references.
- In addition to several new and revised end-of-chapter problems, replaced/added new research cases that provide students with real-world applications of financial reporting for business combinations.

Chapter 3

- Added coverage of post-acquisition procedures for excess fair value attributable to subsidiary long-term debt. Moved coverage of pushdown accounting to Chapter 2.
- Added a Discussion Question that addresses worksheet adjustments to the parent's beginning-of-the-year retained earnings.
- Updated real-world references.
- Added an appendix covering *Accounting Standards Update* (ASU 2014-02) to Topic 350, "Intangibles—Goodwill and Other, on Accounting for Goodwill. The ASU provides an external reporting option (i.e., amortization) for private company goodwill accounting. The appendix also covers ASU 2014-18, Accounting for Identifiable Intangible Assets in a Business Combination, an amendment of Business Combinations (Topic 805). The new standards allow private companies an option to simplify their accounting by recognizing fewer intangible assets in future business combinations.
- Added new equity method end-of-chapter problems requiring the preparation of consolidated financial statements subsequent to acquisition. In addition,

changed the facts and requirements in several end-of-chapter problems.
- Added a new research and analysis case on Microsoft's 2015 goodwill impairment loss.

Chapter 4

- Updated real-world references.
- Added two new equity method end-of-chapter problems.
- Added new end-of-chapter cases using the financial reports of Starbucks (step-acquisition example) and Costco (various noncontrolling interest figures and interpretations).
- Revised the end-of-chapter comprehensive FASB ASC and IFRS research case. The new case, entitled *Bardeen Electric,* continues to focus on valuation issues accompanying a business combination including alternative goodwill measurement under IFRS. In addition, several other end-of-chapter problems have been revised.

Chapter 5

- Updated terminology in discussion of intra-entity gross profits to reflect the new revenue recognition standards (ASC 606).
- Revised and expanded coverage of the deferral and subsequent recognition of intra-entity gains on long-term assets transfers across affiliates. The revised exposition emphasizes the nature of reallocating intra-entity gains across time increasing consistency with the chapter's coverage of intra-entity gross profits in inventory.
- Updated real-world references.
- Changed the facts and requirements in several end-of-chapter problems.

Chapter 6

- Updated real-world references.
- Expanded coverage of post-control period reporting for primary beneficiaries and variable interest entities including an example of consolidated statement preparation.
- Added and revised several end-of-chapter problems.

Chapter 7

- Updated real-world references.
- Added coverage of the FASB 2015 *Proposed Accounting Standards Update* on Income Taxes (Topic 740), entitled Intra-Entity Asset Transfers. The proposed accounting would converge the IFRS and U.S. GAAP treatment.
- Updated terminology in discussion of intra-entity gross profits to reflect the new revenue recognition standards (ASC 606).
- Changed the facts and requirements in several end-of-chapter problems.

Chapter 8

- Deleted the section within Interim Reporting related to extraordinary items.
- Added a real-world example of a company with seasonal items.
- Added the name of the relevant international standard to the title of sections on IFRS.
- Removed reference to IFRS from the learning objectives.
- Updated references to actual company practices and excerpts from annual reports.
- Changed the facts in several end-of-chapter problems.

Chapter 9

- Reduced the size of Exhibit 9.1 containing exchange rates for selected countries.
- Rewrote the section now titled Forward Contracts that was previously titled Spot and Forward Rates.
- Moved the section on foreign currency borrowing from the end of the chapter to immediately follow the section on foreign currency transactions.
- Moved the portion of the IFRS section at the end of the chapter that deals with foreign currency transactions to immediately follow the section on foreign currency borrowing.
- Expanded the learning objective related to how forward contracts and foreign currency options can be used to hedge foreign exchange risk to include understanding what types of foreign exchange risk can be hedged.
- Added new learning objectives on the accounting guidelines for derivatives and the basics of hedge accounting.
- Updated real-world references including examples of company practices, excerpts from annual reports, and foreign exchange rates.

- Added language to more clearly explain the impact that the accounting for a derivative financial instrument used to hedge a foreign exchange risk has on financial statements within the examples demonstrating the accounting for various types of foreign currency hedges.
- Updated the section at the end of the chapter that summarizes the accounting for derivative financial instruments under IFRS.
- Changed the facts in several end-of-chapter problems.
- Updated the develop your skills assignments based on actual exchange rates.

Chapter 10

- Updated references to actual company practice and related excerpts from annual reports.
- In the section on Exchange Rates Used in Translation, added instruction to first read the related Discussion Question before continuing.
- Removed reference to the theoretical possibility of translating income statement items at the current exchange rate.
- Removed reference to a research study published in 1988 that investigated the weighting of functional currency indicators.
- Moved the section on IFRS from the end of the chapter to immediately after the section describing U.S. authoritative literature.
- Changed facts in several end-of-chapter problems.

Chapter 11

- Updated real-world references.
- Removed the discussion of culture as a reason for accounting diversity and the section "A General Model of the Reasons for International Differences in Financial Reporting."
- Expanded discussion of results from the FASB-IASB convergence process to include a new exhibit summarizing successful convergence projects.
- Added a section on "IFRS for SMEs."
- Added a section on the "Relevance of IFRS for U.S. Accountants."
- Removed the section "U.S. GAAP Reconciliations."
- Added a major new section focusing on the "Conversion of IFRS Financial Statements to U.S. GAAP."
- Deleted the section "A Principles-Based Approach to Standard Setting."
- Revised the Comprehensive Illustration to show the process for determining conversion worksheet entries necessary to convert from IFRS to U.S. GAAP for nine differences between the two sets of standards.
- Added several new questions related to material added to the chapter.
- Added several new problems focusing on the conversion of IFRS to U.S. GAAP.
- Deleted the end-of-chapter case related to "Voluntary Adoption of IFRS" and added a new case related to "IFRS Website."

Chapter 12

- Updated SEC data and Registration Statement exemptions.
- Updated SEC division information.
- Updated web link references as necessary.
- Revised end-of-chapter material.

Chapter 13

- Added discussion of reporting issues that companies face as the possibility of bankruptcy grows, such as the need to test goodwill and other assets for impairment and the possibility that a valuation allowance is required to offset any deferred income tax assets.
- Presented coverage of new FASB pronouncement: *Accounting Standards Update 2014-15* ("Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern") which provides accounting and reporting guidance if the possibility arises that substantial doubt exists as to whether a company will be able to remain a going concern.
- Included additional discussion about the liquidation basis of accounting, including examples of the necessary financial statements.
- Revised references to include companies that have recently experienced bankruptcy and liquidation such as RadioShack.

Chapter 14

- Revised tables showing the allocation of partnership income/loss across partners to provide additional emphasis on the step-by-step nature of the income distribution across partners.

- Changed the facts and requirements in several end-of-chapter problems.

Chapter 15

- Split an existing end-of-chapter problem with two unrelated parts into two separate problems.
- Added a new end-of-chapter problem related to learning objectives LO 15-2 and LO 15-5.
- Changed the facts and requirements in several end-of-chapter problems.

Chapter 16

- Updated numerous references to the financial statements of a wide variety of state and local governments such as the City of Baltimore, the City of Houston, the City of Charlotte, and the City of Dallas.

Chapter 17

- Provided coverage of new pronouncement: *GASB Statement No. 76,* "The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments."
- Provided coverage of new pronouncement: *GASB Statement No.* 77, "Tax Abatement Disclosures."
- Updated references to the financial statements of state and local governments such as the City of Los Angeles, the City of Chicago, the City of Orlando, and the City of Boston.

Chapter 18

- Discussed the potential implications of FASB's current projects on the presentation and disclosure of financial statements by not-for-profit entities
- Updated numerous references to the financial statements of a wide variety of private not-for-profit entities such as ChildFund International, Girl Scouts of the United States of America, American Heart Association, and Georgetown University.

Chapter 19

- Updated tax code references, numbers, and statistics.
- Included coverage of the American Taxpayer Relief Act of 2012.
- Revised web links in footnote references as appropriate.
- Revised end-of-chapter material reflecting changes from the chapter.

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 *Advanced Accounting, 13e.*

Thinking Critically

With this text, students gain a well-balanced appreciation of the accounting profession. As *Hoyle 13e* 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 12 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
AT&T	DirecTV
Berkshire Hathaway, Inc.	Precision Castparts
Visa, Inc.	Visa Europe Ltd
Facebook, Inc.	WhatsApp
MeadWestvaco	RockTenn
Intel Corporation	Altera Corporation
CVS Health Corporation	Omnicare, Inc.
Marriott	Starwood Hotels Int
Merck	Cubist
Weyerhaeuser	Plum Creek Timber
Celgene Corporation	Receptos, Inc.
Cox Automotive	Dealertrack Techno
FedEx	TNT Express
Expedia	HomeAway
Microsemi Corporation	PMC-Sierra, Inc.
Constellation Brands	Ballast Point Brewin

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-CONTROL

In Berkshire Hathaway's 2012 annual report, Wa
post-control step acquisitions of Marmon Holdings, In

Marmon provides an example of a clear and su
value and intrinsic value. Let me explain the odd
Last year I told you that we had purchased ac
ownership to 80% (up from the 64% we acquire

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 13th Edition Features

CPA Simulations

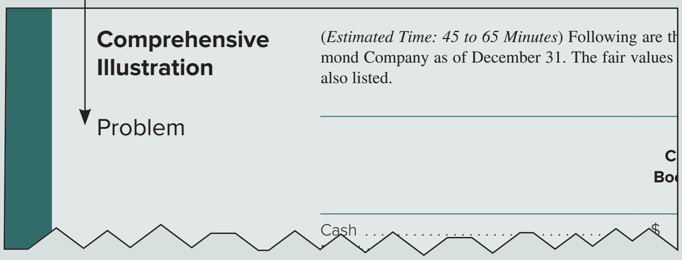
Hoyle 13e provides instructors and students access to CPA Simulations that correspond to several key topics and chapters throughout the text. Students can complete these simulations online, allowing them to practice advanced accounting concepts in a web-based interface that mimics the actual CPA exam. 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.

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 test and, therefore, **expand the students' knowledge** of chapter concepts.

Excel Spreadsheet Assignments extend specific problems and are located on the 13th edition Instructor Resources page, with templated versions that can be provided to students for assignments. An Excel icon appears next to those problems that have corresponding spreadsheet assignments.

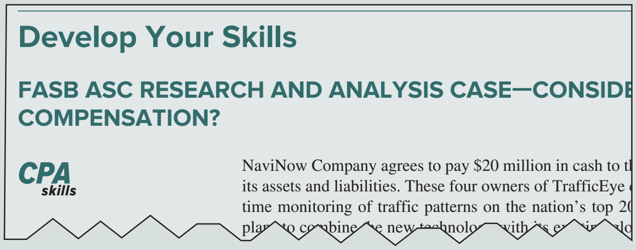
"Develop Your Skills" asks questions that address the four skills students need to master to pass the CPA exam: Research, Analysis, Spreadsheet, and Communication. An icon indicates when these skills are tested.


Comprehensive Illustration

Problem

(*Estimated Time: 45 to 65 Minutes*) Following are th
mond Company as of December 31. The fair values
also listed.

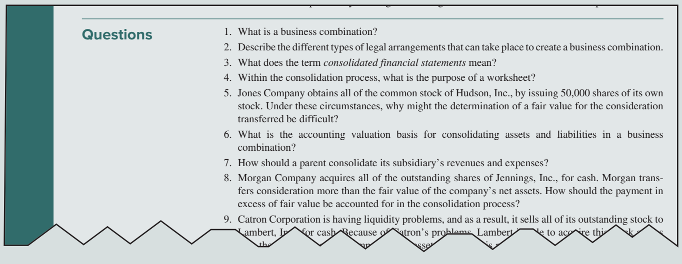
Cash . . . . $


Develop Your Skills

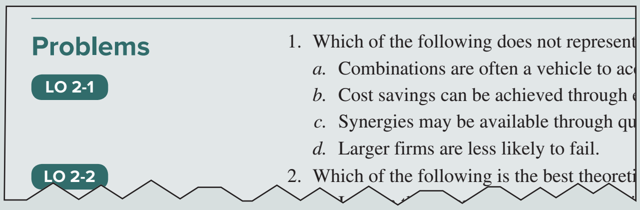
**FASB ASC RESEARCH AND ANALYSIS CASE—CONSIDE
COMPENSATION?**

CPA skills

NaviNow Company agrees to pay $20 million in cash to t
its assets and liabilities. These four owners of TrafficEye
time monitoring of traffic patterns on the nation's top 2


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 payment in excess of fair value be accounted for in the consolidation process?
9. Catron Corporation is having liquidity problems, and as a result, it sells all of its outstanding stock to


Problems

LO 2-1

1. Which of the following does not represent
   a. Combinations are often a vehicle to ac
   b. Cost savings can be achieved through
   c. Synergies may be available through qu
   d. Larger firms are less likely to fail.

LO 2-2

2. Which of the following is the best theoreti

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- **(New for 13e!) SmartBook**® is the market-leading adaptive study resource that is proven to strengthen memory recall, increase retention, and boost grades. SmartBook, powered by LearnSmart, is the first and only adaptive reading experience designed to change the way students read and learn. SmartBook delivers a personalized reading experience by highlighting the most impactful concepts a student needs to learn at that moment in time. As a student engages with SmartBook, the reading experience continuously adapts by highlighting content based on what the student has mastered or is ready to learn. This ensures that the student stays focused on the content he or she needs to learn, while simultaneously promoting long-term retention of material. Both students and Instructors can use SmartBook's real-time reports to quickly identify the concepts that require more attention from individual students—or the entire class. The end result? Students are more engaged with course content, can better prioritize their time, and come to class ready to participate.
- The **End-of-Chapter Content** in Connect provides a robust offering of review and question material designed to aid and assess the student's retention of chapter content. The End-of-Chapter content is composed of both static and algorithmic versions of the problems in each chapter, which are designed to challenge students using McGraw-Hill Education's state-of-the-art online homework technology. Connect helps students learn more efficiently by providing feedback and practice material when and where they need it. Connect grades homework automatically, and students benefit from the immediate feedback that they receive, particularly on any questions they may have missed.

Example of End-of-Chapter Problem

Prepare a consolidated balance sheet for Pratt and Spider as of December 31, 2018.

PRATT COMPANY AND SUBSIDIARY Consolidated Balance Sheet December 31, 2018			
Assets		**Liabilities and Owners' Equity**	
Cash			
Total assets		Total liabilities and equities	

- The **Test Bank** for each chapter has been updated for the 13th edition to stay current with new and revised chapter material, with all questions available for assignment through Connect. Instructors can also create tests and quizzes from the Test Bank through our TestGen software, which is available on the Instructor Resources page.
- The **Instructor and Student Resources** have been updated for the 13th edition and are available in the Connect Instructor Resources page. Available resources include Instructor and Solutions Manuals, PowerPoint presentations, Test Bank files, Excel templates, and Chapter Check Figures. All applicable Student Resources will be available in a convenient file that can be distributed to students for classes either directly, through Connect, or via courseware.

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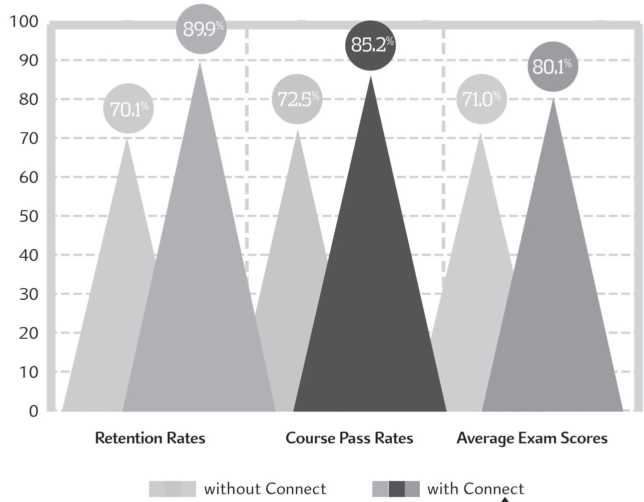

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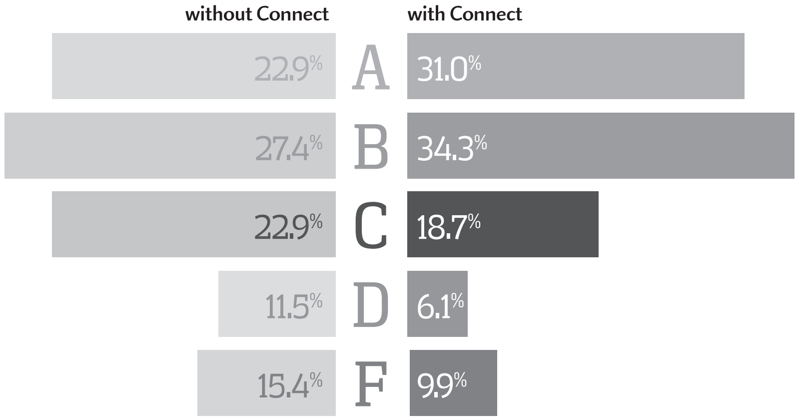
Impact on Final Course Grade Distribution



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*Findings based on 2015 focus group results administered by McGraw-Hill Education

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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 know the guidelines to assess whether the criterion is met.

LO 1-3 Describe the financial reporting for equity method investments and prepare basic equity method journal entries for an investor.

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's other comprehensive income.
c. Investee losses.
d. Sales of equity method investments.

LO 1-6 Describe the rationale and computations to defer the investor's share of gross profits on intra-entity inventory sales until the goods are either consumed by the owner 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 28 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.

Generally accepted accounting principles (GAAP) recognize four different approaches to the financial reporting of investments in corporate equity securities:

1. Fair-value method.
2. Cost method for equity securities without readily determinable fair values.
3. Consolidation of financial statements.
4. 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 321, "Investments—Equity Securities."

Fair value is defined by the ASC (Master Glossary) as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." For most investments in equity securities, quoted stock market prices represent fair values.

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.
- Changes in the fair values of equity securities during a reporting period are recognized as income.[2]
- Dividends declared on the equity securities are recognized as income.

The above procedures are followed for equity security investments (with readily determinable fair values) when the owner possesses neither significant influence nor control.

Cost Method (Investments in Equity Securities without Readily Determinable Fair Values)

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. Such investments sometimes can be found in ownership shares of firms that are not publicly traded or experience only infrequent trades.

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

[2] FASB Accounting Standards Update (ASU) No. 2016-01, Financial Instruments—Overall, requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, unless fair values are not readily determinable. Thus, the previous available-for-sale category with fair value changes recorded in other comprehensive income will no longer be available. The ASU is effective for fiscal years beginning after December 15, 2017, with early adoption permitted.

Investments in equity securities that employ the cost method often continue to be reported at their original cost over time.[3] Income from cost method equity investments usually consists of the investor's share of dividends declared by the investee. However, despite its emphasis on cost measurements, GAAP allows for two fair value assessments that may affect cost method amounts reported on the balance sheet and the income statement.

- First, cost method equity investments periodically must be assessed for impairment to determine if the fair value of the investment is less than its carrying amount. The ASC allows a qualitative assessment to determine if impairment is likely.[4] Because the fair value of a cost method equity investment is not readily available (by definition), if impairment is deemed likely, an entity must estimate a fair value for the investment to measure the amount (if any) of the impairment loss.
- Second, ASC (321-10-35-2) allows for recognition of "observable price changes in orderly transactions for the identical or a similar investment of the same issuer." Any unrealized holding gains (or losses) from these observable price changes are included in earnings with a corresponding adjustment to the investment account. So even if equity shares are only infrequently traded (and thus fair value is not readily determinable), such trades can provide a basis for financial statement recognition under the cost method for equity investments.

Consolidation of Financial Statements

Many corporate investors acquire enough shares to gain actual control over an investee's operations. In financial accounting, such control may be achieved when a stockholder accumulates more than 50 percent of an organization's outstanding voting stock. At that 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.[5] 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. 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 that they owned little or no voting stock in but otherwise 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.

[3] 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.

[4] Impairment indicators include assessments of earnings performance, economic environment, going-concern ability, etc. If the qualitative assessment does not indicate impairment, no further testing is required. If an equity security without a readily determinable fair value is impaired, the investor recognizes the difference between the investment's fair value and carrying amount as an impairment loss in net income (ASC 321-10-35-3).

[5] As discussed in Chapter 2, ownership of a majority voting interest in 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?

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 28 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 records its share of investee dividends declared as a decrease 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.

Finally, as discussed at the end of this chapter, firms may elect 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:[6]

> 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.

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 common 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 ever be 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.

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

- 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.[7]

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) 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:[8]

- 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. For example, the Walt Disney Company reclassified several former equity method investees as variable interest entities and now consolidates these investments.[9]

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

[8] 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.

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

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, The Coca-Cola Company acquired a 16.7 percent investment in Monster Beverage Corporation in 2015. Coca-Cola notes in its annual 2015 financial statements that "Based on our equity ownership percentage, the significance that our expanded distribution and coordination agreements have on Monster's operations, and our representation on Monster's Board of Directors, the Company is accounting for its interest in Monster as an equity method investment."

Conditions can also exist where the equity method is appropriate despite a majority ownership interest. In some instances, 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:

Criterion	Normal Ownership Level	Applicable Accounting Method
Inability to significantly influence	Less than 20%	Fair value or cost method
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

LO 1-3

Describe the financial reporting for equity method investments and prepare basic equity method journal entries for an investor.

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 investment and investment income to reflect the close relationship between the investor and investee. 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 recognizes and reports income.* Also, the investor recognizes investment income using the accrual method—that is, in the same period as reported by the investee in its financial statements. 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. The investor reduces the investment account if the investee reports a loss.

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 recognizes 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 recognized.	Proportionate share of income is recognized.
Dividends are declared.	Investor's share of investee dividends reduce the investment account.

Application of the equity method thus causes the investment account on the investor's balance sheet to vary directly with changes in the investee's equity.

In contrast, the fair-value method reports investments at fair value if it is readily determinable. Also, income is recognized both from changes in fair value and 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, 2017, for $210,000. 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 $245,000, $282,000, and $325,000 at the end of 2017, 2018, and 2019, 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. Income is recognized both through changes in Little's fair value and as Little declares dividends.

In contrast, under the equity method, Big recognizes income as it is recorded by Little. As shown in Exhibit 1.1, Big recognizes $180,000 in income over the three years, and the

EXHIBIT 1.1 Comparison of Fair-Value Method (ASC 321) and Equity Method (ASC 323)

			Accounting by Big Company When Influence Is Not Significant (fair-value method)			Accounting by Big Company When Influence Is Significant (equity method)	
Year	Income of Little Company	Dividends Declared by Little Company	Dividend Income	Fair-Value Change to Income	Carrying Amount of Investment	Equity in Investee Income*	Carrying Amount of Investment†
2017	$200,000	$ 50,000	$10,000	$ 35,000	$ 245,000	$ 40,000	$240,000
2018	300,000	100,000	20,000	37,000	282,000	60,000	280,000
2019	400,000	200,000	40,000	43,000	325,000	80,000	320,000
Total income recognized			$70,000	$115,000		$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 2017, as an example, the $240,000 reported balance is the $210,000 cost plus $40,000 equity income less $10,000 in dividends.

carrying amount of the investment is adjusted upward to $320,000. 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 records 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 recognized 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.

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 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.[10]

Referring again to the information presented in Exhibit 1.1, Little Company reported a net income of $200,000 during 2017 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.

Excess of Investment Cost over Book Value Acquired

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.

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 occurs when the investment cost exceeds the proportionate book value of the investee company.[11]

[10] 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.

[11] 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.