

CONCEPT: EQUITY METHOD INVESTMENTS

- When we have significant influence over another company, GAAP requires the use of the **equity method**
 - *No influence* → _____ % ownership of common stock → use _____ method
 - If you own just a few shares of a company, you cannot influence any decision-making at that company
 - *Significant Influence* → _____ % ownership of common stock → use _____ method
 - With enough common stock, you can influence who is voted onto the decision-making board of directors
 - *Controlling interest* → _____ % ownership of common stock → use _____ method
 - With enough common stock, you can sway all the votes and have complete control of the company
 - Consolidation accounting is beyond the scope of this course
- The **equity method** of accounting has four common journal entries that are made:
 - **Purchase of Investment** – when your company purchases enough shares to have significant influence
 - **Net Income/Loss of Investee** – your investment income is based on the net income/loss of the investee
 - **Dividends Received** – dividends received are _____ investment income in the equity method
 - **Sale of Investment** – when you sell your investment, you take a gain/loss
 - The amount of gain/loss is based on the difference between the selling price and book value
- A journal entry is recorded when the equity method investment is **purchased**:

On January 1, Year 1, Big Old Company purchased 50,000 shares of Small Boy Company's 125,000 outstanding shares of common stock at a market price of \$25 per share.

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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$$\text{Investment Income} = \% \text{ Ownership} * \text{Net Income of Investee}$$

- The company earns **investment income** based on their percentage ownership of the investee's net income:

On December 31, Year 1, Small Boy Company reported a net income of \$560,000..

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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- The company can also have an **investment loss** based on their percentage ownership of the investee's net loss:

On December 31, Year 2, Small Boy Company reported a net loss of \$100,000..

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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- The company **reduces their investment asset** based on their percentage of investee dividends received:

In January Year 3, Small Boy Company declared and paid dividends of \$420,000.

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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- Use a T-account to keep track of the balance in the Investment Asset account:

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- The company reports a **gain on sale of investment** if the selling price _____ the book value of the investment:

On January 2, Year 3, Big Old Company sold its investment in Small Boy Company for \$1,400,000..

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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- The company reports a **loss on sale of investment** if the selling price _____ the book value of the investment:

On January 2, Year 3, Big Old Company sold its investment in Small Boy Company for \$1,100,000..

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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PRACTICE: On January 3, Johnson Corp acquired 35% of the outstanding common stock of Small Company for \$350,000. For the year ended December 31, Small Company reported net income of \$150,000 and paid cash dividends of \$70,000 on its common stock. At December 31, the carrying value of Johnson Corp's investment in Small Company under the equity method is:

- a) \$322,000
- b) \$350,000
- c) \$378,000
- d) \$398,000

PRACTICE: On January 4, The Jones Company purchased 35,000 out of the 87,500 outstanding shares of Miller Company for \$400,000. During the year, the Miller Company reported net income of \$240,000 and paid cash dividends of \$60,000, while the Jones Company reported net income of \$450,000 and paid cash dividends of \$80,000. What is the carrying value of Jones Company's investment in Miller Company at the end of the year under the equity method?

- a) \$400,000
- b) \$472,000
- c) \$496,000
- d) None of the above

PRACTICE: GT Company owns 9,000 of the 48,000 shares of outstanding common stock of Bell Company. GT Company should account for this investment using the:

- a) Market method
- b) Equity method
- c) Lower-of-cost-or-market method
- d) Consolidation method