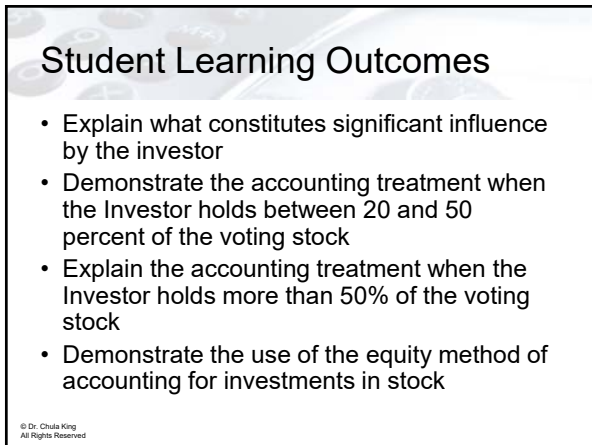


Chapter 12 – Investments Part 2: Investor has Significant Influence

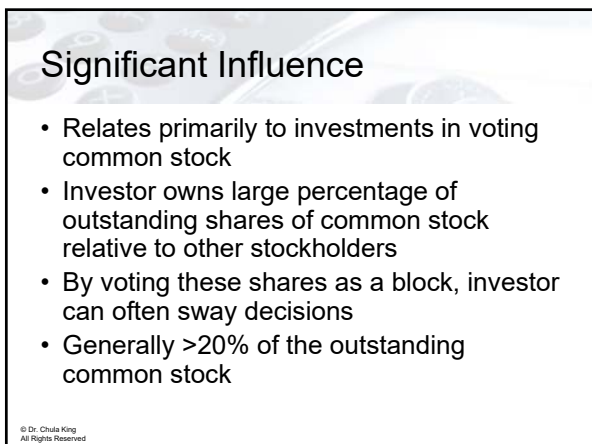
Intermediate Accounting II
Dr. Chula King



Student Learning Outcomes

- Explain what constitutes significant influence by the investor
- Demonstrate the accounting treatment when the Investor holds between 20 and 50 percent of the voting stock
- Explain the accounting treatment when the Investor holds more than 50% of the voting stock
- Demonstrate the use of the equity method of accounting for investments in stock

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Significant Influence

- Relates primarily to investments in voting common stock
- Investor owns large percentage of outstanding shares of common stock relative to other stockholders
- By voting these shares as a block, investor can often sway decisions
- Generally >20% of the outstanding common stock

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Ownership Interest

- < 20%: Part 1
- Between 20% and 50%: Equity method
- >50%: Consolidate financial statements (subject of Advanced Accounting)

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Single Entity Concept

- Under the Equity Method
 - The investor recognizes investment income equal to its percentage share of the net income earned by the investee rather than the portion of net income received as cash dividends
 - Initially, the investment is recorded at cost. The carrying value of the investment is
 - Increased by investor's percentage share of investee's net income (or decreased by share of loss)
 - Decreased by investor's percentage share of dividends paid by investee

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Purchase of Investment

- Recorded at cost.
- For example: On January 1, 2018, Apex, Inc., purchased 30% of XYZ common stock for \$1,500,000 cash.

Investment in XYZ stock	1,500,000
Cash	
1,500,000	

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Adjustments to Investment

- XYZ paid dividends of \$250,000
 - XYZ's net income was \$500,000
- | | |
|-------------------------|---------|
| Cash (30% x 250,000) | 75,000 |
| Investment in XYZ stock | 75,000 |
| Investment in XYZ Stock | 150,000 |
| Investment Revenue | 150,000 |
| (30% x 500,000) | |

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Additional Consideration

- Equity method, investor recognizes percentage share of investee's net income, which is based on book values
- Adjusts Investment Revenue for change in net income as indicated by fair market value of net assets.

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What the "Cost of Investment" Represents

- % ownership of the fair market value of the underlying net assets of the acquired company's stock
- Assets – Liabilities = Equity
- 30% x Equity = 30% x (Assets – Liabilities)
- 30% Total value of XYZ = \$1,500,000
- Total value of XYZ = 1,500,000 ÷ 30% = \$5,000,000

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To Continue the Example

January 1, 2018, the book value and fair values of XYZ's net assets are as follows:

Account	Book Value	Fair Value
Buildings (10-year remaining life, no salvage value)	\$1,000,000	\$1,800,000
Land	500,000	1,200,000
Other net assets (other assets – liabilities)	600,000	600,000
Total	<u>\$2,100,000</u>	<u>\$3,600,000</u>
Goodwill		1,400,000
Total		<u>\$5,000,000</u>
XYZ's 2018 Dividends	\$250,000 x 30% = \$ 75,000	
XYZ's 2018 Net Income	500,000 x 30% = \$150,000	

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To Continue the Example

Investment in XYZ Stock	150,000
Investment Revenue	150,000
(30% x 500,000)	
• Additional Depreciation: $30\% \times [(1,800,000 - 1,000,000) \div 10] = 24,000$	
Investment Revenue	24,000
Investment in XYZ Stock	24,000

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Change from Equity Method

- Appropriate when investor's level of influence changes such that significant influence is no longer present
- Fair Value Through Net Income category
- At the transfer date, the carrying value of the investment under the equity method becomes the "cost" of the security

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Change to the Equity Method

- Appropriate when investor's level of influence changes such that significant influence is now present
- At the date of change, the balance in the investment, including any unrealized holding gains or losses is used as the starting balance for applying the equity method.
- Going forward, that balance is adjusted for the investor's portion of investee earnings and dividends.

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Comparison

Issue	No Significant Influence	Significant Influence (Equity Method)
Acquisition	Record at cost	Record at cost
Receipt of dividends	Record as revenue: Cash xxx Invest Rev xxx	Record as reduction in Investment account: Cash xxx Investment xxx
Investee's Net Income	No impact	Record % share of investee's net income Investment xxx Invest Rev xxx
Change in value	Recognized, with the impact going to Net Income	No impact

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Fair Value Option

- Companies can choose the fair value option for significant influence investments that would otherwise be accounted for under the equity method.
- Fair value option is determined for each individual investment, and is irrevocable
- Investment is still classified on the balance sheet with equity method investments, but the portion at fair value must be clearly indicated

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The Next Step

- Exercises 19, 22, 23
- Problems 10, 12

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