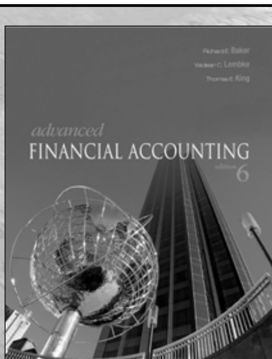


Chapter 2

Reporting Intercorporate Interest

Reporting Intercorporate Interest

- This chapter presents the accounting and reporting procedures for investments in common stock and for selected other types of interests in other entities.

Reporting Intercorporate Interest

- Some companies invest in other companies simply to earn a favorable return by taking advantage of potentially profitable situations.
- As indicated in the next slide, there are various other reasons that companies invest in other companies.

Reporting Intercorporate Interest

- **Reasons Companies Invest in Other Companies:**
  - **Gain control over other companies**
  - **Enter new market or product areas through companies established in those areas**
  - **Ensure a supply of raw materials or other production inputs**
  - **Ensure a customer for production output**
  - **Gain economies associated with greater size**
  - **Diversity**
  - **Gain new technology**
  - **Lessen competition**
  - **Limit risk**

Reporting Intercorporate Interest

- Examples of intercorporate investments include:
  - IBM’s acquisition of a sizable portion of Intel’s stock to ensure a supply of components.
  - AT&T’s purchase of the stock of McCaw Cellular Communications to gain a foothold in the cellular phone market.
  - Texaco’s acquisition of Getty Oil’s stock to acquire oil and gas reserves.

Investments in Common Stock

- The method used to account for investments in common stock depends on the level of influence or control that the investor is able to exercise over the investee.
- The level of influence is the primary factor determining whether the investor and investee will present consolidated financial statements or the investor will report the investment in common stock in its balance sheet using either the cost method (adjusted to market value, if appropriate) or the equity method.

Investments in Common Stock

- Consolidation involves the combining for financial reporting the individual assets, liabilities, revenues, and expenses of two or more related companies as if they were part of a single company.
- This process includes the elimination of all intercompany ownership and activities (such as intercompany sales and purchases, and intercompany loans).

2-7

Investments in Common Stock

- Consolidation is normally appropriate where one company, referred to as the parent, controls another company, referred to as the subsidiary.
- An unconsolidated subsidiary should be reported as an investment on the parent's balance sheet. Unconsolidated subsidiaries are relatively rare.
- The specific requirements for consolidation are discussed in Chapter 3.

2-8

Investments in Common Stock

- The equity method is used for external reporting when the investor exercises significant influence over the operating and financial policies of the investee and consolidation is not appropriate.
- The equity method may not be used in place of consolidation when consolidation is appropriate, and therefore its primary use is in reporting nonsubsidiary investments.
- The equity method is used most often when one company holds between 20 and 50 percent of another company's common stock.

2-9

Investments in Common Stock

- The cost method is used for reporting investments in nonmarketable equity securities when both consolidation and equity method reporting are inappropriate.
- For marketable equity securities, when both consolidation and equity method reporting are inappropriate, the investment is normally accounted for using the cost method and adjusted to market value under **FASB 115**.
- **FASB 115** is not applicable to equity method investments.

2-10

Accounting During the Year Versus Reporting at Year End

- Under normal circumstances, companies using the cost or equity for financial reporting purposes "at year end" also use that method for accounting for the investment on their books "during the year."
- As discussed next, this is not the case with respect to companies required to consolidate their investments in subsidiaries for financial reporting purposes.

2-11

Accounting During the Year Versus Reporting at Year End--Continued

- When consolidated financial statements are prepared for financial reporting purposes "at year end," the parent still must account for the investment in the subsidiary "during the year" (on its books) using the cost or equity method even though the intercorporate investment and related income must be eliminated in preparing the consolidated statements "at year end."

2-12

Cost Method—Influence Not Significant (0 to 20 percent)

- Intercorporate investments accounted for by the cost method are carried by the investor at historical cost.
- Income is recorded by the investor when dividends are declared by the investee.
- The cost method is used when the investor lacks the ability either to control or to exercise significant influence over the investee.

2-13

Cost Method—Influence Not Significant (0 to 20 percent)

- At the time of purchase, the investor records its investment in common stock at the total cost incurred in making the purchase.
- After the time of purchase, the carrying amount of the investment (i.e., the original cost) remains unchanged under the cost method until the time of sale (or unless there is a liquidating dividend—more on this later).

2-14

Cost Method—Influence Not Significant (0 to 20 percent)

- Once the investee declares a dividend, the investor has a legal claim against the investee for a proportionate share of the dividend and realization of the income is considered certain enough to be recognized.
- Recognition of investment income before a dividend declaration is considered inappropriate because the investee's income is not available to the owners until a dividend is declared—dividends do not accrue!!!

2-15

Cost Method—Example

- ABC Company purchases 20 percent of XYZ Company's common stock for $100,000 at the beginning of the year but does not gain significant influence over XYZ.

Investment in XYZ Company Stock	$100,000	
Cash		$100,000

2-16

Cost Method—Example

- During the year, XYZ has net income of $50,000 and pays dividends of $20,000.

Cash ($20,000 X .20)	$4,000	
Dividend Income		$4,000

NOTE: Liquidating dividends are discussed next.

2-17

Cost Method—Liquidating Dividends

- All dividends declared by the investee--in excess of its earnings since acquisition by the investor--are viewed by the investor as **liquidating dividends.**
- In the previous example, if XYZ had no earnings, all dividends would have been viewed by ABC as liquidating dividends.

[Continued on next slide.]

2-18

Cost Method—Liquidating Dividends

- In turn, "Investment in XYZ Company Stock" would be credited in lieu of "Dividend Income."
- Cash ($20,000 X .20) $4,000
  Investment in XYZ
  Common Stock $4,000

2-19

The Equity Method—Significant Influence (20 to 50 percent)

- **APB 18** (as amended) provides the professional guidance regarding the equity method. The equity method of accounting for intercorporate investments in common stock is intended to reflect the investor's changing equity or interest in the investee.
- The equity method is a rather curious one in that the balance in the investment account generally does not reflect either cost or market value, nor does the balance necessarily represent a pro rata share of the investee's book value.

2-20

The Equity Method—Significant Influence (20 to 50 percent)

- Under the equity method, the investor records its investment at the original cost.
- This amount is adjusted periodically for changes in the investee's stockholders' equity occasioned by the investee's profits (or losses) and dividend declarations.

2-21

The Equity Method—Significant Influence (20 to 50 percent)

Reported by Investee:	**Effect On Investor:**
– **Net Income (Loss)**	– **Record income (loss) from investment and increase (decrease) investment account.**
– **Dividend Declaration**	– **Record asset (cash or receivable) and decrease investment account.**

2-22

The Equity Method—Equity Accrual

- Assume ABC Company acquires significant influence over XYZ Company by purchasing 20 percent of the common stock of the XYZ Company at the beginning of the year. XYZ Company reports income for the year of $60,000. ABC records its $12,000 share of XYZ's income with the following entry:

Investment in XYZ
Company Stock ($60,000 X .2) $12,000
Income from Investee $12,000

2-23

Equity Method—Significant Influence

- Because of the ability to exercise significant influence over the policies of the investee, realization of income from the investment is considered to be sufficiently assured to warrant recognition by the investor as the income is earned by the investee.
- This differs from the case in which the investor does not have the ability to significantly influence the investee and the investment must be reported using the cost method; in that case, income form the investment is recognized only upon declaration of a dividend by the investee.

2-24

Equity Method—Recognition of Dividends

- Dividends from an investment are not recognized as income under the equity method because the investor's share of the investee's income is recognized as it is earned by the investee.
- Instead, such dividends are viewed as distributions of previously recognized income that already has been capitalized in the carrying amount of the investment.

2-25

Equity Method—Recognition of Dividends

- In effect, all dividends from the investee are treated as liquidating dividends under the equity method. Thus, if ABC Company owns 20 percent of XYZ's common stock and XYZ declares and pays a $20,000 dividend, the following entry is recorded on the books of ABC to record its share of the dividend:

Cash ($20,000 X .20)	$4,000	
Investment in XYZ Company Stock		$4,000

2-26

Equity Method—Acquisition at Interim Date

- When an investment is purchased, the investor begins accruing income from the investee under the equity method at the date of acquisition.
- No income earned by the investee before the date of acquisition of the investment may be accrued by the investor.

2-27

Equity Method—Acquisition at Interim Date (Continued)

- When the purchase occurs between balance sheet dates, the amount of income earned by the investee from the date of the acquisition to the end of the fiscal period may need to be estimated by the investor in recording the equity accrual.
- For example, if the acquisition (20 percent interest) was transacted on October 31 and the investee earned $60,000 for the entire year, the investor would have an equity accrual of $3,000 (i.e., $60,000 X .20 X 3/12 = $3,000).

2-28

Equity Method—Acquisition at Interim Date (Continued)

- WARNING: Watch out for "liquidating dividends" when acquisitions are transacted at interim dates.

2-29

Investment Cost Versus Underlying Book Value

- When one corporation buys the common stock of another, the purchase price normally is based on the market price of the shares acquired rather than the book values of the investee's assets and liabilities.
- As a result, there often is a difference between the cost of the investment to the investor and the book value of the investor's proportionate share of the underlying net assets of the investee.
- This difference is referred to as a differential.

2-30

Investment Cost Versus Underlying Book Value

- The differential represents the amount paid by the investor in excess of the book value of the investment and is included in the investment amount.
- Hence, the amortization or reduction of the differential involves the reduction of the investment account.
- At the same time, the investor's net income must be reduced by an equal amount to recognize that a portion of the amount paid for the investment has expired.

2-31

Investment Cost Versus Underlying Book Value

- There are several reasons the cost of an investment might exceed the book value of the underlying net assets and give rise to a positive differential.
- One reason is that the investee's assets may be worth more than their book value.
- Another reason could be the existence of unrecorded goodwill associated with the excess earning power of the investee.

2-32

Investment Cost Versus Underlying Book Value

- Purchase differentials related to a limited life asset (e.g., equipment) should be amortized over the life of the related asset.
- If the purchase differential has a debit balance, the equity method entry to amortize the purchase differential will be the opposite of the "equity accrual" entry, that is, with respect to the accounts debited or credited.
- Examples are provided on next slide.

2-33

Investment Cost Versus Underlying Book Value

- To record equity method income of $9,000 (assumed).

Investment in Investee Company	$9,000	
Income from Investee Company		$9,000

- To amortize debit purchase differential of $4,000 (assumed).

Income from Investee Company	$4,000	
Investment in Investee Company		$4,000

2-34

Investment Cost Versus Underlying Book Value

- Any portion of the differential that is related to land is not amortized since land has an unlimited life.
- Any portion of the differential that represents goodwill (referred to as equity method goodwill) is neither amortized nor written down for impairment.
- However, an impairment loss on the investment itself should be recognized if it suffers a decline in the value that is other than temporary.

2-35

Disposal of Differential-Related Assets

- If the investee disposes of any asset to which the differential relates, that portion of the differential must be removed from the investment account on the investor's books.
- When this is done, the investor's share of the investee's gain or loss on disposal of the asset must be adjusted to reflect the fact that the investor paid more for its proportionate share of that asset than did the investee.

2-36

Impairment of Investment Value

- As with many assets, accounting standards require that equity-method investments be written down if their value is impaired.
- If the market value of the investment declines materially below its equity-method carrying amount, and the decline in value is considered other than temporary, the carrying amount of the investment should be written down to the market value and a loss recognized.

2-37

Impairment of Investment Value-con'd

- The new lower value serves as a starting point for continued application of the equity method.
- Subsequent recoveries in the value of the investment may not be recognized.

2-38

Changes in Number of Shares Held

- A change in the number of common shares held by an investor resulting from a stock dividend, split, or reverse split is treated in the same way as under the cost method. No formal accounting recognition is required on the books of the investor.
- On the other hand, purchases and sales of shares do require formal recognition.

2-39

Purchases of Additional Shares

- A purchase of additional shares of common stock already held by an investor and accounted for using the equity method simply involves adding the cost of the new shares to the investment account and applying the equity method in the normal manner from the date of acquisition forward. The new and old investments in the same stock are combined for financial reporting purposes.
- Income accruing to the new shares can be recognized by the investor only from the date of acquisition forward.

2-40

Determination of Significant Influence

- The general rule established in **APB 18** is that the equity method is appropriate where the investor, by virtue of its common stock interest in an investee, is able to exercise significant influence over the operating and financial policies of the investee.
- In the absence of other evidence, common stock ownership of 20 percent or more is viewed as indicating that the investor is able to exercise significant influence over the investee.

2-41

Investments in Partnerships

- Pronouncements of the FASB generally relate to corporations rather than partnerships. Thus, companies holding equity investments in partnerships generally have more flexibility but less guidance in reporting their investments.
- Companies with ownership interests in partnerships typically choose one of the following methods for reporting investments: cost method, equity method, consolidation, or pro-rata consolidation.

2-42

Unrealized Intercompany Profits

- Under **APB 18**, intercompany sales do not result in the realization of income until the intercompany profit is confirmed in some way, usually through a transaction with an unrelated party. Thus, unrealized intercompany profits must be eliminated from both consolidated financial statement amounts as well as equity method amounts.
- The term for the application of the equity method that includes the adjustment for unrealized intercompany profits is "**fully adjusted equity method**."

2-43

Unrealized Intercompany Profits

- Unrealized intercompany profits overstate earnings. Thus the equity method entry to remove the unrealized profit will be the opposite of the "equity accrual" entry, that is, with respect to the accounts debited or credited.
- Examples are provided on the next slide.

2-44

Unrealized Intercompany Profits

- To record equity method income of $9,000 (assumed).

Investment in Investee Company	$9,000	
Income from Investee Company		$9,000

- To remove unrealized intercompany profit of $2,000 (assumed).

Income from Investee Company	$2,000	
Investment in Investee Company		$2,000

2-45

Chapter Three to Chapter Ten

- Three different approaches are followed by companies (in practice) in accounting for their consolidated subsidiary during the year:
  - The fully adjusted equity method (a.k.a., the equity method).
  - The basic equity method.
  - The cost method.

2-46

Chapter Three to Chapter Ten

- The cost method and the fully adjusted equity method (a.k.a., the equity method) were previously discussed in this chapter.
- The basic equity method is used in Chapters 3 to 10 and is discussed in the next slide.

2-47

Chapter Three to Chapter Ten

- In essence, the basic equity method is a modified version of the equity method discussed in this chapter.
- Specifically, the basic equity method avoids "unrealized profit transactions" that will be eliminated during the consolidation process.
- While the basic equity method is "Not GAAP," use of the basic equity method may help provide some "clerical savings" for the parent company—as well as students and teachers.

2-48

You Will Survive Chapter 2 !!!

- There are two sets of accounting records (i.e., books) to analyze.
- You should always ask yourself – does the information relate to the investor or the investee or both ?

2-49

You Will Survive Chapter 2 !!!

- If consolidation is required, the investor may be referred to as the “parent company” and the investee may be referred to as the “subsidiary” company.

2-50

You Will Survive Chapter 2 !!!

- The cost method and the equity method are both accounting methods and reporting methods, that is, they are used during the year as well as at year-end, respectively.
- Unless consolidation is required, the investor would usually use the same method for accounting and reporting purposes.
- If consolidation is required, all balances related to either the cost method or the equity method are eliminated when preparing the consolidated financial statements—thus either method may be used during the year.

2-51

You Will Survive Chapter 2 !!!

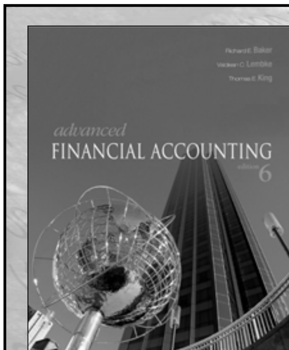
- There is only one “trick” to the cost method—liquidating dividends.
- Remember—dividends do not accrue.
- Remember—only use post-acquisition earnings.

2-52

You Will Survive Chapter 2 !!!

- Think of the equity method in terms of three levels (and start with the bottom level):
  - Top level--Unrealized profits
  - Middle level—Differential
  - Base or bottom level--Book value

2-53



Chapter 2

Reporting Intercorporate Interest

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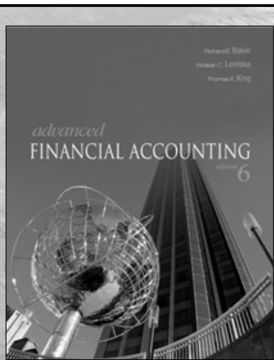

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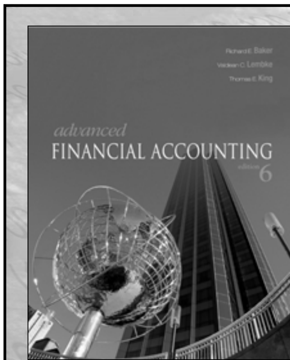

Chapter 2

End of Chapter

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