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Ninth Edition

Fundamentals of **ADVANCED ACCOUNTING**

Hoyle / Schaefer / Douppnik

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Fundamentals of Advanced Accounting

Ninth Edition

Joe B. Hoyle

*Associate Professor of Accounting
Accounting Teaching Fellow
Robins School of Business
University of Richmond*

Thomas F. Schaefer

*Professor Emeritus of Accountancy
Mendoza College of Business
University of Notre Dame*

Timothy S. Douppnik

*Distinguished Professor Emeritus of Accounting
Darla Moore School of Business
University of South Carolina*

**Mc
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FUNDAMENTALS OF ADVANCED ACCOUNTING

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To our families

*The real purpose of books is to trap the
mind into doing its own thinking.*

—Christopher Morley

About the Authors



Courtesy of Joe B. Hoyle

Joe B. Hoyle, *University of Richmond*

Joe B. Hoyle is an associate professor of accounting at the Robins School of Business at the University of Richmond. He is also an Accounting Teaching Fellow. 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.” In 2019, former students raised money to create an Accounting Teaching Fellowship, which will be renamed the “Joe Hoyle Accounting Teaching Fellowship” on his eventual retirement. He has authored a book of essays titled *Tips and Thoughts on Improving the Teaching Process in College*, which is available at <https://facultystaff.richmond.edu/~jhoyle/documents/book-teaching-x.doc.pdf>. 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.



Courtesy of Thomas F. Schaefer

Thomas F. Schaefer, *University of Notre Dame*

Thomas F. Schaefer is a professor emeritus of accountancy at the University of Notre Dame. He has written a number of articles for scholarly journals such as the *Accounting Review*, *Journal of Accounting Research*, *Journal of Accounting & Economics*, *Accounting Horizons*, and others. His primary teaching and research interests are in financial accounting and reporting. Tom is a past president of the American Accounting Association’s Accounting Program Leadership Group. He received the 2007 Joseph A. Silvos Faculty Merit Award from the Federation of Schools of Accountancy and the 2013 Notre Dame Master of Science in Accountancy Dincolo Outstanding Professor Award.



Courtesy of Timothy S. Douplik

Timothy S. Douplik, *University of South Carolina*

Timothy S. Douplik is a distinguished professor emeritus of accounting at the University of South Carolina. His primary teaching interests are in financial and international accounting. Tim has published extensively in the area of international accounting in journals such as the *Accounting Review*; *Accounting, Organizations, and Society*; *Abacus*; *International Journal of Accounting*; and *Journal of International Business Studies*. Tim is a past president of the American Accounting Association’s (AAA) International Accounting Section and a recipient of the section’s Outstanding International Accounting Educator Award. He is a coauthor of the paper that received the AAA’s Notable Contribution to the Auditing Literature Award in 2019.

Fundamentals of Advanced Accounting, Stays

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). We’ve also added new Hint Videos, Integrated Excel problems, and Data Analytics materials available only in Connect!

Chapter Changes for *Fundamentals of Advanced Accounting*, 9th Edition:

Chapter 1

- Updated real-world references and examples.
- Revised several end-of-chapter problems.

Chapter 2

- Three new business combinations are discussed in terms of motivations to combine Goodyear Tire and Rubber-Cooper Tire and Rubber, Google-Fitbit, and Uber-Postmates.
- Updated real-world references and examples.
- Revised several end-of-chapter problems and added three new business combination cases.

Chapter 3

- Added a special *On the Horizon* discussion titled “FASB Considers Goodwill Amortization.”
- Updated real-world references and examples.
- Revised several end-of-chapter problems. In particular, previous asset allocations to customer-related items in acquisitions were changed to other intangible asset categories in light of proposed FASB action.
- Updated and revised end-of-chapter impairment analysis case.

Chapter 4

- Updated real-world references and examples.
- Revised end-of-chapter problems and cases.

- Revised and streamlined the “Does GAAP Undervalue Post-Control Stock Acquisitions?” *discussion question*.
- Revised several end-of-chapter problems (including the conversion of eight multiple choice questions to open-ended problems).
- Included a new step-acquisition case and an updated Costco noncontrolling interest case.

Chapter 5

- Revised end-of-chapter problems including the conversion of six multiple-choice questions to open-ended problems.
- Included a new end-of-chapter problem that focuses on intra-entity transfers (inventory and equipment) for a 100 percent-owned subsidiary.

Chapter 6

- Updated real-world references and examples.
- Revised, clarified, and simplified the section on consolidated earnings per share (EPS). The EPS example now includes only the effect of subsidiary convertible bonds for consideration of the subsidiary’s effect on diluted EPS. The example is not only simplified but provides improved alignment with end-of-chapter problems.
- Revised end-of-chapter problems including the conversion of three multiple-choice questions to open-ended problems.

Chapter 7

- Replaced one of the real-world example companies used in the “Introduction” to demonstrate the significance of export sales and foreign currency hedging for some entities.

Current as the Accounting Profession Changes

- Updated real-world references including excerpts from annual reports.
- Changed the exchange rate in the fictitious International Company illustration included in “Derivatives Accounting” to be more consistent with the current U.S. dollar/Mexican peso exchange rate.
- Added a discussion question “Is Bitcoin a Foreign Currency?”
- Changed several multiple-choice format problems at the end of the chapter to a requirement format.
- Added several new multiple-choice format problems to replace those converted to a requirement format.
- Changed hypothetical company names in several end-of-chapter problems to provide more diversity.
- Made a variety of changes to the historical exchange rates internet case, including changing the company name, locations of customers, and so on.

Chapter 8

- Replaced merger-and-acquisition bullet items at the beginning of this chapter with updated information from a different set of companies.
- Updated information about countries currently meeting the definition of highly inflationary economy.
- Updated real-world references, including examples of company practices and excerpts from annual reports.
- Rephrased most bullet items in the section “*International Accounting Standard 21—The Effects of Changes in Foreign Exchange Rates.*”
- Deleted a quote related to determining the functional currency in “Comparison of the Results from Applying the Two Different Methods.”
- Converted several multiple-choice format problems at the end of the chapter to a requirement format.
- Added one new multiple-choice problem.
- Changed fictitious company names in several problems and cases to increase diversity.

Chapter 9

- Updated real-world references.
- Revised end-of-chapter problems, including the conversion of six multiple-choice questions to open-ended problems.

Chapter 10

- Changed the names of fictitious partners in several illustrations, discussion questions, and end-of-chapter problems and cases to add diversity.
- Converted several multiple-choice format problems to a requirement format.

Chapter 11

- Updated numerous references to the financial statements of a wide variety of state and local governments such as the City of Houston, the City of Dallas, the City of Greensboro, and the City of Las Vegas. This information helps students to see real-world examples of financial reporting in its current form.
- Updated all references from the old terminology (Comprehensive Annual Financial Report) to the new terminology (Annual Comprehensive Financial Report).

Chapter 12

- Provided discussion of GASB’s current project to update the financial reporting model for state and local governments.
- Updated references to the financial statements of state and local governments such as the City of Los Angeles, the City of Buffalo, the City of Atlanta, the City of Detroit, and the City of Boston.
- Created a completely new illustration of the financial statements for a public college or university to help students better understand the meaning and structure of the reporting process.

Students Solve the Accounting Puzzle

The approach used by Hoyle, Schaefer, and Douppnik 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 *Fundamentals of Advanced Accounting, 9e*.

Thinking Critically

With this text, students gain a well-balanced appreciation of the accounting profession. As *Fundamentals of Advanced Accounting, 9e*, 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 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
S&P Global	IHS Markit (United Kingdom)
T-Mobile	Sprint
Analog Devices	Maxim Integrated Products
Salesforce.com	Slack Technologies
Microsoft	Nuance
Intuit	Mailchimp
Merck & Company	Acceleron Pharma
Nvidia	Mellanox
Johnson & Johnson	Momenta Pharmaceuticals
Verizon Communications	Tracfone Wireless
Cisco	Acacia Communications
Uber Technologies	Postmates
Goodyear Tire & Rubber Company	Cooper Tire & Rubber Company
Google	Fitbit
Cosmos Wholesale Corp	Innovel Solutions

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

At a recent board of directors meeting, Margaret Escalator provides an example of how accounting book value and fair value. Let me explain. . .

This year we purchased additional shares of our ownership to 90% (up from the 75% we owned last year). The purchase price was \$10 million.

Discussion Questions

This feature **facilitates student understanding** of the underlying accounting principles at work in particular reporting situations. Similar to mini cases, 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 9th Edition Features



McGraw Hill and UWorld are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession.

In partnership with UWorld, a global leader in education technology, we provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing. Accordingly, students using these McGraw Hill materials will have access to the highest quality CPA Exam task-based simulations from UWorld, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam.

For more information about the full UWorld CPA Review program, exam requirements, and exam content, visit <https://accounting.uworld.com/cpa-review/partner/university/>.

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

“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 (Estimated Time: 45 to 65 Minutes) The following Company and Richmond Company as of December and liabilities are also listed.

Problem

Develop Your Skills

FASB ASC RESEARCH AND ANALYSIS CASE—CONSIDERATION OR COMPENSATION?

CPA skills

AutoNav Company agrees to pay \$20 million in cash to of its assets and liabilities. These four owners of Easy-C time monitoring of traffic patterns on the nation's top 2

Questions

1. What is a business combination?
2. Describe the concept of a synergy. What are some examples of possible synergies in business combinations?
3. Describe the different types of legal arrangements that can take place to create a business combination.
4. What does the term *consolidated financial statements* mean?
5. Within the consolidation process, what is the purpose of a worksheet?
6. 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?
7. What is the accounting valuation basis for consolidating assets and liabilities in a business combination?
8. How should a parent consolidate its subsidiary's revenues and expenses?
9. 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

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 e
 - 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 theoret

Connect for *Fundamentals of*

The 9th edition of *Fundamentals of Advanced Accounting* has a full Connect package, with the following features available for instructors and students.

- **SmartBook®** is the market-leading adaptive study resource that is proven to strengthen memory recall, increase retention, and boost grades. SmartBook 2.0 identifies and closes knowledge gaps through a continually adapting reading and questioning experience that helps students master the key concepts in the chapter. SmartBook 2.0 is the latest version of SmartBook, with key updates to: improve accessibility, provide mobile functionality, allow a more granular level of content selection, and provide the ability to assign Recharge activities.
- 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.

UNNAMED ASSIGNMENT Help Saved Save & Exit Submit

1 Check my work

10 points

On January 1, Beckman, Inc., acquires 60 percent of the outstanding stock of Calvin for \$51,612. Calvin Co. has one recorded asset, a specialized production machine with a book value of \$19,200 and no liabilities. The fair value of the machine is \$75,700, and the remaining useful life is estimated to be 10 years. Any remaining excess fair value is attributable to an unrecorded process trade secret with an estimated future life of 4 years. Calvin's total acquisition date fair value is \$86,020.

At the end of the year, Calvin reports the following in its financial statements:

Revenues	\$ 73,350	Machine	\$ 17,280	Common stock	\$ 19,200
Expenses	29,700	Other assets	40,570	Retained earnings	38,650
Net income	\$ 43,650	Total assets	\$ 57,850	Total equity	\$ 57,850
Dividends paid	\$ 5,000				

Determine the amounts that Beckman should report in its year-end consolidated financial statements for noncontrolling interest in subsidiary income, noncontrolling interest, Calvin's machine (net of accumulated depreciation), and the process trade secret.

	Amount
Noncontrolling interest in subsidiary income	
Total noncontrolling interest	
Calvin's machine (net accumulated depreciation)	
Process trade secret	

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- **NEW! Hint Videos** created and narrated by text author Joe Hoyle provide students with guidance on how to approach key points of selected problems. These Hint videos are available only within Connect. The instructor can choose to turn the Hint feature on or off via assignment settings.
- **NEW! Integrated Excel** assignments pair the power of Microsoft Excel with the power of Connect. A seamless integration of Excel within Connect, Integrated Excel questions allow students to work in live, auto-graded Excel spreadsheets—no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.

Advanced Accounting, 9e

On May 1, Soriano Company reported the following account balances along with their estimated fair values:

Account	Carrying Amount	Fair Value
Receivables	\$256,700	\$256,700
Inventory	\$88,700	\$88,700
Copyrights	\$133,100	\$319,000
Patented technology	\$903,500	\$665,600
Total assets	\$1,382,000	\$1,328,000
Current liabilities	\$262,500	\$262,500
Long-term liabilities	\$749,500	\$739,900
Common stock	\$119,000	
Retained earnings	\$253,000	
	\$1,382,000	
Contingent performance liability	\$39,400	
Soriano's Appraised value	\$250,000	

On that day, Zambrano paid cash to acquire all of the assets and liabilities of Soriano, which will cease to exist as a separate entity. To facilitate the merger, Zambrano also paid \$109,300 to an investment banking firm.

The following information was also available:

Zambrano further agreed to pay an extra \$76,900 to the former owners of Soriano only if they meet certain revenue goals during the next two years. Zambrano estimated the present value of its probability adjusted expected payment for this contingency at \$39,400.

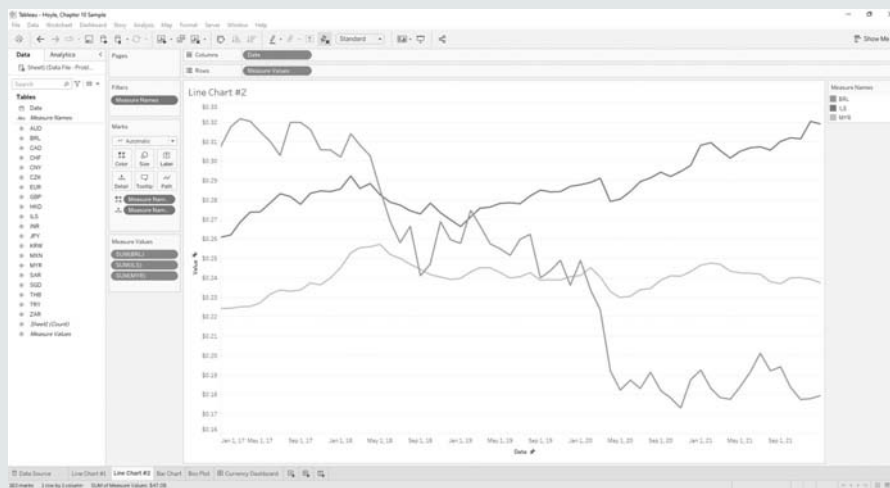
Soriano has a research and development project in process with an appraised value of \$250,000. However, the project has not yet reached technological feasibility, and the project's assets have no alternative future use.

Required:
 Note: Use cells A4 to B17 from the given information to complete this question. All answers should be input and displayed as positive values.

a. Determine whether there is a gain on bargain purchase or goodwill if \$708,000 of cash was paid for Soriano.

32 Cash paid
 33 Contingent performance liability
 34 Total consideration transferred

- **NEW! Applying Tableau** data analytics assignments are available only in Connect. (Tableau software is free to students and instructors). These assignments provide students with an Excel data file and detailed instructions that walk through the necessary steps and functions of creating a Tableau dashboard.



- The **Test Bank** for each chapter has been updated to stay current with new and revised chapter material, with all questions available for assignment through Connect. Instructors can also create tests and quizzes with Test Builder, a cloud-based tool available within Connect that formats tests for printing or for administering within an LMS.
- The **Instructor and Student Resources** have been updated and are available in the Connect Instructor Resources page. Available resources include Instructor and Solutions Manuals and PowerPoint presentations. 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.

Acknowledgments

We could not produce a textbook of the quality and scope of *Fundamentals of Advanced Accounting* without the help of a great number of people. Special thanks go to the following:

- Gregory Schaefer for his Chapter 2 descriptions of recent business combinations.
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Stacie Hughes, *Athens State University*

Marianne James, *California State University, Los Angeles*

Sehan Kim, *University of Houston—Clear Lake*

Laura Lee, *Saint Mary's University—Minnesota*

Lisa Ludlum, *Western Illinois University*

Steven Mezzio, *Pace University*

Daniel Neely, *University of Wisconsin—Milwaukee*

Matthew Njoku, *Central Piedmont Community College*

Peggy O'Kelly, *Northeastern University*

Luis Plascencia, *Harold Washington College*

Philip Slater, *Forsyth Technical Community College*

Hakjoon Song, *California State University, Dominguez Hills*

Vernon Stanger, *Trine University*

Cindy Steward, *University of Illinois at Urbana—Champaign*

Andrea Still, *Indiana University*

William D. Stout, *University of Louisville*

Inho Suk, *SUNY—Buffalo*

Ian A. Van Deventer, *Spalding University*

Cammy Wayne, *Harper College*

James Webb, *University of California—Berkeley*

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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 provide objectivity in financial reporting.

Why Do Business Firms Invest in the Equity Shares of Other Business Firms?

We frequently see businesses buying equity shares (e.g., common stock) of other businesses. To understand the accounting for equity share acquisitions, it's helpful to understand two fundamental motivations for such investments. First, firms may temporarily invest in another firm's equity shares simply to earn a return on otherwise idle cash. Companies such as Microsoft, Google, and Starbucks each have large amounts of short-term investments in marketable equity securities that can produce both dividend income and share value appreciation.

Second, in sufficient quantity, equity shares can provide a powerful business tool to investors. Equity share ownership typically provides voting privileges to elect members to a firm's board of directors. Boards of directors are the highest authority in the management of a corporation. They make strategic decisions regarding how the firm will conduct its business. Boards set company policies and hire (and fire) management. Thus, the ability to vote for directors can be a powerful tool to influence the decisions of an investee corporation. Consequently, many firms will buy sufficient voting shares to enable the election of their representatives to another firm's board of directors. The range of ownership may result in the ability to influence the investee through the election of a single director all the way to complete control.

By exercising their voting rights over the investee, an investor firm can wield power over the strategic direction of the investee in ways that align with its own operating and financial interests. For example, an investee may be considering inventory purchases or sale contracts with several outside firms. An investor firm, through its designated members on the investee

Learning Objectives

After studying this chapter, you should be able to:

- LO 1-1** Describe motivations for a firm to gain significant influence over another firm.
- LO 1-2** Describe in general the various methods of accounting for an investment in equity shares of another company.
- LO 1-3** Identify the sole criterion for applying the equity method of accounting and know the guidelines to assess whether the criterion is met.
- LO 1-4** Describe the financial reporting for equity method investments and prepare basic equity method journal entries for an investor.
- LO 1-5** 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 1-6** 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 1-7** 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 1-8** Explain the rationale and reporting implications of fair-value accounting for investments otherwise accounted for by the equity method.

LO 1-1

Describe motivations for a firm to gain significant influence over another firm.

board of directors, possesses the power to influence the selection of the outside firm—including the investor firm itself. Other examples abound, including cooperation between the investor and investee on research, technology, product development, licensing, advertising, distribution, market expansion, etc. Thus, we see businesses acquiring the equity shares of other businesses throughout the economy.

The Reporting of Investments in Corporate Equity Securities

In its 2021 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 annual report 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.

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 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."

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.

LO 1-2

Describe in general the various methods of accounting for an investment in equity shares of another company.

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 of the fair value method 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 preceding 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.

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

² ASC 320, *Investments—Debt and Equity Securities*, 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.

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).

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 Consequently, 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.

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. 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. For example, Berkshire Hathaway notes in its 2021 annual report that it owns 26.5 percent of the outstanding shares of The Kraft Heinz Company common stock, which is accounted for under the equity method. Undoubtedly, through its ownership, Berkshire Hathaway can influence Kraft Heinz'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 equity method investments represent joint ventures in which two or more companies form a new enterprise to carry out a specified operating purpose. For example, Boeing and Lockheed Martin formed a joint venture named United Launch Alliance that manufactures and operates rocket vehicles for both scientific and national security purposes. 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.

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?

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.

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 1-3

Identify the sole criterion for applying the equity method of accounting and know the guidelines to assess whether the criterion is met.

Criterion 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.

- 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.⁶

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:⁷

- 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.⁸

⁶ FASB ASC (para. 323-10-15-8).

⁷ 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.

⁸ 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 owns a 19 percent investment in Monster Beverage Corporation. Coca-Cola noted in its financial statements following its Monster Beverage investment 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 1-4

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 and 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 purchased a 20 percent interest in Little Company on January 1, 2023, 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 2023, 2024, and 2025, 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.

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†
2023	\$ 200,000	\$ 50,000	\$ 10,000	\$ 35,000	\$245,000	\$ 40,000	\$ 240,000
2024	300,000	100,000	20,000	37,000	282,000	60,000	280,000
2025	400,000	200,000	40,000	43,000	325,000	80,000	320,000
Total income recognized			<u>\$ 70,000</u>	<u>\$115,000</u>		<u>\$180,000</u>	

*Equity in investee income is 20 percent of the current year income reported by Little Company. For simplicity, we assume that Little's assets and liabilities have book values that approximate fair values at the acquisition date and Big's cost is proportionate to Little's book value.

†The carrying amount of an investment under the equity method is the original cost plus income recognized less dividends. For 2023, as an example, the \$240,000 reported balance is the \$210,000 cost plus \$40,000 equity income less \$10,000 in 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 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.⁹

Referring again to the information presented in Exhibit 1.1, Little Company reported a net income of \$200,000 during 2023 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.

LO 1-5

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.

Excess of Investment Cost over Book Value Acquired

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.¹⁰

⁹ 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.

¹⁰ 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.