Equity Investments -- Fair Value Method and Equity Method

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Intercorporate Equity Investments

Why do companies invest in other companies?

- To earn a high rate of return
- To secure certain operating or financing arrangements with another company

How do companies account for their investments? They do so based on

- the type of security (debt or equity) and
- their intent with respect to the investment

Intercorporate Equity Investments

Percentage of Ownership	Less than 20%	Between 20% and 50%	More than 50%
Level of Influence	Little or None	Significant influence	Control
Valuation Method	**Fair Value Method**	**Equity Method**	**Consolidation**

The method selected depends upon the degree of influence the investor has over the investee.

Intercorporate Equity Investments

Category	Valuation	Unrealized Holding Gains or Losses	Other Income Effects
Holdings less than 20%			
1. Trading	Fair value	Recognized in net income	Dividends declared; gains and losses from sale.
2. Non-Trading	Fair value	Recognized in "Other comprehensive income" and as separate component of equity	Dividends declared; gains and losses from sale.
Holdings between 20% and 50%	Equity	Not recognized	Proportionate share of investee's net income.
Holdings more than 50%	Consolidation	Not recognized	Not applicable.

Fair value method

Use when:

- investor holds a small percentage (usually less than 20%) of equity securities of investee
- Investor cannot significantly affect investee's operations
- Investment is made in anticipation of dividends or market appreciation.
- Investments are recorded at cost and subsequently adjusted to fair value, if determinable, otherwise they remain at cost.

Equity Method

Use when:

- Investor has the ability to exercise significant influence on investee operations (whether influence is applied or not)
- Generally used when ownership is between 20% and 50%.
- Significant Influence might be present with much lower ownership percentages.
- Under the equity method, investor's share of investee dividends declared are recorded as decreases in the investment account, not income.

Consolidation of Financial Statements

Use when:

- Investor's ownership exceeds 50% of an organization's outstanding voting stock
- Control exists through legal or contractual arrangement, even when the ownership is less than 50%.
- Special purpose entities must also be consolidated (intended to combat misuse of SPEs to keep large amounts of assets and liabilities off the balance sheet known as "off balance sheet financing")
- One set of financial statements prepared to consolidate all accounts of the parent company and all of its controlled subsidiaries as a single entity

Fair value method

Under IFRS, the presumption is that equity investments less than 20% are **held-for-trading**.

- Investments valued at fair value.
- Record unrealized gains and losses in net income.

IFRS allows companies to classify some equity investments less than 20% as **non-trading**.

- Investments valued at fair value.
- Record unrealized gains and losses in other comprehensive income.

Exercise – trading securities

November 3, 2015, Republic Corp. purchased ordinary shares of three companies, each investment representing less than a 20% interest. These shares are held-for-trading.

	Cost
Burberry	€259,700
Nestlé	317,500
St. Regis Pulp Co.	141,350
Total cost	€718,550

Prepare journal entries for these investments.

	Debit	Credit
Equity Investments	718,550	
Cash		718,550

Exercise – trading securities

On December 6, 2015, Republic receives a cash dividend of €4,200 on its investment in the ordinary shares of Nestlé.

Prepare journal entry.

Account	Debit	Credit
Cash	4,200	
Dividend Revenue		4,200

Exercise – trading securities

EQUITY INVESTMENT PORTFOLIO DECEMBER 31, 2015			
Investments	Carrying Value	Fair Value	Unrealized Gain (Loss)
Burberry	€259,700	€275,000	€ 15,300
Nestlé	317,500	304,000	(13,500)
St. Regis Pulp Co.	141,350	104,000	(37,350)
Total of portfolio	€718,550	€683,000	(35,550)
Previous fair value adjustment balance			–0–
Fair value adjustment—Cr.			€(35,550)

Prepare journal entries for the FV adjustment.

Unrealized Holding Gain or Loss—Income	35,550	
Fair Value Adjustment		35,550

Exercise – trading securities

In addition, assume that on February 10, 2016, Republic purchased €255,000 of Continental Trucking ordinary shares (20,000 shares €12.75 per share), plus brokerage commissions of €1,850. Republic's equity investment portfolio as of December 31, 2016.

EQUITY INVESTMENT PORTFOLIO
DECEMBER 31, 2016

Investments	Carrying Value	Fair Value	Unrealized Gain (Loss)
Continental Trucking	€255,000[a]	€278,350	€ 23,350
Nestlé	317,500	362,550	45,050
St. Regis Pulp Co.	141,350	139,050	(2,300)
Total of portfolio	€713,850	€779,950	66,100
Previous fair value adjustment balance—Cr.			(35,550)
Fair value adjustment—Dr.			€101,650

[a]The brokerage commissions are expensed.

Exercise – trading securities

Prepare the journal entry for Republic.

Fair Value Adjustment	101,650	
Unrealized Holding Gain or Loss—Income		101,650

Exercise – non-trading securities

On December 10, 2015, Republic Corporation purchased 1,000 ordinary shares of Hawthorne Company for €20.75 per share (total cost €20,750). The investment represents less than a 20 percent interest. Hawthorne is a distributor for Republic products in certain locales, the laws of which require a minimum level of share ownership of a company in that region. The investment in Hawthorne meets this regulatory requirement. Republic accounts for this investment at fair value.

Account	Debit	Credit
Equity Investments	20,750	
Cash		20,750

Exercise – non-trading securities

On December 27, 2015, Republic receives a cash dividend of €450 on its investment in the ordinary shares of Hawthorne Company. It records the cash dividend as follows.

	Debit	Credit
Cash	450	
Dividend Revenue		450

Exercise – non-trading securities

At December 31, 2015, Republic's investment in Hawthorne has the carrying value and fair value shown.

Non-Trading Equity Investment	Carrying Value	Fair Value	Unrealized Gain (Loss)
Hawthorne Company	€20,750	€24,000	€3,250
Previous fair value adjustment balance			0
Fair value adjustment (Dr.)			€3,250

Record this adjustment.

Fair Value Adjustment	3,250	
Unrealized Holding Gain or Loss—Equity		3,250

Exercise – non-trading securities

Statement of Financial Position

Investments	
Equity investments	€24,000
Equity	
Accumulated other comprehensive gain	€ 3,250

Statement of Comprehensive Income

Other income and expense	
Dividend revenue	€ 450
Other comprehensive income	
Unrealized holding gain	€ 3,250

Exercise – non-trading securities

On December 20, 2016, Republic sold all of its Hawthorne Company ordinary shares receiving net proceeds of €22,500.

Non-Trading Equity Investment	Cost	Fair Value	Unrealized Gain (Loss)
Hawthorne Company at 12/20/2016	€20,750	€22,500	€ 1,750
Previous fair value adjustment balance (Dr.)			(3,250)
Change in the Fair Value Adjustment account (loss)			€(1,500)

Prepare the journal entry to adjust the carrying value of the non-trading investment.

	Debit	Credit
Unrealized Holding Gain or Loss—Equity	1,500	
Fair Value Adjustment		1,500

Accounting for an Investment - Equity Method

- The investor increases the investment account as the investee earns and reports income. The investor uses the accrual method to record investment income —recognizing it in the same time period as the investee earns it.

- The investor decreases its investment account's carrying value for its share of investee cash dividends. When the investee declares a cash dividend, its owners' equity decreases.

Fair Value vs. Equity Method

Under fair value method:

- The cash dividends received from the investee is reported as revenue (not the investee's profit).
- The investor has no/little influence over the distribution of the investee's net income.

Under equity method:

- The investor reports as revenue its share of the investee's net income.
- With significant influence, the investor can ensure that the investee will pay dividends, if desired.
- Dividend received from the investee reduces the carry amount of Investment Account ("payment received" from the investee).

Sole Criterion for Utilizing the Equity Method

Significant Influence

- Representation on the investee’s Board of Directors
- Participation in the investee’s policy-making process
- Material intra-entity transactions
- Interchange of managerial personnel
- Technological dependency
- Other investee ownership percentages

When Equity Method is not Applicable

The equity method is not appropriate for investments that demonstrate any of the following characteristics regardless of the investor's degree of ownership:

- 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.

What method should they use then?

Exercise -- Equity Method

Assume that Big Company owns a 20% interest in Little Company purchased on January 1, 2014, for $200,000.

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.

Prepare journal entries related to the investment in Little for Dec. 31, 2014.

Exercise -- Equity Method

Big Company records the following journal entries to apply the equity method for 2014:

Account	Debit	Credit
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.		

Exercise -- Equity Method

			Accounting by Big Company When Influence Is Not Significant (available-for-sale security)			Accounting by Big Company When Influence Is Significant (equity method)	
Year	Income of Little Company	Dividends Declared by Little Company	Dividend Income	Carrying Amount of Investment	Fair-Value Adjustment to Stockholders' Equity	Equity in Investee Income	Carrying Amount of Investment
2014	$200,000	$ 50,000	$10,000	$235,000	$ 35,000	$ 40,000*	$230,000†
2015	300,000	100,000	20,000	255,000	55,000	60,000*	270,000†
2016	400,000	200,000	40,000	320,000	120,000	80,000*	310,000†
Total income recognized			$70,000			$180,000	

Exercise -- Equity Method vs. Fair Value

ENTRIES BY MAXI COMPANY

Fair Value Method			Equity Method
On January 2, 2014, Maxi Company acquired 48,000 shares (20% of Mini Company common stock) at a cost of $10 a share.			
Equity Investments	480,000		
Cash		480,000	
For the year 2014, Mini Company reported net income of $200,000; Maxi Company's share is 20%, or $40,000.			
No entry			
At December 31, 2014, the 48,000 shares of Mini Company have a fair value (market price) of $12 a share, or $576,000.			
Fair Value Adjustment (available-for-sale)	96,000		
Unrealized Holding Gain or Loss—Equity		96,000	
On January 28, 2015, Mini Company announced and paid a cash dividend of $100,000; Maxi Company received 20%, or $20,000.			
Cash	20,000		
Dividend Revenue		20,000	
For the year 2015, Mini reported a net loss of $50,000; Maxi Company's share is 20%, or $10,000.			
No entry			
At December 31, 2015, the Mini Company 48,000 shares have a fair value (market price) of $11 a share, or $528,000.			
Unrealized Holding Gain or Loss—Equity	48,000		
Fair Value Adjustment (available-for-sale)		48,000	

Excess of Investment Cost Over Book Value Acquired

- Fair values of specific investee assets and liabilities can differ from their book values. Excess payment can be identified directly with those accounts.
- If purchase price exceeds fair value, future benefits are expected to accrue from the investment due to estimated profitability of the investee or the relationship established between the two companies. The additional payment is attributed to an intangible asset referred to as goodwill rather than to any specific investee asset or liability.

Excess of Cost Over Book Value of Acquired Investment

When Purchase Price > Book Value of an investment acquired, the difference must be identified.

Assets may be undervalued on the investee's books because:

1. The fair values (FV) of some assets and liabilities are different than their book values (BV).
2. The investor may be willing to pay extra because future benefits are expected to accrue from the investment.

Exercise-- Excess of Investment Cost Over Book Value Acquired

Assume Grande Company is negotiating the acquisition of 30 percent of the outstanding shares of Chico Company. Chico's balance sheet reports assets of $500,000 and liabilities of $300,000 for a net book value of $200,000. After investigation, Grande determines that Chico's equipment is undervalued in the company's financial records by $60,000. One of its patents is also undervalued, but only by $40,000.

By adding these valuation adjustments to Chico's book value, Grande arrives at an estimated $300,000 worth for the company's net assets. Based on this computation, Grande pays $125,000 for a 30 percent share of the investee's outstanding stock.

Exercise-- Excess of Investment Cost Over Book Value Acquired

1. What is the amount of goodwill associated with the investment?
2. Assume the acquisition was successfully completed on Jan. 1, 2015. What is the total amount of excess amortization for Grande's 30% investment in Chico for the year 2015? What about for the year 2020?

Exercise-- Excess of Investment Cost Over Book Value Acquired

Payment by investor		$125,000
Percentage of book value acquired ($200,000 × 30%)		60,000
Payment in excess of book value		65,000
Excess payment identified with specific assets:		
Equipment ($60,000 undervaluation × 30%)	$18,000	
Patent ($40,000 undervaluation × 30%)	12,000	30,000
Excess payment not identified with specific assets—goodwill		$ 35,000

Any extra payment that cannot be attributed to a specific asset or liability is assigned to the intangible asset goodwill. The actual purchase price can be computed by different techniques or simply as a result from negotiations.

Exercise-- Excess of Investment Cost Over Book Value Acquired

Payment relating to each asset (except land, goodwill, and other indefinite life intangibles) should be amortized over an appropriate time period.

Account	Cost Assigned	Useful Life	Annual Amortization
Equipment	$18,000	10 years	$1,800
Patent	12,000	5 years	2,400
Goodwill	35,000	Indefinite	–0–
Annual expense (for five years until patent cost is completely amortized)			$4,200

Goodwill associated with equity method investments, for the most part, is measured in the same manner as goodwill arising from a business combination, tested for declines in value and impairment. Goodwill, implicit in equity investments, is not.

Reporting a Change to the Equity Method

Report a change to the equity method if:

- An investment that was recorded using the fair-value method reaches the point where significant influence is established.
- All accounts are restated retroactively so the investor's financial statements appear as if the equity method had been applied from the date of the first acquisition.

Reporting Sale of Equity Investment

If part of an investment is sold during the period:

- The equity method continues to be applied up to the date of the transaction.
- At the transaction date, the Investment account balance is reduced by the percentage of shares sold.
- If significant influence is lost, NO RETROACTIVE ADJUSTMENT is recorded, but the equity method is no longer applied.

Investee Other Comprehensive Income

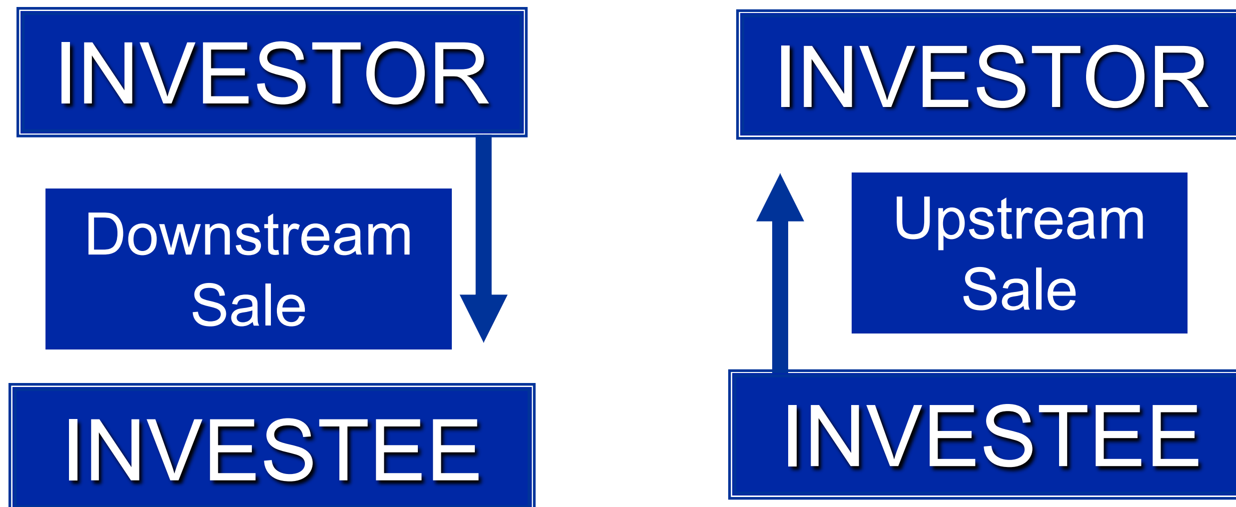
- OCI is defined as revenues, expenses, gains, and losses that are included in comprehensive income but excluded from net income.
- Accumulated Other Comprehensive Income (AOCI) includes unrealized holding gains and losses on available-for-sale securities, foreign currency translation adjustments, and certain pension adjustments.
- OCI is accumulated and reported in stockholders' equity and represents a source of change in investee company net assets that is recognized under the equity method.

Reporting Investee Losses

- A permanent decline in the investee's fair market value is recorded as an impairment loss and the investment account is reduced to the fair value.
- When accumulated losses incurred and dividends paid by the investee reduce the investment account to $-0-, no further loss can be accrued.
- Investor discontinues using the equity method rather than record a negative balance. Balance remains at $-0-, until subsequent profits eliminate all unrecognized losses. A temporary decline is ignored!

Deferral of Unrealized Profits in Inventory

Many equity acquisitions establish ties between companies to facilitate the direct purchase and sale of inventory items. Such intra-entity transactions can occur either on a regular basis or only sporadically.



Deferral of Unrealized Profits in Inventory

- The seller of the goods retains a partial stake in the inventory for as long as the buyer holds it.
- The earning process is not considered complete at the time of the original sale.
- Reporting the profit is delayed until the inventory is consumed within operations or resold to an unrelated party.
- At the disposition of the inventory, the original sale is culminated and gross profit is recognized.

Deferral of Unrealized Profits in Inventory

Clancy Incorporated, sold $210,000 of its inventory to Reid Company during 2013 for $350,000. Reid sold $224,000 of this merchandise in 2013 with the remainder to be disposed of during 2014. Assume Clancy owns 30% of Reid and applies the equity method.

1. What journal entry will be recorded at the end of 2013 to defer the unrealized intra-entity profits?
2. What journal entry will be recorded in 2014 to realize the intra-entity profit that was deferred in 2013?

Criticisms of the Equity Method

- Over-emphasis on possession of 20-50% voting stock in deciding on significant influence vs. control
- Allowing off-balance sheet financing
- Potential manipulation of performance ratios

Financial Reporting Effects of Different Types of Accounting for Investment

The choice of accounting method for investment matters!

Measurements of financial performance often affect the following:

- The firm's ability to raise capital.
- Managerial compensation.
- The ability to meet debt covenants and future interest rates.
- Managers' reputations.