Chapter 1

Accounting for Intercorporate Investments

Learning Objectives – Coverage by question

	Multiple Choice	Exercises	Problems
LO1 – Explain when the equity method should be used.	3, 8, 9, 18		
LO2 – Explain the mechanics of the accounting for investments using the equity method of accounting.	2, 4, 12		
LO3 – Explain the amortization of excess assets, and the deferral of unrealized income.	5, 11, 19-21, 25-28, 40	2, 3	1
LO4 – Explain the process for deferral of unrealized income.	13, 29-32, 39	4	3
LO5 – Explain the equity method of accounting for less than 100% ownership.	1, 10, 11, 16-20, 24-26, 29-40	1-5	1, 3, 4
LO6 – Explain when the equity method should be discontinued.	14	1	
LO7 – Explain the accounting for changes to and from the equity method.	6, ~~7~~, 15, 22, 23		2
LO8 – Explain the required disclosures for equity method investments.			
LO9 – Explain the criticisms of the equity method of accounting.			

Chapter 1: Accounting for Intercorporate Investments

Multiple Choice

Topic: Accounting for Investments Using the Equity Method with Less Than 100% Ownership
LO: 5

1. Frisco Corporation uses the equity method of accounting for its investment in a 30%-owned investee that earned $56,000 and paid $18,000 in dividends. As a result, Frisco Corporation made the following entries:

Equity Investment	16,800	
Equity Income		16,800
Cash	16,800	
Dividend Revenue		16,800

What effect will these entries have on Frisco Corporation's balance sheet?

a. Investment understated, retained earnings understated
b. Investment overstated, retained earnings understated
c. Investment overstated, retained earnings overstated
d. No effect

Answer: c

Topic: Accounting for Investments Using the Equity Method and Fair Value Method
LO: 2

2. Harvey Co. received a cash dividend from a common stock investment. Should Harvey report an increase in the investment account if it accounts for the investment under the fair value method or the equity method?

a. Fair value method, YES; Equity method, YES
b. Fair value method, NO; Equity method, NO
c. Fair value method, YES; Equity method, NO
d. Fair value method, NO; Equity method, YES

Answer: b

Topic: Significant Influence
LO: 1

3. An investor who owns 30% of the common stock of an investee is most likely to exercise significant influence requiring use of the equity method when:

a. The investor and investee sign an agreement under which the investor surrenders significant rights
b. The investor tries and fails to obtain representation on the investee's board of directors
c. The investor tries and fails to obtain financial information from the investee
d. The second largest investor owns only 1% of the investee's outstanding stock

Answer: d

Topic: Accounting for Investments Using the Equity Method
LO: 2

4. An investor uses the equity method to account for an investment in common stock. After the date of acquisition, the equity investment account of the investor is:

a. Not affected by its share of the earnings or losses of the investee
b. Not affected by its share of the earnings of the investee but is decreased by its share of the losses of the investee.
c. Increased by its share of the earnings of the investee but is not affected by its share of the investee's losses.
d. Increased by its share of the earnings of the investee and is decreased by its share of the investee's losses.

Answer: d

Topic: Accounting for Investments Using the Equity Method when Purchase Price Exceeds Book Value
LO: 3

5. Angelo uses the equity method to account for its investment in Fischer on January 1. On the date of acquisition, Fischer's land and buildings were undervalued on its balance sheet. During the year following the acquisition, how do these excesses of fair values over book values affect Angelo's Equity Income from Fischer?

a. Building, Decrease; Land, No Effect
b. Building, Decrease; Land, Decrease
c. Building, Increase; Land, Increase
d. Building, Increase; Land, No Effect

Answer: a

Topic: Change to the Equity Method
LO: 7

6. On January 1, Sons purchased 10% of Heller's common stock. On September 1, it purchased another 30% of Heller's common stock. During November, Heller declared and paid a cash dividend on its common stock.

How much income from Heller should Sons report on its income statement?

a. 10% of Heller's income for January 1 to August 31, plus 40% of Heller's income for the remainder of the year
b. 40% of Heller's income from September 1 to December 31 only
c. 30% of Heller's income
d. The amount of dividends received from Heller.

Answer: b

Topic: Change to the Equity Method **DUPLICATE**
LO: 7

7. ~~On January 1, Sons purchased 10% of Heller's common stock. On September 1, it purchased another 30% of Heller's common stock. During November, Heller declared and paid a cash dividend on its common stock.~~

~~How much income from Heller should Sons report on its income statement?~~

~~a. 10% of Heller's income for January 1 to August 31, plus 40% of Heller's income for the remainder of the year~~
~~b. 40% of Heller's income from September 1 to December 31 only~~
~~c. 30% of Heller's income~~
~~d. The amount of dividends received from Heller.~~

~~*Answer:* b~~

Topic: Significant Influence
LO: 1

8. Which of the following does not indicate an investor company's ability to significantly influence an investee?

a. Material inter-company transactions
b. The investor owns 30% while another investor owns 70%
c. Interchange of personnel
d. Technological dependency

Answer: b

Topic: Equity Method of Accounting for Investments
LO: 1

9. When a company holds between 20% and 50% of the outstanding stock of an investee, which of the following statements applies?

a. The investor should always use the equity method to account for its investment.
b. The investor should use the equity method to account for its investment unless circumstances indicate that it is unable to exercise "significant influence" over the investee.
c. The investor must use the fair value method unless it can clearly demonstrate the ability to exercise "significant influence" over the investee.
d. The investor should always use the fair value method to account for its investment.

Answer: b

Topic: Accounting for Investments Using the Equity Method with Less Than 100% Ownership
LO: 5

10. If a 30% acquisition is made at book value and the investor has significant influence over the investee, what will be the relationship between the Equity Investment account and the investee's stockholders' equity?

a. There is no particular relationship
b. The Equity Investment account will remain at original cost even as the investee's stockholders' equity increases
c. The Equity Investment account balance will equal 30% of investee's stockholders' equity throughout the life of the investment
d. The Equity Investment account balance will equal 30% of investee's stockholders' equity at date of acquisition, but the relationship will change as the investee reports income and dividends.

Answer: c

Topic: Accounting for Investments Using the Equity Method when Purchase Price Exceeds Book Value
LO: 3, 5

11. If a 30% acquisition is made at a price above book value due to an undervalued patent and the investor has significant influence over he investee, what will be the relationship between the Equity Investment account and the investee's stockholders' equity?

a. There is no particular relationship
b. The Equity Investment account will remain at original cost even as the investee's stockholders' equity increases.
c. The Equity Investment account balance will equal 30% of investee's stockholders' equity throughout the life of the investment.
d. The Equity Investment account balance will equal 30% of investee's stockholders' equity at date of acquisition, plus the unamortized cost of the patent.

Answer: d

Topic: Change in Fair Value for an Equity Method Investment
LO: 2

12. In the case of an equity method investment for which there is a change in fair value:

a. Unrealized gains are reported in the income statement, but unrealized losses are not reported
b. Unrealized gains and losses are reported on the balance sheet only
c. Unrealized gains and losses are recognized in other comprehensive income
d. No gains are recognized in income until the investment is sold

Answer: d

Topic: Intercompany Sales of Inventory Effect on Equity Investments
LO: 4

13. If an investor sells merchandise to an investee and the investee resells all of the items to outside parties in the same period, what equity method entry is required?

a. The entire gross profit is deferred with a debit to Equity Income and credit to Equity Investment.
b. No equity method entry is required, since the gross profit is realized.
c. The entire gross profit is deferred with a credit to Equity Income and Debit to Equity Investment
d. The investor's percentage of the gross profit is deferred with a debit to Equity Income.

Answer: b

Topic: Equity Investment Balance of Zero
LO: 6

14. When a noncontrolling, Equity-Method Investment balance is reduced to zero as investee incurs losses:

a. The investment remains at zero until the investment is sold
b. The investment remains at zero until profits have eliminated the unrealized loss
c. The investor must change to the fair value method
d. Additional investment losses will result in a credit balance in Equity Investment

Answer: b

Topic: Change from the Equity Method
LO: 7

15. When an investor can no longer exert significant influence over the investee, it must change to the fair value method if the investment has a readily determinable fair value.

What is the required accounting treatment on investor's books?

a. A prior period adjustment is recorded to bring retained earnings to what it would have been if the new method had been used in the past.
b. The book value on the date of change becomes the "cost" of the investment.
c. The investment will be adjusted to its fair value.
d. Both b and c are required.

Answer: d

Topic: Equity Method Accounting when Less than 100% Ownership
LO: 5

16. On January 2, 2020, Campbell, Inc. purchased a 20% interest in Renner Corp. for $2,000,000 cash. During 2020, Renner's net income was $2,500,000 and it paid dividends of $750,000.

Campbell's 2020 income from Renner was:

a. $500,000
b. $150,000
c. $650,000
d. $350,000

Answer: a

Topic: Equity Method Accounting when Less than 100% Ownership
LO: 5

17. Based on the facts described in Question 16, what Equity Investment balance should Campbell report at December 31, 2020?

a. $2,500,000
b. $ 500,000
c. $2,350,000
d. $2,150,000

Answer: c

Topic: Equity Method Accounting when Less than 100% Ownership
LO: 1, 5

18. Spring Creek, Inc. purchased a 18% interest in Floyd Corporation on January 2, 2020. The purchase price was $200,000. Spring Creek's officers constitute a majority of Floyd Corporation's board of directors. The investee reported net income of $300,000 and paid dividends of $50,000 in 2020.

On the December 31, 2020, balance sheet, what amount should Spring Creek, Inc. report as Equity Investment in Floyd Corporation?

a. $245,000
b. $254,000
c. $263,000
d. $300,000

Answer: a

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

19. Midpark Co. purchased a 30% interest in Cycling Pros, Inc. on December 31, 2020 for $1,000,000. On that date, Cycling Pros' net assets had a book value of $2,000,000 and fair value of $3,000,000.

What amount of goodwill resulted from this acquisition?

a. $-0-
b. $ 100,000
c. $ 400,000
d. $1,000,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

20. On January 1, Hillcrest Co. acquired a 40% interest in Preston, Inc. with the excess of purchase price over book value solely attributable to equipment with a ten-year life and undervaluation by $250,000. During the year of acquisition, Preston reported net income of $500,000.

What amount of Equity Income should Hillcrest report on its income statement for the year of acquisition?

a. $190,000
b. $200,000
c. $210,000
d. $250,000

Answer: a

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3

21. On December 31, 2020, Park Inc. paid $500,000 for all of the common stock of Smith Corp. On that date, Smith had assets and liabilities with book values of $400,000 and $100,000; and fair values of $450,000 and $125,000, respectively.

What amount of goodwill will be reported on the December 31, 2020 balance sheet?

a. $ 50,000
b. $100,000
c. $200,000
d. $175,000

Answer: d

Topic: Change to the Equity Method
LO: 7

22. On January 1, 2019, Windy Meadows Corp. acquired a 10% interest in Jones Enterprises. On January 1, 2020, Windy Meadows acquired an additional 20% Jones's common stock. No goodwill resulted from either purchase. Jones reported net incomes of $500,000 and $400,000 for 2019 and 2020, respectively. Dividends paid by Jones amounted to $275,000 in 2019 and $125,000 in 2020.

What amount of Equity Income should be reported by Windy Meadows Corp in 2020?
a. $120,000
b. $ 95,000
c. $ 82,500
d. $ 55,000

Answer: a

Topic: Change to the Equity Method
LO: 7

23. On January 1, 2019, Windy Meadows Corp. acquired a 10% interest in Jones Enterprises for $20,000. The stock has a readily determinable fair value, so the investor measures the Equity Investment at fair value with all unrealized gains and losses flowing through net income. On December 31, 2019 the fair value of the 10% common stock investment is $24,000.

On April 1, 2020, Windy Meadows acquired an additional 20% Jones's common stock for $52,000 and gains the ability to exert significant influence over its investment and will begin to use the equity method for its investment.

What is the amount of the unrealized holding gain or loss that would be required on April 1, 2020 to appropriately transition to the equity method?
a. $-0-
b. $ 2,000
c. $ 6,000
d. $12,000

Answer: b

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

24. Spring Valley Corp. purchased a 40% interest in A1 Automotive Company on July 1, 2020. On September 23, 2020, A1 Automotive paid dividends of $50,000 to its common stockholders. The investee reported 2020 net income of $150,000, which was earned evenly throughout the year.

What amount of Equity Income should Spring Valley report in its 2020 income statement?
a. $20,000
b. $30,000
c. $60,000
d. $90,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

25. On January 2, 2020, Petunia Co. purchased a 20% interest in Sawyer, Inc. for $300,000. Fair values of Sawyer's net assets exceeded book values due to land undervalued by $400,000. In 2020, Sawyer reported net income of $100,000 and paid no dividends.

What is the amount of Equity Investment on the December 31, 2020, balance sheet?

a. $300,000
b. $320,000
c. $360,000
d. $400,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

26. On January 2, 2020, Bronson Corporation purchased a 30% interest in Martinez, Inc. for $500,000. Fair values of Martinez's net assets equaled book values except for equipment undervalued by $100,000. The equipment had a 10-year remaining life. During 2020, Martinez reported net income of $150,000 and paid dividends of $40,000.

What is Bronson's Equity Income for 2020?

a. $12,000
b. $15,000
c. $30,000
d. $42,000

Answer: d

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3

27. Emily Corporation purchased all of Ace Company's common stock on January 1, 2020, for $1,000,000 cash. The investee's stockholders' equity amounted to $400,000. The excess of $600,000 was due to an unrecorded patent with a six-year life. In 2020, Ace reported net income of $250,000 and paid dividends of $25,000.

For 2020, what amount of Equity Income will Emily record?

a. $150,000
b. $125,000
c. $175,000
d. $825,000

Answer: a

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3

28. Emily Corporation purchased all of Ace Company's common stock on January 1, 2020, for $1,000,000 cash. The investee's stockholders' equity amounted to $400,000. The excess of $600,000 was due to an unrecorded patent with a six-year life. In 2020, Ace reported net income of $250,000 and paid dividends of $25,000.

What is the Equity Investment balance at December 31, 2020?

a. $ 825,000
b. $1,100,000
c. $1,125,000
d. $1,175,000

Answer: c

Topic: Intercompany Sales of Inventory
LO: 4, 5

29. Investor owns 30% of Investee and applies the equity method. In 2020, Investor sells merchandise costing $240,000 to Investee for $300,000. Investee's ending inventory includes $50,000 purchased from Investor.

What amount of unrealized gross profit must be deferred in the equity method entry?

a. $ 3,000
b. $10,000
c. $15,000
d. $50,000

Answer: a

Topic: Intercompany Sales of Inventory
LO: 4, 5

30. Investor owns 30% of Investee and applies the equity method. In 2020, Investor sells merchandise costing $240,000 to Investee for $300,000. Investee's ending inventory includes $50,000 purchased from Investor.

Which of the following is the correct equity method entry to defer the unrealized gross profit?

a.

Equity Income	3,000	
Equity Investment		3,000

b.

Equity Investment	3,000	
Equity Income		3,000

c.

Cost of Goods Sold	50,000	
Equity Investment		50,000

d.

Equity Investment	50,000	
Equity Income		50,000

Answer: a

Topic: Intercompany Sales of Inventory
LO: 4, 5

31. Investor owns 30% of Investee and applies the equity method. In 2020, Investor sells merchandise costing $240,000 to Investee for $300,000. Investee's ending inventory includes $50,000 purchased from Investor.

Which of the following is the correct equity method entry to record the realization of the gross profit in 2021?

a.

Equity Income	3,000	
Equity Investment		3,000

b.

Equity Investment	3,000	
Equity Income		3,000

c.

Equity Investment	50,000	
Cost of Goods Sold		50,000

d.

Equity Income	50,000	
Equity Investment		50,000

Answer: b

Topic: Intercompany Sales of Inventory
LO: 4, 5

32. Investor owns 20% of Investee and applies the equity method. In 2020, Investee sells merchandise costing $100,000 to Investor for $150,000. Investor's ending inventory includes $30,000 purchased from Investee.

What amount of unrealized gross must be deferred in the equity method entry?

a. $ 2,000
b. $ 6,000
c. $10,000
d. $30,000

Answer: a

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

33. On January 2, 2020, Maddison Company purchased 35% of the outstanding common stock of Ellinger, Inc. and subsequently used the equity method to account for the investment. During 2020 Ellinger, Inc. reported net income of $400,000 and distributed dividends of $100,000. The ending balance in the Investment in Ellinger, Inc. account at December 31, 2020 was $500,000 after applying the equity method during 2020.

What was the purchase price Maddison paid for its investment in Ellinger?
a. $175,000
b. $360,000
c. $395,000
d. $400,000

Answer: c

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

34. Jionni Corporation purchased 35% of the common stock of the Hazel Corporation for $1, 000,000 on January 2, 2020. Hazel Corporation paid cash dividends of $200,000 during 2020, and reported net income of $500,000 for 2020.

Jionni's Equity Income from Hazel is:
a. $105,000
b. $ 70,000
c. $245,000
d. $175,000

Answer: d

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

35. Francis, Inc. acquired 40% of Park's voting stock on January 1, 2020 for $420,000. During 2020, Park earned $120,000 and paid dividends of $60,000. During 2021, Park earned $160,000 and paid dividends of $50,000 on April 1 and $40,000 on December 1. On July 1, 2021, Francis sold half of its stock in Park for $275,000 cash.

The Equity Investment balance at December 31, 2020 is:
a. $420,000
b. $444,000
c. $408,000
d. $492,000

Answer: b

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

36. Francis, Inc. acquired 40% of Park's voting stock on January 1, 2020 for $420,000. During 2020, Park earned $120,000 and paid dividends of $60,000. During 2021, Park earned $160,000 and paid dividends of $50,000 on April 1 and $40,000 on December 1. On July 1, 2021, Francis sold half of its stock in Park for $275,000 cash.

What is the gain on sale of the investment if income was earned evenly throughout 2021?

a. $ 39,000
b. $181,000
c. $ 47,000
d. $ 94,000

Answer: c

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

37. On January 1, 2020, Cracker Co. purchased 40% of Dallas Corp.'s common stock at book value of net assets. The balance in Cracker's Equity Investment account was $820,000 at December 31, 2020. Dallas reported net income of $500,000 for the year ended December 31, 2020, and paid dividends totaling $150,000 during 2020.

How much did Cracker pay for its 40% interest in Dallas?

a. $680,000
b. $500,000
c. $560,000
d. $760,000

Answer: a

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

38. On January 1, 2020, Sarai, Inc. purchased 40% of the voting common stock of Rolls Corp. for $500,000. There was no amortization. During 2020, Rolls paid dividends of $50,000 and reported a net loss of $120,000.

What is the balance in the Equity Investment account on December 31, 2020?

a. $432,000
b. $380,000
c. $528,000
d. $548,000

Answer: a

Topic: Intercompany Sales of Inventory
LO: 4, 5

39. Blue Mountain, Inc. owns 40% of Grand Co. and applies the equity method. During the current year, Blue Mountain bought inventory costing $100,000 and then sold it to Grand for $150,000. At year-end, only 25% of the merchandise was still being held by Grand.

What amount of intra-entity inventory profit must be deferred by Blue Mountain?

a. $ 5,000
b. $12,500
c. $15,000
d. $37,500

Answer: a

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

40. On January 1, 2020, Sylvestor, Inc., paid $400,000 for a 20% interest in Happiness Corporation. This investee had assets with a book value of $1,500,000 and liabilities of $700,000. A patent held by Happiness was undervalued by $150,000. The patent had a ten year remaining life. Any goodwill associated with this acquisition is considered to have an indefinite life. During 2020, Happiness reported income of $200,000 and paid dividends of $80,000 while in 2021 it reported income of $230,000 and dividends of $100,000.

What is the balance in Equity Investment at December 31, 2021?

a. $420,000
b. $444,000
c. $450,000
d. $459,000

Answer: b

Exercises

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5, 6

1. On January 1, 2020, Hightower Corporation acquired a 40% interest in Smith, Inc. for $2,000,000, which was equal to book value of Smith's net assets. During 2020, Smith reported net income of $2,500,000 and paid total dividends of $750,000.

Required:

a. How much 2020 income should Hightower report from its equity method investment in Smith?
b. What amount should Hightower report as Equity Investment on its December 31, 2020 balance sheet?
c. What circumstances would require that Hightower discontinue the equity method.

Answer:

a. $2,500,000 x 0.40 = $1,000,000

b. $2,000,000 + $1,000,000 – (0.40 x $750,000) = $2,700,000

c. The following circumstances would require discontinuing the equity method:
- Investee company losses that would reduce the investment account to zero
- The investor no longer exerts significance influence.
- Payment of dividends in excess of accumulated earnings
- There is a permanent decline in fair value of the investment.

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

2. In January 2020, Foster, Inc. acquired a 40% interest in Brady, Inc. for $250,000, giving Foster significant influence over Brady. Any excess of purchase price over book value was considered goodwill. In 2020, Brady reported net income of $100,000 and paid total dividends amounting to $20,000.

Required: Prepare Foster's 2020 journal entries related to its investment in Brady.

Answer:

Equity Investment	250,000	
Cash		250,000
To record investment		
Equity Investment	40,000	
Equity income		40,000
To record investor's share of investee's reported income ($100,000 x 0.40)		
Cash	8,000	
Equity Investment		8,000
To record investor's share of dividends paid by investee ($20,000 x 0.40)		

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 3, 5

3. May Company acquires a 40% interest in Barrett Corporation and concludes that it has significant influence over Barrett. The book value of Barrett's stockholders' equity is $800,000 and May pays $450,000 for the investment. An excess of purchase price over book value was attributable to an unrecorded customer list worth $325,000, with a useful life of 10 years. After the acquisition, Barrett reported net income of $300,000 and paid May a dividend of $20,000. At the end of the year, May sells the investment for $550,000.

Required: Prepare all entries related to the investment during the year.

Answer:

Compute excess of purchase price over book value: $450,000 – (0.40 x $800,000) = $130,000
Compute annual amortization: $325,000 / 10 = $32,500

Journal entries:

Equity Investment	450,000	
Cash		450,000
To record investment.		
Equity Investment	120,000	
Equity Income		120,000
To record investor's share of investee's reported income ($300,000 x 0.40)		
Cash	20,000	
Equity Investment		20,000
To record investor's receipt of dividends		
Equity Income	13,000	
Equity Investment		13,000
To record amortization (32,500 x 0.40)		
Cash	550,000	
Equity Investment		537,000
Gain on Sale of Investment		13,000
To record sale of investment (Equity investment = $450,000 + $120,000 - $20,000 - $13,000)		

Topic: Intercompany Sales of Inventory
LO: 4, 5

4. Lauralee, Inc. owns a 30% interest in Eastwood Co., giving it representation on the investee's board of directors. At the beginning of the year, the Equity Investment was carried on Lauralee's balance sheet at $500,000. During the year, Eastwood reported net income of $250,000 and paid Lauralee a dividend of $50,000.In addition, Lauralee sold inventory to Eastwood, recording a gross profit of $20,000 on the sale. At the end of the year, 50% of the merchandise remained unsold by Eastwood.

Required:

a. Prepare the equity method journal entry to defer the unrealized inventory gross profit.
b. How much equity income should Lauralee report from Eastwood during the year?
c. What is the balance in the Equity Investment at the end of the year?

Answer:

a. Unrealized gross profit = 0.5 x $20,000 = $10,000

Journal entry:

Equity Income	3,000	
Equity Investment		3,000

$10,000 x 0.30 = $3,000

b. Lauralee's equity income from Eastwood: (0.30 x $250,000) – $3,000 = $72,000

c. Year-end Equity Investment balance: $500,000 + $72,000 – $50,000 = $522,000

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

5. Potter, Inc., acquires 10% of Weasley Corporation on January 1, 2020, for $300,000. During 2020, Weasley reported net income of $250,000 and paid total dividends of $50,000. On January 1, 2021, Potter purchased an additional 30% of Weasley for $900,000. During 2021, Weasley reported net income of $420,000 and paid dividends of $20,000.

Required:

a. Prepare the January 1, 2021 entry to adjust the equity investment account for the initial adoption of the Equity Method.
b. Compute the balance in the Equity Investment account at December 31, 2021.

Answer:

Assuming GAAP for years (and interim periods) after the December 15, 2016 effective date of ASU 2016-07.

a. Under the prospective approach in ASU 2016-07, there is no "catch up" adjustment for conversion to the equity method. If the old equity investment had unrealized holding gains/losses, then those gains and losses would be realized upon transition to the Equity Method and investment would be increased/decreased accordingly.

b. Balance in Equity Investment account at December 31, 2021:
$300,000 + $900,000 + 0.40 x ($420,000 – 20,000) = $1,360,000

Problems

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value
LO: 3, 5

1. On January 1, 2020, Skyline Co. paid $200,000 for a 40% interest in Allen Industries. Allen Industries' stockholders' equity amounted to $300,000 on that date. The excess of purchase price over book values was due to an unrecorded patent valued at $200,000 with a 5-year life. During 2020, Allen Industries reported income of $80,000 and paid dividends of $18,000. During 2021, it reported income of $90,000 and dividends of $48,000.

Assume that Skyline Co. has significant influence over the operations of Allen Industries.

Required:

a. What is the amount of goodwill?
b. What is Equity Income for 2020?
c. What is the balance in the Equity Investment account at December 31, 2020?
d. What is Equity Income for 2021?
e. What is the balance in the Equity Investment account at December 31, 2021?

Answer:

a. There is no goodwill because the difference between purchase cost and book value is explained by the undervalued patent.

b. Patent Amortization: $200,000/5 x 0.40 = $16,000
Equity Income for 2020: (0.40 x $80,000) – $16,000 = $16,000

c. Equity Investment at December 31, 2020: $200,000 + $16,000 – (0.40 x $18,000) = $208,800

d. Equity Income for 2021: (0.40 x $90,000) - 16,000 = $20,000

e. Equity Investment at December 31, 2021: $208,800 + $20,000 – (0.40 x $48,000) = $209,600

Topic: Change to the Equity Method
LO: 7

2. Tigger, Inc. acquired 10% of Admore Corporation on January 1, 2020, for $140,000 when the book value of Admore's net assets was $950,000. Tigger determined that Admore's stock does not have a readily determinable fair value. During 2020, Admore reported net income of $250,000 and paid dividends of $40,000. On January 1, 2021, Tigger purchased an additional 30% of Admore for $420,000. Any excess of cost over book value was attributable to goodwill (No amortization). On that same date, Tigger changed to the equity method. During 2021, Admore reported net income of $500,000 and paid dividends of $80,000.

Required:

a. What income did Tigger record from Admore in 2020?
b. What income did Tigger record from Admore in 2021?
c. What was the balance in Equity Investment at December 31, 2021?

Answer:

Assuming GAAP for years (and interim periods) after the December 15, 2016 effective date of ASU 2016-07.

a. In 2020, dividend income of $4,000 was Tigger's only income from Admore. (0.10 X $40,000)

b. Equity Income for 2020: 0.40 x $500,000 = $200,000

c. Equity Investment at December 31, 2020:
$140,000 + $420,000 + $200,000 – (0.40 x $80,000) = $728,000

Topic: Intercompany Sales of Inventory
LO: 4, 5

3. Ally, Inc. bought 40% of Blake Company on January 1, 2020 for $400,000. The equity method was used. No amortization was required. In 2020, Blake shipped to Ally merchandise with a cost of $25,000 and a selling price of $30,000. One-fourth of the merchandise remained in Ally's inventory at year-end and was sold in 2021. In 2021, Blake received merchandise from Ally, who recorded a gross profit of $20,000 on the sale. One-third of the merchandise remained in ending inventory. Blake reported net income of $60,000 in 2020 and $80,000 in 2021. Dividends of $10,000 were paid to Ally each year.

Required: Prepare all equity method entries for 2020 and 2021.

Answer:

Compute unrealized gross profit in December 31, 2020 inventory:
($130,000 – $25,000) x 1/4 = $1,250

Compute unrealized gross profit in December 31, 2021 inventory:
($20,000 x 1/3) = $6,667

2020 Equity Method Entries:

Equity Investment	400,000	
Cash		400,000
To record investment in Blake		
Equity Investment	15,000	
Equity Income		15,000
To record Ally's equity in Blake's reported income 0.40 x $60,000		
Cash	4,000	
Equity Investment		4,000
To record dividends received 0.40 x $10,000		
Equity Income	500	
Equity Investment		500
To recognize deferral of unrealized gross profit 0.40 x $1250		

2021 Equity Method Entries

Equity Investment	32,000	
Equity Income		32,000

To record Ally's equity in Blake's reported income 0.40 x $80,000

Cash	4,000	
Equity Investment		4,000

To record dividends received 0.40 x $10,000

Equity Investment	500	
Equity Income		500

*T*o record realization of deferred gross profit

Equity Income	2,667	
Equity Investment		2,667

To recognize deferral of unrealized gross profit 0.40 x $6,667

Topic: Equity Method Accounting When Less Than 100% Ownership
LO: 5

4. On January 2, 2020, Thoreau Corp. purchased 25,000 shares (25%) of the common stock of Browning & Company. The purchase price was $250,000. Thoreau has significant influence over Browning. No amortization is required. During 2020, Browning reported income of $150,000 and paid dividends of $40,000. On January 2, 2021, Thoreau sold 10,000 shares for $127,500.

Required:

a. Compute the balance in Equity Investment at December 31, 2020.
b. Prepare the journal entry to record the sale of the 10,000 shares.
c. What was the balance in Equity Investment after the shares were sold?

Answer:

a. Compute Equity Investment at December 31, 2020:
$250,000 + [0.25 x ($150,000 – $34,000)] = $277,500

b. Compute book value per share: $277,500/25,000 shares = $11.10/share

Cash	127,500	
Equity Investment		111,000
Gain on Sale of Investment		16,500

To record sale of10,000 shares of Browning & Company Gain = $127,500 – (10,000 x $11.10) = $16,500.

c. Compute Equity Investment balance after sale of 10,000 shares:
$277,500 – $111,000 = $166,500