Reporting a Change to the Equity Method

**LO 1-5a**

Understand the financial reporting consequences for a change to the equity method.

In many instances, an investor’s ability to significantly influence an investee is not achieved through a single stock acquisition. The investor could possess only a minor ownership for some years before purchasing enough additional shares to require conversion to the equity method. Before the investor achieves significant influence, any investment should be reported by either the fair-value method, or if the investment fair value is not readily determinable, the cost method. After the investment reaches the point at which the equity method becomes applicable, a technical question arises about the appropriate means of changing from one method to the other.[**16**](http://html1-cluster-e.mheducation.com/smartbook2/ebook/Hoyle13e_AA_sn360b/OPS/s9ml/remarks.xhtml#key-ch01-14)

FASB ASC (para. 323-10-35-33) addresses the issue of how to account for an investment in the common stock of an investee that, through additional stock acquisition or other means (e.g., increased degree of influence, reduction of investee’s outstanding stock, etc.) becomes qualified for use of the equity method.

If an investment qualifies for use of the equity method…, the investor shall add the cost of acquiring the additional interest in the investee (if any) to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting.

Thus, the FASB requires a prospective approach by requiring that the cost of any new share acquired simply be added to the current investment carrying amount*.* By mandating prospective treatment, the FASB avoids the complexity of restating prior period amounts.[**17**](http://html1-cluster-e.mheducation.com/smartbook2/ebook/Hoyle13e_AA_sn360b/OPS/s9ml/remarks.xhtml#key-455c060e5072421d8b62c4cc50bd4c75)

To illustrate, assume that on January 1, 2017, Alpha Company exchanges $84,000 for a 10 percent ownership in Bailey Company. At the time of the transaction, officials of Alpha do not believe that their company gained the ability to exert significant influence over Bailey. Alpha properly accounts for the investment using the fair-value method and recognizes in net income its 10 percent ownership share of changes in Bailey’s fair value. The fair and book values of Bailey’s common stock appear below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** |  |  | **Fair Value** | **Book Value** |
| January 1, 2017 |  |  | $840,000 | $670,000 |
| December 31, 2017 |  |  |   890,000 |   715,000 |

At the end of 2017, Alpha recognizes the increase in its 10 percent share of Bailey’s fair value and increases its investment account to $89,000. Because the fair-value method is used to account for the investment, Bailey’s $670,000 book value balance at January 1, 2017 does not affect Alpha’s accounting.

Then on January 1, 2018, Alpha purchases an additional 30 percent of Bailey’s outstanding voting stock for $267,000 and achieves the ability to significantly influence the investee’s decision making. Alpha will now apply the equity method to account for its investment in Bailey. To bring about the prospective change to the equity method, Alpha prepares the following journal entry on January 1, 2018:

|  |  |  |
| --- | --- | --- |
| Investment in Bailey Company | 267,000 |  |
| Cash |  | 267,000   |
| To record an additional 30 percent investment in Bailey Company |  |  |

On January 1, 2018, Bailey’s carrying amounts for its assets and liabilities equaled their fair values except for a patent, which was undervalued by $175,000 and had a 10-year remaining useful life.

To determine the proper amount of excess fair value amortization required in applying the equity method, Alpha prepares an investment allocation schedule. The fair value of Alpha’s total (40 percent) investment serves as the valuation basis for the allocation schedule as of January 1, 2018, the date Alpha achieves the ability to exercise significant influence over Bailey. Below is the January 1, 2018 investment allocation schedule:

|  |  |
| --- | --- |
| **Investment Fair Value Allocation Schedule** |  |
| **Investment in Bailey Company** |  |
| **January 1, 2018** |  |
| Current fair value of initial 10 percent ownership of Bailey | $  89,000 |
| Payment for additional 30 percent investment in Bailey | 267,000 |
| Total fair value of 40 percent investment in Bailey | $356,000 |
| Alpha’s share of Bailey’s book value (40% × $715,000) | 286,000 |
| Investment fair value in excess of Bailey’s book value | $  70,000 |
| Excess fair value attributable to Bailey’s patent (40% × $175,000) | $  70,000 |
|  | -0- |

We next assume that Bailey reports net income of $130,000 and declares and pays a $50,000 dividend at the end of 2018. Accordingly, Alpha applies the equity method and records the following three journal entries at the end of 2018:

|  |  |  |
| --- | --- | --- |
| Investment in Bailey Company | 45,000 |  |
| Equity in Investee Income |  | 45,000 |
| To accrue 40 percent of the year 2018 income reported by Bailey Company ($130,000 × 40%) – $7,000 excess patent amortization (10-year remaining life). |  |  |
| Dividend Receivable | 20,000 |  |
| Investment in Bailey Company |  | 20,000 |
| To record the 2018 dividend declaration by Bailey Company ($50,000 × 40%). |  |  |
| Cash | 20,000 |  |
| Dividend Receivable |  | 20,000 |
| To record collection of the cash dividend. |  |  |