

## Chapter 2

### STOCK INVESTMENTS - INVESTOR ACCOUNTING AND REPORTING

#### *Chapter Outline*

**ACCOUNTING FOR STOCK INVESTMENTS – ALL STOCK INVESTMENTS MUST BE RECORDED AT THE INVESTOR’S COST (FAIR VALUE AT ACQUISITION).**

**A** TWO METHODS OF ACCOUNTING FOR STOCK INVESTMENTS GENERALLY APPLY (FAIR VALUE/COST AND EQUITY).

**B** In the absence of evidence to the contrary, **an investment of 20% or more** is presumed to give the investor an ability to exercise significant influence. The equity method requires that the investment be recorded at cost and the investment account adjusted for earnings, losses, and dividends.

**1** The **equity method should not be used** if the ability to exercise significant influence is temporary or if the investee is a foreign company operating under severe exchange restrictions or controls.

**2** **GAAP** provides indicators of the inability to exercise significant influence:

- a** **Opposition by the investee** that challenges the investor’s influence
- b** **Surrender of significant stockholder rights** by agreement between investor and investee
- c** **Concentration of majority ownership**
- d** Inadequate or untimely information to apply the equity method
- e** **Failure to obtain representation** on the investee’s board of directors

#### **ACCOUNTING FOR NONCURRENT COMMON STOCK INVESTMENTS UNDER THE FAIR VALUE/COST METHOD:**

**A** The **fair value/cost method is used for common stock investments of less than 20%** unless it can be demonstrated that the investor company has the ability to exercise significant influence over the investee company.

**B** GAAP classifies equity securities that have a readily determinable market value as either trading securities or available-for-sale securities.

- 1 Investment is **initially recorded at cost**.
- 2 The investment is **adjusted to fair value at the end of the fiscal period**.
- 3 **Unrealized gains or losses are reported** either in income or as an equity adjustment to the balance sheet (other comprehensive income), **depending on the company's intention for holding the stock**.
- 4 **Unrealized gains and losses associated with 'trading' securities are recorded as part of income.**
  - a Trading securities are very short-term holdings – continued relationships are not expected.
- 5 **Unrealized gains and losses associated with 'available for sale' securities are considered "other comprehensive income" and are reported in the income statement, on a separate statement of comprehensive income, or in a statement of changes in equity.**
  - a **Only dividend income and realized gains and losses impact income and EPS for available for sale securities.**

**C Under the fair value/cost method:**

- 1 Investment is **initially recorded at cost**.
- 2 Dividends received are recorded as **dividend income**.
  - a **An exception: Liquidating dividends are deducted from the investment account.** Liquidating dividends are those dividends received in excess of the investor's share of earnings after the stock is acquired and are considered a **return of capital**.

**ACCOUNTING FOR NONCURRENT COMMON STOCK INVESTMENTS UNDER THE EQUITY METHOD:**

**A Application of the equity method**

- 1 The investment is **initially recorded at cost**.
- 2 Subsequently, the **investor records its share of the investee's income as an increase to the investment account** (losses will decrease the investment account).
- 3 **Dividends received from the investee are recorded as a decrease to the investment account.**

- a The **investment account moves in the same direction as the investee's net assets** (for example, income increases assets for both).

**4 Additional adjustments** are required.

- a **Intercompany profits and losses are eliminated until realized.**
- b **Cost-book value differentials are accounted for** as if the investee were a consolidated subsidiary.

(1) The **difference between the investment cost and the underlying equity is assigned to identifiable assets and liabilities based on their fair values** with any remaining difference allocated to goodwill.

(2) The **difference between investment cost and book value acquired will disappear over the remaining lives of identifiable assets and liabilities**, except for amounts assigned to land, goodwill, and intangible assets having an indeterminate life, which are not amortized.

(3) **If the book value acquired is greater than the investment cost**, the difference should be **allocated against non-current assets other than marketable securities** with any remaining amount treated as an extraordinary gain (negative goodwill).

- c The investment is reported on one line of the investor's balance sheet and income on one line of the investor's income statement, **a one-line consolidation.**

(1) **Except extraordinary and other below-the-line items**

**C Accounting for an interim investment**

- 1 Absent evidence to the contrary, **income of the investee is assumed to be earned proportionately throughout the year.**
- 2 The **investee's book value at an interim date** is determined by adding income earned from the last statement date to beginning stockholders' equity and deducting dividends declared to the date of purchase.

**D Investments acquired step-by-step**

- 1 An investor may **acquire significant influence through a series of purchases.**

- 2 Prior to obtaining significant influence, the fair value/cost method is used. When an investment qualifies for the equity method, **the investment account is adjusted to the equity method and the investor's retained earnings are adjusted retroactively.**

a This is a change in reporting entity and it **requires retroactive restatement if material.**

**E** Sale of an equity interest

- 1 When an investor **reduces its equity interest in an investee to below 20%**, the retained investment is accounted for under the **fair value/cost method.**

a **Gain or loss from the equity interest sold** is the difference between the selling price and the book value of the equity interest immediately before the sale.

b Immediately after the sale, **the balance of the investment account becomes the new cost basis.**

**F** If the stock is purchased directly from the investee (rather than its shareholders), the investor's interest is determined by dividing shares acquired by shares outstanding immediately after the issuance of the additional shares.

**G** Investees with preferred stock

- 1 Special adjustments are necessary when investees have both common and preferred stock outstanding.

- 2 Investee's stockholders' equity must be **allocated into its common and preferred stock components to determine the book value of the common stock investment.**

- 3 Investee's **net income must also be allocated** into common and preferred stock components.

- 4 **Call or liquidating premiums and dividends in arrears** must also be considered in determining the investor's share of earnings.

**H** **EXTRAORDINARY ITEMS** – one-line consolidation does not apply. Investment income must be separated into ordinary and extraordinary components.

## **DISCLOSURES FOR EQUITY INVESTMENTS**

- A**     **Material investments accounted for by the equity method require disclosure of:**
- 1**    The **investee's name and percent of ownership in common stock**, the **investor's accounting policies** with respect to investments in common stock, the **cost/book value differentials** and accounting treatment
  - 2**    The **aggregate value of each identified investment** for which quoted market prices are available
  - 3**    **Summarized information about the investee's assets, liabilities, and results of operations**
- B**     Related party transactions
- 1**    Related party transactions **arise when one of the transacting parties has the ability to significantly influence the operations of the other.**
  - 2**    There is **no presumption of arms-length bargaining** between the related parties.
  - 3**    Required disclosures include the **nature of the relationship**, a **description of the transaction**, the **dollar amount** of the transaction (and any change in the method used to establish the terms of the transaction), and **amounts due to or due from related parties** at the balance sheet date for each balance sheet presented.

## **TESTING GOODWILL FOR IMPAIRMENT**

- A**     GAAP eliminates former requirements to amortize goodwill; rather, goodwill must be periodically tested for impairment.
- 1**     Firms may find this **valuable for two reasons.**
    - a**       **Firms may recognize significant impairment losses on initial adoption** which are treated as a "cumulative effect of an accounting change" (appears after "income from operations").
    - b**       Firms will **no longer report annual goodwill expense** charges.
- B**     Recognizing and measuring impairment losses is a **two-step process.**
- 1**    **First, carrying values and fair values of net assets are compared** at the business reporting unit level.

- a **If fair value is greater than carrying value**, goodwill is deemed unimpaired and **no further action is necessary**.
    - b **If carrying value is greater than fair value**, the firm proceeds to step 2.
  - 2 Step 2, when necessary, **requires a comparison of the carrying value of goodwill with its implied fair value**.
  - 3 The implied fair value of goodwill is determined in the same manner used to originally record the goodwill at the business combination date.
    - a Allocate the fair value of the reporting unit to all identifiable assets and liabilities as if they had made the purchase on the measurement date. **Any excess is the implied fair value of goodwill**.
  - 4 The fair value of the reporting unit is the **amount for which it could be purchased or sold in a current, arm's-length transaction**.
    - a **Current market prices** (in an active market) are considered the **most reliable indicator of fair value**.
- C Goodwill impairment testing must be conducted at least annually.**
- 1 **More frequent testing may be required if certain events occur** such as adverse changes in the legal or business climate, new and unanticipated competition, loss of key personnel, and other similar events.
- D Reporting and disclosure**
- 1 Material aggregate amounts of **goodwill must be reported as a separate line item on the balance sheet**.
  - 2 **Goodwill impairment losses are shown separately in the income statement**.
- E Equity method investments**
- 1 **Many of the rules regarding goodwill** in purchase method business combinations (parent acquiring a controlling interest in a sub) **also apply to goodwill arising from use of the equity method**.
  - 2 One notable exception is the rule regarding goodwill impairments – **impairment tests are performed based on fair value versus book value of the investment taken as a whole**.

**Description of assignment material****Minutes**

## Questions (14)

## Exercises (16)

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E2-3	[Tre/Bow] Calculate percentage ownership and goodwill from investment acquired directly from investee	12	
E2-4	[Car/Med] Calculate income for midyear investment	15	
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E2-8	[Ray/Ton] Calculate investment balance four years after acquisition	15	
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E2-10	[Arb/Tee] Calculate income and investment balance for midyear investment	15	
E2-11	[Pim/Fed] Adjust investment account and determine investment income when additional investment qualifies investee for the equity method of accounting	25	
E2-12	[Tal/Riv] Journal entries (investment in previously unissued stock)	15	
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## Problems (12)

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P2-2	[Put/Sel] Journal entries for midyear investment (cost and equity methods)	20
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P2-5	[Quake/Tremor] Prepare an allocation schedule, compute income and the investment balance	15
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P2-10	[Fred/Prima] Computations for a piecemeal acquisition	25
P2-11	[Pat/Sue] Computations and a correcting entry (errors)	25
P2-12	[John/Jojo] Allocation schedule and computations (excess cost over fair value)	25

#### Case study

Coca Cola's 2009 annual report is used to understand the equity method.

#### Internet assignment

Ford's 2009 annual report is used to study Ford's intercompany investments.