CONCEPT: EQUITY METHOD INVESTMENTS

● When we have significant influence over another company, GAAP requires the use of the ***equity method***

□ *No influence* → ____________ % ownership of common stock → use ____________ method

- If you own just a few shares of a company, you cannot influence any decision-making at that company

□ *Significant Influence* → ____________ % ownership of common stock → use ____________ method

- With enough common stock, you can influence who is voted onto the decision-making board of directors

□ *Controlling interest* → ____________ % ownership of common stock → use ____________ method

- With enough common stock, you can sway all the votes and have complete control of the company

- Consolidation accounting is beyond the scope of this course

● The ***equity method*** of accounting has four common journal entries that are made:

□ ***Purchase of Investment –*** when your company purchases enough shares to have significant influence

□ ***Net Income/Loss of Investee –*** your investment income is based on the net income/loss of the investee

□ ***Dividends Received –*** dividends received are _______ investment income in the equity method

□ ***Sale of Investment –*** when you sell your investment, you take a gain/loss

- The amount of gain/loss is based on the difference between the selling price and book value

● A journal entry is recorded when the equity method investment is ***purchased***:

On January 1, Year 1, Big Old Company purchased 50,000 shares of Small Boy Company's 125,000 outstanding shares of common stock at a market price of $25 per share.

Journal Entry:

Assets	=	Liabilities	+	Equity

*Investment Income = % Ownership * Net Income of Investee*

- The company earns ***investment income*** based on their percentage ownership of the investee's net income:

On December 31, Year 1, Small Boy Company reported a net income of $560,000..

Journal Entry:

Assets	=	Liabilities	+	Equity

- The company can also have an ***investment loss*** based on their percentage ownership of the investee's net loss:

On December 31, Year 2, Small Boy Company reported a net loss of $100,000..

Journal Entry:

Assets	=	Liabilities	+	Equity

- The company ***reduces their investment asset*** based on their percentage of investee dividends received:

In January Year 3, Small Boy Company declared and paid dividends of $420,000.

Journal Entry:

Assets	=	Liabilities	+	Equity

- Use a T-account to keep track of the balance in the Investment Asset account:

- The company reports a ***gain on sale of investment*** if the selling price ____________ the book value of the investment:

On January 2, Year 3, Big Old Company sold its investment in Small Boy Company for $1,400,000..

Journal Entry:

Assets	=	Liabilities	+	Equity

- The company reports a ***loss on sale of investment*** if the selling price ____________ the book value of the investment:

On January 2, Year 3, Big Old Company sold its investment in Small Boy Company for $1,100,000..

Journal Entry:

Assets	=	Liabilities	+	Equity

PRACTICE: On January 3, Johnson Corp acquired 35% of the outstanding common stock of Small Company for $350,000. For the year ended December 31, Small Company reported net income of $150,000 and paid cash dividends of $70,000 on its common stock. At December 31, the carrying value of Johnson Corp's investment in Small Company under the equity method is:

a) $322,000
b) $350,000
c) $378,000
d) $398,000

PRACTICE: On January 4, The Jones Company purchased 35,000 out of the 87,500 outstanding shares of Miller Company for $400,000. During the year, the Miller Company reported net income of $240,000 and paid cash dividends of $60,000, while the Jones Company reported net income of $450,000 and paid cash dividends of $80,000. What is the carrying value of Jones Company's investment in Miller Company at the end of the year under the equity method?

a) $400,000
b) $472,000
c) $496,000
d) None of the above

PRACTICE: GT Company owns 9,000 of the 48,000 shares of outstanding common stock of Bell Company. GT Company should account for this investment using the:

a) Market method
b) Equity method
c) Lower-of-cost-or-market method
d) Consolidation method