FA Module 16: Equity method of accounting (overview)

(The attached PDF file has better formatting.)

Reading:

- chapter 15 § 5 Investments in associates and joint ventures, *excluding*
  - Exhibit 6 (Deutsche Bank 2011 annual report)
  - sub-section 5.7 (disclosure)
  - sub-section 5.8 (issues for analysts)

The equity method of accounting (minority active investments) applies when the investor has influence but not control over the investee, indicated by ownership of 20% to 50% of the investee's voting shares. Evidence of control or of lack of influence can rebut the inference drawn from the ownership percentage.

- Income from the investment is the investor's share of the investee's income, not the dividends received.
  - the investee's net income flows through the investor's income statement
  - the investee's other comprehensive income in included in the investor's other comprehensive income
  - dividends from the investee increase cash, not the investor's net income
- The change to the carrying value of the investment is the investor's share of the investee's income *minus* the dividends received.
  - Dividends received increase cash and are not double counted as "investments in associates."

Investment costs exceeding the book value of the investee are allocated:

- to tangible assets or to intangible assets with finite useful lives
- to general goodwill with indefinite useful life

This excess investment cost is depreciated or amortized on the financial statements of the parent (not of the subsidiary or associate) of the estimated useful life of the investee.

Final exam problems derive the accounting entries on the investor's balance sheet and income statement for the investee's net income and other comprehensive income; the dividends received; and the amortization of the excess investment cost.

A previous module covered impairment of fixed assets, and the next module covers impairment of goodwill of consolidated subsidiaries. This module covers impairment of investee values.

Intercompany transactions with associates (or with consolidated subsidiaries) are eliminated from the income statement. The exercises illustrate the adjustments for (i) upstream sales and (ii) downstream sales.

Final exam problems may give the upstream sales or downstream sales in one year, the re-sales to outside parties in the next year, and the percentage ownership, and derive the accounting entries in each year.