

FA Module 16: Equity method of accounting (overview 4th edition)

(The attached PDF file has better formatting.)

(Readings from the fourth 4th edition of the Robinson text.)

- ! chapter 13 § 4 Investments in associates and joint ventures, *excluding*
- ! Exhibit 4 (Deutsche Bank 2011 annual report)
- ! sub-section 4.7 (disclosure)
- ! sub-section 4.8 (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 is 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) over 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.

The final exam does not test 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 to derive the accounting entries in each year.

Know Example 1 Equity Method: Balance in Investment Account, and be able to compute the equity income and the dividends received in each year and the equity investment at the end of each year. The logic is the same as for stock investments, except that income from associates uses book values and stocks use fair values.

Know Example 2 Equity Method Investment in Excess of Book Value; distinguish book values, fair values, and purchase price, so that you can compute net identifiable assets and goodwill. Note that the excess purchase price is the excess over the net book value: $€100,000 - 30\% \times €220,000 = €34,000$. The goodwill is the excess over the net fair value: $€100,000 - 30\% \times €270,000 = €19,000$, which is the excess purchase price minus the part attributable to net assets (textbook: "goodwill is the residual excess not allocated to identifiable assets or liabilities.")

Know Example 3 Equity Method Investments with Goodwill; note the amortization procedure: land and goodwill have indefinite useful lives. The year 2011 is a typo for 2018. Net income and dividends are offsets, not complements. The two ways to compute the balance in the investment account are equivalent. Know the two methods, so you can check your solutions to final exam problems.

Know Example 4 Equity Method with Sale of Inventory: Upstream Sale and Example 5 Equity Method with Sale of Inventory: Downstream Sale; be sure you can calculate the equity income in both years. Final exam problems are likely to include an excess purchase price and either an upstream sale or a downstream sale.