

Chapter 1

Accounting for Intercorporate Investments

Learning Objectives – Coverage by question

	Multiple Choice	Exercises	Problems
LO1 – Identify the types of business combinations and the accounting for each.	2, 9	5	
LO2 – Explain the mechanics of the accounting for investments using the equity method of accounting.	2, 4, 12		
LO3 – Explain when the equity method should be used.	3, 7, 8, 18		
LO4 – Explain the amortization of excess assets, and the deferral of unrealized income.	5, 11, 19, 20, 21, 25, 26, 27, 28, 40	2	1
LO5 – Explain the process for deferral of unrealized income.	13, 29, 30, 31, 32, 39	4	3
LO6 – Explain the equity method of accounting for less than 100% ownership.	1, 10, 11, 16, 17, 18, 24, 33, 34, 35, 36, 37, 38	1, 3, 6	4
LO7 – Explain when the equity method should be discontinued.	14		
LO8 – Explain the accounting for changes to and from the equity method.	6, 15, 22, 23		2
LO9 – Explain the required disclosures for equity method investments.			
LO10 – Explain the criticisms of the equity method of accounting.			

Chapter 1: Accounting for Intercompany Investments

Multiple Choice

Multiple Choice – Theory

Topic: Accounting for Investments Using the Equity Method with Less Than 100% Ownership

LO: 6

1. Grand Corporation uses the equity method of accounting for its investment in a 30%-owned investee that earned \$48,000 and paid \$12,000 in dividends. As a result, Grand Corporation made the following entries:

Equity Investment	14,400	
Equity Income		14,400
Cash	3,600	
Dividend Revenue		3,600

What effect will these entries have on Grand Corporation's balance sheet?

- a. Investment understated, retained earnings understated
- b. Investment overstated, retained earnings overstated
- c. Investment overstated, retained earnings understated
- d. No effect

Answer: b

Topic: Accounting for Investments Using the Equity Method and Fair Value Method

LO: 1, 2

2. Bosch Co. received a cash dividend from a common stock investment. Should Bosch report an increase in the investment account if it accounts for the investment under the fair value method or the equity method?
- a. Fair value method, NO; Equity method, NO
 - b. Fair value method, YES; Equity method, YES
 - c. Fair value method, YES; Equity method, NO
 - d. Fair value method, NO; Equity method, YES

Answer: a

Topic: Significant Influence

LO: 3

3. An investor who owns 30% of the common stock of an investee is most likely to exercise significant influence requiring use of the equity method when:
- a. The investor and investee sign an agreement under which the investor surrenders significant rights
 - b. The investor tries and fails to obtain representation on the investee's board of directors
 - c. Tries and fails to obtain financial information from the investee
 - d. The second largest investor owns only 1% of the investee's outstanding stock

Answer: d

Topic: Accounting for Investments Using the Equity Method

LO: 2

4. An investor uses the equity method to account for an investment in common stock. After the date of acquisition, the equity investment account of the investor is:
- Not affected by its share of the earnings or losses of the investee
 - Not affected by its share of the earnings of the investee but is decreased by its share of the losses of the investee.
 - Increased by its share of the earnings of the investee but is not affected by its share of the investee's losses.
 - Increased by its share of the earnings of the investee and is decreased by its share of the investee's losses.

Answer: d

Topic: Accounting for Investments Using the Equity Method when Purchase Price Exceeds Book Value

LO: 4

5. Richard uses the equity method to account for its investment in Plains on January 1. On the date of acquisition, Plains' land and buildings were undervalued on its balance sheet. How do these excesses of fair values over book values affect Richard's Equity Income from Plains?
- Building, Decrease; Land, Decrease
 - Building, Decrease; Land, No Effect
 - Building, Increase; Land, Increase
 - Building, Increase; Land, No Effect

Answer: b

Topic: Change to the Equity Method

LO: 8

6. On January 1, Wolf purchased 15% of Fieldman's common stock. On August 1, it purchased another 30% of Fieldman 's common stock. During October, Fieldman declared and paid a cash dividend on its common stock. How much income from Fieldman should Wolf report on its income statement?
- 15% of Fieldman 's income for January 1 to July 31, plus 45% of Fieldman 's income for the remainder of the year
 - 45% of Fieldman 's income from August 1 to December 31 only
 - 40% of Fieldman 's income
 - The amount of dividends received from Fieldman.

Answer: a

Topic: Significant Influence

LO: 3

7. Which of the following does not indicate an investor company's ability to significantly influence an investee?
- Material inter-company transactions
 - The investor owns 30% while another investor owns 70%
 - Interchange of personnel
 - Technological dependency

Answer: b

Topic: Equity Method of Accounting for Investments

LO: 3

8. When a company holds between 20% and 50% of the outstanding stock of an investee, which of the following statements applies?
- The investor should always use the equity method to account for its investment.
 - The investor should use the equity method to account for its investment unless circumstances indicate that it is unable to exercise "significant influence" over the investee.
 - The investor must use the fair value method unless it can clearly demonstrate the ability to exercise "significant influence" over the investee.
 - The investor should always use the fair value method to account for its investment.

Answer: b

Topic: Basket Purchase vs. Net Asset Acquisition

LO: 1

9. The main difference between a "basket purchase" and a net asset acquisition is that:
- In a net acquisition, all assets are valued at full fair value regardless of purchase price; while in a "basket purchase" the purchase price is allocated to the various assets.
 - In a "basket purchase", assets are valued at fair value while in a net asset acquisition; assets are recorded at book values.
 - In a net asset acquisition, the assets are not actually recorded on the investor's books.
 - There is no difference in the accounting for the two types of transactions.

Answer: a

Topic: Accounting for Investments Using the Equity Method with Less Than 100% Ownership

LO: 6

10. If a 30% acquisition is made at book value, what will be the relationship between the Equity Investment account and the investee's stockholders' equity?
- There is no particular relationship
 - The Equity Investment account will remain at original cost even as the investee's stockholders' equity increases
 - The Equity Investment account balance will equal 30% of investee's stockholders' equity throughout the life of the investment
 - The Equity Investment account balance will equal 30% of investee's stockholders' equity at date of acquisition, but the relationship will change as the investee reports income and dividends.

Answer: c

Topic: Accounting for Investments Using the Equity Method when Purchase Price Exceeds Book Value

LO: 4, 6

11. If a 30% acquisition is made at a price above book value due to an undervalued patent, what will be the relationship between the Equity Investment account and the investee's stockholders' equity?
- There is no particular relationship
 - The Equity Investment account will remain at original cost even as the investee's stockholders' equity increases.
 - The Equity Investment account balance will equal 30% of investee's stockholders' equity throughout the life of the investment.
 - The Equity Investment account balance will equal 30% of investee's stockholders' equity at date of acquisition, plus the unamortized cost of the patent.

Answer: d

Topic: Change in Market Value for an Equity Method Investment

LO: 2

12. In the case of an equity method investment for which there is a change in market value:
- Unrealized gains are reported in the income statement, but unrealized losses are not reported
 - Unrealized gains and losses are reported on the balance sheet only
 - Unrealized gains and losses are recognized in other comprehensive income
 - No gains are recognized in income until the investment is sold

Answer: d

Topic: Intercompany Sales of Inventory Effect on Equity Investments

LO: 5

13. If an investor sells merchandise to an investee and the investee resells all of the items to outside parties in the same period, what equity method entry is required?
- The entire gross profit is deferred with a debit to Equity Income and credit to Equity Investment.
 - No equity method entry is required, since the gross profit is realized.
 - The entire gross profit is deferred with a credit to Equity Income and Debit to Equity Investment
 - The investor's percentage of the gross profit is deferred with a debit to Equity Income.

Answer: b

Topic: Equity Investment Balance of Zero

LO: 7

14. When the Equity Investment balance is reduced to zero as investee incurs losses:
- The investment remains at zero until the investment is sold
 - The investment remains at zero until profits have eliminated the unrealized loss
 - The investor must change to the fair value method
 - Additional investment losses will result in a credit balance in Equity Investment

Answer: b

Topic: Change from the Equity Method

LO: 8

15. When an investor can no longer exert significant influence over the investee, it must change to the fair value method. What is the required accounting treatment on investor's books?
- A prior period adjustment is recorded to bring retained earnings to what it would have been if the new method had been used in the past.
 - The book value on the date of change becomes the "cost" of the investment.
 - The investment will be adjusted to its fair value.
 - Both b and c are required.

Answer: d

Multiple Choice – Computational

Topic: Equity Method Accounting when Less than 100% Ownership

LO: 6

16. On January 2, 2013, P. T. Binder, Inc. purchased a 25% interest in Funk Corp. for \$1,000,000 cash. During 2013, Funk's net income was \$2,000,000 and it paid dividends of \$600,000. Binder's 2013 income from Funk was:
- a. \$500,000
 - b. \$ 150,000
 - c. \$1,400,000
 - d. \$420,000

Answer: a

Topic: Equity Method Accounting when Less than 100% Ownership

LO: 6

17. Based on the facts described in Question 16, what Equity Investment balance should P. T. Binder report at December 31, 2013?
- a. \$1,000,000
 - b. \$850,000
 - c. \$1,350,000
 - d. \$1,250,000

Answer: c

Topic: Equity Method Accounting when Less than 100% Ownership

LO: 3, 6

18. CFR, Inc. purchased a 10% interest in The Candy Company on January 2, 2013. The purchase price was \$400,000. CFR's officers constitute a majority of The Candy Company's board of directors. The investee reported net income of \$500,000 and paid dividends of \$150,000 in 2013. On the December 31, 2013, balance sheet, what amount should CFR report as Equity Investment in The Candy Company?
- a. \$900,000
 - b. \$870,000
 - c. \$800,000
 - d. \$830,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

19. Koko Co. purchased a 30% interest in Lange Enterprises on December 31, 2014 for \$200,000. On that date, Lange's net assets had a book value of \$500,000 and fair value of \$600,000. What amount of goodwill resulted from this acquisition?
- a. \$0
 - b. \$40,000
 - c. \$60,000
 - d. \$100,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

20. Dot Co. acquired a 40% interest in Jefferson, Inc. with the excess of purchase price over book value solely attributable to equipment with a five-year life and undervaluation by \$100,000. During the year of acquisition, Jefferson reported net income of \$150,000. What amount of Equity Income should Dot report on its income statement for the year of acquisition?
- a. \$80,000
 - b. \$112,000
 - c. \$120,000
 - d. \$104,000

Answer: d

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

21. On December 31, 2013, Ohare, Inc. paid \$430,000 for all of the common stock of High Corp. On that date, High had assets and liabilities with book values of \$400,000 and \$90,000; and fair values of \$420,000 and \$70,000, respectively. What amount of goodwill will be reported on the December 31, 2013 balance sheet?
- a. \$80,000
 - b. \$ 10,000
 - c. \$90,000
 - d. \$120,000

Answer: a

Topic: Change to the Equity Method

LO: 8

22. On January 1, 2013, Julie Corp. acquired a 10% interest in Mizz Enterprises. On January 1, 2014, Julie acquired an additional 20% Mizz's common stock. No goodwill resulted from either purchase. Mizz reported net incomes of \$600,000 and \$650,000 for 2013 and 2014, respectively. Dividends paid by Mizz amounted to \$200,000 in 2013 and \$350,000 in 2014. What amount of Equity Income should be reported by Julie Corp in 2014?
- a. \$52,500
 - b. \$97,500
 - c. \$117,500
 - d. \$72,500

Answer: b

Topic: Change to the Equity Method

LO: 8

23. Assume the same facts as in Question 22. What is the amount of the required prior period adjustment to make Julie's Equity Investment balance at January 1, 2014, equal to what it would have been had the equity method been applied in 2013?
- a. \$80,000
 - b. \$60,000
 - c. \$ 20,000
 - d. \$ 30,000

Answer: c

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

24. Johnson Corp. purchased a 30% interest in Burke Company on July 1, 2013. On November 15, 2013 Burke paid dividends of \$20,000 to its common stockholders. The investee reported 2013 net income of \$60,000, which was earned evenly throughout the year. What amount of Equity Income should Johnson report in its 2013 income statement?
- a. \$18,000
 - b. \$9,000
 - c. \$6,000
 - d. \$ 3,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

25. On January 2, 2012, Ferris Co. purchased a 30% interest in Harvy Corporation for \$125,000. Fair values of Harvy's net assets exceeded book values due to land undervalued by \$100,000. In 2012, Harvy reported net income of \$50,000 and paid no dividends. What is the amount of Equity Investment on the December 31, 2012, balance sheet?
- a. \$105,000
 - b. \$110,000
 - c. \$138,000
 - d. \$140,000

Answer: d

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

26. On January 2, 2013, Quincy Corporation purchased a 40% interest in Mary, Inc. for \$200,000. Fair values of Mary's net assets equaled book values except for equipment undervalued by \$45,000. The equipment had a six-year remaining life. During 2013, Mary reported net income of \$60,000 and paid dividends of \$10,000. What is Quincy's Equity Income for 2013?
- a. \$24,000
 - b. \$21,000
 - c. 4,000
 - d. \$20,000

Answer: b

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

27. Pike purchased all of Milk Company's common stock On January 1, 2014, for \$1,000,000 cash. The investee's stockholders' equity amounted to \$800,000. The excess of \$200,000 was due to an unrecorded patent with a four-year life. In 2014, Milk reported net income of \$160,000 and paid dividends of \$20,000. For 2014, what amount of Equity Income will Pike record?
- a. \$110,000
 - b. \$120,000
 - c. \$150,000
 - d. \$160,000

Answer: a

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

28. Assume the facts in Question 27. What is the Equity Investment balance at December 31, 2014?
- a. \$1,110,000
 - b. \$1,090,000
 - c. \$1,130,000
 - d. \$1,140,000

Answer: b

Topic: Intercompany Sales of Inventory

LO: 5

29. Investor owns 30% of Investee and applies the equity method. In 2012, Investor sells merchandise costing \$108,000 to Investee for \$180,000. Investee's ending inventory includes \$40,000 purchased from Investor. What amount of unrealized gross profit must be deferred in the equity method entry?
- a. \$ 4,800
 - b. \$ 9,600
 - c. \$21,600
 - d. \$ 16,000

Answer: a

Topic: Intercompany Sales of Inventory

LO: 5

30. Assume the facts in Question 29. Which of the following is the correct equity method entry to defer the unrealized gross profit?
- | | | | |
|----|--------------------|--------|--------|
| a. | Equity Income | 4,800 | |
| | Equity Investment | | 4,800 |
| b. | Equity Investment | 4,800 | |
| | Equity Income | | 4,800 |
| c. | Cost of Goods Sold | 16,000 | |
| | Equity Investment | | 16,000 |
| d. | Equity Income | 16,000 | |
| | Equity Investment | | 16,000 |

Answer: a

Topic: Intercompany Sales of Inventory

LO: 5

31. Assume the facts in Question 29. Which of the following is the correct equity method entry to record the realization of the gross profit in 2013?
- | | | | |
|----|--------------------|--------|--------|
| a. | Equity Income | 4,800 | |
| | Equity Investment | | 4,800 |
| b. | Equity Investment | 4,800 | |
| | Equity Income | | 4,800 |
| c. | Equity Investment | 16,000 | |
| | Cost of Goods Sold | | 16,000 |
| d. | Equity Income | 16,000 | |
| | Equity Investment | | 16,000 |

Answer: b

Topic: Intercompany Sales of Inventory

LO: 5

32. Investor owns 40% of Investee and applies the equity method. In 2012, Investee sells merchandise costing \$50,000 to Investor for \$70,000. Investor's ending inventory includes \$30,000 purchased from Investee. What amount of unrealized gross must be deferred in the equity method entry?
- a. \$ 4,000
 - b. \$ 8,000
 - c. \$14,000
 - d. \$ 9,600

Answer: a

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

33. On January 2, 2012 Cannon Company purchased 25% of the outstanding common stock of Angel, Inc. and subsequently used the equity method to account for the investment. During 2012 Angel, Inc. reported net income of \$210,000 and distributed dividends of \$90,000. The ending balance in the Investment in Angel, Inc. account at December 31, 2012 was \$160,000 after applying the equity method during 2012. What was the purchase price Cannon paid for its investment in Angel, Inc?
- a. \$85,000
 - b. \$130,000
 - c. \$190,000
 - d. \$235,000

Answer: b

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

34. Sugar Corporation purchased 25% of the common stock of the Pippen Corporation for \$500,000 on January 2, 2012. Pippen Corporation paid cash dividends of \$30,000 during 2012, and reported net income of \$100,000 for 2012. Sugar's Equity Income from Pippen is:
- a. \$7,500
 - b. \$17,500
 - c. \$25,000
 - d. \$27,500

Answer: c

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

35. Kolasa, Inc. acquired 30% of Karsa's voting stock on January 1, 2013 for \$200,000. During 2013, Karsa earned \$80,000 and paid dividends of \$50,000. During 2014, Karsa earned \$100,000 and paid dividends of \$30,000 on April 1 and \$30,000 on October 1. On July 1, 2014, Kolasa sold half of its stock in Karsa for \$132,000 cash. The Equity Investment balance at December 31, 2013 is:
- a. \$200,000
 - b. \$209,000
 - c. \$224,000
 - d. \$230,000

Answer: b

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

36. Assume the facts in Question 35. What is the gain on sale of the investment if income was earned evenly throughout 2014?
- a. \$32,000
 - b. \$27,500
 - c. \$24,500
 - d. \$20,000

Answer: c

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

37. On January 1, 2013, Value Co. purchased 25% of Thomas Corp.'s common stock at book value of net assets. The balance in Value's Equity Investment account was \$360,000 at December 31, 2013. Thomas reported net income of \$225,000 for the year ended December 31, 2013, and paid dividends totaling \$90,000 during 2013. How much did Value pay for its 25% interest in Thomas?
- a. \$326,250
 - b. \$382,500
 - c. \$393,750
 - d. \$438,750

Answer: a

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

38. On January 1, 2013, Eva, Inc. purchased 30% of the voting common stock of Bob Corp. for \$500,000. There was no amortization. During 2013, Bob paid dividends of \$12,000 and reported a net loss of \$70,000. What is the balance in the Equity Investment account on December 31, 2013?
- a. \$475,400
 - b. \$479,000
 - c. \$418,000
 - d. \$495,050

Answer: a

Topic: Intercompany Sales of Inventory

LO: 5

39. Barker, Inc. owns 30% of Gregory Co. and applies the equity method. During the current year, Barker bought inventory costing \$66,000 and then sold it to Gregory for \$120,000. At year-end, only 20% of the merchandise was still being held by Gregory. What amount of intra-entity inventory profit must be deferred by Barker?
- a. \$3,240
 - b. \$1,620
 - c. \$5,400
 - d. \$8,100

Answer: a

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

- 40.** On January 1, 2013, Eva, Incorporated, paid \$200,000 for a 30% interest in Nash Corporation. This investee had assets with a book value of \$1,110,000 and liabilities of \$600,000. A patent held by Nash was undervalued by \$60,000. The patent had a six year remaining life. Any goodwill associated with this acquisition is considered to have an indefinite life. During 2013, Nash reported income of \$100,000 and paid dividends of \$40,000 while in 2014 it reported income of \$150,000 and dividends of \$60,000. What is the balance in Equity Investment at December 31, 2014?
- a. \$239,000
 - b. \$251,000
 - c. \$233,000
 - d. \$236,000

Answer: a

Exercises

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6, 7

1. On January 1, 2013, Samuel Corporation acquired a 30% interest in Blanton, Inc. for \$315,000, which was equal to book value of Blanton's net assets. During 2013, Blanton reported net income of \$120,000 and paid total dividends of \$37,500.

Required:

- How much 2013 income should Samuel report from its equity method investment in Blanton?
- What amount should Samuel report as Equity Investment on its December 31, 2013 balance sheet?
- What circumstances would require that Samuel discontinue the equity method.

Answer:

- $\$120,000 \times 0.30 = \$36,000$
- $\$315,000 + \$36,000 - 0.30 \times \$37,500 = \$339,750$
- The following circumstances would require discontinuing the equity method:
 - Investee company losses that would reduce the investment account to zero
 - The investor no longer exerts significance influence.
 - Payment of dividends in excess of accumulated earnings
 - There is a permanent decline in market value of the investment.

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

2. In January 2012, Wallace, Inc. acquired a 25% interest in Minaj, Inc. for \$1,750,000, giving Wallace significant influence over Minaj. Any excess of purchase price over book value was considered goodwill. In 2012, Minaj reported net income of \$525,000 and paid total dividends amounting to \$175,000.

Required: Prepare Wallace's 2012 journal entries related to its investment in Minaj.

Answer:

Equity Investment	1,750,000	
Cash		1,750,000
To record investment.		

Equity Investment	131,250	
Equity income		131,250
To record investor's share of investee's reported income (\$525,000 x 0.25).		

Cash	43,750	
Equity Investment		43,750
To record investor's share of dividends paid by investee.		

Topic: Equity Method Accounting When Less Than 100% Ownership**LO: 6**

3. Manger Company acquires a 30% interest in Jones Corporation and concludes that it has significant influence over Jones. The book value of Jones' stockholders' equity is \$600,000 and Manger pays \$300,000 for the investment. An excess of purchase price over book value was attributable to an unrecorded customer list worth \$400,000, with a useful life of 10 years. After the acquisition, Jones reported net income of \$150,000 and paid Manger a dividend of \$12,000. At the end of the year, Manger sells the investment for \$350,000.

Required: Prepare all entries related to the investment during the year.

Answer:

Compute excess of purchase price over book value: $\$300,000 - (0.30 \times \$600,000) = \$120,000$

Compute annual amortization: $\$120,000 / 10 = \$12,000$

Journal entries:

Equity Investment	300,000	
Cash		300,000

To record investment.

Equity Investment	45,000	
Equity Income		45,000

To record investor's share of investee's reported income (\$150,000 x 0.30).

Cash	7,200	
Equity Investment		7,200

To record investor's receipt of dividends.

Equity Income	12,000	
Equity Investment		12,000

To record amortization.

Cash	350,000	
Equity Investment		325,800
Gain on Sale of Investment		24,200

To record sale of investment (Equity investment = $\$300,000 + \$45,000 - \$7,200 - \$12,000$).

Topic: Intercompany Sales of Inventory**LO: 5**

4. McGuinn, Inc. owns a 40% interest in Cervantes Co., giving it representation on the investee's board of directors. At the beginning of the year, the Equity Investment was carried on McGuinn's balance sheet at \$750,000. During the year, Cervantes reported net income of \$240,000 and paid McGuinn a dividend of \$48,000. In addition, McGuinn sold inventory to Cervantes, recording a gross profit of \$60,000 on the sale. At the end of the year, 25% of the merchandise remained unsold by Cervantes.

Required:

- Prepare the equity method journal entry to defer the unrealized inventory gross profit.
- How much income should McGuinn report from Cervantes during the year?
- What is the balance in the Equity Investment at the end of the year?

Answer:

- Unrealized gross profit = $0.25 \times \$60,000 = \$15,000$

Journal entry:

Equity Income	6,000	
Equity Investment		6,000
$\$15,000 \times .40 = \$6,000$		

- McGuinn's Income from Cervantes: $(0.40 \times \$240,000) - 6,000 = \$90,000$
- Year-end Equity Investment balance: $\$750,000 + 90,000 - 48,000 = \$792,000$

Topic: Net Asset Acquisition vs. Stock Acquisition**LO: 1**

5. Oakland Company reports the following summarized balance sheet on the date that it is acquired by Soccer, Inc.:

Current Assets	\$34,000	Current Liabilities	\$30,000
Property, plant, & equipment	<u>40,000</u>	Long-Term Liabilities	28,000
		Stockholders' Equity	<u>16,000</u>
Total Assets	<u>\$74,000</u>	Total liabilities and equity	<u>\$74,000</u>

Soccer acquired Oakland for \$8,000 cash.

Required:

- Prepare the journal entry if Soccer acquires all of the individual assets and liabilities of Oakland in the business combination.
- Prepare the journal entry if Soccer buys 100% of Oakland's common stock.

Answer:

- Journal entry to record acquisition of assets/liabilities:

Current Assets	34,000	
Property, plant and equipment	40,000	
Current liabilities		30,000
Long-term liabilities		28,000
Cash		16,000

- Journal entry to record purchase of 100% of Oakland's common stock:

Equity Investment	16,000	
Cash		16,000

Topic: Equity Method Accounting When Less Than 100% Ownership

LO: 6

6. Ukele, Inc., acquires 10% of Cambridge Corporation on January 1, 2013, for \$140,000. During 2013, Cambridge reported net income of \$360,000 and paid total dividends of \$80,000. On January 1, 2014, Ukele purchased an additional 30% of Cambridge for \$620,000. During 2014, Cambridge reported net income of \$600,000 and paid dividends of \$80,000.

Required:

- a. Prepare the January 1, 2014 entry to adjust the Equity Investment account to what it would have been had the equity method been followed from the initial purchase of the investment.
- b. Compute the balance in the Equity Investment account at December 31, 2014.

Answer:

- a. Journal entry to adjust the Equity Investment account balance to what it would have been at January 1, 2014, had the equity method been applied from the initial purchase of stock:

Equity Investment	28,000	
Retained Earnings		28,000
$0.10 \times (\$360,000 - 80,000)$		

- b. Balance in Equity Investment account at December 31, 2014:
 $\$140,000 + 28,000 + \$620,000 + 0.40 \times (\$600,000 - 80,000) = \$996,000$

Problems

Topic: Accounting for Equity Investments When the Purchase Price Exceeds Book Value

LO: 4

1. On January 1, 2013, Compton Co. paid \$20,000 for a 20% interest in General Enterprises. General's stockholders' equity amounted to \$40,000 on that date. The excess of purchase price over book values was due to an unrecorded patent valued at \$60,000 with a 10-year life. During 2013, General Enterprises reported income of \$10,000 and paid dividends of \$2,000. During 2014, it reported income of \$15,000 and dividends of \$3,000. Assume that Compton has significant influence over the operations of General.

Required:

- What is the amount of goodwill?
- What is Equity Income for 2013?
- What is the balance in the Equity Investment account at December 31, 2013?
- What is Equity Income for 2014?
- What is the balance in the Equity Investment account at December 31, 2014?

Answer:

- There is no goodwill because the difference between purchase cost and book value is explained by the undervalued patent.
- Patent Amortization: $\$60,000/10 \times 0.20 = \$1,200$
Equity Income for 2013: $(0.20 \times \$10,000) - 1,200 = \800
- Equity Investment at December 31, 2013: $\$20,000 + 800 - (0.20 \times 2,000) = \$20,400$
- Equity Income for 2014: $(0.20 \times \$15,000) - 1,200 = \$1,800$
- Equity Investment at December 31, 2014: $\$20,400 + 1,800 - (0.20 \times 3,000) = \$21,600$

Topic: Change to the Equity Method

LO: 8

2. Statement Enterprises acquired 15% of Cima Corporation on January 1, 2012, for \$126,000 when the book value of Cima's net assets was \$720,000. During 2012, Cima reported net income of \$180,000 and paid dividends of \$60,000. On January 1, 2013, Statement purchased an additional 25% of Cima for \$240,000. Any excess of cost over book value was attributable to goodwill (No amortization). On that same date, Statement changed to the equity method. During 2013, Cima reported net income of \$240,000 and paid dividends of \$90,000.

Required:

- What income did Statement record from Cima in 2012?
- What income did Statement record from Cima in 2013?
- What journal entry was made to convert to the equity method?
- What was the balance in Equity Investment at December 31, 2013?

Answer:

- In 2012, dividend income of \$9,000 was Statement's only income from Cima. $(0.15 \times \$60,000)$
- Equity Income for 2013: $0.40 \times \$240,000 = \$96,000$
- Entry (Prior Period Adjustment) at January 1, 2013 to Convert to Equity Method:

Equity Investment	18,000	
Retained Earnings		18,000
$0.15 \times (\$180,000 - 60,000)$		
- Equity Investment at December 31, 2013:
 $\$126,000 + 240,000 + 18,000 + 96,000 - (0.40 \times \$90,000) = \$444,000$

Topic: Intercompany Sales of Inventory**LO: 5**

3. BIG, Inc. bought 30% of Small Company on January 1, 2012 for \$135,000. The equity method was used. No amortization was required. In 2012, Small shipped to BIG merchandise with a cost of \$9,000 and a selling price of \$13,500. One-third of the merchandise remained in BIG's inventory at year-end and was sold in 2013. In 2013, Small received merchandise from BIG, who recorded a gross profit of \$12,000 on the sale. One-fourth of the merchandise remained in ending inventory. Small reported net income of \$30,000 in 2012 and \$36,000 in 2013. Dividends of \$3,600 were paid to BIG each year.

Required: Prepare all equity method entries for 2012 and 2013.

Answer:

Compute unrealized gross profit in December 31, 2012 inventory:
 $(\$13,500 - 9,000) \times 1/3 = \$1,500$

Compute unrealized gross profit in December 31, 2013 inventory: $(\$12,000 \times 1/4) = \$3,000$

2012 Equity Method Entries

Equity Investment	135,000	
Cash		135,000

To record investment in Small.

Equity Investment	9,000	
Equity Income		9,000

To record BIG's equity in Small's reported income $0.30 \times \$30,000$.

Cash	1,080	
Equity Investment		1,080

To record dividends received $0.30 \times \$3,600$.

Equity Income	450	
Equity Investment		450

To recognize deferral of unrealized gross profit $0.30 \times \$1,500$.

2013 Equity Method Entries

Equity Investment	10,800	
Equity Income		10,800

To record BIG's equity in Small's reported income $0.30 \times \$36,000$.

Cash	1,080	
Equity Investment		1,080

To record dividends received $0.30 \times \$3,600$.

Equity Investment	450	
Equity Income		450

To record realization of deferred gross profit.

Equity Income	900	
Equity Investment		900

To recognize deferral of unrealized gross profit $0.30 \times \$3,000$.

Topic: Equity Method Accounting When Less Than 100% Ownership**LO: 6**

4. On January 2, 2013, JKL Corp. purchased 24,000 shares (40%) of the common stock of MNO & Company. The purchase price was \$240,000. JKL has significant influence over MNO. No amortization is required. During 2013, MNO reported income of \$60,000 and paid dividends of \$24,000. On January 2, 2014 JKL sold 3,000 shares for \$37,500.

Required:

- Compute the balance in Equity Investment at December 31, 2013.
- Prepare the journal entry to record the sale of the 3,000 shares.
- What was the balance in Equity Investment after the shares were sold?

Answer:

- Compute Equity Investment at December 31, 2013:

$$\$240,000 + .40 \times (\$60,000 - 24,000) = \$254,400$$
- Compute book value per share: $\$254,400 / 24,000 \text{ shares} = \$10.60/\text{share}$

Cash	37,500	
Equity Investment		31,800
Gain on Sale of Investment		5,700

To record sale of 3,000 shares of MNO & Company Gain =
 $\$37,500 - (3,000 \times \$10.60) = \$5,700.$
- Compute Equity Investment balance after sale of 3,000 shares:
 $\$254,400 - 31,800 = \$222,600$