Chapter 02
Reporting Intercorporate Interests

Multiple Choice Questions

On January 1, 2007, Rotor Corporation acquired 30 percent of Stator Company's stock for $150,000. On the acquisition date, Stator reported net assets of $450,000 valued at historical cost and $500,000 stated at fair value. The difference was due to the increased value of buildings with a remaining life of 15 years. During 2007 and 2008 Stator reported net income of $25,000 and $15,000 and paid dividends of $10,000 and $12,000, respectively. Rotor uses the equity method.

1. Based on the preceding information, what amount of differential will be amortized annually?
A. $0
B. $750
C. $1,000
D. $2,000

2. Based on the preceding information, what will be the balance in the investment account on Dec 31, 2007?
A. $150,000
B. $157,500
C. $154,500
D. $153,500

3. Based on the preceding information, what amount of investment income will be reported by Rotor for the year 2007?
A. $6,500
B. $7,500
C. $7,000
D. $25,000

4. Based on the preceding information, what amount will Rotor report as the balance in the investment account on Dec 31, 2008?
A. $150,000
B. $157,500
C. $153,400
D. $153,500

5. Based on the preceding information, what amount of investment income will be reported by Rotor for 2008?
A. $6,500
B. $7,500
C. $3,500
D. $4,500

6. Based on the preceding information, had Rotor Corporation used the cost method, what would have been the balance in the investment account on Dec 31, 2008?
A. $150,000
B. $157,500
C. $153,400
D. $153,500

On January 1, 2007, Firewire Company acquired 40 percent of Browser Company's common stock. For this acquisition, Firewire paid $45,000 above book value. The full differential was attributed to equipment with a remaining life of ten years and zero salvage value at the date of acquisition. During 2007 and 2008, Browser reported net income of $90,000 and $50,000 and paid dividends of $40,000 and $60,000, respectively. Firewire reported a balance in its investment account of $230,000 on December 31, 2008. It uses the equity method in accounting for this investment.

7. Based on the preceding information, what is the annual amount of amortization of differential over the ten year period?
A. $0
B. $1,800
C. $4,500
D. $8,500

8. Based on the preceding information, during 2007, Firewire will report:
A. an increase in the investment account balance of $15,500.
B. a decrease in the investment account balance of $20,000.
C. an increase in the investment account balance of $36,000.
D. a decrease in the investment account balance of $31,500.

9. Based on the preceding information, during 2008, Firewire will report:
A. an increase in the investment account balance of $8,000.
B. a decrease in the investment account balance of $15,500.
C. an increase in the investment account balance of $20,000.
D. a decrease in the investment account balance of $8,500.

10. Based on the information provided, what would be the amount paid by Firewire for this acquisition?
A. $254,000
B. $223,000
C. $230,000
D. $174,000

11. On January 1, 2009 Athlon Company acquired 30 percent of the common stock of Opteron Corporation, at underlying book value. For the same year, Opteron reported net income of $55,000, which includes an extraordinary gain of 40,000. It did not pay any dividends during the year. By what amount would Athlon's investment in Opteron Corporation increase for the year, if Athlon used the equity method?
A. $0
B. $16,500
C. $4,500
D. $12,000

On January 1, 2008, William Company acquired 30 percent of eGate Company's common stock, at underlying book value of $100,000. eGate has 100,000 shares of $2 par value, 5 percent cumulative preferred stock outstanding. No dividends are in arrears. eGate reported net income of $150,000 for 2008 and paid total dividends of $72,000. William uses the equity method to account for this investment.

12. Based on the preceding information, what amount would William Company receive as dividends from eGate for the year?
A. $62,000
B. $21,600
C. $18,600
D. $54,000

13. Based on the preceding information, what amount of investment income will William Company report from its investment in eGate for the year?
A. $45,000
B. $42,000
C. $62,000
D. $35,000

14. Based on the preceding information, what amount would be reported by William Company as the balance in its investment account on December 31, 2008?
A. $100,000
B. $123,400
C. $120,400
D. $142,000

Denver Corporation owns 25 percent of the voting shares of Alamos Corporation. In 2008, Alamos reported net income of $120,000 and paid dividends of $30,000. Denver uses the equity method to account for this investment. Denver reported taxable income of $160,000 on its separate operations and has an effective tax rate of 40 percent. There is an 80 percent exemption on intercompany dividends.

15. Based on the preceding information, income tax expense for Denver for the year 2008 will be:
A. $67,000
B. $64,600
C. $64,000
D. $66,400

16. Based on the preceding information, income taxes payable for Denver for the year 2008 will be:
A. $67,000
B. $64,600
C. $64,000
D. $76,000

Connector Corporation invested in an unincorporated joint venture and elected to use pro rata consolidation in preparing its financial statements. Connector reported income of $120,000 from its separate operations and net income of $150,000 for the year ended December 31, 2008. The joint venture reported assets of $150,000 and liabilities of $60,000 on January 1, 2008, and assets of $240,000 and liabilities of $75,000 on December 31, 2008. It made no distributions to owners during the year. Connector reports total assets (excluding its investment in the unincorporated joint venture) of $550,000 at December 31, 2008.

17. Based on the preceding information, what is Connector's percentage ownership in the joint venture?
A. 20 percent
B. 50 percent
C. 40 percent
D. 25 percent

18. Based on the preceding information, what amount of total assets will Connector report in its balance sheet on December 31, 2008?
A. $646,000
B. $625,000
C. $610,000
D. $628,000

19. Based on the preceding information, Connector's total assets at the end of the year will be highest if it were able to use:
A. pro rata consolidation.
B. equity-method reporting.
C. cost-method reporting.
D. full consolidation.

On January 1, 2008, Gulfstream Corporation acquired 40 percent of the voting shares of Hunter Company for $65,000. Hunter reported net income of $45,000 and paid dividends of $10,000 in 2008. Gulfstream reported operating income of $50,000 for the year. There is 80 percent exemption of intercompany dividends and the effective tax rate is 35 percent. Assume that the equity method is being used.

20. Based on the preceding information, what would Gulfstream report as income tax expense for the year?
A. $17,500
B. $18,760
C. $23,800
D. $22,540

21. Based on the preceding information, what amount would Gulfstream report as net income (after taxes) for the year?
A. $49,240
B. $68,000
C. $64,000
D. $67,500

On January 1 2007, Wheeley Company issued common shares with a par value of $20,000 and a market value of $172,000 in exchange for 40 percent ownership of Twain Company. Balance sheet information reported by Twain on that date is given below:

TWAIN COMPANY
Balance Sheet
January 1, 2007

	Book Value	Fair Value
Assets		
Cash and Receivables	$100,000	$100,000
Inventory (FIFO Basis)	88,000	100,000
Buildings and Equipment (net)	168,000	225,000
Patent		40,000
Total Assets	$356,000	$465,000
Liabilities and Equities		
Accounts Payable	$35,000	$35,000
Common Stock	120,000	
Additional Paid-In Capital	25,000	
Retained Earnings	176,000	
Total Liabilities and Equities	$356,000	

Twain reported net income of $56,000 and paid dividends of $25,000 during the year. Wheeley uses the equity method of accounting. The estimated economic life of the patents held by Twain is 8 years. The buildings and equipment are expected to last 6 more years on average with zero salvage value.

22. Based on the information provided, differential assigned by Wheeley to inventory for the year is:
A. $0
B. $12,000
C. $4,800
D. $22,000

23. Based on the information provided, what amount of differential assigned to buildings and equipment will be amortized for the year?
A. $0
B. $4,800
C. $2,000
D. $3,800

24. Based on the information provided, what amount of differential assigned to patents will be amortized for the year?
A. $0
B. $4,800
C. $2,000
D. $3,800

25. Based on the information provided, what amount of income will be reported by Wheeley from its investment in Twain for the year 2007?
A. $22,400
B. $11,800
C. $4,800
D. $12,400

26. Based on the information provided, what will be the balance in the investment account on December 31, 2007 reported by Wheeley?
A. $172,000
B. $173,800
C. $183,800
D. $194,400

On January 1, 2007, Yang Corporation acquired 25 percent of the outstanding shares of Spiel Corporation for $100,000 cash. Spiel Company reported net income of $75,000 and paid dividends of $30,000 for both 2007 and 2008. The fair value of shares held by Yang was $110,000 and $105,000 on December 31, 2007 and 2008 respectively.

27. Based on the preceding information, what amount will be reported by Yang as income from its investment in Spiel for 2008, if it used the equity method of accounting?
A. $7,500
B. $11,250
C. $18,750
D. $26,250

28. Based on the preceding information, what amount will be reported by Yang as balance in investment in Spiel on December 31, 2008, if it used the equity method of accounting?
A. $111,250
B. $118,750
C. $100,000
D. $122,500

29. Based on the preceding information, what amount will be reported by Yang as income from its investment in Spiel for 2007, if it used the fair value method of accounting?
A. $17,500
B. $12,500
C. $11,250
D. $7,500

30. Based on the preceding information, what amount will be reported by Yang as income from its investment in Spiel for 2008, if it used the fair value method of accounting?
A. $11,250
B. $2,500
C. $6,250
D. $7,500

31. Based on the preceding information, what amount will be reported by Yang as balance in investment in Spiel on December 31, 2008, if it used the fair value method of accounting?
A. $105,000
B. $118,750
C. $100,000
D. $122,500

32. A change from the cost method to the equity method of accounting for an investment in common stock resulting from an increase in the number of shares held by the investor requires:
A. only a footnote disclosure.
B. that the cumulative amount of the change be shown as a line item on the income statement, net of tax.
C. that the change be accounted for as an unrealized gain included in other comprehensive income.
D. retroactive restatement as if the investor always had used the equity method.

33. Under the equity method of accounting for a stock investment, the investment initially should be recorded at:
A. cost.
B. cost minus any differential.
C. proportionate share of the fair value of the investee company's net assets.
D. proportionate share of the book value of the investee company's net assets.

34. From an investor's point of view, a liquidating dividend from an investee is:
A. A dividend declared by the investee in excess of its earnings in the current year.
B. A dividend declared by the investee in excess of its earnings since acquisition by the investor.
C. Any dividend declared by the investee since acquisition.
D. A dividend declared by the investee in excess of the investee's retained earnings.

35. Under the cost method of accounting for a stock investment, the differential:
A. is written off.
B. is amortized.
C. is written down if related to limited-life assets.
D. is not amortized or written off.

36. Usually, an investment of 20 to 50 percent in another company's voting stock is reported under the:
A. cost method.
B. equity method.
C. full consolidation method.
D. fair value method.

37. Which of the following observations is consistent with the equity method of accounting?
A. Dividends declared by the investee are treated as income by the investor.
B. It is used when the investor lacks the ability to exercise significant influence over the investee.
C. It may be used in place of consolidation.
D. Its primary use is in reporting nonsubsidiary investments.

38. Which of the following observations is NOT consistent with the cost method of accounting?
A. Investee dividends from earnings since acquisition by investor are treated as reduction of investment.
B. Investments are carried by the investor at historical cost.
C. Differential is not amortized or written off.
D. It is consistent with the treatment normally accorded noncurrent assets.

Essay Questions

39. A cash dividend returns assets to the stockholders while reducing corporate liquidity. Why are not all cash dividends considered to be "liquidating dividends"? In your response include a discussion of how an investor accounts for a liquidating dividend.

40. In the absence of other evidence, common stock ownership of 20 percent or more is viewed as indicating that the investor is able to exercise significant influence over the investee. What are some of the other factors that could constitute evidence of the ability to exercise significant influence?

41. On January 31, 2008, Argentine Company acquired 20 percent of Silver Corporation's common stock at book value. During 2008 and 2009 Silver reported net income and dividends and Argentine reported operating income as follows:

	2008	2009
Silver's net income	$36,000	$24,000
Silver's dividends	12,000	16,000
Argentine's operating income	80,000	125,000

Assume an 80 percent exemption of intercompany dividends. Argentine has an effective tax rate of 35 percent.
Required: Calculate the amount of income tax expense and net income Argentine Company should report for 2008 and 2009 under the:
Cost method
Equity Method

42. On January 1, 2007, Xeta Corporation acquired 45 percent of the voting common stock of Yvonne Company by issuing common stock with a par value of $50,000 and fair value of $135,000. Immediately after this transaction, Yvonne acquired 30 percent of the voting common stock of Zerox Corporation by issuing bonds payable with a par value and market value of $35,700. On January 1, 2007, the book values of Yvonne's net assets were equal to their fair values except for equipment that had a fair value $48,000 greater than book value and patents that had a fair value $12,000 greater than book value. At that date the equipment had a remaining economic life of ten years and the patents had a remaining economic life of six years. The book values of Zerox's assets were equal to their fair values except for inventory that had a fair value $4,000 in excess of book value and was accounted for on a FIFO basis. Selected balance sheet information at January 1, 2007, and income statement data for 2007 for Xeta Corporation, Yvonne Company, and Zerox Corporation are provided below:

Account Balances	**Xeta**	**Yvonne**	**Zerox**
Cash and Receivables	$150,000	$90,000	$60,000
Inventory	75,000	45,000	35,000
Fixed Assets (net)	350,000	265,000	150,000
Total Assets	$575,000	$400,000	$245,000
Accounts Payable	$95,000	$60,000	$30,000
Bonds Payable	100,000	100,000	100,000
Common Stock	50,000	35,000	10,000
Additional Paid-in Capital	120,000	85,000	25,000
Retained Earnings	210,000	120,000	80,000
Total Liabilities and Equity	$575,000	$400,000	$245,000
Income from Operations in 2007	$140,000	$75,000	
Net Income for 2007			$30,000
Dividends Declared and Paid	30,000	10,000	15,000

Required:
1) What will be the net income reported by Xeta Corporation for 2008, assuming the equity method is used by both Xeta and Yvonne in accounting for intercorporate investments.
2) Provide all journal entries recorded by Xeta relating to its investment in Yvonne during 2007.

Chapter 02 Reporting Intercorporate Interests Answer Key

Multiple Choice Questions

On January 1, 2007, Rotor Corporation acquired 30 percent of Stator Company's stock for $150,000. On the acquisition date, Stator reported net assets of $450,000 valued at historical cost and $500,000 stated at fair value. The difference was due to the increased value of buildings with a remaining life of 15 years. During 2007 and 2008 Stator reported net income of $25,000 and $15,000 and paid dividends of $10,000 and $12,000, respectively. Rotor uses the equity method.

1. Based on the preceding information, what amount of differential will be amortized annually?
A. $0
B. $750
C. $1,000
D. $2,000

AACSB: Analytic
AICPA: Measurement

2. Based on the preceding information, what will be the balance in the investment account on Dec 31, 2007?
A. $150,000
B. $157,500
C. $154,500
D. $153,500

AACSB: Analytic
AICPA: Measurement

3. Based on the preceding information, what amount of investment income will be reported by Rotor for the year 2007?
A. $6,500
B. $7,500
C. $7,000
D. $25,000

AACSB: Analytic
AICPA: Measurement

4. Based on the preceding information, what amount will Rotor report as the balance in the investment account on Dec 31, 2008?
A. $150,000
B. $157,500
C. $153,400
D. $153,500

AACSB: Analytic
AICPA: Measurement

5. Based on the preceding information, what amount of investment income will be reported by Rotor for 2008?
A. $6,500
B. $7,500
C. $3,500
D. $4,500

AACSB: Analytic
AICPA: Measurement

6. Based on the preceding information, had Rotor Corporation used the cost method, what would have been the balance in the investment account on Dec 31, 2008?
A. $150,000
B. $157,500
C. $153,400
D. $153,500

AACSB: Analytic
AICPA: Measurement

On January 1, 2007, Firewire Company acquired 40 percent of Browser Company's common stock. For this acquisition, Firewire paid $45,000 above book value. The full differential was attributed to equipment with a remaining life of ten years and zero salvage value at the date of acquisition. During 2007 and 2008, Browser reported net income of $90,000 and $50,000 and paid dividends of $40,000 and $60,000, respectively. Firewire reported a balance in its investment account of $230,000 on December 31, 2008. It uses the equity method in accounting for this investment.

7. Based on the preceding information, what is the annual amount of amortization of differential over the ten year period?
A. $0
B. $1,800
C. $4,500
D. $8,500

AACSB: Analytic
AICPA: Measurement

8. Based on the preceding information, during 2007, Firewire will report:
A. an increase in the investment account balance of $15,500.
B. a decrease in the investment account balance of $20,000.
C. an increase in the investment account balance of $36,000.
D. a decrease in the investment account balance of $31,500.

AACSB: Analytic
AICPA: Measurement

9. Based on the preceding information, during 2008, Firewire will report:
A. an increase in the investment account balance of $8,000.
B. a decrease in the investment account balance of $15,500.
C. an increase in the investment account balance of $20,000.
D. a decrease in the investment account balance of $8,500.

AACSB: Analytic
AICPA: Measurement

10. Based on the information provided, what would be the amount paid by Firewire for this acquisition?
A. $254,000
B. $223,000
C. $230,000
D. $174,000

AACSB: Analytic
AICPA: Measurement

11. On January 1, 2009 Athlon Company acquired 30 percent of the common stock of Opteron Corporation, at underlying book value. For the same year, Opteron reported net income of $55,000, which includes an extraordinary gain of 40,000. It did not pay any dividends during the year. By what amount would Athlon's investment in Opteron Corporation increase for the year, if Athlon used the equity method?
A. $0
B. $16,500
C. $4,500
D. $12,000

AACSB: Analytic
AICPA: Measurement

On January 1, 2008, William Company acquired 30 percent of eGate Company's common stock, at underlying book value of $100,000. eGate has 100,000 shares of $2 par value, 5 percent cumulative preferred stock outstanding. No dividends are in arrears. eGate reported net income of $150,000 for 2008 and paid total dividends of $72,000. William uses the equity method to account for this investment.

12. Based on the preceding information, what amount would William Company receive as dividends from eGate for the year?
A. $62,000
B. $21,600
C. $18,600
D. $54,000

AACSB: Analytic
AICPA: Measurement

13. Based on the preceding information, what amount of investment income will William Company report from its investment in eGate for the year?
A. $45,000
B. $42,000
C. $62,000
D. $35,000

AACSB: Analytic
AICPA: Measurement

14. Based on the preceding information, what amount would be reported by William Company as the balance in its investment account on December 31, 2008?
A. $100,000
B. $123,400
C. $120,400
D. $142,000

AACSB: Analytic
AICPA: Measurement

Denver Corporation owns 25 percent of the voting shares of Alamos Corporation. In 2008, Alamos reported net income of $120,000 and paid dividends of $30,000. Denver uses the equity method to account for this investment. Denver reported taxable income of $160,000 on its separate operations and has an effective tax rate of 40 percent. There is an 80 percent exemption on intercompany dividends.

15. Based on the preceding information, income tax expense for Denver for the year 2008 will be:
A. $67,000
B. $64,600
C. $64,000
D. $66,400

AACSB: Analytic
AICPA: Measurement

16. Based on the preceding information, income taxes payable for Denver for the year 2008 will be:
A. $67,000
B. $64,600
C. $64,000
D. $76,000

AACSB: Analytic
AICPA: Measurement

Connector Corporation invested in an unincorporated joint venture and elected to use pro rata consolidation in preparing its financial statements. Connector reported income of $120,000 from its separate operations and net income of $150,000 for the year ended December 31, 2008. The joint venture reported assets of $150,000 and liabilities of $60,000 on January 1, 2008, and assets of $240,000 and liabilities of $75,000 on December 31, 2008. It made no distributions to owners during the year. Connector reports total assets (excluding its investment in the unincorporated joint venture) of $550,000 at December 31, 2008.

17. Based on the preceding information, what is Connector's percentage ownership in the joint venture?
A. 20 percent
B. 50 percent
C. 40 percent
D. 25 percent

AACSB: Analytic
AICPA: Measurement

18. Based on the preceding information, what amount of total assets will Connector report in its balance sheet on December 31, 2008?
A. $646,000
B. $625,000
C. $610,000
D. $628,000

AACSB: Analytic
AICPA: Measurement

19. Based on the preceding information, Connector's total assets at the end of the year will be highest if it were able to use:
A. pro rata consolidation.
B. equity-method reporting.
C. cost-method reporting.
D. full consolidation.

AACSB: Analytic
AICPA: Reporting

On January 1, 2008, Gulfstream Corporation acquired 40 percent of the voting shares of Hunter Company for $65,000. Hunter reported net income of $45,000 and paid dividends of $10,000 in 2008. Gulfstream reported operating income of $50,000 for the year. There is 80 percent exemption of intercompany dividends and the effective tax rate is 35 percent. Assume that the equity method is being used.

20. Based on the preceding information, what would Gulfstream report as income tax expense for the year?
A. $17,500
B. $18,760
C. $23,800
D. $22,540

AACSB: Analytic
AICPA: Measurement

21. Based on the preceding information, what amount would Gulfstream report as net income (after taxes) for the year?
A. $49,240
B. $68,000
C. $64,000
D. $67,500

AACSB: Analytic
AICPA: Measurement

On January 1 2007, Wheeley Company issued common shares with a par value of $20,000 and a market value of $172,000 in exchange for 40 percent ownership of Twain Company. Balance sheet information reported by Twain on that date is given below:

TWAIN COMPANY
Balance Sheet
January 1, 2007

	Book Value	Fair Value
Assets		
Cash and Receivables	$100,000	$100,000
Inventory (FIFO Basis)	88,000	100,000
Buildings and Equipment (net)	168,000	225,000
Patent		40,000
Total Assets	$356,000	$465,000
Liabilities and Equities		
Accounts Payable	$35,000	$35,000
Common Stock	120,000	
Additional Paid-In Capital	25,000	
Retained Earnings	176,000	
Total Liabilities and Equities	$356,000	

Twain reported net income of $56,000 and paid dividends of $25,000 during the year. Wheeley uses the equity method of accounting. The estimated economic life of the patents held by Twain is 8 years. The buildings and equipment are expected to last 6 more years on average with zero salvage value.

22. Based on the information provided, differential assigned by Wheeley to inventory for the year is:
A. $0
B. $12,000
C. $4,800
D. $22,000

AACSB: Analytic
AICPA: Measurement

23. Based on the information provided, what amount of differential assigned to buildings and equipment will be amortized for the year?
A. $0
B. $4,800
C. $2,000
D. $3,800

AACSB: Analytic
AICPA: Measurement

24. Based on the information provided, what amount of differential assigned to patents will be amortized for the year?
A. $0
B. $4,800
C. $2,000
D. $3,800

AACSB: Analytic
AICPA: Measurement

25. Based on the information provided, what amount of income will be reported by Wheeley from its investment in Twain for the year 2007?
A. $22,400
B. $11,800
C. $4,800
D. $12,400

AACSB: Analytic
AICPA: Measurement

26. Based on the information provided, what will be the balance in the investment account on December 31, 2007 reported by Wheeley?
A. $172,000
B. $173,800
C. $183,800
D. $194,400

AACSB: Analytic
AICPA: Measurement

On January 1, 2007, Yang Corporation acquired 25 percent of the outstanding shares of Spiel Corporation for $100,000 cash. Spiel Company reported net income of $75,000 and paid dividends of $30,000 for both 2007 and 2008. The fair value of shares held by Yang was $110,000 and $105,000 on December 31, 2007 and 2008 respectively.

27. Based on the preceding information, what amount will be reported by Yang as income from its investment in Spiel for 2008, if it used the equity method of accounting?
A. $7,500
B. $11,250
C. $18,750
D. $26,250

AACSB: Analytic
AICPA: Measurement

28. Based on the preceding information, what amount will be reported by Yang as balance in investment in Spiel on December 31, 2008, if it used the equity method of accounting?
A. $111,250
B. $118,750
C. $100,000
D. $122,500

AACSB: Analytic
AICPA: Measurement

29. Based on the preceding information, what amount will be reported by Yang as income from its investment in Spiel for 2007, if it used the fair value method of accounting?
A. $17,500
B. $12,500
C. $11,250
D. $7,500

AACSB: Analytic
AICPA: Measurement

30. Based on the preceding information, what amount will be reported by Yang as income from its investment in Spiel for 2008, if it used the fair value method of accounting?
A. $11,250
B. $2,500
C. $6,250
D. $7,500

AACSB: Analytic
AICPA: Measurement

31. Based on the preceding information, what amount will be reported by Yang as balance in investment in Spiel on December 31, 2008, if it used the fair value method of accounting?
A. $105,000
B. $118,750
C. $100,000
D. $122,500

AACSB: Analytic
AICPA: Measurement

32. A change from the cost method to the equity method of accounting for an investment in common stock resulting from an increase in the number of shares held by the investor requires:
A. only a footnote disclosure.
B. that the cumulative amount of the change be shown as a line item on the income statement, net of tax.
C. that the change be accounted for as an unrealized gain included in other comprehensive income.
D. retroactive restatement as if the investor always had used the equity method.

AACSB: Reflective Thinking
AICPA: Reporting

33. Under the equity method of accounting for a stock investment, the investment initially should be recorded at:
A. cost.
B. cost minus any differential.
C. proportionate share of the fair value of the investee company's net assets.
D. proportionate share of the book value of the investee company's net assets.

AACSB: Reflective Thinking
AICPA: Decision Making

34. From an investor's point of view, a liquidating dividend from an investee is:
A. A dividend declared by the investee in excess of its earnings in the current year.
B. A dividend declared by the investee in excess of its earnings since acquisition by the investor.
C. Any dividend declared by the investee since acquisition.
D. A dividend declared by the investee in excess of the investee's retained earnings.

AACSB: Reflective Thinking
AICPA: Decision Making

35. Under the cost method of accounting for a stock investment, the differential:
A. is written off.
B. is amortized.
C. is written down if related to limited-life assets.
D. is not amortized or written off.

AACSB: Reflective Thinking
AICPA: Decision Making

36. Usually, an investment of 20 to 50 percent in another company's voting stock is reported under the:
A. cost method.
B. equity method.
C. full consolidation method.
D. fair value method.

AACSB: Reflective Thinking
AICPA: Reporting

37. Which of the following observations is consistent with the equity method of accounting?
A. Dividends declared by the investee are treated as income by the investor.
B. It is used when the investor lacks the ability to exercise significant influence over the investee.
C. It may be used in place of consolidation.
D. Its primary use is in reporting nonsubsidiary investments.

AACSB: Reflective Thinking
AICPA: Decision Making

38. Which of the following observations is NOT consistent with the cost method of accounting?
A. Investee dividends from earnings since acquisition by investor are treated as reduction of investment.
B. Investments are carried by the investor at historical cost.
C. Differential is not amortized or written off.
D. It is consistent with the treatment normally accorded noncurrent assets.

AACSB: Reflective Thinking
AICPA: Decision Making

Essay Questions

39. A cash dividend returns assets to the stockholders while reducing corporate liquidity. Why are not all cash dividends considered to be "liquidating dividends"? In your response include a discussion of how an investor accounts for a liquidating dividend.

A dividend represents earnings of a company being returned to its shareholders.
A liquidating dividend occurs when an investee declares dividends in excess of the earnings from the purchase date of the investment. An individual investor must treat a liquidating dividend associated with its investment as a return of capital and reduce the investment account accordingly. It is possible for blocks of stock acquired at different times to have different amounts associated with a potential liquidating dividend.

AACSB: Communication
AICPA: Decision Making

40. In the absence of other evidence, common stock ownership of 20 percent or more is viewed as indicating that the investor is able to exercise significant influence over the investee. What are some of the other factors that could constitute evidence of the ability to exercise significant influence?

APB stated that these include 1. Representation on board of directors; 2. Participation in policy making; 3. Material intercompany transactions; 4. Interchange of managerial personnel; 5. Technological dependency; and 6. Size of investment in relation to concentration of other shareholdings.

AACSB: Communication
AICPA: Decision Making

41. On January 31, 2008, Argentine Company acquired 20 percent of Silver Corporation's common stock at book value. During 2008 and 2009 Silver reported net income and dividends and Argentine reported operating income as follows:

	2008	2009
Silver's net income	$36,000	$24,000
Silver's dividends	12,000	16,000
Argentine's operating income	80,000	125,000

Assume an 80 percent exemption of intercompany dividends. Argentine has an effective tax rate of 35 percent.
Required: Calculate the amount of income tax expense and net income Argentine Company should report for 2008 and 2009 under the:
Cost method
Equity Method

1. Cost Method

2008 Income Tax Expense

Operating income of Argentine Company	$80,000
Dividends received from Silver	
($12,000 x .20) x (1.00 - .80)	480
Income subject to taxation	$80,480
Income tax expense (35%)	$28,168

2008 Net Income

Operating income of Argentine Company	$80,000
Dividend income from Silver	
($12,000 x .20)	2,400
Income before tax expense	$82,400
Income tax expense	(28,168)
Net income of Argentine Company	$54,232

2009 Income Tax Expense

Operating income of Argentine Company	$125,000
Dividends received from Silver	
($16,000 x .20) x (1.00 - .80)	640
Income subject to taxation	$125,640
Income tax expense (35%)	$43,974

2009 Net Income

Operating income of Argentine Company	$125,000
Dividend income from Silver	
($16,000 x .20)	3,200
Income before tax expense	$128,200
Income tax expense	(43,974)
Net income of Argentine Company	$84,226

2. Equity Method

2008 Income Tax Expense

Operating income of Argentine Company	$80,000
Equity method income from investment in Silver	
subject to taxation ($36,000 x .20) x (1.00 - .80)	1,440
Income subject to taxation	$81,440
Income tax expense (35%)	$28,504

2008 Net Income

Operating income of Argentine Company	$80,000
Investment income from Silver	
($36,000 x .20)	7,200
Income before tax expense	$87,200
Income tax expense	(28,504)
Net income of Argentine Company	$58,696

2009 Income Tax Expense

Operating income of Argentine Company	$125,000
Equity method income from investment in Silver	
subject to taxation ($24,000 x .20) x (1.00 - .80)	960
Income subject to taxation	$125,960
Income tax expense (35%)	$44,086

2009 Net Income

Operating income of Argentine Company	$125,000
Investment income from Silver	
($24,000 x .20)	4,800
Income before tax expense	$129,800
Income tax expense	(44,086)
Net income of Argentine Company	$85,714

AACSB: Analytic
AICPA: Measurement

42. On January 1, 2007, Xeta Corporation acquired 45 percent of the voting common stock of Yvonne Company by issuing common stock with a par value of $50,000 and fair value of $135,000. Immediately after this transaction, Yvonne acquired 30 percent of the voting common stock of Zerox Corporation by issuing bonds payable with a par value and market value of $35,700. On January 1, 2007, the book values of Yvonne's net assets were equal to their fair values except for equipment that had a fair value $48,000 greater than book value and patents that had a fair value $12,000 greater than book value. At that date the equipment had a remaining economic life of ten years and the patents had a remaining economic life of six years. The book values of Zerox's assets were equal to their fair values except for inventory that had a fair value $4,000 in excess of book value and was accounted for on a FIFO basis. Selected balance sheet information at January 1, 2007, and income statement data for 2007 for Xeta Corporation, Yvonne Company, and Zerox Corporation are provided below:

Account Balances	**Xeta**	**Yvonne**	**Zerox**
Cash and Receivables	$150,000	$90,000	$60,000
Inventory	75,000	45,000	35,000
Fixed Assets (net)	350,000	265,000	150,000
Total Assets	$575,000	$400,000	$245,000
Accounts Payable	$95,000	$60,000	$30,000
Bonds Payable	100,000	100,000	100,000
Common Stock	50,000	35,000	10,000
Additional Paid-in Capital	120,000	85,000	25,000
Retained Earnings	210,000	120,000	80,000
Total Liabilities and Equity	$575,000	$400,000	$245,000
Income from Operations in 2007	$140,000	$75,000	
Net Income for 2007			$30,000
Dividends Declared and Paid	30,000	10,000	15,000

Required:
1) What will be the net income reported by Xeta Corporation for 2008, assuming the equity method is used by both Xeta and Yvonne in accounting for intercorporate investments.
2) Provide all journal entries recorded by Xeta relating to its investment in Yvonne during 2007.

1.

Operating income of Xeta for 2007		$140,000
Operating income of Yvonne for 2007	$75,000	
Add: Equity income from Zerox		
[($30,000 - $4,000) x .30]	7800	
Yvonne net income for 2008	$82,800	
Proportion of stock held by Xeta	x .45	$37,260
Amortization of differential:		
Equipment [($48,000 x .45) / 10 years]		(2,160)
Patents [($12,000 x .45) / 6 years]		(900)
Net income of Xeta for 2007		$174,200

2.

Investment in Yvonne Corporation Stock	135,000	
Common Stock		50,000
Additional paid-In Capital		85,000
Purchase of Yvonne Corporation Stock.		
Cash	4500	
Investment in Yvonne Corporation Stock		4500
Record dividend from Yvonne: $10,000 x .45		
Investment in Yvonne Corporation Stock	37,260	
Income from Yvonne Corporation		37,260
Record equity-method income: $82,800 x .45		
Income from Yvonne Corporation	3,060	
Investment in Yvonne Corporation Stock		3,060
Amortize differential: $3,060 = $2,160 + $900		

AACSB: Analytic
AICPA: Measurement