

---

# Advanced Accounting

Joe Ben Hoyle

---

# ADVANCED ACCOUNTING

**Joe Ben Hoyle**

University of Richmond

**1984**



**BUSINESS PUBLICATIONS, INC. Plano, Texas 75075**

Material from Uniform CPA Examination Questions and Unofficial Answers, © 1957, 1960, 1963, 1964, and 1966–1982 by the American Institute of Certified Public Accountants, Inc., is adapted or reprinted with permission.

FASB material © 1976 and 1981 by Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut, 06905. Reprinted with permission. Copies of the complete document are available from the FASB.

© BUSINESS PUBLICATIONS, INC., 1984

*All rights reserved.* No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher.

ISBN 0-256-03067-7  
Library of Congress Catalog Card No. 83-71600  
*Printed in the United States of America*

1 2 3 4 5 6 7 8 9 0 K 1 0 9 8 7 6 5 4

# PREFACE

---

The development of this advanced accounting textbook was undertaken with one underlying objective: to produce a clear and comprehensive approach to each topic so that students would find the material to be interesting as well as challenging. To this end, every effort has been made to create a textbook that will serve as an efficient educational tool. Because of the many complexities involved in such topics as consolidations, foreign currency translation, and nonprofit accounting, college students often experience difficulty mastering the fundamental concepts and principles. For this reason, this textbook attempts to present each subject from a logical and structured perspective. In addition it has been written in what one reviewer has referred to as a “conversational tone.” This writer firmly believes that a textbook need not read like a dictionary in order to be comprehensive. Regardless of the difficulty of the material, the educational process will be enhanced if students find the material to be interesting to read and study.

Chapter 1 of this textbook examines the equity method of accounting. Although this subject is important in itself, it also serves as an excellent introduction to the area of consolidated financial statements. Often referred to as a “single-line consolidation,” this study of the equity method provides the student with an understanding of such essential topics as intercompany transactions, acquisition price allocation, and amortization of goodwill.

The consolidation of financial statements is introduced in Chapter 2. Both the purchase method and the pooling of interests method are discussed in detail, with numerous examples being incorporated to assist the student in understanding the logic behind each approach. Excerpts from both *Accounting Research Bulletin No. 51* and *Accounting Principles Board Opinion No. 16* are included to aid the student in mentally assimilating the various complexities that are encountered.

Chapters 3 through 7 analyze many additional aspects of consolidated financial statements from intercompany transactions to mutual ownerships and income tax consequences. Chapter 4, for example, discusses minority interest ownership. That topic is introduced through an analysis of the valua-

tion theories (the proprietary theory, the entity theory, and the parent company theory) that have been put forth to explain the fundamental purpose of consolidated financial statements. Chapter 5 introduces intercompany asset transfers, while Chapters 6 and 7 study miscellaneous topics such as the accounting for subsidiary preferred stocks and the issuance of new equity shares.

Chapter 8 introduces two similar topics: branch accounting and consignments. In both cases, a company's assets are being disseminated geographically. The accounting problems created by the distance and number of separate reporting units are discussed and illustrated through a number of examples.

The important topic of foreign currency translation and remeasurement is analyzed in Chapter 9. A full coverage of *SFAS 52* of the Financial Accounting Standards Board is presented along with a discussion of the controversy created by the now-defunct *SFAS 8*. This writer feels that students can better appreciate the logic of *SFAS 52* by being exposed to the debate created by the original pronouncement.

Segment reporting is presented to the students in Chapter 10. Industry segments, geographical segments, export sales, and transactions with major customers are all covered by means of real-life illustrations as well as through excerpts from *SFAS 14* of the Financial Accounting Standards Board.

Chapters 11 and 12 present the various accounting procedures utilized by partnerships. The creation of a partnership is discussed along with the development of an equitable profit and loss allocation agreement. The dissolution of a partnership is also examined from both the goodwill and the bonus approach. Finally, the liquidation of a partnership's assets is set forth, including the computation of safe capital balances and the development of a predistribution plan for distributing available cash.

The last three chapters of this textbook (13 through 15) provide a comprehensive coverage of nonprofit accounting. The accounting for state and local governments, colleges and universities, hospitals, and voluntary health and welfare organizations is presented in detail. Fund accounting in each area is outlined as well as the various accounting procedures commonly encountered.

At the end of each chapter, a comprehensive illustration has been produced for the educational benefit of the student. These problems attempt to tie together many of the important elements found in the chapters and allow the student a chance to work through a complete problem subsequent to reading the chapter. For each of these problems, a solution is provided to the student along with an explanation of the procedures being used. This writer hopes that the student will use these comprehensive illustrations to obtain a better understanding of the subject material prior to coming to class. In this manner, class discussion can be more efficient and effective.

Also at the end of each chapter are numerous questions, multiple-choice problems, and longer computational problems. Questions from past CPA examinations have been used in many chapters where the questions were considered relevant to the material covered in the chapter. All other questions and problems were produced by the writer to test the students' knowledge of the material that had been presented.

\* \* \* \* \*

Numerous people have provided enormous assistance to me during the writing of this textbook. I could never possibly thank these people enough for their encouragement and their help. At the University of Richmond, Dean Thomas Reuschling and Department Chairman Jerry Bennett have provided assistance to me in many ways. Also, I would like to thank my good friend Dr. Clarence Jung, whose humor and kindness helped me to keep my sanity during the long months when I was writing my original manuscript. A number of wonderful people had the patience to put up with me in the constant typing and retyping of the manuscript: Mary Anne Wilbourne, Elizabeth Patrick, Wanda C. Green, and Linda Crescioli. I would also like to thank Kim VanHuss, who assisted me in developing the problem materials.

I have been privileged to work with some great reviewers in the development of this textbook. Their comments and suggestions have been invaluable to me, and their ideas have been incorporated throughout this textbook. My thanks go to the following people who have reviewed portions or all of the manuscript:

RICHARD BAKER  
*Northern Illinois University*  
CHARLES CATO  
*Louisiana Technical University*  
JAMES DON EDWARDS  
*University of Georgia*  
PHILLIP A. LANGEFELD  
*University of Texas at Austin*  
GALE E. NEWELL  
*Western Michigan University*

ARTHUR NIEMINSKY  
*California State University*  
JERRY TRAPNELL  
*Louisiana State University*  
JACKSON WHITE  
*University of Arkansas*  
SENIOR CLASS OF 1982 AND 1983  
*University of Richmond*

I would like to thank my two sons, Jamin and Brendan. While writing this textbook, I have not had the opportunity to play with them as I would have liked. They have been quite understanding, and I do appreciate their love.

Most of all I would like to thank my wife Sarah. Being married to a writer is a very difficult task. The writer must spend countless hours locked in a room with a typewriter. When the writer does occasionally emerge, he is

often distracted or grumpy or both. My wife has not only put up with this behavior, but she has also provided me with the love and encouragement that have made this textbook possible.

JOE BEN HOYLE

“The real purpose of books is to trap the mind into doing its own thinking.”

*Christopher Morley*

# CONTENTS

---

- 1. The Equity Method of Accounting for Investments      1**  
Procedures Used to Report Investments in Corporate Securities.  
Application of the Equity Method: *Criteria for Utilizing the Equity Method. Accounting for an Investment—the Equity Method.*  
Accounting Procedures for Applying the Equity Method: *Reporting a Change to the Equity Method. Reporting Investee Income from Other than Continuing Operations. Reporting Investee Losses. Reporting the Sale of an Equity Investment.* Excess of Investment Cost over Book Value Acquired. Elimination of Unrealized Gains in Inventory: *Downstream Sales of Inventory. Upstream Sales of Inventory.* Deferred Income Taxes.
- 2. Consolidation of Financial Information      41**  
Aspects of the Consolidation Process: *Single Economic Entity. Business Combinations. Consolidation of Financial Information.*  
Procedures for Consolidating Financial Information: *Purchase Method Where Dissolution Takes Place. Purchase Method Where Separate Incorporation Is Maintained. Pooling of Interests Where Dissolution Takes Place. Pooling of Interests Where Separate Incorporation Is Maintained.* Unconsolidated Subsidiaries. Summary. Appendix: *Twelve Criteria for a Pooling of Interests.*
- 3. Consolidations—Subsequent to the Date of Acquisition      101**  
Consolidation—the Effects Created by the Passage of Time.  
Investment Accounting—Individual Recording by Acquiring Company. Subsequent Consolidation—Investment Recorded by the Equity Method: *Acquisition Made during the Current Year. Consolidation Subsequent to Year of Acquisition—Equity Method.*  
Subsequent Consolidations—Investment Recorded on Other than the Equity Method: *Acquisition Made during the Current Year. Consolidation Subsequent to Year of Acquisition—Other than the Equity Method.*



Subsequent Consolidations—Bargain Purchases. Subsequent Consolidations—Pooling of Interests.

**4. Consolidated Financial Statements—Minority Interest 151**

Valuation of Subsidiary Accounts: *The Proprietary Theory. The Entity Theory. The Parent Company Theory. Valuation Theories in Practice.* Consolidations Involving a Minority Interest—Subsequent to Acquisition: *Minority Interest Computations. Effects Created by Alternative Investment Methods.* Step-by-Step Acquisitions: *Composition of Investment Accounts. Worksheet-Step-by-Step Acquisition. Acquisition Made within the Fiscal Year. Retroactive Treatment Created by Step-by-Step Acquisition.* Sales of Subsidiary Stock: *Establishment of Investment Book Value. Cost Flow Assumptions. Accounting for Any Remaining Shares.*

**5. Consolidated Financial Statements—Intercompany Asset Transactions 205**

Intercompany Inventory Transfers: *The Sales and Purchases Accounts. Unrealized Gains—Year of Sale. Unrealized Gains—Year Following Sale. Unrealized Gains—Effect on Minority Interest Valuation. Intercompany Inventory Transfers Illustrated. Effects on Consolidation of Alternative Investment Methods.* Intercompany Land Transfers: *Accounting for Land Transactions. Eliminating Unrealized Gains—Land Transfers. Effect on Minority Interest Valuation—Land Transfers.* Intercompany Transfer of Depreciable Assets: *The Deferral of Unrealized Gains. Depreciable Asset Transfers Illustrated. Effect on Minority Interest Valuation—Depreciable Asset Transfers.*

**6. Consolidated Financial Statements—Miscellaneous Topics: I 259**

Intercompany Debt Transactions: *Acquisition of Affiliate's Debt from an Outside Party. Accounting for Intercompany Debt Transactions—Individual Company Financial Records. Effects on Consolidation Process. Assignment of Retirement Gain or Loss. Intercompany Debt Transactions—Subsequent to Year of Acquisition.* Subsidiary Preferred Stock: *Preferred Stock Viewed as a Debt Instrument. Preferred Stock Viewed as an Equity Interest.* Subsidiary Stock Transactions: *Change in Subsidiary Book Value—Stock Transactions. Effect on Parent Company Created by Subsidiary Stock Transactions.*

**7. Consolidated Financial Statements—Miscellaneous Topics: II 321**

Indirect Subsidiary Control: *Consolidation when Indirect Control Is Present. Consolidation Process—Indirect Control.* Indirect

Subsidiary Control—Connecting Affiliation. Mutual Ownership: *Treasury Stock Approach. Conventional Approach. Mutual Ownership Illustrated.* Income Tax Accounting for a Business Combination: *Affiliated Groups. Consolidated Tax Returns. Income Tax Expense—Effect on Minority Interest. Filing Separate Tax Returns. Separate Tax Returns Illustrated.*

**8. Branch and Consignment Accounting 373**

Branch Accounting: *Proliferation of Branch Operations. Structuring of Branch Organizations. Accounting for Intracompany Transactions. Branch Accounting Illustrated. Unrealized Gains Created by Intracompany Transfers.* Consignment Accounting: *Relationship between the Consignor and the Consignee. Accounting Used by the Consignor. Consignment Accounting Illustrated from the Consignor's Perspective. Accounting Used by the Consignee.*

**9. Foreign Currency Translation 417**

Foreign Currency Translation—the Controversy: *Accounting for Fluctuation in Exchange Rates. Opposition to the Temporal Method.* The Translation Process Revised—*SFAS 52: Translating the Accounts of a Foreign Subsidiary. The Translation Process Illustrated. Remeasurement of Foreign Currency Transactions. The Remeasurement Process Illustrated. Financial Statements Remeasured. Remeasurement in a Highly Inflationary Economy. Hedging. Forward Exchange Contract—Investment for Speculation.*

**10. Segment Reporting 465**

Disaggregated Information—Historical Perspective: *SFAS 14—Guidelines for Segment Reporting. Segment Reporting Overviewed. Usefulness of Disaggregated Financial Information.* Disaggregated Information—Industry Segments: *Identifying Industry Segments. Determination of Significant Industry Segments. Testing for Reportable Industry Segments.* Disaggregated Information—Foreign and Domestic Operations: *Testing for Significant Geographic Segments. Testing Procedures Illustrated. Geographic Segments—Disclosure Requirements.* Disaggregated Information—Exports and Reliance on Major Customers.

**11. Partnerships: Formation and Operation 499**

Partnerships—Advantages and Disadvantages. Partnership Accounting—Capital Accounts: *Articles of Partnership. Accounting for Capital Contributions. Allocation of Income. Accounting for Partnership Dissolution. Dissolution—Admission of a New Partner. Dissolution—Withdrawal by a Partner.*

- 12. Partnerships: Termination and Liquidation 543**  
Termination and Liquidation—Protecting the Interest of All Parties. The Termination and Liquidation Process: *Termination and Liquidation Procedures Illustrated. Schedule of Liquidation. Marshaling of Assets. Preliminary Distribution of Partnership Assets. Predistribution Plan.*
- 13. Accounting for Nonprofit Organizations: I 581**  
Introduction to the Accounting for State and Local Governments: *Control—an Underlying Objective. Reporting Diverse Governmental Activities—Fund Accounting. Fund Accounting Classifications.* Accounting for Service-Oriented Funds: *Budgetary Entries. Modified Accrual Accounting—Expenditures. Modified Accrual Accounting—Revenues. Sale of Bonds. Interfund Transfers. Encumbrances. Unrestricted Fund Balance.*
- 14. Accounting for Nonprofit Organizations: II 625**  
Accounting for State and Local Governments—Nonservice Funds: *Objective—Income Determination. Enterprise Funds. Internal Service Funds. Pension Trust Funds. Nonexpendable Trust Funds. Agency Funds.* Accounting for State and Local Governments—Financial Reporting Process. Accounting for Colleges and Universities: *Fund Accounting for Colleges and Universities. Application of Accrual Accounting. Utilization of Fund Balance Accounts. Financial Statements for Colleges and Universities. Accounting for Current Funds. Accounting for the Other Funds of Colleges and Universities.*
- 15. Accounting for Nonprofit Organizations: III 677**  
Accounting for Hospitals: *Influence of Third-Party Payors. Fund Accounting for Hospitals. Accounting for Patient Service Revenues. Accounting for Other Operating Revenues. Accounting for Nonoperating Revenues. Accounting for Pledges. Financial Statements for a Hospital.* Accounting for Voluntary Health and Welfare Organizations: *Application of Generally Accepted Accounting Principles. Fund Accounting by Voluntary Health and Welfare Organizations. Overview of Accounting Process. Recording Expenses and Expenditures. Statement of Functional Expenses.*

# **CHAPTER 1**

---

## **THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS**

A headline in a recent issue of *The Wall Street Journal* read “U.S. Filter Corp. Buys 23% Stake in Koehring Co.” This story, which indicated that United States Filter had paid approximately \$16.9 million for this investment, is hardly of an unusual nature in the business world. Investors, both corporate as well as individual, constantly buy and sell the ownership shares of domestic and foreign businesses. These stock investments can range from the purchase of a few shares to the acquisition of 100 percent control of a corporation. Although not unusual, large acquisitions of corporate equity securities such as the one made by United States Filter do pose a considerable number of accounting problems. This chapter will detail the appropriate accounting procedures for reporting such investments through the use of the equity method.

### **PROCEDURES USED TO REPORT INVESTMENTS IN CORPORATE SECURITIES**

---

At the present time, accounting standards recognize three different sets of procedures for reporting investments in corporate securities: the lower-of-cost-or-market method, the equity method, and the consolidation of financial

statements.<sup>1</sup> These three are not interchangeable; a specific method is required when any given set of circumstances and factors exist. The method to be used in a particular situation depends primarily upon the influence the investor has over the investee which is best indicated by the relative size of the investment.

In many instances, the investor will hold only a small percentage of the outstanding shares of the investee company. Because of this limited percentage of ownership, the investor cannot expect to have a significant impact upon the decision-making process of the investee. Such investments are made primarily in anticipation of cash dividends and appreciation of stock market values. Appropriate guidelines for reporting such investments, using the lower-of-cost-or-market method, have been established by the Financial Accounting Standards Board (FASB) in its *Statement of Financial Accounting Standards No. 12* (abbreviated *SFAS 12*), "Accounting for Certain Marketable Securities," issued December 1975. Since a full coverage of *SFAS 12* is presented in most intermediate accounting textbooks, only two of its basic principles will be noted here. First, for investments where a small percentage of the outstanding stock is owned, income is to be recognized by the investor only in the form of cash dividends received. Second, both the short-term and long-term stock portfolios are to be carried on the balance sheet at the lower of aggregate cost or market value. These two principles are consistent with the convention of conservatism in accounting, but as will be shown later, they are both in direct contrast with the procedures used in the equity method.

Just as there are many investment situations where only a small percentage of stock is owned, there are a great number of other instances where an investor acquires enough stock to be able to actually control a company's operations. A review of the financial statements of America's largest corporations indicates that holding legal control over one or more subsidiary companies is an almost universal practice. In financial accounting, this control of a company is recognized whenever an investor owns over 50 percent of the outstanding voting stock. At that point, rather than just influencing the decisions of the investee, the investor can clearly control the decision-making process.

An investment that enables the owner to control the investee presents an entirely different economic situation from that covered by *SFAS 12* and, thus, requires a different set of accounting procedures. Normally, when such control is present, the investor-investee relationship has become so closely connected that the two corporations are viewed as a single entity by

---

<sup>1</sup> It would be possible to come up with more than three methods. Consolidations can be broken down into either the purchase method or the pooling of interests method. The lower-of-cost-or-market method has one set of procedures for short-term portfolios and a different set for long-term portfolios. Also, some specialized industries account for investments using the market value method. Thus, the three methods indicated are only the broad categories generally encountered in practice.

outside parties. As indicated by *Accounting Principles Board Opinion No. 16* (abbreviated *APB Opinion 16*), "Business Combinations," August 1970, such circumstances generally require the *consolidation of the financial statements* of the two companies into a single set of statements to be used for external reporting purposes.<sup>2</sup> The accounting procedures necessary for this consolidation process will be covered in subsequent chapters.

Finally, a third type of investment relationship can be identified which is appropriately accounted for by means of the equity method. In United States Filter's acquisition of 23 percent of the voting stock of Koehring, as well as in many other corporate stock acquisitions, legal control has not been gained. United States Filter is not even close to the 50 percent ownership level that would indicate such control. Yet, despite lacking actual control, United States Filter does maintain a large ownership interest in the investee company. Through this ownership, United States Filter can undoubtedly have some impact upon the decisions and operations of Koehring.

In the business world, there are many similar examples of corporations that own large shares of other companies without having actual control. Just a few of these examples would include Borg-Warner Corp.'s 21 percent ownership of Hughes Tool Company; Sears, Roebuck & Co.'s holding of 31 percent of De Soto, Inc., and 39 percent of Roper Corporation; and the ownership of 32 percent of Curtiss-Wright Corp. by Teledyne, Inc. Since many countries prohibit outside parties from owning a controlling interest in their companies, this list of such investments is considerably longer when ownership in foreign corporations is included.

In each of the indicated cases, control has not been achieved by the investor since less than a majority of the voting stock has been acquired. Thus, the preparation of consolidated financial statements would be inappropriate. Even though there is no legal control, the size of the investment would indicate that the investor possesses some ability to affect the decision-making process of the investee. This influence would signify an investment relationship that is not adequately reflected by the lower-of-cost-or-market method as established by FASB *SFAS 12*.

Generally accepted accounting principles (GAAP) recognize that a level of ownership does exist where neither the consolidation of financial statements nor the lower-of-cost-or-market method is really applicable. In this situation, control of the investee is not present, but the investor does have a degree of ownership and influence that has gone beyond the level anticipated by the lower-of-cost-or-market method. In order to reflect this relationship between the investor and investee, such investments must be accounted for under the equity method. This method was officially established by *Opinion 18*, "The Equity Method of Accounting for Investments in Common Stock," which was issued by the APB in March of 1971.

---

<sup>2</sup> It will be noted in the next chapter that control of an investee alone will not always lead to consolidation of the financial statements.

---

## APPLICATION OF THE EQUITY METHOD

---

In attempting to gain an understanding of the equity method, the APB's treatment of two questions is of immediate importance:

1. What parameters could be established to identify this middle area of ownership where the equity method would be applicable?
2. How should the financial statements of the investor be reported under the equity method in order to properly reflect the relationship between investor and investee?

---

### Criteria for Utilizing the Equity Method

---

Looking first at the problem of establishing parameters for the application of the equity method, the APB stated that as the level of ownership increases, the investor would begin to have the ability to significantly influence the decision-making process of the investee. According to *APB Opinion 18* (par. 17), it is this "ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock" that is the sole criterion for determining whether the investment is such that the equity method is appropriate and necessary.

Clearly a term such as the *ability to exercise significant influence* is quite nebulous and subject to a variety of judgments and interpretations in actual practice. In order to give guidance in this area, *APB Opinion 18* lists several possible conditions that would serve as indicators of the investor's ability to influence the activities of the investee. In viewing each of these factors, it should be remembered that only the *ability* to significantly influence need be present. There is no requirement that this influence must have ever been used in actual practice.

The factors set out by the APB are as follows:

Investor representation on the board of directors of the investee.

Investor participation in the policy-making process of the investee.

Material intercompany transactions.

Interchange of managerial personnel.

Technological dependency.

Extent of ownership by the investor in relation to the size and concentration of other ownership interests in the investee.

No single one of the indicators set forth by the APB should be used in making the determination as to the applicability of the equity method. Instead, all of these elements should be evaluated together to determine the presence or absence of the sole criterion: the ability to significantly influence the investee.

Even given the above guidelines, a great deal of leeway would still be available in making the decision as to applying the equity method in a specific situation. In order to provide a degree of consistency in the application of this standard, the APB went on to establish a general test that could be used as an indication of the investor's ability to significantly influence the investee.

The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.<sup>3</sup>

At first, the 20 percent rule may appear to be an arbitrarily chosen boundary that merely provides for consistent application for all investments. It should be noted, however, that the essential criterion is still the ability to significantly influence the investee and not the 20 percent ownership rule. If the absence of this ability can be demonstrated, then the equity method should not be used regardless of the ownership percentage. If, on the other hand, this ability can be demonstrated, then the equity method should be applied without concern for the percentage of ownership. As an example, Bangor Punta Corporation accounted for its investment in Lone Star Industries, Inc., by the equity method in 1980 despite owning only 6.6 percent of the outstanding shares of that company. In its annual report for that year, Bangor Punta gives its explanation for adoption of this method by stating: "The equity method was adopted as the Company has the ability to exercise significant influence over operating and financial policies at Lone Star due to common officers and directors."

In order to give further guidance in this area, in May 1981, the FASB issued its *Interpretation 35*, "Criteria for Applying the Equity Method of Accounting for Investments in Common Stock." The pronouncement dealt specifically with the evaluation of the applicability of the equity method to investments of over 20 percent. According to the *Interpretation* (par. 3), in such cases, "the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary." The pronouncement goes on to give several examples of occurrences that might indicate this inability to exert significant influence over the investee:

---

<sup>3</sup> APB Opinion 18, par. 17.



An agreement between the investor and investee whereby the investor surrenders significant rights as a shareholder.

Concentration of ownership that operates the company without regard to the views of the investor.

Investor attempts but fails to obtain representation on the investee's board of directors.

To summarize, the following table indicates the appropriate application of the various methods of accounting for investments:

<i>Criterion</i>	<i>Normal Ownership Level</i>	<i>Applicable Accounting Method</i>
Lack of ability to significantly influence	Less than 20%	Lower of aggregate cost or market (FASB SFAS 12)
Presence of ability to significantly influence	20–50%	Equity method (APB Opinion 18)
Legal control	Over 50%	Consolidated financial statements* (APB Opinion 16)

\* As will be demonstrated in subsequent chapters, having legal control over another company does not always lead to consolidation of the financial statements.

### Accounting for an Investment—the Equity Method

Having identified the criteria that set the parameters for the appropriate application of the equity method, the next logical step is to review the accounting procedures used in the equity method. Within the investor's financial statements, the equity method affects the timing of income recognition and the carrying value of the investment account. The equity method attempts to reflect these investment accounts in such a manner as to demonstrate the close relationship that exists between the investor and investee.

In order to better understand the impact of the equity method in these two areas, a review of the lower-of-cost-or-market method (as established by FASB SFAS 12) will be presented to serve as a point of reference. When the ability to exert significant influence is not present, SFAS 12 requires that income should be recognized by the investor only when cash dividends are received. The pronouncement further states that the carrying value of the investment account would be at the lower-of-cost-or-market value based on aggregate totals for both short-term and long-term portfolios.

In contrast to SFAS 12, the equity method provides for the accrual of investment income by the investor as soon as it is earned by the investee. Thus, if the investee reports an income of \$100,000, an investor holding a 30 percent ownership would immediately recognize \$30,000 in income. Furthermore, although the investor will initially record its investment at original cost, that amount will be adjusted in subsequent periods to reflect the operations of the investee. Upward adjustments are made when the investee