

What is the Equity Method?

Worksheet

Under the equity method, an investor records its investment at cost and then increases or decreases that carrying value by its proportional share of the investee's net income or loss, reducing it for dividends received.

$$I = I_0 + p(\text{NI}) - p(D)$$

Questions

1. An investor owns 35% of a company. The investee earns \$100,000 net income. By how much does the investment's carrying value increase?
A) \$100,000
B) \$35,000
C) \$65,000
D) \$0
2. Under the equity method, dividends received from the investee are recorded as:
A) Investment income
B) A reduction of the investment's carrying value
C) Retained earnings
D) Other comprehensive income
3. The equity method is typically used when ownership is:
A) Less than 20%
B) 20% to 50%
C) More than 50%
D) Exactly 100%
4. If the investee reports a net loss, the investor's carrying value:
A) Increases
B) Stays the same
C) Decreases by the proportional share of the loss
D) Is written off entirely
5. Company A buys 30% of Company B for \$200,000. Company B reports net income of \$60,000 and pays \$15,000 in dividends. Find the carrying value at year-end.
6. Company X holds 25% of Company Y, initial cost \$500,000. Company Y reports a net loss of \$40,000 and pays no dividends. What is the new carrying value?
7. An investor owns 40% of an associate, initial investment \$1,200,000. The associate earns \$300,000 net income and distributes \$50,000 in dividends total. Compute the carrying value.
8. Define: When is the equity method used?
9. Define: How does the equity method treat dividends?
10. Define: What increases the carrying value under the equity method?

Answer Key

1. B) $\$35,000 - 35\% \$100,000 = \$35,000$ is the investor's share of net income.
2. B) A reduction of the investment's carrying value - Dividends are treated as a return of investment, reducing the carrying value.
3. B) 20% to 50% - 20%-50% ownership generally indicates significant influence, the threshold for the equity method.
4. C) Decreases by the proportional share of the loss - The investor recognizes its proportional share of losses, reducing the carrying value.
5. Share of net income = $30\% \$60,000 = \$18,000$ Share of dividends = $30\% \$15,000 = \$4,500$ Carrying value = $\$200,000 + \$18,000 - \$4,500 = \$213,500$
6. Share of net loss = $25\% \$40,000 = \$10,000$ Carrying value = $\$500,000 - \$10,000 = \$490,000$
7. Share of net income = $40\% \$300,000 = \$120,000$ Share of dividends received = $40\% \$50,000 = \$20,000$ Carrying value = $\$1,200,000 + \$120,000 - \$20,000 = \$1,300,000$
8. When an investor holds significant influence over an investee, usually 20%-50% ownership, without full control.
9. Dividends received reduce the investment's carrying value - they are not recorded as income.
10. The investor's proportional share of the investee's net income.

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