4. The Equity Method of Accounting

On occasion, an investor may acquire enough ownership in the stock of another company to permit the exercise of "significant influence" over the investee company. For example, the investor has some direction over corporate policy, and can sway the election of the board of directors and other matters of corporate governance and decision making. Generally, this is deemed to occur when one company owns more than 20% of the stock of the other -- although the ultimate decision about the existence of "significant influence" remains a matter of judgment based on an assessment of all facts and circumstances. Once significant influence is present, generally accepted accounting principles require that the investment be accounted for under the "equity method" (rather than the methods previously discussed, such as those applicable to trading securities or available for sale securities).

With the equity method, the accounting for an investment is set to track the "equity" of the investee. That is, when the investee makes money (and experiences a corresponding increase in equity), the investor will similarly record its share of that profit (and vice-versa for a loss). The initial accounting commences by recording the investment at cost:

4-1-X3	Investment		50,000	
	Cash			50,000
	To record the purchase of 5,000 shares of Legg stock at $10 per share. Legg has 20,000 shares outstanding, and the investment in 25% of Legg (5,000/20,000 = 25%) is sufficient to give the investor significant influence			

Next, assume that Legg reports income for the three-month period ending June 30, 20X3, in the amount of $10,000. The investor would simultaneously record its "share" of this reported income as follows:

6-30-X3	Investment		2,500	
	Investment Income			2,500
	To record investor's share of Legg's reported income (25% X $10,000)			

Importantly, this entry causes the Investment account to increase by the investor's share of the investee's increase in its own equity (i.e., Legg's equity increased $10,000, and the entry causes the investor's Investment account to increase by $2,500), thus the name "equity method." Notice, too, that the credit causes the investor to recognize income of $2,500, again corresponding to its share of Legg's reported income for the period. Of course, a loss would be reported in just the opposite fashion.

When Legg pays out dividends (and decreases its equity), the investor will need to reduce its Investment account:

7-1-X3	Cash		1,000	
	Investment			1,000
	To record the receipt of $1,000 in dividends from Legg -- Legg declared and paid a total of $4,000 ($4,000 X 25% = $1,000)			

The above entry is based on the assumption that Legg declared and paid a $4,000 dividend on July 1. This treats dividends as a return of the investment (not income, because the income is recorded as it is earned rather than when distributed). In the case of dividends, notice that the investee's equity reduction is met with a corresponding proportionate reduction of the Investment account on the books of the investor.

Note that market-value adjustments are usually not utilized when the equity method is employed. Essentially, the Investment account tracks the equity of the investee, increasing as the investee reports income and decreasing as the investee distributes dividends.