Problem 6

Summer Fun Corporation acquired 30% of the stock of Island Adventures. Summer Fun's investment is a long-term strategic investment. Summer Fun anticipates that its investment will permit it to elect certain board members and otherwise exercise influence over the plans and policies implemented by Island Adventures.

Summer Fun paid $5,000,000 for its 30% interest. The acquisition occurred on January 1, 20X3. On that date, Island Adventures had total stockholders' equity of $25,000,000. During 20X3, Island Adventures earned $6,000,000 and paid $1,000,000 in dividends. Both companies have December 31 year ends.

a) Prepare Summer Fun's entries to account for the activity pertaining to the investment in Island Adventures.

b) Calculate the change in Island Adventure's total equity during the year, and compare this to the change in Summer Fun's Investment in Island Adventure's account. Are they correlated, and does this help explain the term "equity" method of accounting.

Worksheet

a)

GENERAL JOURNAL			
Date	**Accounts**	**Debit**	**Credit**

b)

Solution

a)

GENERAL JOURNAL			
Date	**Accounts**	**Debit**	**Credit**
1-Jan	Investment in Island Adventures	5,000,000	
	Cash		5,000,000
	To record the purchase of 30% of the shares of Delta		
31-Dec	Investment in Island Adventures	1,800,000	
	Investment Income		1,800,000
	To record share of Island Adventure's income (30% X $6,000,000)		
31-Dec	Cash	300,000	
	Investment		300,000
	To record share of Island Adventure's dividends (30% X $1,000,000)		

b) Island Adventure's equity increased from $25,000,000 to $30,000,000 ($25,000,000 + $6,000,000 - $1,000,000). This $5,000,000 correlates with the $4,000,000 increase (30%) in the Investment in Island Adventure account on Coastal's books ($5,000,000 beginning balance + $1,800,000 debit - $300,000 credit = $6,500,000 ending balance). This correlation between the equity of the investee and Investment account of the investor is expected, and help explains why the term "equity" method is used to describe the accounting approach.