

Accounting 402

Illustration of How the Cost method could be used to Smooth Income for Investor

Investor Company purchases a 30% interest in Investee Company. Incomes for Investee and Investor and dividends declared by Investee for five years are as follows.

	year 1	year 2	year 3	year 4	year 5
Investee income	\$ 50,000	\$ 70,000	\$ 90,000	\$ 100,000	\$ 110,000
Investee dividends (influenced by investor)	\$ 0	\$ 0	\$ 0	\$ 0	max. allowable
Investor w/o investee income	\$ 120,000	\$ 130,000	\$ 140,000	\$ 150,000	\$ 34,000
Investor with income from investee -cost					
Investor with income from investee-equity					

Compute the investor's income for each of the five years using the cost method and the equity method of accounting for the investment in the investee company.

If the investor uses the cost method to account for the investment, but has the ability to exercise significant influence over the affairs of the investee, what possible problems might arise?