Thammasat University
Faculty of Economics
Bachelor of Economics (International Program)

AC201
Fundamental Accounting

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Course Package OY 05

Topic:

Reporting and Interpreting
Investments in Other Corporations

Session:

Session OY 05

Instructor:

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REPORTING AND INTERPRETING INVESTMENTS IN OTHER CORPORATIONS

<u>**Chapter Take-Aways**</u>

1. **Analyze and report investments in debt securities held to maturity.**
   When management intends to an investment in a debt security (such as a bond or note) until it matures, the held-to-maturity security is recorded at cost when acquired and reported at amortized cost on the balance sheet. Any interest earned during the period is reported on the income statement.
2. **Analyze and report passive investments in securities using the fair value method.**
   Acquiring debt securities not held to maturity or less than 20 percent of the outstanding voting shares of another company's common stock is presumed to be a passive stock investment. Passive investments may be classified as
   - Trading securities (actively traded to maximize return) or
   - Available-for-sale securities (earn a return but are not as actively traded), depending on management's intent.

   The investments are recorded at cost and adjusted to fair value at year-end. The resulting unrealized gain or loss is recorded.
   - For trading securities, the net unrealized gains and losses are reported in net income.
   - For available-for-sale securities, the net unrealized gains and losses are reported as a component of stockholders' equity in other comprehensive income.

   Any dividends earned are reported as revenue, and any gains or losses on sales of passive investments are reported on the income statement.
3. **Analyze and report investments involving significant influence using the equity method.**
   If between 20 and 50 percent of the outstanding voting shares are owned, significant influence over the affiliate firm's operating and financing policies is presumed, and the equity method is applied. Under the equity method, the investor records the investment at cost on the acquisition date. Each period thereafter, the investment amount is increased (or decreased) by the proportionate interest in the income (or loss) reported by the affiliate corporation and decreased by the proportionate share of the dividends declared by the affiliate corporation.
4. **Analyze and report investments in controlling interests.**
   Mergers occur when one company purchases all of the net assets of another and the target company ceases to exist as a separate legal entity. Mergers and ownership of a controlling interest of another corporation (more than 50 percent of the outstanding voting shares) must be accounted for using the purchase method. The acquired company's assets and liabilities are measured at their fair values on the date of the transaction. Any amount paid above the fair value of the assets less liabilities is reported as goodwill by the buyer.

Key Ratio

Economic Return from Investing measures the performance of a company's securities portfolios. Investment returns include both dividends received and any change in the fair value. A high or rising ratio suggests that a firm's securities portfolio is improving. It is computed as follows

Economic Return from Investing = (Dividends and Interest Received + Change in Fair Value) ÷ Fair Value of Investments (beginning of period)

Change in Fair Value = Beginning Balance of Investments – Ending Balance of Investments

Finding Financial Information

Balance Sheet

Current Assets
- Investment in trading securities
- Investment in available-for-sale securities

Noncurrent Assets
- Investment in available-for-sale securities
- Investment in affiliates (or associated companies)
- Investments held to maturity

Stockholders' Equity

Other comprehensive income:
- Net unrealized gains and losses (on available-for-sale securities)

Income Statement

Under "Other Items"

Dividend (and interest) revenue
Loss or gain on sale of investments
Net unrealized gains/losses (on trading securities)
Equity in affiliate earnings/losses

Statement of Cash Flows

Operating Activities

Net income adjusted for:
- Gains/losses on sale of investments
- Equity in earnings/losses of affiliates
- Dividends received from affiliates
- Net unrealized gains/losses on trading securities

Investing Activities
- Purchase/sale of investments

Notes

In Various Notes

Accounting policies for investments
Details on securities held as trading and available-for-sale securities and investments in affiliates

Chapter Outline	**Notes**
LO 1 – Analyze and report bond investments held to maturity.	

I. Types of Investments and Accounting Methods

- A. Passive Investments in Debt and Equity Securities
  1. Passive investments – Made to earn a return on funds that may be needed for future
  2. Category includes:
     - a. Investments in debt (bonds and notes); always considered passive investments
       - i. If the company intends to hold the securities until they reach maturity, the investments are measured and reported at amortized cost
       - ii. If they are to be sold before maturity, they are reported using the fair value method
     - b. Investments in equity securities (stock)
       - i. Presumed passive if the investing company owns less than 20% of the outstanding voting shares of the other company
       - ii. The fair value method is used to measure and report the investments
- B. Investments in Stock for Significant Influence
  1. Significant influence – The ability to have an important impact on the operating, investing, and financing policies of another company
     - a. Presumed if the investing company owns from 20% to 50% of the outstanding voting shares of the other company
     - b. Other factors may also indicate that significant influence exists
       - i. Membership on the board of directors of the other company
       - ii. Participation in the policy-making processes
       - iii. Evidence of material transactions between the two companies
       - iv. An interchange of management personnel
       - v. Technological dependency
  2. Equity method is used to measure and report investments in stock for significant influence
- C. Investments in Stock for Control
  1. Control – The ability to determine the operating and financing policies of another company through ownership of voting stock
  2. Presumed when the investing company owns more than 50% of the outstanding voting stock of the other company
  3. Purchase accounting and consolidation are applied to combine the companies

II. Debt Held to Maturity: Amortized Cost Method

A. Terminology

1. Held-to-maturity investments – Investments in debt securities that management has the intent and ability to hold until maturity
2. Amortized cost method – Reports investments in debt securities held to maturity at cost minus any premium or plus any discount

B. Bond Purchases

1. On the date of purchase, a bond may be acquired at the maturity amount (at par), for less than the maturity amount (at a discount), or for more than the maturity amount (at a premium)
2. The total cost of the bond, including all incidental acquisition costs such as transfer fees and broker commissions, is debited to the Held-to-Maturity Investments account
3. On July 1, 2013, Washington Post paid the par value of $100,000 for 8% bonds that mature on June 30, 2015; interest at 8% is paid each June 30 and December 31, and management plans to hold the bonds for five years, until maturity

Dr. Held-to-Maturity Investments (+A)	100,000	
Cr. Cash (–A)		100,000

Assets = Liabilities + Stockholders' Equity

Held-to-Maturity Investments (A) + 100,000 + Cash (A) – 100,000 = 0

B. Interest Earned

1. Since no premium or discount needs to be amortized, the book value remains constant over the life of the investment; revenue earned from the investment each period is measured as the amount of interest collected in cash or accrued at year-end
2. Interest is received on December 31

Dr. Cash (+A) ($100,000 x .08 x 6/12)	4,000	
Cr. Interest Revenue (+R, +SE)		4,000

Assets = Liabilities + Stockholders' Equity

Cash (A) + 4,000 = Interest Revenue (R) + 4,000

C. Principal at Maturity

1. Principal payment is received when the bonds mature on June 30, 2015

Dr. Cash (+A)	100,000	
Cr. Held-to-Maturity Investments (–A)		100,000

Assets = Liabilities + Stockholders' Equity

Cash (A) + 100,000+ Held-to-Maturity Investments (A) – 100,000 = 0

2. If sold before maturity, any difference between market value (the proceeds from the sale) and net book value would be reported as a gain or loss on sale
3. If management intends to sell the bonds before the maturity date, they are treated in the same manner as investments in stock classified as available-for-sale securities (discussed in next section)

LO 2 – Analyze and report passive investments in securities using the fair value method.

III. Passive Stock Investments: The Fair Value Method

A. Reporting Method for Passive Stock Investments
   1. Among all assets and liabilities, only passive investments in marketable securities (other than debt held to maturity) are required to be reported using the fair value method
   2. Fair value method – used to report securities at their current market value (the amount that would be received in an orderly sale)
   3. Reasons that passive investments are reported at fair value:
      a. Relevance – best estimate of cash that could be generated by the sale of these securities is their current fair value
      b. Measurability – only items that can be measured in dollar terms with a high degree of reliability (an unbiased and verifiable measurement) are recorded
   4. Whenever the fair value of investments changes:
      a. The investment account is adjusted
      b. The other account affected is for unrealized holding gains or losses
         i. Unrealized holding gains or losses – amounts associated with price changes of securities that are currently held
         ii. Unrealized because no actual sale has taken place; value has changed simply by holding the security
         iii. Financial statement treatment depends on the classification of the passive investments

B. Classifying Passive Stock Investments

   Depends on management's intent; passive investments are classified as:
   1. Trading securities
      a. All investments in stocks or bonds held primarily for the purpose of active trading (buying and selling) in the near future
      b. Classified as short term
   2. Available-for-Sale Securities
      a. All passive investments other than trading securities and debt held to maturity
      b. Classified as short or long term

C. Available-for-Sale Securities

1. Purchase of Securities
    a. Recorded initially at cost
    b. At the beginning of 2012, Washington Post purchases for cash 15,000 shares of INews common stock for $10 per share; Washington Post owns 15% of INews, which is treated as a passive investment

        Dr. Investments in AFS (+A) 150,000
            Cr. Cash (–A) 150,000

        Assets = Liabilities + Stockholders' Equity
        Investments in AFS (A) + 150,000 + Cash (A) – 150,000 = 0
2. Dividends Earned
    a. Dividends earned are reported as investment income on the income statement and are included in the computation of net income for the period
    b. Washington Post received a $1 per share cash dividend from INews totaling $15,000

        Dr. Cash (+A) 15,000
            Cr. Dividend Revenue (+R, +SE) 15,000

        Assets = Liabilities + Stockholders' Equity
        Cash (A) + 15,000 = Dividend Revenue (R) + 15,000
3. Year-End Valuation
    a. At end of accounting period, passive investments are reported on the balance sheet at fair value
    b. Reporting the AFS investment at fair value requires adjusting the Investment in AFS to fair value
    c. The gain is credited or the loss is debited to the Net Unrealized Losses/Gains account
        i. For available-for-sale securities, the Net Unrealized Losses/Gains account is reported in the stockholders' equity section of the balance sheet under Other Comprehensive Income (denoted as OCI).
        ii. Thus, the balance sheet remains in balance.
    d. Only when the security is sold are any realized gains or losses included in net income
    e. INews had an $8 per share fair value at the end of 2012; the investment had lost value ($10 − $8 = $2 per share) for the year

        Dr. Net Unrealized Losses/Gains (–OCI, –SE) (15,000 x $2) 30,000
            Cr. Investments in AFS (–A) 30,000

        Assets = Liabilities + Stockholders' Equity
        Investments in AFS (A) – 30,000 = Net Unrealized Losses/Gains (OCI) – 30,000

f. INews had an $11 per share fair value at the end of 2013; the investment had gained value ($11 − $8 = $2 per share) for the year

   Dr. Investments in AFS (+A) 45,000
   Cr. Net Unrealized Losses/Gains (+OCI, +SE) (15,000 x $3) 45,000

   Assets = Liabilities + Stockholders' Equity
   Investments in AFS (A) + 45,000 = Net Unrealized Losses/Gains (OCI) + 45,000

g. On its balance sheet at the end of 2013, Washington Post would report:
   i. Under Assets – an investment in available-for-sale securities of $165,000
   ii. Under Other Comprehensive Income – its net unrealized gain on available-for-sale securities of $15,000 ($30,000 debit at end of 2013 offset by $45,000 credit at end of 2013 = account balance of $15,000)

4. Sale of Securities
   a. When available-for-sale securities are sold, Cash is increased and two accounts on the balance sheet are eliminated: Investments in AFS (A) and Net Unrealized Losses/Gains (OCI, SE)
   b. Proceeds from sale − Investment Cost = Gain if positive (Loss if negative)
   c. At the end of 2014, Washington Post sold all of its AFS investment in INews for $13 per share for $195,000 in cash ($13 × 15,000 shares) for stock it paid $150,000 for in 2012 ($10 × 15,000 shares)

      Dr. Cash (+A) 195,000
      Net Unrealized Losses/Gains (– OCI, – SE) 15,000
      Cr. Investments in AFS (−A) 165,000
      Gain on Sale of Investments (+Gain, +SE) 45,000

      Assets = Liabilities + Stockholders' Equity
      Cash (A) +195,000 + Investments in AFS (A) − 165,000 + Net Unrealized Losses/Gains (OCI) − 15,000 = Gain on Sale of Investments (Gain) + 45,000

D. Comparing Trade and Available-for- Sale Securities
   1. Available-for-Sale Portfolio
      a. Balance in net unrealized holding gains and losses is reported as a separate component of stockholders' equity (under Other Comprehensive Income)
         i. Not reported on the income statement
         ii. Does not affect net income
      b. At the time of sale:
         i. Difference between the proceeds from the sale and the original cost of the investment is recorded as a gain or loss on sale of available-for-sale securities
         ii. At the same time, the Investment in AFS and Net Unrealized Losses/Gains accounts are eliminated
   2. Trading Securities Portfolio
      a. Amount of the adjustment to record net unrealized holding gains and losses is included on each period's income statement
         i. Net holding gains increase and net holding losses decrease net income
         ii. This also means that the amount recorded as net unrealized gains and losses on trading securities is closed to Retained Earnings at the end of the period
      b. At time of sale , only the Cash and Investments in TS account are affected
      c. Only the difference between the cash from the sale and the book value (not cost) of the Investment in TS is recorded as a gain or loss on sale
   3. Over time, the total income reported is the same for both trading securities and available-for-sale securities; only the allocation across the three periods differs

E. Financial Analysis: Reporting the Fair Value of Investments
   1. GAAP requires that companies disclose the measurements used to determine the fair values of assets
   2. The fair value of an asset is the amount that would be received in an orderly sale
   3. The standard recognizes three approaches in order of decreasing reliability:
      a. Level 1: Quoted prices in active markets for identical assets
      b. Level 2: Estimates based on other observable inputs (e.g., prices for similar assets)
      c. Level 3: Estimates based on unobservable estimates (the company's own estimates of factors that market participants would consider)
   4. Fair value should be determined using the most reliable method available (Level 1 if possible)
   5. Reporting company must disclose the amounts determined under each approach in a note to the financial statements

F. Key Ratio Analysis: Economic Return from Investing
   1. Economic Return from Investing = Dividends and Interest Received + Change in Fair Value ÷ Fair Value of Investments (beginning of period)
   2. Change in Fair Value = Beginning balance of Investments − Ending balance of Investments
   3. Ratio provides a percentage of what was earned plus any realized and/or unrealized gains or losses on the portfolio

LO 3 – Analyze and report investments involving significant influence using the equity method.

IV. Investments for Significant Influence: Equity Method

A. Recording Investments Under the Equity Method
   1. An investor may want to exert influence (presumed by owning 20% to 50% of the outstanding voting stock) without becoming the controlling shareholder (presumed when owning more than 50% of the voting stock) for the following reasons:
      a. A retailer may want to influence a manufacturer to be sure that it can obtain certain products designed to its specifications
      b. A manufacturer may want to influence a computer consulting firm to ensure that it can incorporate the consulting firm's cutting-edge technology in its manufacturing processes
      c. A manufacturer may recognize that a parts supplier lacks experienced management and could prosper with additional managerial support
   2. Equity method – Used when an investor can exert significant influence over an affiliate; the method permits recording the investor's share of the affiliate's income
   3. Investments in affiliates or associated companies – Investments in stock held for the purpose of influencing the operating and financing strategies of the entity for the long term
   4. Under the equity method, the investor's 20% to 50% ownership of a company presumes significant influence over the affiliate's process of earning income
      a. As a consequence, the investor reports its portion of the affiliate's net income as its income and increases the investment account by the same amount
      b. The receipt of dividends by the investor is treated as a reduction of the investment account (not revenue)

5. Summary:

Investments in Affiliates (A)

Beginning balance Purchases Company's % share of affiliates' net income (credit Equity in Affiliate Earnings [increase income])	Sales Company's % share of affiliates' net losses (debit Equity in Affiliate Losses [decrease income] Company's % share of affiliates' dividends declared for the period (debit Cash)
Ending balance	

6. Purchase of Stock
   In 2013, Washington Post purchased 40,000 shares of the outstanding voting common stock of INews for $400,000; Washington Post acquired 40% and was presumed to have significant influence
   Dr. Investments in Affiliates (+A) 400,000
   Cr. Cash (–A) 400,000
   Assets = Liabilities + Stockholders' Equity
   Investments in Affiliates (A) + 400,000 + Cash (A) – 400,000 = 0
7. Earnings of Affiliates
   During 2013, INews reported a net income of $500,000 for the year
   Dr. Investments in Affiliates (+A) 200,000
   Cr. Equity in Affiliate Earnings (+R, +SE) 200,000
   Assets = Liabilities + Stockholders' Equity
   Investments in Affiliates (A) + 200,000 = Equity in Affiliate Earnings (R) + 200,000
8. Dividends Received
   During 2013, INews declared and paid a cash dividend of $1 per share to stockholders; Washington Post received $40,000 ($1 × 40,000 shares)
   Dr. Cash (+A) 40,000
   Cr. Investments in Affiliates (–A) 40,000
   Assets = Liabilities + Stockholders' Equity
   Investments in Affiliates (A) + 200,000 + Cash (A) – 200,000 = 0

B. Reporting Investments Under the Equity Method
   1. The Investments in Affiliates account is reported on the balance sheet as a long-term asset
      a. The investment account does not reflect either cost or fair value; instead:
         i. The investment account is increased by the cost of shares that were purchased and the proportional share of the affiliates' net income
         ii. The account is reduced by the amount of dividends received from the affiliate companies and the proportional share of any affiliates' net losses
      b. At the end of the accounting period, accountants do not adjust the investment account to reflect changes in the fair value of the securities that are held.
      c. When sold, the difference between the cash received and the book value of the investment is:
         i. Recorded as a gain or loss on the sale of the investment
         ii. Reported on the income statement in the Other Items section

C. Focus on Cash Flows: Investments
   1. The cash resulting from the sale or purchase is reflected in the Investing Activities section
   2. In the Operating Activities section, there are a number of adjustments to net income:
      a. Any gain (loss) on the sale is subtracted from (added to) net income
      b. Any unrealized holding gain (loss) on trading securities is subtracted from (added to) net income
      c. Equity in affiliate earnings (losses) is subtracted from (added to) net income because no cash was involved in the recording of the revenue under the equity method
      d. Any dividends received from an affiliate are added to net income because, when cash was received, no revenue was recorded under the equity method.

LO 4 – Analyze and report investments in controlling interests.

V. Controlling Interests: Mergers and Acquisitions

A. Reasons for Acquiring Control of Another Corporation
  1. Vertical integration – in this type of acquisition, a company acquires another at a different level in the channels of distribution
  2. Horizontal growth – These acquisitions involve companies at the same level in the channels of distribution
  3. Synergy – The operations of two companies together may be more profitable than the combined profitability of the companies as separate entities

B. Recording a Merger
  1. Merger – occurs when one company purchases all of the assets and liabilities of another and the acquired company goes out of existence
  2. Purchase method – records assets and liabilities acquired in a merger or acquisition at their fair value on the transaction date
     a. Only method allowed by U.S. GAAP and IFRS for recording a merger or acquisition.
     b. Requires that the assets and liabilities of the company acquired be recorded by the acquiring company on its books at their fair value on the date of the merger
     c. Acquiring company must go through a two-step process, often called the purchase price allocation, to determine how to record the acquisition:
        i. Step 1: Estimate the fair value of the acquired company's tangible assets, identifiable intangible assets, and liabilities
        ii. Step 2: Compute goodwill (cost in excess of net assets acquired) – the excess of the purchase price of a business over the fair value of the acquired company's assets and liabilities

C. Reporting for the Combined Companies
  1. After the merger, the acquiring company will treat the acquired assets and liabilities in the same manner as if they were acquired individually
     a. For example, the company will depreciate amounts added to equipment over its remaining useful life
     b. Goodwill is considered to have an indefinite life
        i. As a consequence, it is not amortized, but, like all long-lived assets, goodwill is reviewed for possible impairment of value
        ii. Recording an impairment loss would increase expenses for the period and reduce the amount of goodwill on the balance sheet

2. When a company acquires another, and both companies continue their separate legal existence, consolidated financial statements must be presented
    a. The parent company is the company that gains control over the other company
    b. The subsidiary company is the company that the parent acquires
    c. When the parent buys 100% of the subsidiary, the resulting consolidated financial statements look the same as they would if the companies were combined into one in a simple merger (as discussed above)

IV. Chapter Supplement A – Held-to-Maturity Bonds Purchased at Other than Par Value: Amortized Cost Method

A. Bond Purchases
1. On the date of purchase, a bond may be acquired at the maturity amount (at par), for less than the maturity amount (at a discount), or for more than the maturity amount (at a premium)
2. The total cost of the bond, including all incidental acquisition costs such as transfer fees and broker commissions, is debited to the Held-to-Maturity Investments account
3. On 7/1/13, Washington Post paid $92,277 cash for an 8%, 5-year $100,000 bond that paid interest semiannually (on 6/30 and 12/31); bond's yield was 10%
    Present value of the bond investment = Present value of the face + Present value of the interest annuity
    $92,277 = ($100,000 x .6139) + ($4,000 x 7.7217)
    [n = 10 periods; interest rate = 5%]

Dr. Held-to-Maturity Investments (+A)	92,277	
Cr. Cash (−A)		92,277

    Assets = Liabilities + Stockholders' Equity
    Held-to-Maturity Investments (A) + 92,277 + Cash (A) − 92,277 = 0

B. Interest Earned
1. The discount that needs to be amortized over the life of the investment; using the effective interest amortization method:
    a. Cash received is based on the face amount of the bond multiplied by the stated rate of interest for half of a year (4%)
    b. Revenue earned is computed by multiplying the present value of the bond times the market rate for half of a year (5%)

2. Receipt of interest on 12/31/13:

Dr. Cash (+A)	4,000	
Held-to-Maturity Investments (+A)	614	
Cr. Interest Revenue (+R, +SE)		4,614

   Assets = Liabilities + Stockholders' Equity
   Cash (A) + 4,000 + Held-to-Maturity Investments (A) + 614 = Interest Revenue (R) + 4,614
3. The amount reported on the balance sheet at 12/31/13 is $92,891 ($92,277 + $614), which will be the present value of the bond used in determining interest revenue on the next payment date of 6/30/14
4. If the bond investment must be sold before maturity, any difference between market value on the date of sale and net book value would be reported as a gain or loss on sale

REPORTING AND INTERPRETING INVESTMENTS IN OTHER CORPORATIONS

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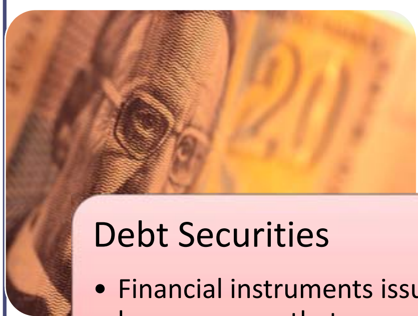
Investment in Debt and Equity Securities

- **Investments in securities can include both debt and equity securities.**
  - ***Debt securities*** reflect a ***creditor*** relationship.
  - ***Equity securities*** result an ***owner*** relationship.



Debt Securities

- Financial instruments issued by a company that carry with them a promise of interest payments and the repayment of principal.

Equity Securities

- Shares of ownership in a corporation that can change significantly in value and that provide for a return to investors in the form of dividends.

Accounting Basics for Debt Securities

- **Acquisition:**
  - Debt securities are recorded at cost when purchased.
    - Music City paid 30,000 Baht on Sept. 1, 20X8, to buy Mega's 7%, two-year bonds payable with a 30,000 Baht par value. The bonds pay interest semiannually on Aug. 31 and Feb. 28.
    - The bonds will be matured on Aug, 31, 20X10.

20X8	Dr. Investments in Mega bonds [A+]	30,000	
Sept. 1	Cr. Cash [A-]		30,000
	Purchased bonds for 30,000 Baht		

Accounting Basics for Debt Securities

- **Interest earned:**
  - Interest revenue for investments in debt securities is recorded when earned.
    - On Dec. 31, 20X8, at the end of its accounting period, Music City accrues interest receivable in the adjustment process.

20X8	Dr. Interest receivable [A+]	700	
Dec. 31	Cr. Interest revenue [REV+, E+]		700
	Accrued interest earned (30,000 x 7% x 4/12)		

- Interest revenue
  - 700 Baht

Statement of Income

- Investments in bonds
  - 30,000 Baht
- Interest receivable
  - 700 Baht

Statement of Financial Position

Accounting Basics for Debt Securities

- **Interest received:**
  - On Feb. 28, 20X9, Music City records receipt of semiannual interest for 1,050 Baht.

20X9	Dr. Cash [A+]	1,050	
Feb. 28	Cr. Interest receivable [A-]		700
	Interest revenue [REV+, E+]		350
	Received six months' interest on bonds		

- **Disposition:**
  - When the bonds mature, the proceeds are recorded.

20X10	Dr. Cash [A+]	30,000	
Aug. 31	Cr. Investment in Mega bonds [A-]		30,000
	Received cash from matured bonds		

Accounting Basics for Equity Securities

- **Acquisition:**
  - Equity securities are recorded at cost when acquired, including commissions or brokerage fee paid.
    - Music City purchases 1,000 shares of Sage's ordinary share at par value for 86,000 Baht on Oct. 10, 20X8.

20X8	Dr. Investments in Sage stock [A+]	86,000	
Oct. 10	Cr. Cash [A-]		86,000
	Purchased 1,000 shares of common stock		

Accounting Basics for Equity Securities

- **Dividend earned:**
  - Any cash dividends received are credited to Dividend revenue and reported in the Statement of income.
    - On Sept. 30, Music City receives 1,720 Baht cash dividend on shares.

20X8	Dr. Cash [A+]	1,720	
Sept. 30	Cr. Dividend revenue [REV+, E+]		1,720
	Received dividend of 1.72 Baht per share		

- Dividend revenue
  - 1,720 Baht

Statement of income

- Investments in share
  - 86,000 Baht

Statement of Financial Position

AC201-BE-1-2016

Accounting Basics for Equity Securities

- **Disposition:**
  - When the securities are sold, sale proceeds are compared with the cost, and any gain or loss is recorded.
    - On Jan. 20, 20X9, Music City sells 500 shares for 45,000 Baht cash.

20X9	Dr. Cash [A+]	45,000	
Jan. 20	Cr. Investment in Sage stocks [A-]		43,000
	Gain on sale of investment in stocks [REV+, E+]		2,000
	Sold 500 shares of common stock (86,000 x 500/1,000)		

Categories of Investments

- **Investments in the Securities of Other Companies:**

Debt Securities | Equity Securities

- Debt Securities
  - Passive
- <20% of Outstanding share
  - Passive
- 20-50% of Outstanding share
  - Significant influence
- >50% of Outstanding share
  - Control

Passive or noninfluential investment | Investment with significant influence | Investment with control

Classification and Reporting of Investments

Noninfluential Investments				
➊ Held-to-maturity	➋ Trading	➌ Available-for-sale	➍ Significant influence	➎ Controlling influence
Debt only	Debt or Equity	Debt or Equity	Equity only	Equity only
Debt securities intended to be held until maturity	Debt and noninfluential equity securities (<20%) that are actively traded	Debt and noninfluential equity securities (<20%)	Equity securities (20%-50%) with significant influence	Equity securities (>50%) with controlling influence
Amortized cost	Market value	Market value	Equity method	Consolidated financial statements

Classification of Investment in Debt Securities

Noninfluential Investments:
Trading Securities

Noninfluential Investments:
Held-to-Maturity Securities

Noninfluential Investments:
Available-for-Sale Securities

Debt Securities

Classification of Investment in Equity Securities

Noninfluential Investments:
Available-for-Sale Securities

Investments with Significant Influence:
Equity Method

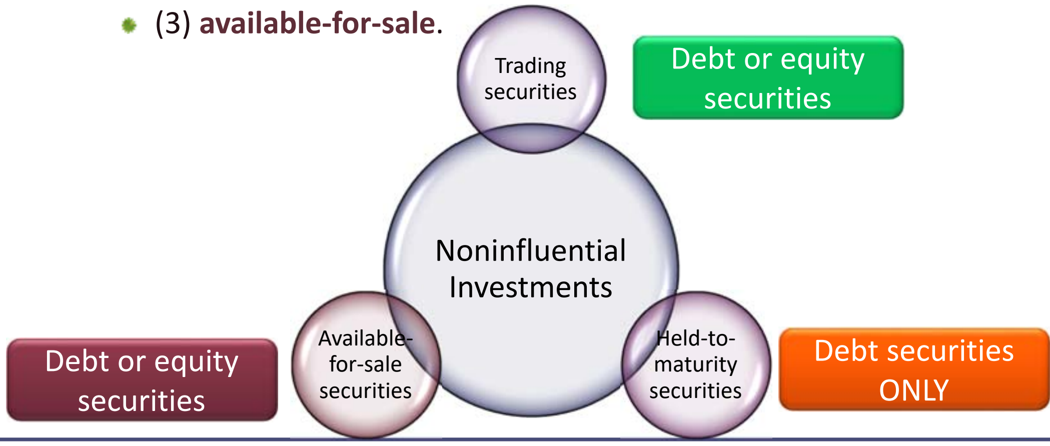
Noninfluential Investments:
Trading Securities

Investments with Controlling Influence:
Consolidated Financial Statements

Equity Securities

Reporting of Noninfluential Investments

- **Companies must value and report most noninfluential investments at fair market value.**
  - The exact requirements depend on whether the investments are classified as
    - (1) **held-to-maturity**,
    - (2) **trading**, or
    - (3) **available-for-sale**.



❶Held-to-Maturity Securities

- ***Held-to-maturity securities*** **are debt securities a company intends and is able to hold until maturity. → *Intent* and *Ability***
  - Classification: **Current** VS **Noncurrent**
    - They are reported in ***current assets*** if their maturity dates are within one year or the operating cycle, whichever is longer.
    - HTM securities are reported in ***long-term assets*** when the maturity dates extend beyond one year or the operating cycle, whichever is longer.
  - All HTM securities are recorded **at cost** when purchased, and interest revenue is recorded when earned.
  - The portfolio of HTM securities is reported *at amortized cost*.

❶Held-to-Maturity Securities (Cont.)

- **Acquisition:**
  - On Jan. 1, 20X1, Music City purchased a 10%, 5-year, 500,000 Baht bond issued by Phoenix Corp. The interest payments are made *semiannually*. Assume the effective rate is 12%.
    - N = 10, I = 6%, PMT = 25,000, FV = 500,000 → PV = 463,199

20X1	Dr. Investments in Phoenix Bonds - HTM [A+]	463,199	
Jan. 1	Cr. Cash [A-]		463,199
	Purchased Phoenix bonds to be held as HTM		

Discount on Investment in Bonds
= 500,000 – 463,199
= 36,801

Amortized over bond's life

❶Held-to-Maturity Securities (Cont.)

- **Amortization of Premium or Discount on Investments in Bonds:**
  - **Effective-Interest Amortization:**
    - A method of systematically writing off a bond premium or discount that takes into consideration the time value of money and results in an equal rate of amortization for each period

    Preferable
  - **Straight-Line Amortization:**
    - A method of systematically writing off a bond discount or premium in equal amounts each period until maturity

❶Held-to-Maturity Securities (Cont.)

	A	B	C	D	E	F
Semiannual Interest Period	Carrying Amount at Beginning of Period	Semiannual Interest Revenue at 12% to Be Recorded (12% x 6/12 x A)	Semiannual Cash Interest Receipt at 10% (500,000 x 10% x 6/12)	Amortization of Discount in Investment in Bonds (B-C)	Unamortized Discount at End of Period (E-D)	Carrying Amount at End of Period (A-D) ***AMORTIZED COST***
0					36,801.00	463,199.00
1	463,199.00	**27,791.94**	**25,000.00**	**2,791.94**	34,009.06	465,990.94
2	465,990.94	27,959.46	25,000.00	2,959.46	31,049.60	468,950.40
3	468,950.40	28,137.02	25,000.00	3,137.02	27,912.58	472,087.42
4	472,087.42	28,325.25	25,000.00	3,325.25	24,587.33	475,412.67
5	475,412.67	28,524.76	25,000.00	3,524.76	21,062.57	478,937.43
6	478,937.43	28,736.25	25,000.00	3,736.25	17,326.33	482,673.67
7	482,673.67	28,960.42	25,000.00	3,960.42	13,365.91	486,634.09
8	486,634.09	29,198.05	25,000.00	4,198.05	9,167.86	490,832.14
9	490,832.14	29,449.93	25,000.00	4,449.93	4,717.94	495,282.06
10	495,282.06	29,717.94	25,000.00	4,717.94	-	500,000.00

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❶Held-to-Maturity Securities (Cont.)

- **Amortization:**

20X1	Dr. Investments in Phoenix Bonds - HTM [A+]	2,792	
Jun. 30	Cash [A+]	25,000	
	Cr. Interest revenue [REV+, E+]		27,792
	Recorded Interest revenue		

Amortization of discount on investment in bonds increases investment in bonds balance.

- **Disposition:**

20X5	Dr. Cash [A+]	500,000	
Dec. 31	Cr. Investment in Phoenix Bonds -- HTM [A-]		500,000
	Recorded bonds maturity		

❷Trading Securities

- ***Trading securities*** **are debt and equity securities that the company intends to <u>actively manage and trade for profit</u>.**
  - Frequent purchases and sales are expected and are made to earn profits on short-term price changes.
- **Valuing and reporting trading securities:**
  - The entire portfolio of trading securities is reported at its *market value*; this requires a market adjustment from the cost of the portfolio.
    - The term **portfolio** refers to a group of securities.
  - Any **unrealized gain (or loss)** from a change in the market value of the portfolio of trading securities is reported on the ***<u>Statement of income</u>***.

AC201-BE-1-2016

❷Trading Securities (Cont.)

- **Acquisition:**
  - On Nov. 1, 20X8, Music City purchased a portfolio of trading securities at a total cost of 11,500 Baht.

20X8	Dr. Investment in trading securities [A+]	11,500	
Nov. 1	Cr. Cash [A-]		11,500
	Purchased common stock to be held as trading securities		

❷Trading Securities (Cont.)

- **Adjustments:**
  - Music City's portfolio of trading securities had a total cost of 11,500 Baht and a market value of 13,000 Baht on Dec. 31, 20X8, the first year it held trading securities.
    - The difference between the 11,500 Baht cost and the 13,000 Baht market value reflects a 1,500 Baht gain.
      - It is an unrealized gain because it is not yet confirmed by actual sales.
      - The market adjustment for trading securities is recorded with an adjusting entry at the end of each period to equal the difference between the portfolio's cost and its market value.

20X8	Dr. Allowance to value at market -- Trading	1,500	
Dec. 31	[Asset adjustment account+, A+]		
	Cr. Net unrealized holding gain/loss		1,500
	-- Trading [REV+, E+]		
	To reflect an unrealized gain in market values of trading securities		

❷Trading Securities (Cont.)

Statement of Financial Position Dec. 31, 20X8

- Investment in trading securities (at cost) 11,500 Baht
- Add: Allowance to value at market – Trading 1,500 Baht
- Investment in trading securities (at market) 13,000 Baht
  - OR
- Investment in trading securities
- (at market; cost is 11,500 Baht) 13,000 Baht

Statement of Income for 20X8

- Net unrealized holding gain/loss – Trading 1,500 Baht

❸Available-for-Sale Securities

- ***Available-for-sale securities*** **are debt and equity securities** **<u>not classified as trading or held-to-maturity securities.</u>**
  - AFS securities are purchased to yield interest, dividends, or increases in market value (called capital gain).
  - If the intent is to sell AFS securities within the longer of one year or operating cycle, they are classified as short-term investments. Otherwise, they are classified as long-term.
- **Valuing and reporting available-for-sale securities.**
  - As with trading securities, companies adjust the cost of the portfolio of AFS securities to reflect changes in *market value*.
  - Any **unrealized gain (or loss)** for the portfolio of AFS securities is one component of other comprehensive income (OCI), which is reported in Statement of Comprehensive Income. It is also reported in ***<u>equity section of the Statement of Financial Position</u>***.

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❸Available-for-Sale Securities (Cont.)

- **Adjustments:**
  - The company must record year-end adjusting entry to record the market value of these investments.
    - Cost and market value of the investments in bonds and shares on Dec. 31, 20X8 are as follows:

	Cost	Market Value	Unrealized Gain (Loss)
Improv bonds	30,000	29,050	-950
Intex common stock, 500 shares	43,000	45500	2,500
Total	**73,000**	**74,550**	**1,550**

20X8 Dec. 31	Dr. Allowance to value at market -- AFS [Asset adjustment account+, A+]	1,550	
	Cr. Net unrealized holding gain/loss -- AFS [OCI+, E+]		1,550
	To reflect an unrealized gain in market values of AFS securities		

❸Available-for-Sale Securities (Cont.)

Assets

Investment in AFS securities (at cost)	73,000 Baht
Add: Allowance to value at market – AFS	1,550 Baht
Investment in AFS securities (at market)	74,550 Baht
OR	
Investment in AFS securities (at market, cost is 73,000 Baht)	74,550 Baht

Liabilities

- None

Equity

- OCI: Net unrealized holding gain/loss – AFS
  1,550 Baht

❸Available-for-Sale Securities (Cont.)

- **Adjustments (Cont.):**
  - Assume that at the end of its next calendar year (Dec. 31, 20X9), Music City's portfolio of investments in AFS securities has an 81,000 Baht cost and an 82,000 Baht market value.

20X9 Dec. 31	Dr. Net unrealized holding gain/loss -- AFS [OCI-, E-]	550	
	Cr. Allowance to value at market -- AFS [Asset adjustment account-, A-]		550
	To reflect an unrealized loss in market values of AFS securities		

Allowance to value at market -- AFS

B/L 12/31/08	1,550	*Adj. 12/31/09*	*550*
B/L 12/31/09	**1,000**		

Net unrealized Holding Gain/loss -- AFS (B/S)

Adj. 12/31/09	*550*	B/L 12/31/08	1550
		B/L 12/31/09	**1,000**

Financial Statement Presentation – Investment in Debt and Equity Securities

Statement of Comprehensive Income

- Revenue
  - Interest revenue
  - Dividend revenue
- - Expenses
- +/- Unrealized holding G/L – TS
- = Profit or loss

+/- Other comprehensive income

OCI#1: Unrealized holding G/L -- AFS
OCI#2:
OCI#3:
OCI#4:
OCI#5:

= Total comprehensive income

Statement of Financial Position

- Assets
  - Investment in TS (@Mkt value)
  - Investment in AFS (@Mkt value)
  - Investment in HTM (@Amortized cost)
- Liabilities
- Equity
  - Share capital
  - Retained earnings
  - Unrealized holding G/L -- AFS

STATEMENTS OF FINANCIAL POSITION

PRESIDENT BAKERY PUBLIC COMPANY LIMITED
As at 31 December 2011 and 2010

Example of Financial Statement Presentation & Disclosure: Investments
[Source: www.farmhouse.co.th]

(Unit: Baht)

	NOTE	SEPARATE FINANCIAL STATEMENTS 2011	2010
Non-current assets			
Investment in joint venture	12	5,850,000	5,850,000
Other long-term investment	13	15,000,000	-
Property, plant and equipment	14	2,786,147,285	2,660,925,587
Advance payments for purchase of assets		29,022,722	15,347,413
Intangible assets	15	805,771	1,294,434
Leasehold rights	16	1,996,354	2,323,734
Other non-current assets		6,356,402	6,541,253
Total non-current assets		2,845,178,534	2,692,282,421
Total assets		4,312,142,658	3,762,471,123

6.5 Investment

a) Investment in other company, which is non-marketable equity securities, is stated at cost. An allowance for impairment loss will be made when the net recoverable amount is lower than the cost of investment.

b) Investment in joint venture is accounted for in the financial statements in which the equity method is applied using the equity method.

c) Investment in joint venture is accounted for in the separate financial statements using the cost method.

The Siam Cement Public Company Limited and its Subsidiaries

Consolidated balance sheets

As at 31 December 2010 and 2009

in thousand Baht

Assets	Note	2010	2009
Current assets			
Cash and cash equivalents	6	63,827,071	28,937,114
Current investments		6,000,000	-
Trade accounts and notes receivable			
- Related parties	5, 7	2,640,924	3,406,356
- Other companies	7	22,767,262	19,651,879
Receivables from and short-term loans to related parties	5	1,357,919	1,019,229
Inventories	8	36,917,404	31,103,906
Other current assets		7,884,814	5,987,814
Total current assets		**141,395,394**	**90,106,298**

Example of Financial Statement Presentation & Disclosure: Investments

[Source: www.scg.co.th]

The Siam Cement Public Company Limited and its Subsidiaries

Consolidated balance sheets

As at 31 December 2010 and 2009

in thousand Baht

Assets	Note	2010	2009
Non-current assets			
Investments in associates	9	39,750,575	57,618,240
Investments in jointly-controlled entity	9	957,569	1,071,782
Other long-term investments	10	13,734,888	3,227,938
Long-term loans to related party	5	392,927	436,129
Long-term loans to other companies	31	139,194	1,569,430
Property, plant and equipment	11	151,399,494	150,152,215
Intangible assets	12	4,797,684	4,038,263
Deferred tax assets	13	2,504,331	3,211,563
Other non-current assets	14	4,146,810	4,560,012
Total non-current assets		**217,823,472**	**225,885,572**
Total assets		**359,218,866**	**315,991,870**

(e) Investments

Investments in associates and jointly-controlled entity

Investments in associates and jointly-controlled entity are accounted for using the equity method.

Investments in other debt and equity securities

Debt securities and marketable equity securities held for trading are classified as current assets and are stated at fair value, with any resultant gain or loss recognised in the statement of income.

Debt securities that the Group has the positive intent and ability to hold to maturity are classified as held-to-maturity investments, which are stated at amortised cost less any impairment losses. The difference between the acquisition cost and redemption value of such debt securities is amortised using the effective interest rate method over the period to maturity.

Debt securities and marketable equity securities, other than those securities held for trading or intended to be held to maturity, are classified as available-for-sale investments. Available-for-sale investments are, subsequent to initial recognition, stated at fair value, and changes therein, other than impairment losses and foreign currency differences on available-for-sale monetary items, are recognised directly in equity.

Impairment losses and foreign exchange differences are recognised in the statement of income. When these investments are derecognised, the cumulative gain or loss previously recognised directly in equity is recognised in the statement of income. Where these investments are interest-bearing, interest calculated using the effective interest method is recognised in the statement of income.

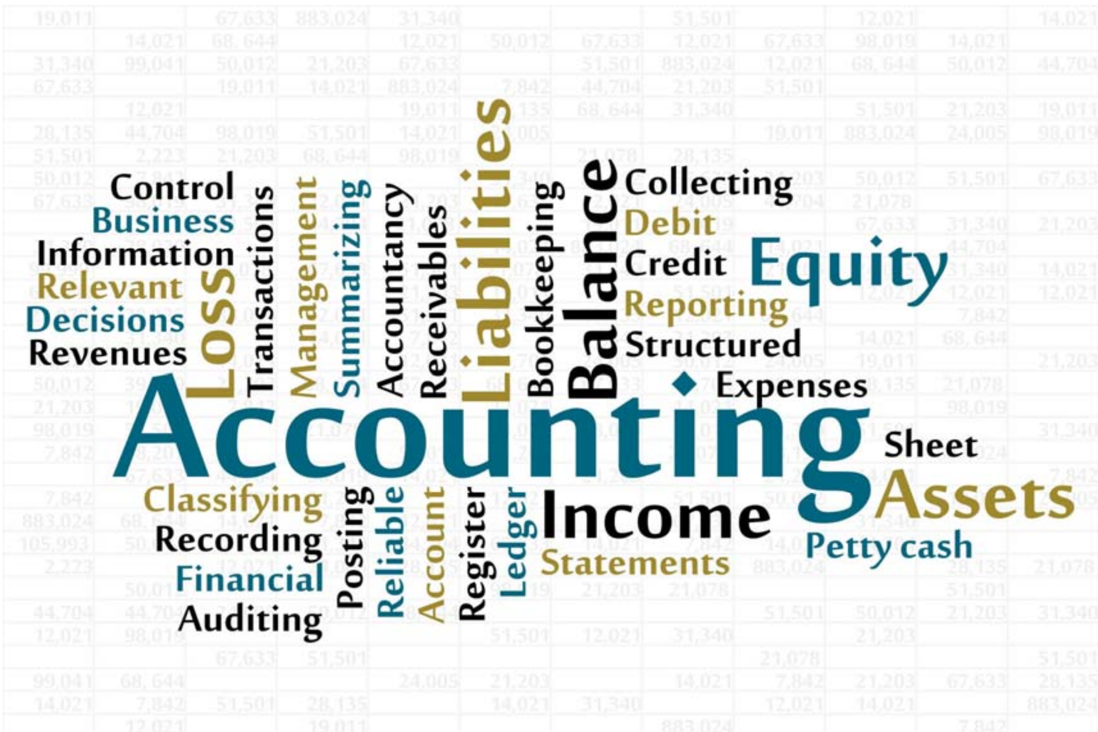
Equity securities which are not marketable are stated at cost less any impairment losses.

The fair value of financial instruments classified as held-for-trading and available-for-sale is determined as the quoted bid price at the reporting date.

Disposal of investments

On disposal of an investment, the difference between net disposal proceeds and the carrying amount together with the associated cumulative gain or loss that was reported in equity is recognised in the statement of income.

If the Group disposes of part of its holding of a particular investment, the deemed cost of the part sold is determined using the weighted average method applied to the carrying value of the total holding of the investment.



Investment in Debt and Equity Securities

1. Types of securities

Characteristics	Debt securities		Equity securities	
Instruments	Bonds		Share capital	
Relationship	Creditor		Owner	
Returns	Interest revenue Capital gain		Dividend revenue Capital gain	
Classification	(1) Trading (2) Available-for-sale (3) Held-to-maturity	No influence | passive investment	(1) Trading (2) Available-for-sale	No influence | passive investment
			(3) Joint venture	Joint control
			(4) Associate	Significant influence 20%-50% ownership
			(5) Subsidiary	Control >50% ownership

CLASSIFICATION #1: Held-to-maturity securities

Held-to-maturity securities are debt securities a company intends and is able to hold until maturity
--> Intent and Ability

Classification: Current VS Noncurrent

- They are reported in current assets if their maturity dates are within one year or the operating cycle, whichever is longer.
- HTM securities are reported in long-term assets when the maturity dates extend beyond one year or the operating cycle, whichever is longer.

All HTM securities are recorded at cost when purchased, and interest revenue is recorded when earned.
The interest revenue is determined under the "effective interest amortization" method
The portfolio of HTM securities is reported at amortized cost on the statement of financial position as part of the assets.

Example:

Par	1,000,000		Issue date	Jan. 1, 20X1	
Stated i	5%	per year	Due date	Dec. 31, 20X2	
Period	Quarterly		Life	2	years
Market i	4%	per year			

Investment in Bond -- Price Calculation
[N=8, I=1%, PV=?, PMT=12,500,FV=1,000,000] ฿1,019,129

Effective Interest Amortization Method

Interest Receipt Period	Book Value of Investment in Bonds at the Beginning of the period	Effective Interest Revenue = BV x MKTi x Time	Cash Interest Receipt = Par x STATEDi x Time	Discount/ Premium Amortization	Unamortized Discount/ Premium	Book Value of Investment in Bonds at the End of the period
0					19,129	1,019,129
1	1,019,129	10,191	12,500	2,309	16,820	1,016,820
2	1,016,820	10,168	12,500	2,332	14,489	1,014,489
3	1,014,489	10,145	12,500	2,355	12,134	1,012,134
4	1,012,134	10,121	12,500	2,379	9,755	1,009,755
5	1,009,755	10,098	12,500	2,402	7,352	1,007,352
6	1,007,352	10,074	12,500	2,426	4,926	1,004,926
7	1,004,926	10,049	12,500	2,451	2,475	1,002,475
8	1,002,475	10,025	12,500	2,475	0	1,000,000

Prepare journal entries related to investment in held-to-maturity securities.

Date	General Journal	Debit	Credit
Jan. 1, 20X1			
	Acquired investment in bonds at a price of ฿1,019,129.		
Mar. 31, 20X1			
	Recorded the interest revenue under effective interest method.		
	…… n = 8		
Dec. 31, 20X2			
	Recorded the maturity of bonds.		

Prepare partial statement of financial position and statement of comprehensive income for the year 20X1.

COMPANY A
STATEMENT OF FINANCIAL POSITION (PARTIAL)
AS AT DECEMBER 31, 20X1
(IN BAHT)

ASSETS

CURRENT ASSETS

Investment in HTM, at amortized cost

NONCURRENT ASSETS

Investment in HTM, at amortized cost xxx

LIABILITIES

EQUITY

COMPANY A
STATEMENT OF COMPREHENSIVE INCOME (PARTIAL)
FOR THE YEAR ENDED DECEMBER 31, 20X1
(IN BAHT)

REVENUE

Interest revenue

EXPENSES

GAINS/LOSSES

PROFIT FOR THE YEAR

OTHER COMPREHENSIVE INCOME

TOTAL COMPREHENSIVE INCOME

CLASSIFICATION #2: Trading securities

Trading securities are debt and equity securities that the company intends to actively manage and trade for profit.

Frequent purchases and sales are expected and are made to earn profits on short-term price changes.

The entire portfolio of trading securities is reported at its market value (fair value); this requires a market adjustment from the cost of the portfolio.

>> The term portfolio refers to a group of securities.

Any unrealized gain (or loss) from a change in the market value of the portfolio of trading securities is reported on the Statement of Comprehensive Income. It will affect the profit for the year (net income).

Example:

On Nov. 1, 20X1, Company A purchased a portfolio of trading securities at a total cost of 11,500 Baht.

Date	General Journal	Debit	Credit
Nov. 1, 20X1			
	Acquired investment in trading securities at a price of ฿11,500.		

Company A's portfolio of trading securities had a total cost of 11,500 Baht and a market value of 13,000 Baht on Dec. 31, 20X1, the first year it held trading securities.

The difference between the 11,500 Baht cost and the 13,000 Baht market value reflects a 1,500 Baht gain.

It is an unrealized gain because it is not yet confirmed by actual sales.

The market adjustment for trading securities is recorded with an adjusting entry at the end of each period to equal the difference between the portfolio's cost and its market value.

Date	General Journal	Debit	Credit
Dec. 31, 20X1			
	To reflect the changes in the market value of trading securities.		

Prepare partial statement of financial position and statement of comprehensive income for the year 20X1.

COMPANY A
STATEMENT OF FINANCIAL POSITION (PARTIAL)
AS AT DECEMBER 31, 20X1
(IN BAHT)

ASSETS

CURRENT ASSETS

Investment in trading securities, at market value

NONCURRENT ASSETS

LIABILITIES

EQUITY

COMPANY A
STATEMENT OF COMPREHENSIVE INCOME (PARTIAL)
FOR THE YEAR ENDED DECEMBER 31, 20X1
(IN BAHT)

REVENUE		
	Interest|Dividend revenue	xxx
EXPENSES		
GAINS/LOSSES		
	Unrealized holding gain -- Trading	
PROFIT FOR THE YEAR		xxx
OTHER COMPREHENSIVE INCOME		
TOTAL COMPREHENSIVE INCOME		

CLASSIFICATION #3: Available-for-sale securities

Available-for-sale securities are debt and equity securities not classified as trading or held-to-maturity securities.
AFS securities are purchased to yield interest, dividends, or increases in market value (called capital gain).
If the intent is to sell AFS securities within the longer of one year or operating cycle, they are classified as short-term investments. Otherwise, they are classified as long-term.
As with trading securities, companies adjust the cost of the portfolio of AFS securities to reflect changes in market value. The investment in AFS securities must be presented at its market value on the statement of financial position as part of assets.

Any unrealized gain (or loss) for the portfolio of AFS securities is reported in OTHER COMPREHENSIVE INCOME section of Statement of Comprehensive Income and also in equity section of the Statement of Financial Position.
--> UNREALIZED HOLDING GAIN|LOSS FROM AFS SECURITIES WILL NOT AFFECT PROFIT FOR THE YEAR (NET INCOME).

Example:

The company must record year-end adjusting entry to record the market value of these investments.
Cost and market value of the investments in bonds and shares on Dec. 31, 20X1 are as follows:

	Cost	Market Value	Unrealized Gain (Loss)
Improv bonds	30,000	29,050	-950
Intex common stock, 500 shares	43,000	45,500	2,500
Total	73,000	74,550	1,550

Date	General Journal	Debit	Credit
Nov. 1, 20X1			
	Acquired investment in AFS securities at a price of ฿73,000.		
Dec. 31, 20X1			
	To reflect the changes in the market value of AFS securities.		

Prepare partial statement of financial position and statement of comprehensive income for the year 20X1.

COMPANY A
STATEMENT OF FINANCIAL POSITION (PARTIAL)
AS AT DECEMBER 31, 20X1
(IN BAHT)

ASSETS	
CURRENT ASSETS	
Investment in available-for-sale securities, at market value	
NONCURRENT ASSETS	
Investment in available-for-sale securities, at market value	xxx
LIABILITIES	
EQUITY	
OCI -- Unrealized holding gain -- AFS securities	

COMPANY A
STATEMENT OF COMPREHENSIVE INCOME (PARTIAL)
FOR THE YEAR ENDED DECEMBER 31, 20X1
(IN BAHT)

REVENUE	
Interest|Dividend revenue	xxx
EXPENSES	
GAINS/LOSSES	
PROFIT FOR THE YEAR = Net income	xxx
OTHER COMPREHENSIVE INCOME (OCI)	
Net unrealized holding gain|loss -- AFS securities	
TOTAL COMPREHENSIVE INCOME	

EXERCISES

Available with McGraw-Hill's Homework Manager

E12-1 **Recording Bonds Held to Maturity**
LO1
Macy's

Macy's, Inc., operates over 850 Macy's and Bloomingdale's department stores nationwide. The company does more than $26 billion in sales each year.

Assume that as part of its cash management strategy, Macy's purchased $10 million in bonds at par for cash on July 1, 2010. The bonds pay 10 percent interest annually with payments each June 30 and December 31 and mature in 10 years. Macy's plans to hold the bonds until maturity.

Required:

1. Record the purchase of the bonds on July 1, 2010.
2. Record the receipt of interest on December 31, 2010.

Comparing Market Value and Equity Methods

E12-2
LO2, 3

Company A purchased a certain number of Company B's outstanding voting shares at $20 per share as a long-term investment. Company B had outstanding 20,000 shares of $10 par value stock. Complete the following table relating to the measurement and reporting by Company A after acquisition of the shares of Company B stock.

Questions	Market Value Method	Equity Method
a. What is the applicable level of ownership by Company A of Company B to apply the method?	____%	____%

For *b, e, f,* and *g*, assume the following:		
Number of shares acquired of Company B stock	1,500	5,000
Net income reported by Company B in the first year	$59,000	$59,000
Dividends declared by Company B in the first year	$12,000	$12,000
Market price at end of first year, Company B stock	$ 17	$ 17

Questions	Market Value Method	Equity Method
b. At acquisition, the investment account on the books of Company A should be debited at what amount?	$____	$____
c. When should Company A recognize revenue earned on the stock of Company B? Explanation required.	____	____
d. After the acquisition date, how should Company A change the balance of the investment account net of the allowance with respect to the stock owned in Company B (other than for disposal of the investment)? Explanation required.	____	____
e. What is the net balance in the investment account on the balance sheet of Company A at the end of the first year?	$____	$____
f. What amount of revenue from the investment in Company B should Company A report at the end of the first year?	$____	$____
g. What amount of unrealized loss should Company A report at the end of the first year?	$____	$____

Recording Transactions in the Trading Securities Portfolio

E12-3
LO2

On June 30, 2010, MetroMedia, Inc., purchased 7,000 shares of Mitek stock for $20 per share. Management purchased the stock for speculative purposes and recorded the stock in the trading securities portfolio. The following information pertains to the price per share of Mitek stock:

	Price
12/31/2010	$24
12/31/2011	31
12/31/2012	25

MetroMedia sold all of the Mitek stock on February 14, 2013, at a price of $23 per share. Prepare any journal entries that are required by the facts presented in this case.

Recording Transactions in the Available-for-Sale Portfolio

E12-4
LO2

Using the data in E12–3, assume that MetroMedia management purchased the Mitek stock for the available-for-sale portfolio instead of the trading securities portfolio. Prepare any journal entries that are required by the facts presented in the case.

Reporting Gains and Losses in the Trading Securities Portfolio

E12-5
LO2

On March 10, 2009, General Solutions, Inc., purchased 10,000 shares of MicroTech stock for $45 per share. Management purchased the stock for speculative purposes and recorded it in the trading securities portfolio. The following information pertains to the price per share of MicroTech stock:

	Price
12/31/2009	$50
12/31/2010	35
12/31/2011	37

General Solutions sold all of the MicroTech stock on September 12, 2012, at a price of $34 per share. Prepare any journal entries that are required by the facts presented in this case.

E12-6 LO2 Reporting Gains and Losses in the Available-for-Sale Portfolio

Using the data in E12–5, assume that General Solutions management purchased the MicroTech stock for the available-for-sale portfolio instead of the trading securities portfolio. Prepare any journal entries that are required by the facts presented in the case.

E12-7 LO3 Recording and Reporting an Equity Method Security

Felicia Company acquired some of the 65,000 shares of outstanding common stock (no-par) of Nueces Corporation during 2011 as a long-term investment. The annual accounting period for both companies ends December 31. The following transactions occurred during 2011:

Jan. 10 Purchased 22,750 shares of Nueces common stock at $11 per share.

Dec. 31 a. Received the 2011 financial statements of Nueces Corporation that reported net income of $80,000.

b. Nueces Corporation declared and paid a cash dividend of $0.60 per share.

c. Determined the market price of Nueces stock to be $10 per share.

Required:

1. What accounting method should the company use? Why?
2. Give the journal entries for each of these transactions. If no entry is required, explain why.
3. Show how the long-term investment and the related revenue should be reported on the 2011 financial statements (balance sheet and income statement) of the company.

E12-8 LO3 Interpreting the Effects of Equity Method Investments on Cash Flow from Operations

Using the data in E12–7, answer the following questions.

Required:

1. On the current year cash flow statement, how would the investing section of the statement be affected by the preceding transactions?
2. On the current year cash flow statement (indirect method), how would the equity in the earnings of the affiliated company and the dividends from the affiliated company affect the operating section? Explain the reasons for the effects.

E12-9 LO4 Determining the Appropriate Accounting Treatment for an Acquisition

The Colgate-Palmolive Company

The notes to recent financial statements of Colgate-Palmolive contained the following information:

> **2. Acquisitions**
>
> On December 18, the Company agreed to acquire GABA Holding AG (GABA), a privately owned European oral care company headquartered in Switzerland. The transaction is structured as an all-cash acquisition of between 80% and 100% of the outstanding shares of GABA for an aggregate price ranging from 800 million Swiss francs to 1,050 million Swiss francs (approximately $645.0 to $846.5 based on December 31, exchange rates). . . .

Assume that Colgate-Palmolive acquired 100 percent of the fair value of the net assets of GABA in the recent year for $700 million in cash. GABA's assets at the time of the acquisition had a book value of $510 million and a market value of $550 million. Colgate-Palmolive also assumed GABA's liabilities of $170 million (book value and market value are the same). Prepare the entry on the date of the acquisition assuming it is a merger.

E12-10
LO5
Timberland

Analyzing and Interpreting the Return on Assets Ratio

Timberland is a leading designer of shoes and clothing. In a recent year, it reported the following:

	Current Year	Prior Year
Revenue	$1,342,123	$1,190,896
Net income	117,879	95,113
Total assets	641,716	538,671
Total stockholders' equity	428,463	372,785

Required:
1. Determine the return on assets ratio for the current year.
2. Explain the meaning of the ratio.

E12-11

TOYOTA
moving forward ▸

(Supplement A) Interpreting Consolidation Policy

Toyota Motor Corporation produces passenger car brands Lexus, Toyota, and Scion. A recent annual report includes the statement that "The consolidated financial statements include the accounts of the parent company and those of its majority-owned subsidiary companies." It then suggests that "All significant intercompany transactions and accounts have been eliminated." In your own words, explain the meaning of this last statement. Why is it necessary to eliminate all intercompany accounts and transactions in consolidation?

E12-12

(Supplement A) Analyzing Goodwill and Reporting the Consolidated Balance Sheet

On January 1, 2010, Company P purchased 100 percent of the outstanding voting shares of Company S in the open market for $80,000 cash. On that date, the separate balance sheets (summarized) of the two companies reported the following book values:

	IMMEDIATELY AFTER THE ACQUISITION JANUARY 1, 2010	
	Company P	Company S
Cash	$ 11,500	$17,500
Investment in Co. S (at cost)	80,000	
Property and equipment (net)	31,000	41,500
Total assets	$122,500	$59,000
Liabilities	$ 41,000	$10,000
Common stock:		
Company P (no-par)	77,000	
Company S (par $10)		40,500
Retained earnings	4,500	8,500
Total liabilities and stockholders' equity	$122,500	$59,000

It was determined on the date of acquisition that the market value of the assets and liabilities of Company S were equal to their book values.

Required:
1. Give the journal entry that Company P made at date of acquisition to record the investment. If none is required, explain why.
2. Analyze the acquisition to determine the amount of goodwill purchased.
3. Prepare a consolidated balance sheet immediately after acquisition.

E12-13

(Supplement A) Determining Consolidated Net Income

Assume that P Company acquired S Company on January 1, 2011, for $110,000 cash. At the time, the net book value of S Company was $86,000. The market value was $95,000 with property and equipment having a market value of $9,000 over book value. The property and equipment has a three-year remaining life and is depreciated straight-line with no residual value. During 2011, the companies reported the following operating results:

	P Company	S Company
Revenues related to their own operations	$460,000	$80,000
Expenses related to their own operations	340,000	60,000

Compute consolidated net income for the year ended December 31, 2011.

EXERCISES

E12–1.
Req. 1
July 1, 2010:

Investment in bonds (+A)	10,000,000	
Cash (–A)		10,000,000

Req. 2
Dec 31, 2010:

Cash (+A)	500,000	
Interest revenue (+R, +SE)		500,000

($10 million x 10% x 6/12 of a year)

E12–2.

Questions	*Method of Measurement*	
	Market Value Method	*Equity Method*
a	Less than 20%.	At least 20% but not more than 50%.
b	At cost: 1,500 shares x $20 = $30,000.	At cost: 5,000 shares x $20 = $100,000.
c	When Co. B declares a cash dividend; not for any holding gains and losses on securities-available-for-sale.	When Co. B reports income or loss for the period; not when dividends are declared or paid.
d	Record increases and decreases based on stock price changes through the valuation allowance.	Increase the investment account for proportionate part of income, less proportionate part of dividends and losses of Co. B.
e	1,500 shares x $17 = $25,500 market value.	Cost of $100,000 plus $14,750 ($59,000 x 25%) equity in investee's earnings minus $3,000 ($12,000 x 25%) dividends received equals $111,750.
f	Company A owns 7.5% of Company B (1,500 shares ÷ 20,000 shares outstanding). $12,000 dividends declared x 7.5% = $900 dividend revenue for Company A.	$59,000 Company B net income x 25% = $14,750 equity in earnings of investee.
g	1,500 x ($20 – $17) = $4,500 reported in stockholders' equity.	None.

E12–3.

June 30, 2010:		
Investment in TS (+A)	140,000	
Cash (–A)		140,000
(7,000 shares x $20 per share)		
Dec 31, 2010:		
Allowance to value at market – TS (+A)	28,000	
Net unrealized loss/gain – TS (+Gain, +SE)		28,000
Dec. 31, 2011:		
Allowance to value at market – TS (+A).	49,000	
Net unrealized loss/gain – TS (+Gain, +SE)		49,000
Dec. 31, 2012:		
Net unrealized loss/gain – TS (+Loss, –SE)	42,000	
Allowance to value at market – TS (–A)		42,000

Computations:

Year	Market	– Cost	= Allowance Balance	– Unadjusted Balance	= Adjustment
2010	$168,000	$140,000	+$28,000	$0	+$28,000
2011	217,000	140,000	+ 77,000	+ 28,000	+ 49,000
2012	175,000	140,000	+ 35,000	+ 77,000	– 42,000

Feb. 14, 2013:		
Cash (+A) (7,000 shares x $23)	161,000	
Loss on sale of investment (+Loss, –SE)	14,000	
Investment in TS (–A).		140,000
Allowance to value at market – TS (–A)		35,000

Note: The net unrealized loss/gain is an income statement account. This item is reported on the current income statement and affects the computation of net income. It is closed to Retained Earnings at the end of each year.

E12–4.

June 30, 2010:		
Investment in SAS (+A)	140,000	
Cash (–A)		140,000
Dec. 31, 2010:		
Allowance to value at market – SAS (+A)..	28,000	
Net unrealized loss/gain – SAS (+SE)		28,000
Dec. 31, 2011:		
Allowance to value at market – SAS (+A).	49,000	
Net unrealized loss/gain – SAS (+SE)		49,000
Dec. 31, 2012:		
Net unrealized loss/gain – SAS (–SE)	42,000	
Allowance to value at market – SAS (–A).		42,000

Computations:

Year	Market	– Cost	= Allowance Balance	– Unadjusted Balance	= Adjustment
2010	$168,000	$140,000	+$28,000	$0	+$28,000
2011	217,000	140,000	+ 77,000	+ 28,000	+ 49,000
2012	175,000	140,000	+ 35,000	+ 77,000	– 42,000

Feb. 14, 2013:		
Cash (+A) (7,000 shares x $23).	161,000	
Net unrealized loss/gain – SAS (–SE)	14,000	
Allowance to value at market – SAS (–A).		14,000
Investment in SAS (–A).		140,000
Gain on sale of investment (+Gain, +SE)		21,000

Note: The net unrealized loss/gain account is a balance sheet account. It does not affect the computation of net income each year. Because it is a balance sheet account, it maintains its balance from year to year. Therefore, the decline in stock price that occurs in 2012 is reported as an adjustment to the net unrealized loss/gain account. When the stock is sold in 2013, the net unrealized loss/gain is closed along with the Allowance to Value at Market account, and the difference between the purchase price (original cost) and the selling price is reported as a gain on the income statement.

E12–5.

March 10, 2009:		
Investment in TS (+A)	450,000	
Cash (–A)		450,000
(10,000 shares x $45 per share)		
Dec. 31, 2009:		
Allowance to value at market – TS (+A)	50,000	
Net unrealized loss/gain – TS (+Gain, +SE)		50,000
Dec. 31, 2010:		
Net unrealized loss/gain – TS (+Loss, –SE)	150,000	
Allowance to value at market – TS (–A)		150,000
Dec. 31, 2011:		
Allowance to value at market – TS (+A)	20,000	
Net unrealized loss/gain – TS (+Gain, +SE)		20,000

Computations:

Year	Market –	Cost	= Allowance Balance	– Unadjusted Balance	= Adjustment
2009	$500,000	$450,000	+$50,000	$0	+$50,000
2010	350,000	450,000	–100,000	+ 50,000	– 150,000
2011	370,000	450,000	– 80,000	–100,000	+ 20,000

Sept. 12, 2012:		
Cash (+A) (10,000 shares x $34)	340,000	
Allowance to value at market – TS (+A)	80,000	
Loss on sale of investment (+Loss, –SE)	30,000	
Investment in TS (–A)		450,000

Note: The net unrealized loss/gain is an income statement account. This item is reported on the current income statement and affects the computation of net income. It is closed to Retained Earnings at the end of each year.

E12–6.

March 10, 2009:		
Investment in SAS (+A)	450,000	
Cash (–A)		450,000
Dec. 31, 2009:		
Allowance to value at market – SAS (+A)	50,000	
Net unrealized loss/gain – SAS (+SE)		50,000
Dec. 31, 2010:		
Net unrealized loss/gain – SAS (–SE)	150,000	
Allowance to value at market – SAS (–A)		150,000
Dec. 31, 2011:		
Allowance to value at market – SAS (+A)	20,000	
Net unrealized loss/gain – SAS (+SE)		20,000

Computations:

Year	Market –	Cost	= Allowance Balance	– Unadjusted Balance	= Adjustment
2009	$500,000	$450,000	+$50,000	$0	+$50,000
2010	350,000	450,000	–100,000	+ 50,000	–150,000
2011	370,000	450,000	– 80,000	–100,000	+ 20,000

Sept. 12, 2012:		
Cash (+A) (10,000 shares x $34)	340,000	
Allowance to value at market – SAS (+A)	80,000	
Loss on sale of securities (+Loss, –SE)	110,000	
Investment in SAS (–A)		450,000
Net unrealized loss/gain – SAS (+SE)		80,000

Note: The unrealized loss/gain account is a balance sheet account. It does not affect the computation of net income each year. Because it is a balance sheet account, it maintains its balance from year to year. Therefore, the decline in stock price that occurs in 2010 is reported as an adjustment to the net unrealized loss/gain account and the increase in stock price that occurs in 2011 is also reported as an adjustment to the net unrealized loss/gain account. When the stock is sold in 2012, the net unrealized loss/gain is closed along with the Allowance to Value at Market account, and the difference between the purchase price and the selling price is reported as a loss on the income statement.

E12–7.

Req. 1

The equity method must be used because the company owns 35% (22,750 ÷ 65,000) of the total shares outstanding of Nueces Corporation. The equity method must be used when there is at least 20% but not more than 50% ownership in existence. The Felicia Company must use the equity method because it can exercise significant influence, but not control, over the operating and financing policies of Nueces Corporation.

Req. 2

January 10, 2011:		
Investment in affiliated companies (+A)	250,250	
Cash (–A)		250,250
(22,750 shares x $11 per share) -- 35% of the voting common stock		
December 31, 2011:		
Investment in affiliated companies (+A).	28,000	
Equity in investee earnings (+R, +SE)		28,000
($80,000 x 35% = $28,000)		
December 31, 2011:		
Cash (+A)	13,650	
Investment in affiliated companies (–A).		13,650
(22,750 shares x $.60 = $13,650)		

No entry is made under the equity method to record changes in market value.

Req. 3

Balance Sheet—At December 31, 2011

Long-term Investments:	
Investment in affiliated companies (equity basis*)	$264,600
Income Statement—For the Year Ended December 31, 2011	
Equity in investee earnings	$ 28,000

* Investment in Affiliated Companies

Cost		250,250		
% Investee's net income	28,000		13,650	% Investee's dividends declared
		264,600		

E12–8.

Req. 1 Investing activities

Purchase of investments in affiliated companies	–250,250

Req. 2 Operating activities

Net Income	
Adjusted for:	
Equity in earnings of affiliated companies (no cash received)	–28,000
Dividends received from affiliated companies (cash received)	+13,650

E12–9.

(in millions)

Assets (+A, not detailed).	550	
Goodwill (+A)	320	
Liabilities (+L, not detailed)		170
Cash (–A)		700

E12–10.

Req. 1

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

$$\frac{\$117{,}879}{(\$538{,}671 + \$641{,}716) \div 2} = .20\ (20\%)$$

Req. 2

ROA measures how much the firm earned for each dollar of investment. It is the broadest measure of profitability and management effectiveness, independent of financing strategy.

E12–11.

Consolidation is an accounting process that brings together financial information from two or more companies to make it appear as if there is a single economic entity. These companies may have engaged in transactions with each other during the year (these transactions are called intercompany transactions). Some examples are lending money or selling merchandise. During consolidation, intercompany transactions are eliminated or reversed so that on the consolidated statements, it appears as if the transactions never took place.
It is necessary to eliminate intercompany transactions because a single economic entity cannot logically do business with itself. It makes no sense, for example, to report as a liability an amount that an entity owes itself.

E12–12.

Req. 1

Investment in Co. S (100%) (+A)	80,000	
Cash (–A)		80,000

Req. 2

Purchase price for 100% interest in Co. S	$80,000
Market value of Company S net assets purchased equaled book value ($59,000 – $10,000)	49,000
Goodwill purchased	$31,000

Req. 3

COMPANY P AND ITS SUBSIDIARY, COMPANY S (100% OWNED)
Consolidated Balance Sheet
January 1, 2010 (immediately after acquisition)

	Separate Balance Sheets				
	Company P	*Company S*	*Eliminations*		*Consolidated Balance Sheet*
Assets:					
Cash	$ 11,500	$17,500			$ 29,000
Investment in Co. S (at cost)	80,000		–	80,000	
Property and equipment (net)	31,000	41,500			72,500
Goodwill			+	31,000	31,000
Totals	$122,500	$59,000			$132,500
Liabilities:					
Liabilities	$ 41,000	$10,000			$ 51,000
Stockholders' Equity:					
Common stock, Co. P	77,000				77,000
Common stock, Co. S		40,500	–	40,500	
Retained earnings, Co. P	4,500				4,500
Retained earnings, Co. S		8,500	–	8,500	
Totals	$122,500	$59,000			$132,500

E12–13.

Goodwill calculation:

Purchase price	$110,000
Market value of net assets	95,000
Goodwill	$ 15,000
Additional Depreciation ($9,000 ÷ 3 years)	$ 3,000

Revenues ($460,000 + 80,000)	$540,000
Expenses ($340,000 + $60,000 + $3,000)	403,000
Net Income	$137,000