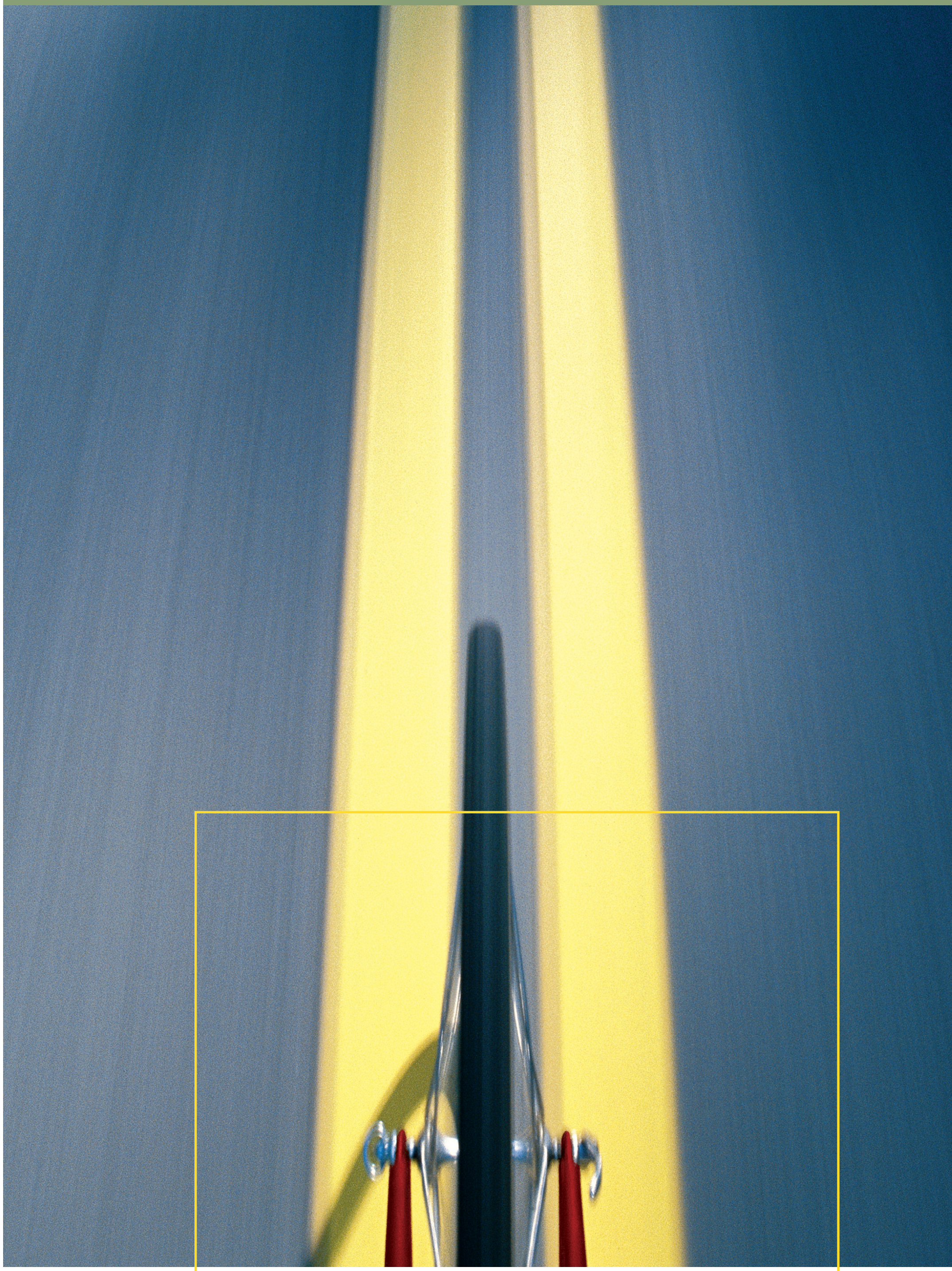


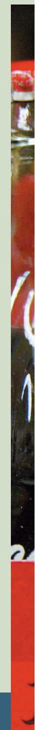
Financial Instruments and Liabilities

3

SECTION

12 CHAPTER

Investments



OVERVIEW

In this chapter, you will learn that investments that companies make in the stock and debt securities of other companies are accounted for differently depending on the nature of the investments. For instance, you'll see that investment securities categorized as securities held-to-maturity are reported at amortized cost, while securities available-for-sale and trading securities are reported at their fair values.

We also discuss the equity method—a completely different way to record and report investments in stock when specific characteristics indicate that the investor can significantly influence the operating and financial policies of the investee.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO1 Demonstrate how to identify and account for investments classified for reporting purposes as held-to-maturity.
- LO2 Demonstrate how to identify and account for investments classified for reporting purposes as available-for-sale.
- LO3 Demonstrate how to identify and account for investments classified for reporting purposes as trading securities.
- LO4 Explain what constitutes significant influence by the investor over the operating and financial policies of the investee.
- LO5 Demonstrate the way investments are recorded and reported by the equity method.
- LO6 Explain the adjustments made in the equity method when the fair value of the net assets underlying an investment exceeds their book value at acquisition.

Financial Reporting Case

A Case of Coke

You are the lone accounting major in your five-member group in your Business Policy class. A part of the case your group is working on is the analysis of the financial statements of the Coca-Cola Company.

The marketing major in the group is confused by the following disclosure note from Coca-Cola's 2004 annual report:

Note 8: Financial Instruments (in part)

CERTAIN DEBT AND MARKETABLE EQUITY SECURITIES

Investments in debt and marketable equity securities, other than investments accounted for by the equity method, are categorized as either trading, available-for-sale or held-to-maturity. On December 31, 2003 and 2002, we had no trading securities. Securities categorized as available-for-sale are stated at fair value, with unrealized gains and losses, net of deferred income taxes, reported as a component of accumulated other comprehensive income. Debt securities categorized as held-to-maturity are stated at amortized cost.

On December 31, 2004, available-for-sale and held-to-maturity securities consisted of the following (in millions)

		Gross Unrealized		
December 31, 2004	**Cost**	**Gains**	**Losses**	**Estimated Fair Value**
Available-for-sale securities				
Equity securities	$ 144	$146	$ (2)	$ 288
Other debt securities	5	—	(1)	4
	$ 149	$146	$ (3)	$ 292
Held-to-maturity securities				
Bank and corporate debt	$4,479	$ —	$ —	$4,479
Other debt securities	107	$ —	$ —	107
	$4,586	$ —	$ —	$4,586

"They say unrealized gains and losses are reported as part of comprehensive income? I don't see these gains and losses on the income statement," he complained. "Maybe comprehensive income is something else altogether. And held-to-maturity securities—why are they treated differently?"

By the time you finish this chapter, you should be able to respond appropriately to the questions posed in this case. Compare your response to the solution provided at the end of the chapter.

QUESTIONS

1. How should you respond? Why are held-to-maturity securities treated differently from other investment securities? (page 562)
2. Why are unrealized gains and losses on available-for-sale securities not reported on the income statement? (page 564)
3. What is comprehensive income? (page 564)
4. Anticipate his next question and explain why Coke accounts for some of its investments by the equity method and what that means. (page 576)

Most companies invest in financial instruments issued by other companies. For some investors, these investments represent ongoing affiliations with the companies whose securities are acquired. For instance, in 2004 **Kmart** acquired all the common stock of **Sears** to become the nation's third-largest retailer. **Microsoft** invested $600 million in nationwide wireless phone company **Nextel Communications Inc.,** gaining access to wireless Internet users. Some investments, though, are made not to obtain a favorable business relationship with another firm but simply to earn a return from the dividends or interest the securities pay or from increases in the market prices of the securities—the same prospective rewards that might motivate you to buy stocks, bonds, or other investment securities. With such diversity in investment objectives, it's understandable that no single accounting method is adequate to report every investment. As you'll discover when reading this chapter, investments are accounted for in six ways, depending on the nature of the investment relationship. Before we discuss these in detail, see the quick overview of the six approaches in Graphic 12–1.

GRAPHIC 12–1
Reporting Categories for Investments

Characteristics of the Investment	Reporting Method
The investor *controls* the investee:	
The investor owns *more than 50% of the voting stock* of the investee	**Consolidation**—financial statements are combined as if a single company
The investor can *"significantly influence"* the operating and financial policies of the investee:	
Typically the investor owns *between 20% and 50% of the voting stock* of the investee	**Equity method**—cost adjusted for subsequent growth of the investee
The investor *cannot* "significantly influence" the operating and financial policies of the investee:	
Investments in debt securities for which the investor has the "positive intent and ability" to *hold to maturity*	**Held-to-maturity**—investment reported at amortized cost
Investments *not* held in active trading account for immediate resale nor to be held to maturity	**Securities available-for-sale**—investment reported at fair value (with unrealized gains and losses excluded from earnings and reported in shareholders' equity)
Investments held in *active trading account* for immediate resale	**Trading securities**—investment reported at fair value (with unrealized gains and losses included in earnings)
Fair value of the investments *not* determinable	**Cost method**—investment reported at cost

We discuss the last four categories in Part A of the chapter. The equity method is described in Part B, as well as an abbreviated discussion of consolidated statements.

PART A ACCOUNTING FOR INVESTMENT SECURITIES

To finance its operations and often the expansion of those operations, a corporation raises funds by selling equity securities (common and preferred stock) and debt securities (bonds and notes). These securities are purchased as investments by individual investors, mutual funds, and also by other corporations. In later chapters we discuss equity and debt securities from the perspective of the issuing company. Our focus in this chapter is on the corporations that invest in securities issued by other corporations as well as those issued by governmental units (bonds, Treasury bills, and Treasury bonds).

For reporting purposes, all investments in *debt* securities and investments in *equity* securities that have readily determinable fair values (except those for which the equity method or consolidation is appropriate) are classified in one of three categories and accounted for differently depending on the classification as shown in Graphic 12–2.[1]

Graphic 12–2
Reporting Categories for Investments in Marketable Securities

Reporting Category	Classification Criteria
Held-to-maturity	Debt securities for which the investor has the positive intent and ability to hold to maturity
Securities available-for-sale	Debt or equity securities not classified as either securities held-to-maturity or trading securities (typically securities whose sale depends on market factors and financial conditions of the company)
Trading securities	Debt or equity securities held for immediate resale

For all three categories, we include in the determination of earnings *realized* gains and losses—those that arise when securities are sold. Similarly, we include investment income (dividends and interest) in the determination of earnings for all three categories. The differences in accounting treatment among the categories of securities arise with respect to *unrealized* gains and losses, those that arise from holding securities during a period when their market values change.

As you know, the purpose of accounting is to provide information useful in making decisions. What's most relevant for that purpose is not necessarily the same for each investment a company might make. For example, day-to-day changes in market value are less descriptive of investment success for an investment in corporate bonds that management *fully intends to hold until the bonds mature* than for an investment in the common stock of another corporation *acquired with the hope of profiting from market price changes.* Let's examine the three reporting classifications, one by one.

Securities to Be Held to Maturity

● LO1

Unlike a share of stock, a bond or other debt security has a specified date on which it matures. On its maturity date, the "face amount" is paid to investors. In the meantime, interest equal to a specified percentage of the face amount is paid to investors on specified interest dates. However, even though the maturity amount is fixed and interest payments are fixed, this doesn't mean the market value of the security doesn't change. On the contrary, if "market" rates of interest *rise* after a fixed-rate security is purchased, the value of the now-below-market, fixed-interest payments declines. So, the market value of the investment falls. Conversely, if "market" rates of interest *fall* after a fixed-rate security is purchased, the fixed interest payments become relatively attractive, so the market value of the investment rises.

The market value of a fixed-rate investment moves in the opposite direction of market rates of interest.

The Board (FASB) deliberately chose to make the held-to-maturity category restrictive because it believes that the use of amortized cost must be justified for each investment in a debt security. At acquisition, an entity should establish the positive intent and ability to hold a security to maturity, which is distinct from the mere absence of intent to sell.[2]

Are these movements in market price relevant? Not if the investor has no intention of selling the investment before maturity. Increases and decreases in the market value between the time a debt security is acquired and the day it matures to a prearranged maturity value are less important if sale before maturity isn't an alternative. For this reason, if an investor has the "positive intent and ability"

Changes in market value are less relevant to an investor who will hold a security to its maturity regardless of those changes.

[1] "Accounting for Certain Investments in Debt and Equity Securities," *Statement of Financial Accounting Standards No. 115* (Norwalk, Conn.: FASB, 1993).
[2] Ibid., par. 46.

to hold the securities to maturity, investments in debt securities are classified as **held-to-maturity** and reported at amortized *cost* in the balance sheet.

A debt security is *not* classified as held-to-maturity if the investor might sell it in response to changes in market prices or interest rates, to meet the investor's liquidity needs, or similar factors. For instance, an investment would not be classified as held-to-maturity if the investor might sell it to achieve favorable tax treatment. An investment in securities to be "held to maturity" by the investor is demonstrated in Illustration 12–1.

ILLUSTRATION 12–1 Held-to-Maturity Securities	On January 1, 2006, United Intergroup, Inc. purchased as an investment $700,000 of 12% bonds. Because the 12% stated rate was less than the rate paid by other companies on similar bonds, say 14%, United was able to buy the securities at a "discounted" price of $666,633. Interest of $42,000 [$700,000 × (12% ÷ 2)] is receivable semiannually on June 30 and December 31.

Purchase of Investment. The journal entry to record the *purchase* of investment securities is:

All investment securities are initially recorded at cost.

January 1		
Investment in bonds (face amount)	700,000	
Discount on bond investment (difference)		33,367
Cash (price paid for the bonds)		666,633

Investment Revenue. Interest accrues on bonds, or any other interest-bearing security for that matter, at a *constant percentage* of the investment each period. Of course, under the concept of *accrual accounting,* the periodic effective interest is unaffected by when the cash interest actually is received. Recording interest each period as the *effective market rate of interest multiplied by the outstanding balance of the investment* (during the interest period) is referred to as the effective interest method. This simply is an application of the accrual concept, consistent with accruing all revenues as they are earned, regardless of when cash is received.

The effective interest on debt is the *market rate of interest multiplied by the outstanding balance of the debt.*

Continuing our example, the initial investment is $666,633. Since the effective interest rate is 14%, interest recorded as *revenue* to the investor for the first six-month interest period is $46,664:

$666,633	×	[14% ÷ 2]	=	$46,664
Outstanding balance		Effective rate		Effective interest

However, the bond security calls for semiannual interest payments of only $42,000—the *stated* rate (6%) times the *face amount* ($700,000). As always, when only a portion of revenue is received, the remainder becomes an asset—in this case an addition to the existing investment. So the difference, $4,664, increases the investment and is reflected as a reduction in the discount (a valuation account). The journal entry to record the interest received for the first six months as *investment revenue* is:

The "unreceived" portion of the effective interest increases the existing investment.

Dividend and interest income from all investment securities is included in earnings.

June 30		
Cash (stated rate × face amount)	42,000	
Discount on bond investment (difference)	4,664	
Investment revenue (market rate × outstanding balance)		46,664

The amortized cost of the investment now is $700,000 − ($33,367 − 4,664) = $671,297, which is higher than the original investment. Because the balance of the investment increases each period, the dollar amount of interest revenue (market rate × outstanding balance) also will increase each period. We discuss this in much greater detail in Chapter 14.

Reporting Investments in Securities to Be Held to Maturity. Securities to be held to maturity are recorded at cost as illustrated above, and holding gains or losses from market price changes are ignored. So if the market value of the investment were to increase from

$666,633 at January 1 to, say, $680,000 at June 30, we would ignore that holding gain and report the investment in a balance sheet at that date at its amortized cost of $671,297 as determined above:

Investment in bonds	$700,000
Less: Discount on bond investment	28,703
Book value (amortized cost)	$671,297

We will revisit our discussion of investments in debt securities to be "held to maturity" in Chapter 14, "Bonds and Long-Term Notes." This way we can more readily see that accounting by the company that issues bonds and by the company that invests in those bonds is opposite but parallel; that is, each side of the transaction is the mirror image of the other. When we resume our discussion of bond investments at that point, be sure to notice that we continue the same numerical illustration we began in this chapter.

Let's turn our attention now to accounting and reporting for investments referred to as "securities available-for-sale" and "trading securities." These include investments in *debt* securities that are not classified as held-to-maturity and *equity* securities that have *readily determinable fair values.* You'll notice that, unlike held-to-maturity securities, we report investments in the other two categories at their fair market values.

Graphic 12–3 provides a description from a recent annual report of how **United Community Financial Corporation** accounts for its investments in each of the three reporting categories.

Note (in part): Investment and Mortgage-Backed Securities
Securities are classified as available for sale, held to maturity, or trading upon their acquisition. Securities classified as available for sale are carried at an estimated fair value with the unrealized holding gain or loss reflected as a component of equity, net of taxes. Securities classified as held to maturity are carried at amortized cost. Securities classified as trading are carried at estimated fair value with the market value adjustment reflected in the income statement. . . . Realized gains and losses on the sale of debt securities are recorded based on the amortized cost of the securities sold.

GRAPHIC 12–3
Investments in Securities to Be Held to Maturity—United Community Financial Corporation

Obviously, not all investments are intended to be held to maturity. When an investment is acquired to be held for an *unspecified period of time,* we classify the investment as either (a) "securities available-for-sale" or (b) "trading securities." The trading securities category concerns primarily banks and other financial institutions who frequently buy and sell securities expecting to earn profits on short-term changes in price. On the other hand, securities available for sale is a more general classification that includes all investments other than trading securities or securities to be held to maturity. So, we'll discuss the less restrictive securities available-for-sale category first.

Securities Available-for-Sale

LO2

The Board concluded that fair value information is more relevant than amortized cost information, in part because it reflects the effects of a management decision to buy a financial asset at a specific time and then continue to hold it for an unspecified period of time.[3]

When you or I buy stock in a corporation, say **Coca-Cola,** we hope the market value will rise before we sell it. We also might look forward to the cash dividends Coca-Cola pays its shareholders every three months. We may even have fairly defined criteria for when we plan to sell the stock, or we may intend to wait and see what happens to market prices. In either case, our investment is available to sell given the right combination of market factors and our own cash situation. So it often is, too, with companies who invest in the securities of other corporations or

[3]Ibid., par. 51.

Investments in securities to be held for an *unspecified period of time* are reported at their fair values.

governmental entities. When a company acquires an investment, not for an active trading account (as a financial institution might) or to be held to maturity (which of course couldn't be stock because it has no maturity date), the company classifies its investment as **securities available-for-sale.** Because these securities are not expressly intended to be held to some scheduled maturity date, the investment is reported in a balance sheet at the *fair market value* of the investment securities on the reporting date. Just like any investment, regardless of how we classify it, the investment is initially recorded at its cost—that is, the total amount paid for the securities including any brokerage fees. But then, when a balance sheet is prepared, this type of investment is written up or down to its fair value, or "marked to market."

FINANCIAL REPORTING CASE

Q1, p. 557

Be sure to notice that mark-to-market accounting is a departure from historical costs, which is the way most assets are reported in balance sheets. Why the difference? For these investments, fair value information is more relevant than for other assets intended primarily to be used in company operations, like buildings, land and equipment, or for investments to be *held to maturity.*[4] For instance, consider an investment in debt. As interest rates rise or fall, the fair value of the investment will decrease or increase. Movements in fair values are less relevant if the investment is to be held to maturity; the investor receives the same contracted interest payments and principal at maturity, regardless of changes in fair value. This is similar to changes in the fair values of operational assets, typically intended to be held throughout their productive lives.

Fair values are less relevant for investments to be held to maturity.

ADDITIONAL CONSIDERATION

No More Cherry Picking

One motivation of the FASB when deciding to move to mark-to-market accounting for investments was to curtail what it perceived as (and the SEC insisted was) a common practice at the time—"cherry picking." This refers to a company carefully choosing when and which of its securities to sell. Specifically, it means selling a security that had risen in value in order to realize a gain or not selling a security that had declined in value in order not to realize a loss, or even choosing to realize a loss in good years in order to "smooth" income.

As just argued, market values and changes in market value are less relevant to an investor who will hold a security to its maturity regardless of value changes. On the other hand, for investments of unspecified length, changes in market values, and thus market returns, provide an indication of management's success in deciding when to acquire the investment, when to sell it, whether to invest in fixed-rate or variable-rate securities, and whether to invest in long-term or short-term securities. Accounting for securities available for sale is demonstrated in Illustration 12–2.

ILLUSTRATION 12–2
Investment in Securities Available-for-Sale

American Capital buys and sells both debt and equity securities of other companies as investments. The following transactions during 2006 pertain to American's investment portfolio. Assume American Capital buys securities, *not* intending to profit from short-term changes in price and *not* intending to hold debt securities to maturity. The securities are properly classified as available-for-sale. The company's fiscal year-end is December 31.

November 1	Purchased ABM Corporation 10% notes for $120 million (face amount).	
November 30	Received cash interest of $1 million on the investment in ABM Corporation notes, calculated as $120 million × 10% × 1⁄12 year.	
December 1	Sold the ABM Corporation notes for $123 million.	
December 21	Acquired two new investments costing:	
	Millington Industries common shares	$30 million
	Bartlett Corporation common shares	20 million
December 31	The market prices of the investments are:	
	Millington Industries common shares	$35 million
	Bartlett Corporation common shares	19 million

[4]Investments to be held to maturity, of course, include only debt securities.

Purchase of Investment. The journal entry to record the purchase of investment securities is:

November 1	($ in millions)	
Investment in ABM notes	120	
Cash		120

All investment securities are initially recorded at cost.

Investment Revenue. The journal entry to record the cash interest is:

November 30	($ in millions)	
Cash ($120 million × 10% × 1/12 year)	1	
Investment revenue		1

Dividend and interest income is included in earnings.

Sale of Investments. The journal entry to record the sale of the ABM Corporation notes is:

December 1	($ in millions)	
Cash	123	
Investment in ABM notes		120
Gain on sale of investments		3

Realized gains and losses are included in earnings.

Purchase of Investments. The journal entry to record the purchase of investment securities is:

December 21	($ in millions)	
Investment in Millington shares	30	
Investment in Bartlett shares	20	
Cash		50

All investment securities are initially recorded at cost.

Adjusting Investments to Fair Value. Reporting investments at their fair values means adjusting their carrying amounts for changes in fair value after their acquisition (or since the last reporting date if they were held at that time). These changes are called "unrealized holding gains and losses" because they haven't yet been realized through the sale of the securities. They must be recorded (or updated) any time financial statements are prepared for external use. The journal entry to adjust the investments in our illustration to fair market value at year-end is:

($ in millions) **Available-for-Sale Securities**	**Cost**	**Fair Value**	**Unrealized Gain (Loss)**
Millington Industries shares	$30	$35	$5
Bartlett Corporation shares	20	19	(1)
Totals	$50	$54	$4*

December 31		
Fair value adjustment (calculated above)	4	
Net unrealized holding gains and losses		4

*The $4 million balance in the accumulated unrealized holding gains and losses is reported as *accumulated other comprehensive income*, a component of shareholders' equity in the 2006 balance sheet. The $4 million *change* in the accumulated balance is reported as 2006 *other comprehensive income*.

Notice that we record the increase in fair value *indirectly* by debiting a valuation account, fair value adjustment, rather than directly debiting the investment account itself.[5]

All investment securities (except those held to maturity) are adjusted to their fair values on each reporting date.

Securities available-for-sale	$50
Plus: Fair value adjustment	4
	$54

The other half of the adjusting entry is a shareholders' equity account, net unrealized holding gains or losses. The reason for this is explained in the next section.

ADDITIONAL CONSIDERATION

When the Fair Value Isn't Readily Determinable

The fair value of equity securities is considered "readily determinable" if selling prices are currently available on a securities exchange.

If the fair value of an equity security is *not* readily determinable, an investment in that security is carried and reported at cost (except when the equity method described in Part B of this chapter is appropriate). Any dividends received would be recognized as investment revenue, and a gain or loss would be reported only when actually realized, which is when the investment is sold.

Having a readily determinable fair value is not a requirement for *debt* securities to be reported at fair value. Even though some debt securities don't trade regularly, their fair values can be reasonably estimated by determining the discounted present value of their interest and principal payments. You learned how to do this in Chapter 6 and will gain considerably more exposure to the process in Chapter 14.

Reporting Investments in Securities Available-for-Sale. Investments in securities *available-for-sale* are reported in a balance sheet at fair value. Holding gains and losses from retaining securities during periods of price change are *not* included in the determination of income for the period. Instead, they are accumulated and reported as a separate component of shareholders' equity, as part of Other Comprehensive Income. That is, an unrealized holding gain would increase shareholders' equity; an unrealized holding loss would decrease shareholders' equity.

FINANCIAL REPORTING CASE

Q2, p. 557

By definition, these securities are *not* acquired for the purpose of profiting from short-term market price changes, so gains and losses from holding these securities while prices change are not considered relevant performance measures to be included in earnings. This, in fact, is the argument made by the FASB. A by-product of this treatment is the avoidance of earnings volatility that would come from adjusting earnings for gains and losses as they occur. Opponents of this view argue that this amounts to a form of "income smoothing" that lessens earnings quality. This counterargument suggests that periodic gains and losses from holding securities during periods of changes in market value are, indeed, relevant measures of the performance of management that can, at its discretion, choose whether or not to realize the gains and losses by selling the securities.

On the 2006 balance sheet, investments available-for-sale are reported at the *fair value* of the investment securities ($35 + 19 = $54 million), but the *net* unrealized holding gain ($5 − 1 = $4 million) is not reported in the income statement. Instead, it's reported in the balance sheet as a separate component of shareholders' equity, specifically as part of accumulated *other comprehensive income.*

FINANCIAL REPORTING CASE

Q3, p. 557

Comprehensive income, as you may recall from Chapter 4, is a more expansive view of the change in shareholders' equity than traditional net income. In fact, it encompasses all changes in equity *other than from transactions with owners.*[6] So, in addition to net income, comprehensive income includes up to four other changes in equity as indicated in Illustration 12–2A.

[5]An acceptable alternative to increasing (or decreasing) an investment to fair value *indirectly* as we've done here is to debit (or credit) the investment account directly. This, however, would be inconvenient for a debt security, like an investment in bonds, classified as available-for-sale, because of the difficulty in amortizing its cost separately from fair market adjustments.

[6]Transactions with owners primarily include dividends and the sale or purchase of shares of the company's stock.

ILLUSTRATION 12–2A
Comprehensive Income

Comprehensive income includes net income as well as other gains and losses that change shareholders' equity but are not included in traditional net income.

		($ in millions)
Net income		$xxx
Other comprehensive income:		
Net unrealized holding gains (losses) from investments (net of tax)*	$ 4	
Gains (losses) from and amendments to postretirement benefit plans (net of tax)†	(x)	
Deferred gains (losses) from derivatives (net of tax)‡	x	
Gains (losses) from foreign currency translation (net of tax)§	x	xx
Comprehensive income		$xxx

*Changes in the market value of securities available-for-sale.
†Gains and losses due to revising assumptions or market returns differing from expectations and prior service cost from amending the plan (described in Chapter 17).
‡When a derivative designated as a cash flow hedge is adjusted to fair value, the gain or loss is deferred as a component of comprehensive income and included in earnings later, at the same time as earnings are affected by the hedged transaction (described in the Derivatives Appendix to the text).
§Gains or losses from changes in foreign currency exchange rates. The amount could be an addition to or reduction in shareholders' equity. (This item is discussed elsewhere in your accounting curriculum.)

To communicate the relationship between the two measures, companies must report both net income and comprehensive income and reconcile the difference between the two.[7] We see the impact on financial statements of the transactions in Illustration 12–2B.

ILLUSTRATION 12–2B
Reporting Securities Available-for-Sale

Only realized gains and losses are reported in the income statement.

Comprehensive income other than net income includes unrealized holding gains and losses that occur *during the reporting period.*

Securities available-for-sale are reported at fair value.

Shareholders' equity includes net unrealized holding gains or losses *accumulated over the current and prior periods.*

Cash flows from buying and selling securities are classified as investing activities.

		($ in millions)
Income Statement		
Revenues		$ ♦
Expenses		(♦)
Other Income (Expense)		
Investment revenue		1
Gain on sale of investments		3
Net Income		$ ♦
Other Comprehensive Income*		
Unrealized holding gain on investments†		$ 4
Balance Sheet		
Assets		
Securities available-for-sale	$50	
Plus: Fair value adjustment	4	$ 54
Liabilities		
Not affected		
Shareholders' Equity		
Accumulated other comprehensive income		
Net unrealized holding gain (loss)		$ 4
Statement of Cash Flows		
Operating Activities		
Investment revenue		$ 1
Investing Activities		
Purchase of investment securities		$120
Sale of investment securities		$123
Financing Activities		
Not affected		

*Can be reported either (a) as an extension of the income statement, (b) as a separate statement in a disclosure note, or (c) as part of the statement of shareholders' equity.
†Unlike for trading securities, unrealized holding gains and losses for securities available-for-sale are not included in income but, instead, as a component of *other comprehensive income.*

[7]*Statement of Financial Accounting Standards No. 130,* "Reporting Comprehensive Income," (Norwalk, Conn.: FASB, 1997).

Retained earnings Jan. 1 | Acc. other compr. income, Jan. 1
Net income (less div.) | Other compr. income
Retained earnings, Dec. 31 | Acc. other compr. income, Dec. 31

In addition to reporting the unrealized holding gains or losses that occur in the current reporting period, $4 million in this instance, we must also report these amounts on a cumulative basis in the balance sheet. This is consistent with the way we report net income and retained earnings. Comprehensive income includes (a) net income and (b) other comprehensive income. We report net income that occurs in the current reporting period in the income statement and also report *accumulated* net income (that hasn't been distributed as dividends) in the balance sheet as retained earnings. Similarly, we report other comprehensive income as it occurs in the current reporting period (see Illustration 12–2A) and also report *accumulated* other comprehensive income in the balance sheet. After completion of the 2006 transactions listed in Illustration 12–2, the account balances are those shown in Illustration 12–2B.

Individual securities available for sale are classified as either current or noncurrent assets, depending on how long they're likely to be held. An example from the 2004 annual report of **Cisco Systems** is shown in Graphic 12–4.

GRAPHIC 12–4

Investments in Securities Available-for-Sale—Cisco Systems

2. Summary of Significant Accounting Policies (in part)

The Company's investments comprise U.S. government notes and bonds; corporate notes, bonds, and asset-backed securities; municipal notes and bonds; and publicly traded equity securities. Investments with original or remaining maturities of more than three months and less than one year are considered to be short-term. These investments are held in the custody of a major financial institution. The specific identification method is used to determine the cost basis of fixed income securities disposed of. The weighted-average method is used to determine the cost basis of publicly traded equity securities disposed of. At July 31, 2004 and July 26, 2003, the Company's investments were classified as available-for-sale. These investments are recorded in the Consolidated Balance Sheets at fair value. Unrealized gains and losses on these investments are included as a separate component of accumulated other comprehensive income, net of tax.

7. Investments (in part)

The following tables summarize the Company's investments (in millions):

July 31, 2004	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed Income securities:				
U.S. government notes and bonds	$ 4,408	$ 9	$(20)	$ 4,397
Corporate notes, bonds, and asset-backed securities	9,333	14	(42)	9,305
Municipal notes and bonds	710	—	(1)	709
Total fixed income securities	14,451	23	(63)	14,411
Publicly traded equity securities	755	387	(8)	1,134
Total	$15,206	$410	$(71)	$15,545
Reported as:				
Short-term investments				$ 4,947
Investments				10,598
Total				$15,545

ADDITIONAL CONSIDERATION

Be sure to note that the effect on *total* shareholders' equity is precisely the same as if the holding gains and losses had been included in earnings. The difference is that, if included in earnings, the impact would be an increase or decrease in retained earnings rather than a separate component of shareholders' equity. You might think of it this way. Accumulated other comprehensive income accumulates other comprehensive income just as retained earnings *accumulates* traditional net income (that hasn't been distributed as dividends).

Selling Securities Previously Adjusted to Fair Value. To see how to record the sale of a security that was previously adjusted to fair value, let's assume the Millington shares are sold on June 9, 2007, for $36 million. The fair value of the shares has risen $6 million since the investment was acquired for $30 million. Five million dollars of that increase occurred in 2006 but that gain wasn't recognized in 2006 earnings because it wasn't yet realized by selling the investment. Now, the entire $6 million gain is recognized in 2007 when it is actually realized:

June 9, 2007[8]	($ in millions)	
Cash	36	
Investment in Millington shares (cost)		30
Gain on sale of investments (difference)		6

Gains and losses from securities available-for-sale are included in earnings when they are realized by selling the securities.

Purchase of Investments. Now suppose American buys common stock of Eads Industries for $45 million on October 7.

October 7, 2007	($ in millions)	
Investment in Eads shares	45	
Cash		45

We initially record all investment securities at cost.

Subsequent Adjustments to Fair Value. At December 31, 2007, the market prices of the investments are: Bartlett Corporation shares, $16 million, and Eads Industries shares, $46 million.

December 31, 2007

($ in millions) **Securities Available-for-Sale**	**Cost**	**Fair Value**	**Unrealized Gain (Loss)**
Bartlett Corporation shares	$20	$16	$(4)
Eads Industries shares	45	46	1
Totals	$65	$62	$(3)

Moving from a positive $4 (2006) to a negative $3 requires a reduction of $7:

−3 0 +4

−7

Net unrealized holding gains and losses ($4 credit to $3 debit)	7	
Fair value adjustment ($4 debit to $3 credit)		7

We need to report a $3 million accumulated net *loss*, but last year's balance was a $4 million net *gain*, so we need to change the balance by $7 million.

The fair value adjustment to the securities available-for-sale account also needs to be changed by $7 million to a credit balance of $3 million.

After the 2007 transactions and adjusting entry, these are the account balances:

Assets

Securities Available-for-Sale

Debit		Credit	
2006 Balance	50	30	Sale
Purchase	45		
2007 Balance	65		

Fair Value Adjustment

Debit		Credit	
2006 Balance	4	7	Other compr. income
		3	2007 Balance

Securities available-for-sale	$65
Less: Fair value adjustment	(3)
	$62

We report the $7 million *change* in the net unrealized holding gains and losses as 2007 *other comprehensive income.*

After the fair value adjustment, the securities available-for-sale are reported at fair value, $62 million.

[8]Alternatively, a company could choose to make an additional entry at the time of sale that would reverse out (a) the fair value adjustment related to the security sold and (b) the portion of the accumulated net unrealized holding gains and losses related to the security sold:

Net unrealized holding gains and losses (related to Millington shares)	5	
Fair value adjustment (December 31 adjustment to Millington shares)		5

The effect of this second entry, though, is accomplished as part of the December 31 market value adjustment as it is demonstrated later.

The $3 million debit balance in the account is reported as *accumulated other comprehensive loss,* a negative component of shareholders' equity in the 2007 balance sheet.

Shareholders' Equity
Accumulated Other Comprehensive Income

Net Unrealized Holding Gains and Losses

		4	2006 Balance
Other compr. income	7		
2007 Balance	3		

Financial Statement Presentation. The 2007 financial statements will include the amounts shown in Illustration 12–2C.

ILLUSTRATION 12–2C
Reporting Securities Available-for-Sale

Only realized gains and losses are reported in the income statement.

Securities available-for-sale are reported at fair value.

Shareholders' equity includes net unrealized holding gains or losses *accumulated over the current and prior periods.*

Cash flows from buying and selling securities are classified as investing activities.

Income Statement

		($ in millions)
Revenues		$ ♦
Expenses		(♦)
Other Income (Expense)		
Gain on sale of investments		$ 6
Net Income		$ ♦

Other Comprehensive Income*

Unrealized holding loss on investments†		$ 7

Balance Sheet

Assets		
Securities available-for-sale	$65	
Less: Fair value adjustment	(3)	$62
Liabilities		
Not affected		
Shareholders' Equity		
Accumulated other comprehensive income		
Net unrealized holding gain (loss)		$ (3)

Statement of Cash Flows

Operating Activities	
None	
Investing Activities	
Purchase of investment securities	$45
Sale of investment securities	36
Financing Activities	
Not affected	

*Can be reported either (a) as an extension of the income statement, (b) as a separate statement in a disclosure note, or (c) as part of the statement of shareholders' equity.
†Unlike for trading securities, unrealized holding gains and losses for securities available-for-sale are not included in income but, instead, as a component of *other comprehensive income*.

Bartlett shares	
Cost	$20
Loss	(1)
FV 2006	$19
Loss	(3)
FV 2007	$16

Eads shares	
Cost	$45
Gain	1
FV 2007	$46

Millington shares	
Cost	$30
2006 Gain	5
FV 2006	$35
2007 Gain	1
Sale price	$36

Reclassification Adjustment. Let's look closer at the $7 million negative amount reported for 2007 as other comprehensive income. It actually is composed of three amounts:

	$ in millions
1. An additional $3 million unrealized loss from the drop during 2007 in the value of the Bartlett shares (from the $19 million fair value last year to the $16 million value now).	$(3)
2. A $1 million unrealized gain from the increase during 2007 in the value of the Eads shares acquired this year (from their $45 million cost to their current $46 million value).	1
3. A reclassification adjustment: the "reversal" of the $5 million unrealized gain reported in 2006 on the Millington shares reported again this year as part of the gain realized when the shares were sold.	(5)
Other comprehensive income for 2007	$(7)

Components one and two are relatively intuitive. Each represents a change in the fair value of American Capital's investment portfolio while holding securities available-for-sale during 2007.

The third component, however, needs further examination. We saw earlier that a $5 million unrealized holding gain was reported in 2006 on the Millington shares because the shares had risen in value from a $30 million cost to $35 million at the end of 2006. The shares increased in value another $1 million and were sold during 2007 for $36 million, and a gain was recorded for the entire $6 million increase in value because that was the amount realized through the sale of the shares. Recall, though, that comprehensive income includes both net income and other comprehensive income. Net income in 2007 includes the $6 million realized gain. However, $5 million of that gain already has been reported in comprehensive income—as an unrealized holding gain in 2006. Isn't that double-counting? Yes it is, unless we compensate by reducing comprehensive income by the $5 million portion of the 2007 realized gain that already has been reported. That's what the third component does; it reduces this year's comprehensive income by the amount that was reported last year to keep it from being reported twice.

$5 million of the realized gain was reported previously and shouldn't be reported again.

Cash	36	
2006 gain		5
2007 gain		1
Investment		30

This adjustment takes no additional action. It's automatically accomplished each period when we compare the cost of the portfolio with its fair value. Remember, we compared the $65 million cost with the $62 million fair value to see that balances in the fair value adjustment and the net unrealized gains and losses accounts needed to be a negative $3 million. Comparing that with the positive $4 million existing balances indicated that we needed the $7 million reduction. As shown above, that $7 million already includes the $5 million adjustment.

Because the cost and fair value of the Millington shares no longer are included in the $65 million and $62 million portfolio amounts, elimination of the previous holding gain is automatically a part of the $7 million reduction in comprehensive income.

In Illustration 12–2C, we simply reported the total $7 million negative *other comprehensive income.* It's common practice, though, to separately report the current period's net unrealized holding gains or losses and the adjustment for the reclassification of previously reported holding gains and losses.[9] Doing so would cause our statement of comprehensive income to appear as follows:

Other Comprehensive Income

Unrealized holding gains (losses) on investments	$(2)
Reclassification adjustment of 2006 unrealized gain included in 2007 net income	(5)
Net unrealized holding gains (losses)	$(7)

The $7 million reduction in other comprehensive income includes the $2 million 2007 net unrealized loss ($3 − 1) and the embedded reversal of the $5 million 2006 unrealized gain that's also included in the 2007 realized gain.

It usually is called a *reclassification adjustment* because we are reclassifying an amount ($5 million in this instance) from what otherwise would appear as a 2007 holding loss to a disclosure that a portion of the *2007 realized gain* was reported previously as a *2006 holding gain.*

Impairment of Investments. Occasionally, the fair value of a security will decline for a specific reason that's judged to be "other than temporary." For instance, a bankruptcy filing might indicate a degradation in the creditworthiness of the issuer of bonds. An investor holding the bonds as an investment might conclude that a drop in the market price of the bonds is an other-than-temporary impairment. In that case, when the investment is written down to its fair value, the amount of the write-down should be treated as though it were a realized loss (meaning it's included in income for the period). After the other-than-temporary write-down, the normal treatment of unrealized gains or losses is resumed; that is, changes in fair value are reported as a separate component of shareholders' equity. In the 2002 fourth quarter, **Texas Instruments** recorded a $638 million write-down of investment securities due to a decline in market value the company considered other than temporary.

A loss inherent in an "other-than-temporary" impairment is recognized in earnings even though the security hasn't been sold.

[9]If not separately reported within the statement in which comprehensive income is reported, components must be separately reported in the disclosure note pertaining to comprehensive income per "Reporting Comprehensive Income," *Statement of Financial Accounting Standards No. 130,* (Norwalk, Conn.: FASB, 1997).

Trading Securities

LO3

Trading securities are actively managed in a trading account for the purpose of profiting from short-term price changes.

Some companies—primarily financial institutions—actively and frequently buy and sell securities expecting to earn profits on short-term differences in price. Investments in debt or equity securities acquired principally for the purpose of selling them in the near term are classified as **trading securities.** The holding period for trading securities generally is measured in hours and days rather than months or years. By definition, these are short-term investments to be reported among the investor's current assets.

The approach used to account for trading securities differs from how we account for securities available-for-sale in one major respect. Specifically, we report unrealized holding gains or losses on trading securities in the income statement as if they actually had been realized. Keep in mind as you study this section that relatively few investments are classified this way because, typically, only banks and other financial operations invest in securities in the manner and for the purpose necessary to be categorized as trading securities.

ADDITIONAL CONSIDERATION

Bankers' Objections

Perhaps the strongest objections to mark-to-market accounting when *SFAS No. 115* was being proposed came from the banking and insurance industries. Their concern was the volatile impact on earnings from reporting unrealized gains and losses on assets (trading securities) while not being permitted to mark liabilities to market as well. These objections were (and are) not merely self-interested urgings; there is an ongoing academic debate concerning this apparent inconsistency.

Holding gains and losses for trading securities are *included in earnings.*

When securities are actively managed, as trading securities are, with the expressed intent of profiting from short-term market price changes, the gains and losses that result from holding securities during market price changes are appropriate measures of success or lack of success in that endeavor. For that reason, it's appropriate to report these holding gains and losses in earnings for the period of change, even if they haven't yet been realized through the sale of the securities. To see how, let's modify our illustration to assume the investment securities we considered earlier in Illustration 12–2 are trading securities, rather than securities available-for-sale. Consider Illustration 12–3:

ILLUSTRATION 12–3
Investments in Trading Securities

American Capital buys and sells both debt and equity securities of other companies as investments. The following transactions during 2006 pertain to the investment portfolio. Assume American Capital frequently and actively buys and sells both debt and equity securities, intending to profit from short-term differences in price. The company's fiscal year-end is December 31.

November 18	Purchased ABM Corporation 10% notes for \$120 million (face amount).	
November 30	Received cash interest of \$1 million on the investment in ABM Corporation notes, calculated as \$120 million × 10% × 1/12 year.	
December 1	Sold the ABM Corporation notes for \$123 million.	
December 21	Acquired two new investments costing:	
	Millington Industries shares	\$30 million
	Bartlett Corporation shares	20 million
December 31	The market prices of the investments are:	
	Millington Industries shares	\$35 million
	Bartlett Corporation shares	19 million

Purchase of Investment. The journal entry to record the purchase of investment securities is recorded in precisely the same way for trading securities as for investments classified as available-for-sale:

November 18	($ in millions)	
Investment in ABM notes	120	
Cash		120

All investment securities are initially recorded at cost.

Investment Revenue. The journal entry to record the cash interest is:

November 30	($ in millions)	
Cash ($120 million × 10% × 1⁄12 year)	1	
Investment revenue		1

Dividend and interest income is included in earnings.

Sale of Investments. The journal entry to record the sale of the ABM Corporation notes is:

December 1	($ in millions)	
Cash	123	
Investment in ABM notes		120
Gain on sale of investments		3

Realized gains and losses are included in earnings.

Purchase of Investments. The journal entry to record the purchase is:

December 21	($ in millions)	
Investment in Millington shares	30	
Investment in Bartlett shares	20	
Cash		50

All investment securities are initially recorded at cost.

Adjusting Investments to Fair Value. Although it's acceptable to record the changes in fair value *indirectly* by debiting a valuation account as we did in the previous section for securities available-for-sale, companies that invest in trading securities typically do not because the investments turn over quickly. Instead they record fair value adjustments directly to the investment accounts as demonstrated in the following journal entries:

December 31	($ in millions)	
Investment in Millington shares	5	
Unrealized holding gain on investments ($35 − 30)		5
Unrealized holding loss on investments ($19 − 20)	1	
Investment in Bartlett shares		1

All investment securities (except those held to maturity) are adjusted to their fair values on each reporting date.

The key difference in reporting trading securities as opposed to securities available-for-sale is that we report unrealized holding gains or losses as part of current earnings as explained next.

Financial Statement Presentation. For *trading securities* unrealized holding gains and losses are included in earnings of the period the changes in value occur. In the balance sheet, the investments in our illustration are reported at the *fair value* of the investment securities ($35 + 19 = $54 million), and the *net* unrealized holding gain ($5 − 1 = $4 million) is reported in the income statement. The 2006 financial statements will include the amounts shown in Illustration 12–3A.

ILLUSTRATION 12–3A

Reporting Trading Securities

Unrealized holding gains and losses on trading securities as well as realized gains and losses are reported in the income statement.

Trading securities are reported at fair value.

Cash flows from buying and selling trading securities are classified as operating activities.

Income Statement

	($ in millions)
Other Income (Expense)	
Investment revenue	$ 1
Gain on sale of investments	3
Net unrealized holding gain on investments	4

Other Comprehensive Income

none

Balance Sheet

Assets	
Trading securities at fair value (cost $50)	$ 54

Statement of Cash Flows

Operating Activities	
Investment revenue	$ 1
Purchase of trading securities*	(120)
Sale of trading securities*	123

*Inflows and outflows of cash from buying and selling trading securities typically are considered operating activities because financial institutions that routinely transact in trading securities consider them an appropriate part of their normal operations.

Transfers between Reporting Categories

A transfer of a security between reporting categories is accounted for at fair value and in accordance with *the new reporting classification.*

At acquisition, an investor assigns debt and equity securities to one of the three reporting classifications—held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification is reassessed. For instance, if the investor no longer has the ability to hold certain securities to maturity and will now hold them for resale, those securities would be reclassified. When a security is reclassified between two reporting categories, the security is transferred at its fair value on the date of transfer. Any unrealized holding gain or loss at reclassification should be accounted for *in a manner consistent with the classification into which the security is being transferred.* A summary is provided in Graphic 12–5.

GRAPHIC 12–5

Transfer between Investment Categories

Transfer from:	To:	Unrealized Gain or Loss from Transfer at Fair Market Value
Either of the other	Trading	Include in current earnings
Trading	Either of the other	There is none (already recognized in earnings)
Held-to-maturity	Available-for-sale	Report as a separate component of shareholders' equity (in Other Comprehensive Income)
Available-for-sale	Held-to-maturity	Don't write off any existing unrealized holding gain or loss, but amortize it to earnings over the remaining life of the security (fair value amount becomes the security's amortized cost basis).

Reclassifications are quite unusual, so when they occur, disclosure notes should describe the circumstances that resulted in the transfers. Other footnote disclosures are described in a later section.

CONCEPT REVIEW EXERCISE

VARIOUS INVESTMENT SECURITIES

Diversified Services, Inc., offers a variety of business services, including financial services through its escrow division. Diversified entered into the following investment activities during the last month of 2006 and the first week of 2007. Diversified's fiscal year ends on December 31. The only securities held by Diversified at December 1 were 12 million common shares of Shelby Laminations, Inc., purchased in November for $48 million and classified as available-for-sale.

2006

Dec. 1	Purchased $30 million of 12% bonds of Vince-Gill Amusement Corporation and $24 million of 10% bonds of Eastern Waste Disposal Corporation, both at face value and both to be held until they mature. Interest on each bond issue is payable semiannually on November 30 and May 31.
9	Sold one-half of the Shelby Laminations common shares for $25 million.
29	Received cash dividends of $1.5 million from the Shelby Laminations common shares.
30	Purchased U.S. Treasury bonds for $5.8 million as trading securities hoping to earn profits on short-term differences in prices.
31	Recorded the necessary adjusting entry(s) relating to the investments.

The year-end market price of the Shelby Laminations common stock was $4.25 per share. The fair values of the bond investments were $32 million for Vince-Gill Amusement Corporation and $20 million for Eastern Waste Disposal Corporation. A sharp rise in short-term interest rates on the last day of the year caused the fair value of the Treasury bonds to fall to $5.7 million.

2007

Jan. 7	Sold the remaining Shelby Laminations common shares for $26 million.

Required:

Prepare the appropriate journal entry for each transaction or event and show the amounts that would be reported in the company's 2006 income statement relative to these investments.

SOLUTION

2006

Dec. 1 Purchased $30 million of 12% bonds of Vince-Gill Amusement Corporation and $24 million of 10% bonds of Eastern Waste Disposal Corporation, both at face value and both to be held until they mature. Interest on each bond issue is payable semiannually on November 30 and May 31.

	($ in millions)	
Investment in Vince-Gill Amusement bonds	30	
Investment in Eastern Waste Disposal bonds	24	
Cash		54

Dec. 9 Sold one-half of the Shelby Laminations common shares for $25 million.

	($ in millions)	
Cash (selling price)	25	
Investment in Shelby Laminations common shares ($48 × ½)		24
Gain on sale of investments (difference)		1

Dec. 29 Received cash dividends of $1.5 million from the Shelby Laminations common shares.

	($ in millions)	
Cash	1.5	
Investment revenue		1.5

Dec. 30 Purchased U.S. Treasury bonds for $5.8 million as trading securities, hoping to earn profits on short-term differences in prices.

	($ in millions)	
Investment in U.S. Treasury bonds.	5.8	
Cash		5.8

Dec. 31 Recorded the necessary adjusting entry(s) relating to the investments.

Accrued Interest (one month)	($ in millions)	
Investment revenue receivable—Vince-Gill Amusement		
($30 million × 12% × 1⁄12)	0.3	
Investment revenue receivable—Eastern Waste Disposal		
($24 million × 10% × 1⁄12)	0.2	
Investment revenue		0.5
Fair Value Adjustments		
Unrealized holding loss on investments ($5.7 − 5.8 million)	0.1	
Investment in U.S. Treasury bonds		0.1
Fair value adjustment.	1.5	
Net unrealized holding gains and losses on securities available-for-sale ([12 million shares × ½ × $4.25] − [$48 million × ½])		1.5

Note: Securities held-to-maturity are not adjusted to fair value.

Reported in the 2006 Income Statement:	($ in millions)
Investment revenue ($1.5 + 0.5)	$2.0
Gain on sale of investments (Shelby)	1.0
Unrealized holding loss on investments (trading securities)	(0.1)

Note: The unrealized holding gain for the Shelby Laminations common shares is not included in income because it pertains to securities available-for-sale rather than trading securities.

2007

Jan. 7 Sold the remaining Shelby Laminations common shares for $26 million.

	($ in millions)	
Cash (selling price)	26	
Investment in Shelby Laminations common shares (cost: ½ × $48) . . .		24
Gain on sale of investments (difference)		2

Financial Statement Presentation and Disclosure

Trading securities are current assets by definition. Held-to-maturity and available-for-sale securities are either current or noncurrent depending on when they are expected to mature or to be sold. However, it's not necessary that a company report individual amounts for the three categories of investments—held-to-maturity, available-for-sale, or trading—on the face of the balance sheet as long as that information is presented in the disclosure notes.[10]

On the statement of cash flows, inflows and outflows of cash from buying and selling trading securities typically are considered operating activities because for companies that routinely transact in trading securities (financial institutions), trading in those securities constitutes an appropriate part of the companies' normal operations. But because held-to-maturity and available-for-sale securities are not purchased and held principally to be sold in

[10]*Statement of Financial Accounting Standards No. 115,* "Accounting for Certain Investments in Debt and Equity Securities," (Norwalk, Conn.: FASB, 1993), par. 18.

the near term, cash flows from the purchase, sale, and maturity of these securities are considered investing activities.

Investors should disclose the following in the disclosure notes for each year presented:

- Aggregate fair value.
- Gross realized and unrealized holding gains.
- Gross realized and unrealized holding losses.
- Change in net unrealized holding gains and losses.
- Amortized cost basis by major security type.

Information about maturities should be reported for debt securities by disclosing the fair value and cost for at least four maturity groupings: (a) within 1 year, (b) after 1 year through 5 years, (c) after 5 years through 10 years, and (d) after 10 years.[11] A disclosure note from **Microsoft**'s 2004 annual report (Graphic 12–6) provides an example.

GRAPHIC 12–6
Disclosures of Investment Securities—Microsoft Corporation

The maturities of debt securities at June 30, 2004, were as follows:

(In millions)	Cost Basis	Estimated Fair Value
Due in one year or less	$37,348	$37,388
Due after one year through five years	14,077	14,064
Due after five years through ten years	5,636	5,665
Due after ten years	4,994	4,956
Total	$62,055	$62,073

THE EQUITY METHOD

PART B

When a company invests in the equity securities (primarily common stock) of another company, the investor can benefit either (a) *directly* through dividends and/or market price appreciation or (b) *indirectly* through the creation of desirable operating relationships with the investee. The way we report a company's investment in the stock of another company depends on the nature of the relationship between the investor and the investee.

For reporting purposes, we classify the investment relationship in one of three ways, and account for the investment differently depending on the classification, as shown in Graphic 12–7:

GRAPHIC 12–7
Reporting Classifications for Investment Relationships

Classification	Reporting Method
The investor *cannot* significantly influence the investee (usually < 20% equity ownership)	Varies by reporting category (see Part A of this chapter)
The investor can significantly influence the operating and financial policies of the investee (usually 20%–50% equity ownership)	Equity method
The investor controls the investee (usually >50% equity ownership)	Consolidation

The *equity method* is used when an investor can't control, but can significantly influence, the investee.

We focused on the first classification in Part A of this chapter. Now, let's turn our attention to the second classification—the **equity method.** A detailed discussion of the third classification—consolidated financial statements—is beyond the scope of this book. That

[11]Ibid., par. 20.

FINANCIAL REPORTING CASE

Q4, p. 557

discussion often is a major focus of the advanced accounting course or is taught as a separate consolidations course. In this chapter, we'll briefly overview the subject only to provide perspective to aspects of the equity method that purposely mimic some effects of consolidation. Let's do that now, before addressing the specifics of the equity method.

How the Equity Method Relates to Consolidated Financial Statements

If a company acquires more than 50% of the voting stock of another company, it's said to have a controlling interest because by voting those shares, the investor actually can control the company acquired. The investor is referred to as the *parent;* the investee is termed the *subsidiary.* For reporting purposes (although not legally), the parent and subsidiary are considered to be a single reporting entity, and their financial statements are *consolidated.* Both companies continue to operate as separate legal entities and the subsidiary reports separate financial statements. However, because of the controlling interest, the parent company reports consolidated financial statements.

Consolidated financial statements **combine the individual elements of the parent and subsidiary statements.**

Consolidated financial statements combine the separate financial statements of the parent and the subsidiary each period into a single aggregate set of financial statements as if there were only one company. This entails an item-by-item combination of the parent and subsidiary statements (after first eliminating any amounts that are shared by the separate financial statements).[12] For instance, if the parent has $8 million cash and the subsidiary has $3 million cash, the consolidated balance sheet would report $11 million cash.

The acquired company's assets are included in consolidated financial statements at their fair values and the difference between the acquisition price and fair value of the acquired net assets is recorded as goodwill.

Two aspects of the consolidation process are of particular interest to us in understanding the equity method. First, in consolidated financial statements, the acquired company's assets are included in the financial statements at their fair values rather than their book values. Second, if the acquisition price is more than the fair value of the acquired net assets (assets less liabilities), that difference is recorded as an intangible asset—goodwill.[13] We'll return to the discussion of these two aspects when we reach the point in our discussion of the equity method where their influence is felt. As we'll see, the equity method is in many ways a partial consolidation.

We use the equity method when the investor can't control the investee but can exercise significant influence over the operating and financial policies of an investee.

What Is Significant Influence?

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When effective control is absent, the investor still may be able to exercise significant influence over the operating and financial policies of the investee. This would be the case if the investor owns a large percentage of the outstanding shares relative to other shareholders. By voting those shares as a block, decisions often can be swayed in the direction the investor desires. When significant influence exists, the investment should be accounted for by the equity method. It should be presumed, in the absence of evidence to the contrary, that the investor exercises **significant influence** over the investee when it owns between 20% and 50% of the investee's voting shares.[14]

Usually an investor can exercise *significant influence* over the investee when it owns between 20% and 50% of the investee's voting shares.

ADDITIONAL CONSIDERATION

It's possible that a company that owns over 20% of the voting shares cannot exercise significant influence over the investee. If, for instance, another company or a small group of shareholders owns 51% or more of the shares, that company controls the

[12]This avoids double counting those amounts in the consolidated statements. For example, amounts owed by one company to the other are represented by accounts payable in one set of financial statements and accounts receivable in the other. These amounts are not included in the statements of the consolidated entity because a company can't "owe itself."

[13]This is the usual case because most companies are worth more than the sum of the values of individual components of the company due to reputation, longevity, managerial expertise, customer loyalty, or a host of other possibilities.

[14]Shareholders are the owners of the corporation. By voting their shares, it is they who determine the makeup of the board of directors—who, in turn, appoint officers—who, in turn, manage the company. Common stock usually is the class of shares given voting privileges. However, a corporation can create classes of preferred shares that also have voting rights. This is discussed at greater length in Chapter 18.

investee regardless of how other investors vote their shares. *FASB Interpretation No. 35* provides this and other examples of indications that an investor may be unable to exercise significant influence:

- The investee challenges the investor's ability to exercise significant influence (through litigation or complaints to regulators).
- The investor surrenders significant shareholder rights in a signed agreement.
- The investor is unable to acquire sufficient information about the investee to apply the equity method.
- The investor tries and fails to obtain representation on the board of directors of the investee.[15]

In such cases, the equity method would be inappropriate.

Conversely, it's also possible that a company that owns *less than* 20% of the voting shares *is* able to exercise significant influence over the investee. Ability to exercise significant influence with less than 20% ownership might be indicated, for example, by having an officer of the investor corporation on the board of directors of the investee corporation or by having, say, 18% of the voting shares while no other investor owns more than ½%. In such cases the equity method would be appropriate. Amazon.com provided the following example in a recent disclosure note:

Note 6—Investments

At December 31, 2000, the Company's equity-method investees and the Company's approximate ownership interest in each investee, based on outstanding shares, were as follows:

Company	Percentage Ownership
Basis Technology	11%
Drugstore.com	21
Eziba.com	20
Greenlight.com	5
Kozmo.com	16

Although the Company's ownership percentage for Basis Technology, Greenlight.com and Kozmo.com is below 20%, the Company's representation on the investees' Board of Directors and the impact of commercial arrangements result in the Company having significant influence over the operations of each investee.

A Single Entity Concept

● LO5

The investor's ownership interest in individual assets and liabilities of the investee is represented by a single investment account.

Much like consolidation, the equity method views the investor and investee collectively as a special type of single entity (as if the two companies were one company). However, using the equity method, the investor doesn't include separate financial statement items of the investee on an item-by-item basis as in consolidation. Instead, the investor reports its equity interest in the investee as a single investment account.

The investment account is adjusted to reflect the investor's share of both increases and decreases in the investee's net assets.

Under the equity method, the investor recognizes investment income equal to its percentage share (based on stock ownership) of the net income earned by the investee rather than the portion of that net income received as cash dividends. The rationale for this approach is the presumption of the equity method that the fortunes of the investor and investee are sufficiently intertwined that as the investee prospers, the investor prospers proportionately. Stated differently, as the investee earns additional net assets, the investor's share of those net assets increases.

Initially, the investment is recorded at cost. The carrying amount of this investment subsequently is:

[15]"Criteria for Applying the Equity Method of Accounting for Investments in Common Stock," *FASB Interpretation No. 35* (Stamford, Conn.: FASB, 1981).

- Increased by the investor's percentage share of the investee's net income (or decreased by its share of a loss).
- Decreased by dividends paid.

Let's look at the example in Illustration 12–4.

ILLUSTRATION 12–4
Equity Method

On January 2, 2006, American Capital Corporation purchased 25% of the outstanding common shares of Embassy Message Corporation for $200 million. The following information is available regarding Embassy Message Corporation during 2006:

	($ in millions)
Net assets at acquisition:*	
Fair value	$600
Book value	480
2006 net income	100
2006 dividends declared and paid	24

When a company invests in shares of another corporation, the asset initially is recorded at cost. In accordance with the cost principle, the recorded amount includes any brokerage fees or commissions paid to acquire the shares.

The *cost principal* governs the acquisition of assets.

Initial Acquisition	($ in millions)	
Investment in equity securities (cost of shares)	200	
Cash		200

Following the acquisition, the investment account is adjusted for the investor's percentage share of net income reported by the investee.†

As the investee earns additional net assets, the investment in those net assets increases.

Investee Net Income		
Investment in equity securities.	25	
Investment revenue (25% share of $100 million earned).		25

Adjusting the investment account reflects the equity method's presumption that as the investee earns additional net assets, the investor's equity interest in those net assets increases proportionately. This reasoning also supports recognizing investment revenue as the investee earns net income, not when those earnings actually are distributed as dividends.

As the investee prospers, the investor prospers proportionately.

In fact, when the investor actually receives dividends, the investment account is *reduced* accordingly:

As the investee distributes net assets as dividends, the investment in those net assets declines.

Dividends		
Cash (25% share of $24 million dividends paid)	6	
Investment in equity securities		6

Because investment revenue is recognized as it is earned by the investee, it would be inappropriate to recognize revenue again as earnings are distributed as dividends. Instead, we view the dividend distribution as a *reduction of the investee's net assets,* indicating that the investor's equity interest in those net assets declines proportionately.

*Recall that net assets are equivalent to shareholders' equity. Each is what's left over after creditor claims have been subtracted from assets:

$\underbrace{\text{Assets} - \text{Liabilities}}_{\text{Net assets}} = \text{Shareholders' equity}$

†If any portion of the investee's net income was reported by the investee as an extraordinary item, the investor also would report the same proportion of its share as an extraordinary item. In this illustration, for instance, if $4 million, or 4%, of Embassy Message Corporation's income had been reported as an extraordinary gain, then American Capital Corporation would report 4% of its $25 million share, or $1 million, as an extraordinary gain as well.

Further Adjustments

● LO6

When the investor's expenditure to acquire an investment exceeds the book value of the underlying net assets acquired, additional adjustments to both the investment account and investment revenue might be needed. The purpose is to approximate the effects of consolidation, without actually consolidating financial statements. More specifically, both the investment account and investment revenue are adjusted for differences between net income reported by the investee and what that amount would have been if consolidation procedures had been followed. Let's look closer at what that means.

As mentioned earlier, consolidated financial statements report (a) the acquired company's assets at their fair market values rather than their book values and (b) goodwill for the excess of the acquisition price over the fair value of the identifiable net assets acquired.

The first of these two consequences of the consolidation process usually has an effect on income, and it's the income effect that we're interested in when applying the equity method. First, increasing asset balances to their fair values usually will result in higher expenses. For instance, if buildings, equipment, or other depreciable assets are written up to higher values, depreciation expense will be higher during their remaining useful lives. Likewise, if the recorded amount of inventory is increased, cost of goods sold will be higher when the inventory is sold. However, if it's land that's increased, there is no income effect because we don't depreciate land.

On the other hand, recording goodwill will not result in higher expenses. Goodwill is an intangible asset, but one whose cost usually is not charged to earnings.[16] As a consequence, then, of increasing asset balances to fair value but not of recording goodwill, expenses will rise and income will fall. It is this negative effect on income that the equity method seeks to imitate.

Recall that our illustration provides the following information regarding Embassy Message Corporation's net assets at the time American Capital Corporation pays $200 million for a 25% interest in the company:

Net Assets at Acquisition:	($ in millions)
Fair value	$600
Book value	480

Let's assume that (a) two-thirds of the difference between the book value of the net assets and their fair market value is attributable to depreciable assets having a fair market value in excess of their undepreciated cost and (b) the remaining third is attributable to land having a fair market value in excess of its cost. We can determine the portion of these differences that American Capital purchased with its $200 million investment and, therefore, any additional amounts to be expensed as shown in Graphic 12–8.

GRAPHIC 12–8
Source of Differences between the Investment and the Book Value of Net Assets Acquired

	Investee Net Assets ↓	Net Assets Purchased ↓	Difference Attributed to: ↓ ($ in millions)	
Cost		$200		
			Goodwill:	$50
Fair value	$600 × 25% =	$150		
			Undervaluation of:	
			Depreciable assets (⅔)	$20
			Land (⅓)	$10
Book value	$480 × 25% =	$120		

Notice in Graphic 12–8 that American Capital paid $200 million for identifiable net assets worth $150 million, and the $50 million difference is attributable to goodwill. Similarly, the identifiable net assets worth $150 million have a book value of only $120 million, and we assumed the $30 million difference is attributable to undervalued depreciable assets ($20 million) and land ($10 million).

[16]Beginning in 2002, goodwill is not amortized periodically to expense. Only if the asset's value is subsequently judged to be impaired is all or a portion of the recorded amount charged against earnings. "Goodwill and Other Intangible Assets," *Statement of Financial Accounting Standards No. 141* (Norwalk, Conn.: FASB, 2001). For review, see Chapter 11.

Amortization of Additional Depreciation. Remember, we assumed that two-thirds of the difference between the book value of the net assets and their fair market value is attributable to depreciable assets having a fair market value in excess of their undepreciated cost, or ($150 − 120 million) × ⅔ = $20 million. Let's also assume that these depreciable assets have an average remaining useful life of 10 years, and are being depreciated by the straight-line method. Investment revenue and the investment both would be reduced by the negative income effect of the "extra depreciation" the higher fair value would cause:

Additional Depreciation	($ in millions)	
Investment revenue ($20 million ÷ 10 years)	2	
Investment in equity shares		2

We would need to record this adjustment in each of the next nine years as well, since the average remaining useful life is 10 years.[17]

No Amortization of Land. On the contrary, the remaining $10 million difference between the book value of the net assets and their fair market value has no effect on earnings. Unlike buildings and equipment, land is not an asset we depreciate. As a result, writing up the land from book value to fair value (as would occur in consolidation) would not cause higher expenses, so as we mimic consolidation here in the equity method, we have no need to adjust Investment revenue or the Investment in equity securities.

No Amortization of Goodwill. Recall from Chapter 11 that goodwill, unlike most other intangible assets, should not be amortized. In that sense, goodwill resembles land. Expenses are unaffected by whether goodwill is recorded or not. So acquiring goodwill ($50 million in our example) will not cause higher expenses, so we have no need to adjust Investment revenue or the Investment in equity securities.

Reporting the Investment

The market value of the investment shares at the end of the reporting period is not reported when using the equity method. The investment account is reported at its original cost, increased by the investor's share of the investee's net income (adjusted for additional expenses like depreciation), and decreased by the portion of those earnings actually received as dividends. In other words, the investment account represents the investor's share of the investee's net assets initially acquired, adjusted for the investor's share of the subsequent increase in the investee's net assets (net assets earned and not yet distributed as dividends).

The carrying amount of the investment is its initial cost plus the investor's equity in the undistributed earnings of the investee.

Investment in Equity Securities
($ in millions)

Cost	200		
Share of income	25		
		6	Dividends
		2	Depreciation
Balance	217		

When the Investee Reports a Net Loss. Our illustration assumed the investee earned net income. If the investee reports a *net loss* instead, the investment account would be *decreased* by the investor's share of the investee's net loss (adjusted for additional expenses).

[17]If the $20 million difference between fair value and book value had been attributable to undervalued inventory rather than undervalued depreciable assets, we would adjust Investment revenue and the Investment in equity securities by the entire $20 million the first year. The reasoning is that inventory usually is sold within a year—unlike buildings and equipment that last several years. So, if inventory is increased by $20 million, cost of goods sold will be $20 million higher the first year.

When the Investment Is Acquired in Mid-Year. Obviously, we've simplified the illustration by assuming the investment was acquired at the beginning of 2006, entailing a full year's income, dividends, and amortization. In the more likely event that an investment is acquired sometime after the beginning of the year, the application of the equity method is easily modified to include the appropriate fraction of each of those amounts. For example, if the investment in our illustration had been acquired on October 1 rather than January 2, we would simply record income, dividends, and amortization for three months, or $\frac{3}{12}$ of the year. This would result in the following adjustments to the investment account:

Changes in the investment account the first year are adjusted for the fraction of the year the investor has owned the investment.

Investment in Equity Securities
($ in millions)

Cost	200.00		
Share of income ($\frac{3}{12}$ × $25)	6.25		
		1.50	($\frac{3}{12}$ × $6) Dividends*
		.50	($\frac{3}{12}$ × $2) Depreciation
Balance	204.25		

*This example assumes quarterly dividends and that the dividend was declared for the October 1–December 31 quarter. Investors receive the entire amount of any dividends declared while they own stock, regardless of how long they have held the shares.

ADDITIONAL CONSIDERATION

It's possible that the investor's proportionate share of investee losses could exceed the carrying amount of the investment. If this happens, the investor should discontinue applying the equity method until the investor's share of subsequent investee earnings has equaled losses not recognized during the time the equity method was discontinued. This avoids reducing the investment account below zero.

Amazon.com reported its investments in affiliated companies for which it exercised significant influence using the equity method as shown in Graphic 12–9.

GRAPHIC 12–9
Equity Method—Amazon.com

In millions

December 31	2003	2002
Total current assets	$1,820,809	$1,615,676
Fixed assets, net	224,285	239,398
Goodwill, net	69,121	70,811
Other intangibles, net	518	3,460
Equity investments	14,831	15,442
Other assets	32,469	45,662
Total assets	$2,162,033	$1,990,449

What If Conditions Change?

A Change from the Equity Method to Another Method. When the investor's level of influence changes, it may be necessary to change from the equity method to another method. This could happen, for instance, if a sale of shares causes the investor's ownership interest to fall from, say, 25% to 15%, resulting in the equity method no longer being appropriate.[18] Another example is provided by **Sprint,** which in February 2001 agreed to end its exclusive alliance with **EarthLink** and relinquished its seats on EarthLink's board of directors.

[18]When a portion of an equity method investment is sold, the investor removes from the investment account the appropriate proportion of the carrying value and records a gain or loss for the difference between that amount and the selling price.

As a result, Sprint discontinued using the equity method for its investment in EarthLink. When this situation happens, *no adjustment* is made to the remaining carrying amount of the investment. Instead, the equity method is simply discontinued and the new method applied from then on. The balance in the investment account when the equity method is discontinued would serve as the new cost basis for writing the investment up or down to market value on the next set of financial statements.

A Change from Another Method to the Equity Method. On the other hand, when a change *to* the equity method is appropriate, because the investor's ownership interest rises from 15% to 25%, the investment account should be retroactively adjusted to the balance that would have existed if the equity method always had been used. As income also would have been different, retained earnings would be adjusted as well. For example, assume it's determined that an investor's share of investee net income, reduced by dividends, was $4 million during a period when the equity method was not used, but additional purchases of shares cause the equity method to be appropriate now. The following journal entry would record the change:

Both the investment and retained earnings would be increased by the investor's share of the undistributed earnings in years prior to a change to the equity method.

	($ in millions)	
Investment in equity securities	4	
Retained earnings (investment revenue from the equity method) . .		4

In addition to the adjustment of account balances, financial statements would be restated to the equity method for each year reported in the annual report for comparative purposes. Also, the income effect for years prior to those shown in the comparative statements is reported on the statement of retained earnings as an adjustment to beginning retained earnings of the earliest year reported. A disclosure note also should describe the change. Reporting accounting changes is described in more detail in Chapter 20.

ADDITIONAL CONSIDERATION

Effect on Deferred Income Taxes

Investment revenue is recorded by the equity method when income is earned by the investee, but that revenue is not taxed until it's actually received as cash dividends. This creates a temporary difference between book income and taxable income. You will learn in Chapter 16 that the investor must report a deferred tax liability for the income tax that ultimately will be paid when the income eventually is received as dividends.

IF AN EQUITY METHOD INVESTMENT IS SOLD

When an investment being reported by the equity method is sold, a gain or loss is recognized if the selling price is more or less than the carrying amount (book value) of the investment. For example, let's continue our illustration and assume American Capital Corporation sells its investment in Embassy Message Corporation at the end of 2006 for $234 million. A journal entry would record a gain as follows:

When an equity method investment is sold, a gain or loss is recognized for the difference between its selling price and its carrying amount.

	($ in millions)	
Cash (proceeds from sale)	234	
Investment in equity securities (balance)		217
Gain on sale of investment (difference).		17

CONCEPT REVIEW EXERCISE

THE EQUITY METHOD

Delta Apparatus bought 40% of Clay Crating Corp.'s outstanding common shares on January 2, 2006, for $540 million. The carrying amount of Clay Crating's net assets (shareholders' equity) at the purchase date totaled $900 million. Book values and fair values were the same for all financial statement items except for inventory and buildings, for which fair values exceeded book values by $25 million and $225 million, respectively. All inventory on hand at the acquisition date was sold during 2006. The buildings have average remaining useful lives of 18 years. During 2006, Clay Crating reported net income of $220 million and paid an $80 million cash dividend.

Required:

1. Prepare the appropriate journal entries during 2006 for the investment.
2. Determine the amounts relating to the investment that Delta Apparatus should report in the 2006 financial statements:
   a. As an investment in the balance sheet.
   b. As investment revenue in the income statement.
   c. Among investing activities in the statement of cash flows.

SOLUTION

1. Prepare the appropriate journal entries during 2006 for the investment.

	($ in millions)	
Purchase		
Investment in Clay Crating shares	540	
Cash		540
Net income		
Investment in Clay Crating shares (40% × $220 million)	88	
Investment revenue		88
Dividends		
Cash (40% × $80 million)	32	
Investment in Clay Crating shares		32
Inventory		
Investment revenue (higher cost of goods sold during 2006 if beginning inventory had been adjusted to fair value)	10	
Investment in Clay Crating shares (40% × $25 million)		10
Buildings		
Investment revenue ([$225 million × 40%] ÷ 18 years)	5	
Investment in Clay Crating shares		5

	Investee Net Assets ↓	Net Assets Purchased ↓	Difference Attributed to ↓	
Cost		$540		
			Goodwill:	$80 [difference]
Fair value	$1,150† × 40% =	$460		
			Undervaluation of inventory	$10 [$25 × 40%]
Book value	$ 900 × 40% =	$360		
			Undervaluation of buildings	$90 [$225 × 40%]

†($900 + 25 + 225)

2. Determine the amounts that Delta Apparatus should report in the 2006 financial statements:
   a. As an investment in the balance sheet:

Investment in Clay Crating Shares
($ in millions)

Cost	540		
Share of income	88		
		32	Dividends
		10	Inventory
		5	Buildings
Balance	581		

b. As investment revenue in the income statement:

$$\underset{\text{(share of income)}}{\$88 \text{ million}} - \underset{\text{(adjustments)}}{[\$10 + 5] \text{ million}} = \underline{\underline{\$73 \text{ million}}}$$

c. In the statement of cash flows:
- Among investing activities: $540 million cash outflow
- Among operating activities: $32 million cash inflow

Corporations invest in other corporations for a variety of reasons.

DECISION MAKERS' PERSPECTIVE

The way we account for investments has considerable impact on both the valuation of corporate assets and income determination. Consequently, it is critical that both managers and external decision makers clearly understand those impacts and make decisions accordingly.

Managerial decisions concerning investments in other corporations are motivated by a variety of factors. Short-term investments in actively traded securities are common among banks, insurance companies, and other financial institutions. Manufacturing, merchandising, and nonfinancial service firms are more likely to make short-term investments to optimize the use of temporarily idle cash. Substantial portfolios of long-term securities are prominent among financial institutions who must keep large amounts of funds invested for long periods. Other firms, though, invest long term to derive any number of operating benefits such as creating desirable relationships with suppliers or customers. The way we report a company's investment in the stock of another company depends on the nature of the relationship between the investor and the investee. That is, the choice is dictated by the situation; it's not a discretionary matter.

The way an investment is accounted for impacts reported income as well as various financial ratios.

By and large, the way we account for an investment has little effect on a company's cash flows. On the other hand, profits companies report often are significantly impacted by methods used to account for investments. For example, suppose Investor Company owns 20% of Investee Company. Investee's net income is $1 million. Suppose also that Investee distributes one-half its earnings as dividends. (Thus, Investor receives 20% × $1 million × ½ = $100,000.) Also assume the fair value of Investor's investment in Investee's common stock increased by $250,000 during the year. The investment revenue Investor includes on its income statement varies greatly depending on whether the investment is reported as a trading security, a security held for sale, or an investment accounted for by the equity method. The variation is shown in Graphic 12–10.

GRAPHIC 12–10
Variation in Earnings by Method Used to Account for Investments

Which accounting method causes reported income to be highest?

	Accounting Method Used		
	Trading Security	Security Held for Sale	Equity Method
Share of Investee income*	$100,000	$100,000	$200,000
Increase in Investee's fair value†	250,000	0	0
Investor's investment income	$350,000	$100,000	$200,000

*Recognized whether received as dividends or not by the equity method; only if received as dividends otherwise.
†Reported in income for trading securities, component of shareholders' equity for securities available for sale, and not recognized at all for equity-method investments.

Thus, despite the lack of real impact on cash flows, the accounting method affects net income, including calculations of earnings per share and any rate of return ratios. When analyzing a company's profitability, lenders and investors should be alert to the way accounting methods affect reported net income. Clearly, managerial intent plays a crucial role in classifying securities. This discretion introduces the possibility of earnings management (manipulation of income) which has obvious implications for earnings quality. As an analyst, you would want to be particularly wary if the method changes from one year to the next. Companies have been known to adjust their ownership percentage, and therefore their method of accounting, suspiciously in concert with the prosperity of an investee.

Actually, the equity method was designed in part to prevent the manipulation of income that would be possible if investing corporations recognized income only when received as dividends, even when they have significant influence over investees. This would create the possibility that an investing corporation can dictate when and if dividends are paid, effectively manipulating the timing of income recognition. The equity method limits that potential method of managing earnings but given the discretion management has in classifying investments, creates other potential abuses. ■

Accounting methods intended to limit the opportunities for income manipulation sometimes actually create other opportunities.

Financial Instruments and Investment Derivatives

A **financial instrument** is defined as:

- Cash,
- Evidence of an *ownership interest* in an entity,[19]
- A contract that (a) imposes on one entity an obligation to *deliver* cash (say accounts payable) or another financial instrument and (b) conveys to the second entity a right to *receive* cash (say accounts receivable) or another financial instrument, or
- A contract that (a) imposes on one entity an obligation to *exchange* financial instruments on potentially unfavorable terms (say the issuer of a stock option) and (b) conveys to a second entity a right to *exchange* other financial instruments on potentially favorable terms (say the holder of a stock option).[20]

An entirely new class of financial instruments has emerged in recent years in response to the desire of firms to manage risks. In fact, these financial instruments would not exist in their own right, but have been created solely to hedge against risks created by other financial instruments or by transactions that have yet to occur but are anticipated. Financial futures, interest rate swaps, forward contracts, and options have become commonplace.[21] These financial instruments often are called **derivatives** because they "derive" their values or contractually required cash flows from some other security or index. For instance, an option to buy an asset in the future at a preset price has a value that is dependent on, or derived from, the value of the underlying asset. Their rapid acceptance as indispensable components of the corporate capital structure has left the accounting profession scrambling to keep pace.

***Derivatives* are financial instruments that "derive" their values from some other security or index.**

The urgency to establish accounting standards for financial instruments has been accelerated by headline stories in the financial press reporting multimillion-dollar losses on exotic derivatives by **Enron Corporation**, **Procter & Gamble**, **Orange County** (California), **Piper Jaffrey**, and **Gibson Greetings**, to mention a few. The headlines have tended to focus attention on the misuse of these financial instruments rather than their legitimate use in

GLOBAL PERSPECTIVE

No other country reports its investments exactly like we do in the United States. Most countries report short-term investments at lower of cost or market. Some, including Argentina and Israel, report at fair value.

Most countries report noncurrent investments (other than equity method investees) at some variation of cost, but methods vary widely, ranging from unadjusted historical cost (China) to fair market value (New Zealand).

However, International Financial Reporting Standards (IAS 39) classify investments as available-for-sale, trading, or held-to-maturity as we do in the U.S. Available-for-sale and trading securities are carried at fair value and unrealized gains and losses are treated the same way as in the U.S.

[19]This category includes not just shares of stock, but also partnership agreements and stock options.

[20]"Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk," *Statement of Financial Accounting Standards No. 105,* (Stamford, Conn.: FASB, 1990), par. 6.

[21]Interest rate futures were traded for the first time in 1975 on the Chicago Board of Trade. Interest rate swaps were invented in the early 1980s. They now comprise over 70% of derivatives in use.

managing risk. So maligned in the press have been derivatives that, in a recent conference, James Leisenring, then the FASB's vice chairman, facetiously defined a derivative as "any investment that lost money this year."

The FASB's ongoing financial instruments project is expected to lead to a consistent framework for accounting for all financial instruments.

Actually, the FASB has been involved since 1986 in a project to provide a consistent framework for resolving financial instrument accounting issues, including those related to derivatives and other "off-balance-sheet" instruments. The financial instruments project has three separate but related parts: disclosure, recognition and measurement, and distinguishing between liabilities and equities. Unfortunately, issues to be resolved are extremely complex and will likely require several years to resolve. To help fill the disclosure gap in the meantime, the FASB has offered a series of temporary, "patchwork" solutions. These are primarily in the form of additional disclosures for financial instruments. More recently, the FASB has tackled the issues of recognition and measurement. We discuss these requirements in Appendix A after we've spent some time with the measurement issues necessary to understand accounting for derivatives.

FINANCIAL REPORTING CASE SOLUTION

1. **How should you respond? Why are held-to-maturity securities treated differently from other investment securities?** *(p. 562)* You should explain that if an investor has the positive intent and ability to hold the securities to maturity, investments in debt securities are classified as held-to-maturity and reported at amortized cost in the balance sheet. Increases and decreases in market value are not reported in the financial statements. The reasoning is that the changes are irrelevant to an investor who will hold a security to its maturity regardless of those changes. Changes in the market value between the time a debt security is acquired and the day it matures to a prearranged maturity value aren't important if sale before maturity isn't an alternative.
2. **Why are unrealized gains and losses not reported on the income statement?** *(p. 564)* Available-for-sale securities are *not* acquired for the purpose of profiting from short-term market price changes, so the argument made by the FASB is that gains and losses from holding these securities while prices change are not considered relevant performance measures to be included in earnings.
3. **What is comprehensive income?** *(p. 564)* Comprehensive income is a more expansive view of the change in shareholders' equity than traditional net income. In fact, it encompasses all changes in equity other than from transactions with owners. In addition to net income, comprehensive income includes up to four other changes in equity.
4. **Anticipate his next question and explain why Coke accounts for some of its investments by the equity method and what that means.** *(p. 576)* When an investor does not have "control," but still is able to exercise *significant influence* over the operating and financial policies of the investee, the investment should be accounted for by the equity method. Apparently Coke owns between 20% and 50% of the voting shares of some of the companies it invests in. By the equity method, Coke recognizes investment income in an amount equal to its percentage share of the net income earned by those companies, instead of the amount of that net income it receives as cash dividends. The rationale is that as the investee earns additional net assets, Coke's share of those net assets increases. ■

THE BOTTOM LINE

1. Investment securities are classified for reporting purposes as held-to-maturity, available-for-sale, or trading securities. If an investor has the positive intent and ability to hold the securities to maturity, investments in debt securities are classified as held-to-maturity and reported at amortized cost in the balance sheet. These investments are recorded at cost, and holding gains or losses from market price changes are ignored.
2. Investments in debt and equity securities that don't fit the definitions of the other reporting categories are classified as available-for-sale. They are reported at their fair values.

Holding gains and losses from retaining securities during periods of price change are not included in the determination of income for the period; they are reported as a separate component of shareholders' equity.

3. Investments in debt or equity securities acquired principally for the purpose of selling them in the near term are classified as trading securities. They are reported at their fair values. Holding gains and losses for trading securities are included in earnings.
4. When an investor is able to exercise significant influence over the operating and financial policies of the investee, the investment should be accounted for by the equity method. Usually an investor can exercise significant influence when it owns between 20% and 50% of the investee's voting shares.
5. By the equity method, the investor recognizes investment income equal to its percentage share (based on share ownership) of the net income earned by the investee, rather than the portion of that net income received as cash dividends. The investment account is adjusted for the investor's percentage share of net income reported by the investee. When the investor actually receives dividends, the investment account is reduced accordingly.
6. When the cost of an investment exceeds the book value of the underlying net assets acquired, both the investment account and investment revenue are adjusted for differences between net income reported by the investee and what that amount would have been if consolidation procedures had been followed. ■

APPENDIX 12A

OTHER INVESTMENTS (SPECIAL PURPOSE FUNDS, INVESTMENTS IN LIFE INSURANCE POLICIES)

Special Purpose Funds

It's often convenient for companies to set aside money to be used for specific purposes. You learned about one such special purpose fund in Chapter 7 when we discussed petty cash funds. Recall that a petty cash fund is money set aside to conveniently make small expenditures using currency rather than having to follow the time-consuming, formal procedures normally used to process checks. Similar funds sometimes are used to pay interest, payroll, or other short-term needs. Like petty cash, these short-term special purpose funds are reported as current assets.

Some special purpose funds—like petty cash—are current assets.

Special purpose funds also are sometimes established to serve longer term needs. It's common, for instance, to periodically set aside cash into a fund designated to repay bonds and other long-term debt. Such funds usually accumulate cash over the debt's term to maturity and are composed of the company's periodic contributions plus interest or dividends from investing the money in various return-generating investments. In fact, some debt contracts require the borrower to establish such a fund to repay the debt. In similar fashion, management might voluntarily choose to establish a fund to accumulate money to expand facilities, provide for unexpected losses, to buy back shares of stock, or any other special purpose that might benefit from an accumulation of funds. Of course, these funds that won't be used within the upcoming operating cycle are noncurrent assets. They are reported as part of investments and funds. The same criteria for classifying securities into reporting categories that we discussed previously should be used to classify securities in which funds are invested. Any investment revenue from these funds is reported as such on the income statement.

A special purpose fund can be established for virtually any purpose.

Noncurrent special purpose funds are reported within the category *investments and funds.*

Investments in Life Insurance Policies

Companies frequently buy life insurance policies on the lives of their key officers. Under normal circumstances, the company pays the premium for the policy and as beneficiary, receives the proceeds when the officer dies. Of course, the objective is to compensate the company for the untimely loss of a valuable resource in the event the officer dies. However, some types of life insurance policies can be surrendered while the insured is still alive in exchange for a determinable amount of money, called the **cash surrender value**. In effect, a

Certain life insurance policies can be surrendered while the insured is still alive in exchange for its *cash surrender value.*

portion of each premium payment is not used by the insurance company to pay for life insurance coverage, but instead is invested on behalf of the insured company in a fixed-income investment. Accordingly, the cash surrender value increases each year by the portion of premiums invested plus interest on the previous amount invested. This is simply a characteristic of whole life insurance, unlike term insurance whose lower premiums provide death benefits only.

Part of each insurance premium represents an increase in the cash surrender value.

From an accounting standpoint, the periodic insurance premium should not be expensed in its entirety. Rather, part of each premium payment, the investment portion, is recorded as an asset. Illustration 12A–1 provides an example. ■

ILLUSTRATION 12A–1
Cash Surrender Value

Several years ago, American Capital acquired a $1 million insurance policy on the life of its chief executive officer, naming American Capital as beneficiary. Annual premiums are $18,000, payable at the beginning of each year. In 2006, the cash surrender value of the policy increased according to the contract from $5,000 to $7,000. The CEO died at the end of 2006.

Part of the annual premium represents a build-up in the cash surrender value.

Insurance expense (difference)	16,000	
Cash surrender value of life insurance ($7,000 − 5,000)	2,000	
Cash (2006 premium)		18,000

To record insurance expense and the increase in the investment.

The cash surrender value is considered to be a noncurrent investment and would be reported in the investments and funds section of the balance sheet. Of course when the insured officer dies, the corporation receives the death benefit of the insurance policy, and the cash surrender value ceases to exist because canceling the policy no longer is an option. The corporation recognizes a gain for the amount of the death benefit less the cash surrender value:

When the death benefit is paid, the cash surrender value becomes null and void.

Cash (death benefit)	1,000,000	
Cash surrender value of life insurance (balance)		7,000
Gain on life insurance settlement (difference)		993,000

To record the proceeds at death.

APPENDIX 12B

IMPAIRMENT OF A RECEIVABLE DUE TO A TROUBLED DEBT RESTRUCTURING

When a creditor's receivable becomes impaired due to a troubled debt restructuring or for any other reason, the receivable is remeasured based on the discounted present value of currently expected cash flows at the loan's original effective rate (regardless of the extent to which expected cash receipts have been reduced).

When the original terms of a debt agreement are changed as a result of financial difficulties experienced by the debtor (borrower), the new arrangement is referred to as a **troubled debt restructuring**. We discuss troubled debt restructurings in much more detail in Chapter 14. The essential point here is that such an arrangement involves some concessions on the part of the creditor (lender), resulting in the impairment of the creditor's asset: the investment in a receivable.

When the Receivable Is Settled Outright

Sometimes a receivable in a troubled debt restructuring is actually settled at the time of the restructuring with the receipt of cash (or a noncash asset), or even shares of the debtor's stock. In that case, the creditor simply records a loss for the difference between the carrying amount of the receivable and the fair value of the asset(s) or equity securities received. Illustration 12B–1 provides an example.

First Prudent Bank is owed $30 million by Brillard Properties under a 10% note with two years remaining to maturity. Due to financial difficulties of the developer, the previous year's interest ($3 million) was not received. The bank agrees to settle the receivable (and accrued interest receivable) in exchange for property having a fair market value of $20 million.

	($ in millions)	
Land (fair market value)	20	
Loss on troubled debt restructuring	13	
Accrued interest receivable (10% × $30 million)		3
Note receivable (balance)		30

For most active lenders, a troubled debt restructuring unfortunately is not both unusual and infrequent; so usually the loss is not reported as an extraordinary loss.

ILLUSTRATION 12B–1

Debt Settled at the Time of a Restructuring

The carrying amount of the receivable is $33 million

When the Receivable Is Continued, but with Modified Terms

In the previous example we assumed that First Prudent Bank agreed to accept property in full settlement of the receivable. In a troubled debt restructuring, it is more likely that the bank would allow the receivable to continue but with the terms of the debt agreement modified to make it easier for the debtor to comply. The lender might agree to reduce or delay the scheduled interest payments. Or, it may agree to reduce or delay the maturity amount. Often a troubled debt restructuring will call for some combination of these concessions.

As one of many possibilities, suppose the bank agrees to (1) forgive the interest accrued from last year, (2) reduce the two remaining interest payments from $3 million each to $2 million each, and (3) reduce the face amount from $30 million to $25 million. Clearly, the bank's investment in the receivable has been impaired. The extent of impairment is the difference between the $33 million carrying amount of the receivable (the present value of the receivable's cash flows prior to the restructuring) and the present value of the revised cash flows discounted at the loan's original effective rate (10%). See Illustration 12B–2 for a demonstration.

After restructuring, the lender still records interest annually at the 10% effective rate. ■

Brillard Properties owes First Prudent Bank $30 million under a 10% note with two years remaining to maturity. Due to financial difficulties of the developer, the previous year's interest ($3 million) was not paid. First Prudent Bank agrees to:
1. Forgive the interest accrued from last year.
2. Reduce the remaining two interest payments to $2 million each.
3. Reduce the principal to $25 million.

Analysis

Previous Value			
Accrued interest	(10% × $30,000,000)	$ 3,000,000	
Principal		30,000,000	
Carrying amount of the receivable			$33,000,000
New Value			
Interest	$ 2 million × 1.73554* =	$ 3,471,080	
Principal	$25 million × 0.82645† =	20,661,250	
Present value of the receivable			(24,132,330)
Loss			$ 8,867,670

*Present value of an ordinary annuity of $1: $n = 2$, $i = 10\%$
†Present value of $1: $n = 2$, $i = 10\%$

Journal Entry

Loss on troubled debt restructuring (to balance)	8,867,670	
Accrued interest receivable (10% × $30,000,000)		3,000,000
Note receivable ($30,000,000 − 24,132,330)		5,867,670

ILLUSTRATION 12B–2

Receivable Impaired by Troubled Debt Restructuring—Terms Modified

The discounted present value of the cash flows prior to the restructuring was the same as the receivable's carrying amount.

The discounted present value of the cash flows after the restructuring is less.

The difference is a loss.

QUESTIONS FOR REVIEW OF KEY TOPICS

Q 12–1 All investments in *debt* securities and investments in *equity* securities that have readily determinable fair values (except those for which the equity method or consolidation is appropriate) are classified for reporting purposes in one of three categories and accounted for differently depending on the classification. What are these three categories?

Q 12–2 When market rates of interest *rise* after a fixed-rate security is purchased, the value of the now-below-market, fixed-interest payments declines, so the market value of the investment falls. On the other hand, if market rates of interest *fall* after a fixed-rate security is purchased, the fixed-interest payments become relatively attractive, and the market value of the investment rises. How are these price changes reflected in the investment account for a security classified as held-to-maturity?

Q 12–3 When is the fair value of an equity security considered to be readily determinable? How is an investment in an equity security reported if its fair value is *not* readily determinable?

Q 12–4 When an investment is acquired to be held for an unspecified period of time as opposed to being held to maturity, it is reported at the fair value of the investment securities on the reporting date. Why?

Q 12–5 Reporting an investment at its fair value means adjusting its carrying amount for changes in fair value after its acquisition (or since the last reporting date if it was held at that time). Such changes are called unrealized holding gains and losses because they haven't yet been realized through the sale of the security. If the security is classified as available-for-sale, how are unrealized holding gains and losses reported?

Q 12–6 What is "comprehensive income"? Its composition varies from company to company but may include which financial items?

Q 12–7 Why are holding gains and losses treated differently for trading securities and securities available-for-sale?

Q 12–8 The market value of Helig Forestry and Mining Corporation common stock dropped 6⅛ points when the federal government passed new legislation banning one of the company's primary techniques for extracting ore. Harris Corporation owns shares of Helig and classifies its investment as securities available-for-sale. How should the decline in market value be handled by Harris?

Q 12–9 Western Die-Casting Company holds an investment in unsecured bonds of LGB Heating Equipment, Inc. When the investment was acquired, management's intention was to hold the bonds for resale. Now management has the positive intent and ability to hold the bonds to maturity. How should the reclassification of the investment be accounted for?

Q 12–10 Is it necessary for an investor to report individual amounts for the three categories of investments— held-to-maturity, available-for-sale, or trading—in the financial statements? What information should be disclosed about these investments?

Q 12–11 Under what circumstances is the equity method used to account for an investment in stock?

Q 12–12 The equity method has been referred to as a *one-line consolidation.* What might prompt this description?

Q 12–13 In the application of the equity method, how should dividends from the investee be accounted for? Why?

Q 12–14 The fair value of depreciable assets of Penner Packaging Company exceeds their book value by $12 million. The assets' average remaining useful life is 10 years. They are being depreciated by the straight-line method. Finest Foods Industries buys 40% of Penner's common shares. When adjusting investment revenue and the investment by the equity method, how will the situation described affect those two accounts?

Q 12–15 Superior Company owns 40% of the outstanding stock of Bernard Company. During 2006, Bernard paid a $100,000 cash dividend on its common shares. What effect did this dividend have on Superior's 2006 financial statements?

Q 12–16 Sometimes an investor's level of influence changes, making it necessary to change from the equity method to another method. How should the investor account for this change in accounting method?

Q 12–17 Define a financial instrument. Provide three examples of current liabilities that represent financial instruments.

Q 12–18 Some financial instruments are called derivatives. Why?

Q 12–19 (Based on Appendix 12A) Northwest Carburetor Company established a fund in 2003 to accumulate money for a new plant scheduled for construction in 2006. How should this special purpose fund be reported in Northwest's balance sheet?

Q 12–20 (Based on Appendix 12A) Whole-life insurance policies typically can be surrendered while the insured is still alive in exchange for a determinable amount of money called the *cash surrender value.* When a company buys a life insurance policy on the life of a key officer to protect the company against the untimely loss of a valuable resource in the event the officer dies, how should the company account for the cash surrender value?

Q 12–21 (Based on Appendix 12B) Marshall Companies, Inc., holds a note receivable from a former subsidiary. Due to financial difficulties, the former subsidiary has been unable to pay the previous year's interest on the note. Marshall agreed to restructure the debt by both delaying and reducing remaining cash payments. The concessions impair the creditor's investment in the receivable. How is this impairment recorded?

BRIEF EXERCISES

BE 12–1
Securities held-to-maturity; bond investment; effective interest
● LO1

Lance Brothers Enterprises acquired $720,000 of 3% bonds, dated July 1, on July 1, 2006, as a long-term investment. Management has the positive intent and ability to hold the bonds until maturity. The market interest rate (yield) was 4% for bonds of similar risk and maturity. Lance Brothers paid $600,000 for the investment in bonds and will receive interest semiannually on June 30 and December 31. Prepare the journal entries (a) to record Lance Brothers' investment in the bonds on July 1, 2006, and (b) to record interest on December 31, 2006, at the effective (market) rate.

BE 12–2
Purchase and sale of investment securities
● LO2

CPS, Inc. purchased 2,000 shares of **Walt Disney** common stock at $27 per share and paid a brokerage fee of $900. The company sold the shares three months later for $29 per share, paying a brokerage fee on the sale of $950. What are the journal entries CPS recorded for the purchase and the sale?

BE 12–3
Securities available-for-sale; adjusting entry
● LO2

For several years Fister Links Products has held shares of **Microsoft** common stock, considered by the company to be securities available-for-sale. The shares were acquired at a cost of $500,000. Their fair value last year was $610,000 and is $670,000 this year. At what amount will the investment be reported in this year's balance sheet? What adjusting entry is required to accomplish this objective?

BE 12–4
Classification of securities; reporting
● LO2

FedEx Corporation

Adams Industries holds 40,000 shares of **FedEx** common stock. On December 31, 2005, and December 31, 2006, the market value of the stock is $95 and $100 per share, respectively. What is the appropriate reporting category for this investment and at what amount will it be reported in the 2006 balance sheet?

BE 12–5
Trading securities
● LO3

S&L Financial buys and sells securities expecting to earn profits on short-term differences in price. On December 27, 2006, S&L purchased **Coca-Cola** common shares for $875,000 and sold the shares on January 3, 2007, for $880,000. At December 31, the shares had a fair value of $873,000. What pretax amounts did S&L include in its 2006 and 2007 earnings as a result of this investment?

BE 12–6
Trading securities
● LO3

S&L Financial buys and sells securities which it classifies as available-for-sale. On December 27, 2006, S&L purchased **Coca-Cola** common shares for $875,000 and sold the shares on January 3, 2007, for $880,000. At December 31, the shares had a fair value of $873,000. What pretax amounts did S&L include in its 2006 and 2007 earnings as a result of this investment?

BE 12–7
Equity method
● LO4 LO5

Turner Company owns 40% of the outstanding stock of ICA Company. During the current year, ICA paid a $5 million cash dividend on its common shares. What effect did this dividend have on Turner's 2006 financial statements?

BE 12–8
Equity method
● LO4 LO5

Turner Company owns 10% of the outstanding stock of ICA Company. During the current year, ICA paid a $5 million cash dividend on its common shares. What effect did this dividend have on Turner's 2006 financial statements?

BE 12–9
Equity method
● LO6

The fair value of Wallis, Inc.'s depreciable assets exceeds their book value by $50 million. The assets have an average remaining useful life of 15 years and are being depreciated by the straight-line method. Park Industries buys 30% of Wallis's common shares. When Park adjusts its investment revenue and the investment by the equity method, how will the situation described affect those two accounts?

BE 12–10
Impairment
● LO5

LED Corporation owns 100,000 shares of Branch Pharmaceuticals common stock and classifies its investment as securities available-for-sale. The market price of Branch's stock fell over 30%, by 4.5 points when the FDA banned one of the company's principal drugs. What journal entry should LED record to account for the decline in market value? How should the decline be reported?

BE 12–11
Change in principle; change to the equity method
● LO5

At the beginning of 2006, Pioneer Products' ownership interest in the common stock of LLB Co. increased to the point that it became appropriate to begin using the equity method of accounting for the investment. The balance in the investment account was $44 million at the time of the change but would have been $56 million if Pioneer had used the equity method and the account had been adjusted for investee net income and dividends. How should Pioneer report the change? Would your answer be the same if Pioneer is changing *from* the equity method rather than *to* the equity method?

EXERCISES

available with McGraw-Hill's Homework Manager www.mhhe.com/spiceland4e

An alternate exercise and problem set is available on the text website: www.mhhe.com/spiceland4e

E 12–1
Securities held-to-maturity; bond investment; effective interest
● LO1

Tanner-UNF Corporation acquired as a long-term investment $240 million of 6% bonds, dated July 1, on July 1 2006. Company management has the positive intent and ability to hold the bonds until maturity. The market interest rate (yield) was 8% for bonds of similar risk and maturity. Tanner-UNF paid $200 million for the bonds. The company will receive interest semiannually on June 30 and December 31. As a result of changing market conditions, the fair value of the bonds at December 31, 2006, was $210 million.

Required:

1. Prepare the journal entry to record Tanner-UNF's investment in the bonds on July 1, 2006.
2. Prepare the journal entries by Tanner-UNF to record interest on December 31, 2006, at the effective (market) rate.
3. At what amount will Tanner-UNF report its investment in the December 31, 2006, balance sheet? Why?
4. Suppose Moody's bond rating agency downgraded the risk rating of the bonds motivating Tanner-UNF to sell the investment on January 2, 2007, for $190 million. Prepare the journal entry to record the sale.

E 12–2
Securities held-to-maturity
● LO1

FF&T Corporation is a confectionery wholesaler that frequently buys and sells securities to meet various investment objectives. The following selected transactions relate to FF&T's investment activities during the last two months of 2006. At November 1, FF&T held $48 million of 20-year, 10% bonds of Convenience, Inc., purchased May 1, 2006, at face value. Management has the positive intent and ability to hold the bonds until maturity. FF&T's fiscal year ends on December 31.

Nov. 1	Received semiannual interest of $2.4 million from the Convenience, Inc., bonds.
Dec. 1	Purchased 12% bonds of Facsimile Enterprises at their $30 million face value, to be held until they mature in 2019. Semiannual interest is payable May 31 and November 30.
31	Purchased U.S. Treasury bills that mature in two months for $8.9 million.
31	Recorded any necessary adjusting entry(s) relating to the investments.

The fair values of the investments at December 31 were:

Convenience bonds	$44.7 million
Facsimile Enterprises bonds	30.9 million
U.S. Treasury bills	8.9 million

Required:

Prepare the appropriate journal entry for each transaction or event.

E 12–3
Purchase and sale of investment securities
● LO2 LO3

Shott Farm Supplies Corporation purchased 800 shares of **General Motors** stock at $50 per share and paid a brokerage fee of $1,200. Two months later, the shares were sold for $53 per share. The brokerage fee on the sale was $1,300.

Required:

Prepare entries for the purchase and the sale.

E 12–4
Securities available-for-sale; adjusting entries
● LO2

Loreal-American Corporation purchased several marketable securities during 2006. At December 31, 2006, the company had the investments in common stock listed below. None was held at the last reporting date, December 31, 2005, and all are considered securities available-for-sale.

	Cost	Fair Value	Unrealized Holding Gain (Loss)
Short term:			
Blair, Inc.	$ 480,000	$ 405,000	$(75,000)
ANC Corporation	450,000	480,000	30,000
Totals	$ 930,000	$ 885,000	$(45,000)
Long term:			
Drake Corporation	$ 480,000	$ 560,000	$ 80,000
Aaron Industries	720,000	660,000	(60,000)
Totals	$1,200,000	$1,220,000	$ 20,000

Required:

1. Prepare appropriate adjusting entries at December 31, 2006.
2. What amounts would be reported in the income statement at December 31, 2006, as a result of these adjusting entries?

E 12–5
Classification of securities; adjusting entries
● LO2

On February 18, 2006, Union Corporation purchased 10,000 shares of **IBM** common stock as a long-term investment at $60 per share. On December 31, 2006, and December 31, 2007, the market value of IBM stock is $58 and $61 per share, respectively.

Required:
1. What is the appropriate reporting category for this investment? Why?
2. Prepare the adjusting entry for December 31, 2006.
3. Prepare the adjusting entry for December 31, 2007.

E 12–6
Various transactions related to securities available-for-sale
● LO2

Construction Forms Corporation buys securities to be available for sale when circumstances warrant, not to profit from short-term differences in price and not necessarily to hold debt securities to maturity. The following selected transactions relate to investment activities of Construction Forms whose fiscal year ends on December 31. No investments were held by Construction Forms at the beginning of the year.

2006

Mar. 2	Purchased 1 million Platinum Gauges, Inc., common shares for $31 million, including brokerage fees and commissions.
Apr. 12	Purchased $20 million of 10% bonds at face value from Zenith Wholesale Corporation.
July 18	Received cash dividends of $2 million on the investment in Platinum Gauges, Inc., common shares.
Oct. 15	Received semiannual interest of $1 million on the investment in Zenith bonds.
16	Sold the Zenith bonds for $21 million.
Nov. 1	Purchased 500,000 LTD International preferred shares for $40 million, including brokerage fees and commissions.
Dec. 31	Recorded the necessary adjusting entry(s) relating to the investments. The market prices of the investments are $32 per share for Platinum Gauges, Inc., and $74 per share for LTD International preferred shares.

2007

Jan. 23	Sold half the Platinum Gauges, Inc., shares for $32 per share.
Mar. 1	Sold the LTD International preferred shares for $76 per share.

Required:
1. Prepare the appropriate journal entry for each transaction or event.
2. Show the amounts that would be reported in the company's 2006 income statement relative to these investments.

E 12–7
Securities available-for-sale; journal entries
● LO2

On January 2, 2006, Sanborn Tobacco, Inc. bought 5% of Jackson Industry's capital stock for $90 million as a temporary investment. Sanborn classified the securities acquired as available-for-sale. Jackson Industry's net income for the year ended December 31, 2006, was $120 million. The fair value of the shares held by Sanborn was $98 million at December 31, 2006. During 2006, Jackson declared a dividend of $60 million.

Required:
1. Prepare all appropriate journal entries related to the investment during 2006.
2. Indicate the effect of this investment on 2006 income before taxes.

E 12–8
Various transactions relating to trading securities
● LO3

Rantzow-Lear Company buys and sells securities expecting to earn profits on short-term differences in price. The company's fiscal year ends on December 31. The following selected transactions relating to Rantzow-Lear's trading account occurred during December 2006 and the first week of 2007.

2006

Dec. 17	Purchased 100,000 Grocers' Supply Corporation preferred shares for $350,000.
28	Received cash dividends of $2,000 from the Grocers' Supply Corporation preferred shares.
31	Recorded any necessary adjusting entry relating to the Grocers' Supply Corporation preferred shares. The market price of the stock was $4 per share.

2007

Jan. 5	Sold the Grocers' Supply Corporation preferred shares for $395,000.

Required:
1. Prepare the appropriate journal entry for each transaction.
2. Indicate any amounts that Rantzow-Lear Company would report in its 2006 balance sheet and income statement as a result of this investment.

E 12–9
Various investment securities
● LO1 LO2 LO3

At December 31, 2006, Hull-Meyers Corp. had the following investments that were purchased during 2006, its first year of operations:

	Cost	Fair Value
Trading Securities:		
Security A	$ 900,000	$ 910,000
Security B	105,000	100,000
Totals	$1,005,000	$1,010,000
Securities Available-for-Sale:		
Security C	$ 700,000	$ 780,000
Security D	900,000	915,000
Totals	$1,600,000	$1,695,000
Securities to Be Held-to-Maturity:		
Security E	$ 490,000	$ 500,000
Security F	615,000	610,000
Totals	$1,105,000	$1,110,000

No investments were sold during 2006. All securities except Security D and Security F are considered short-term investments. None of the market changes is considered permanent.

Required:

Determine the following amounts at December 31, 2006.

1. Investments reported as current assets.
2. Investments reported as noncurrent assets.
3. Unrealized gain (or loss) component of income before taxes.
4. Unrealized gain (or loss) component of shareholders' equity.

E 12–10
Securities available-for-sale; adjusting entries
● LO2

The accounting records of Jamaican Importers, Inc. at January 1, 2006, included the following:

Assets:	
Investment in IBM common shares	$1,345,000
Less: Fair value adjustment	(145,000)
	$1,200,000
Shareholders' Equity:	
Accumulated unrealized holding gains and losses	$ 145,000

No changes occurred during 2006 in the investment portfolio.

Required:

Prepare appropriate adjusting entry(s) at December 31, 2006, assuming the market value of the IBM common shares was:

1. $1,175,000
2. $1,275,000
3. $1,375,000

E 12–11
Securities available-for-sale; fair value adjustment
● LO2

The investments of Harlon Enterprises included the following cost and fair value amounts:

($ in millions)		Fair Value, Dec. 31	
Securities Available-for-Sale	**Cost**	**2006**	**2007**
A Corporation shares	$ 20	$14	na
B Corporation bonds	35	35	$ 37
C Corporation shares	15	na	14
D Industries shares	45	46	50
Totals	$115	$95	$101

Harlon Enterprises sold its holdings of A Corporation shares on June 1, 2007, for $15 million. On September 12, it purchased the C Corporation shares.

Required:

1. What is the effect of the sale of the A Corporation shares and the purchase of the C Corporation shares on Harlon's 2007 pretax earnings?
2. At what amount should Harlon's securities available-for-sale portfolio be reported in its 2007 balance sheet? What adjusting entry is needed to accomplish this? What is the effect of the adjustment on Harlon's 2007 pretax earnings?

E 12–12
Multiple choice; investment securities
● LO1 LO2 LO3

The following questions dealing with investments are adapted from questions that appeared in recent CPA examinations. Determine the response that best completes the statements or questions.

1. Nola Co. has adopted *Statement of Financial Accounting Standards No. 115,* "Accounting for Certain Investments in Debt and Equity Securities." Nola has a portfolio of marketable equity securities that it

does not intend to sell in the near term. How should Nola classify these securities, and how should it report unrealized gains and losses from these securities?

Classify as	Report as a
a. Trading securities	Component of income from continuing operations
b. Available-for-sale	Separate component of shareholders' equity
c. Trading securities	Separate component of shareholders' equity
d. Available-for-sale	Component of income from continuing operations

2. Kale Co. has adopted *Statement of Financial Accounting Standards No. 115,* "Accounting for Certain Investments in Debt and Equity Securities." Kale purchased bonds at a discount on the open market as an investment and intends to hold these bonds to maturity. Kale should account for these bonds at:
   a. Cost
   b. Amortized cost
   c. Fair value
   d. Lower of cost or market

E 12–13
Investment securities and equity method investments compared

● LO2 LO4

As a long-term investment, Painters' Equipment Company purchased 20% of AMC Supplies, Inc.'s 400,000 shares for $480,000 at the beginning of the fiscal year of both companies. On the purchase date, the fair value and book value of AMC's net assets were equal. During the year, AMC earned net income of $250,000 and distributed cash dividends of 25 cents per share. At year-end, the fair value of the shares is $505,000.

Required:
1. Assume no significant influence was acquired. Prepare the appropriate journal entries from the purchase through the end of the year.
2. Assume significant influence was acquired. Prepare the appropriate journal entries from the purchase through the end of the year.

E 12–14
Equity method; purchase; investee income; dividends

● LO4 LO5

As a long-term investment at the beginning of the fiscal year, Florists International purchased 30% of Nursery Supplies, Inc.'s 8 million shares for $56 million. The fair value and book value of the shares were the same at that time. During the year, Nursery Supplies earned net income of $40 million and distributed cash dividends of $1.25 per share. At the end of the year, the fair value of the shares is $52 million.

Required:
Prepare the appropriate journal entries from the purchase through the end of the year.

E 12–15
Change in principle; change to the equity method

● LO5

The Trump Companies, Inc. has ownership interests in several public companies. At the beginning of 2006, the company's ownership interest in the common stock of Milken Properties increased to the point that it became appropriate to begin using the equity method of accounting for the investment. The balance in the investment account was $31 million at the time of the change. Accountants working with company records determined that the balance would have been $48 million if the account had been adjusted for investee net income and dividends as prescribed by the equity method.

Required:
1. Prepare the journal entry to record the change in principle.
2. Briefly describe other steps Trump should take to report the change.
3. Suppose Trump is changing *from* the equity method rather than *to* the equity method. How would your answers to requirements 1 and 2 differ?

E 12–16
Error corrections; investment

● LO1 LO2 LO3

On December 12, 2006, an investment costing $80,000 was sold for $100,000. The total of the sale proceeds was credited to the investment account.

Required:
1. Prepare the journal entry to correct the error assuming it is discovered before the books are adjusted or closed in 2006. (Ignore income taxes.)
2. Prepare the journal entry to correct the error assuming it is not discovered until early 2007. (Ignore income taxes.)

E 12–17
Equity method; adjustment for depreciation

● LO5 LO6

Fizer Pharmaceutical paid $68 million on January 2, 2006, for 4 million shares of Carne Cosmetics common stock. The investment represents a 25% interest in the net assets of Carne and gave Fizer the ability to exercise significant influence over Carne's operations. Fizer received dividends of $1 per share on December 21, 2006, and Carne reported net income of $40 million for the year ended December 31, 2006. The market value of Carne's common stock at December 31, 2006, was $18.50 per share.

- The book value of Carne's net assets was $192 million.
- The fair market value of Carne's depreciable assets exceeded their book value by $32 million. These assets had an average remaining useful life of eight years.
- The remainder of the excess of the cost of the investment over the book value of net assets purchased was attributable to goodwill.

Required:
Prepare all appropriate journal entries related to the investment during 2006.

E 12–18
Equity method

● LO5 LO6

On January 1, 2006, Cameron, Inc. bought 20% of the outstanding common stock of Lake Construction Company for $300 million cash. At the date of acquisition of the stock, Lake's net assets had a fair value of $900 million. Their book value was $800 million. The difference was attributable to the fair value of Lake's buildings and its land exceeding book value, each accounting for one-half of the difference. Lake's net income for the year ended December 31, 2006, was $150 million. During 2006, Lake declared and paid cash dividends of $30 million. The buildings have a remaining life of 10 years.

Required:
1. Prepare all appropriate journal entries related to the investment during 2006, assuming Cameron accounts for this investment by the equity method.
2. Determine the amounts to be reported by Cameron:
   a. As an investment in Cameron's 2006 balance sheet.
   b. As investment revenue in the income statement.
   c. Among investing activities in the statement of cash flows.

E 12–19
Multiple choice; CPA exam; equity method

● LO5

The following questions dealing with the equity method are adapted from questions that appeared on previous CPA examinations. Determine the response that best completes the statements or questions. Questions 1–3 are based on the following information.

Grant, Inc. acquired 30% of South Co's voting stock for $200,000 on January 2, 2006. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 2006, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 2007, and $200,000 for the year ended December 31, 2007. On July 1, 2007, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 2007.

1. Before income taxes, what amount should Grant include in its 2006 income statement as a result of the investment?
   a. $15,000
   b. $24,000
   c. $50,000
   d. $80,000
2. In Grant's December 31, 2006, balance sheet, what should be the carrying amount of this investment?
   a. $200,000
   b. $209,000
   c. $224,000
   d. $230,000
3. In its 2007 income statement, what amount should Grant report as gain from the sale of half of its investment?
   a. $24,500
   b. $30,500
   c. $35,000
   d. $45,500

E 12–20
Multiple choice; CMA exam; investments

● LO1 LO2

The following questions dealing with investments are adapted from questions that previously appeared on Certified Management Accountant (CMA) examinations. The CMA designation sponsored by the Institute of Management Accountants (**www.imanet.org**) provides members with an objective measure of knowledge and competence in the field of management accounting. Determine the response that best completes the statements or questions.

1. An investment in available-for-sale securities is valued on the balance sheet at
   a. The cost to acquire the asset.
   b. Accumulated income minus accumulated dividends since acquisition.
   c. Fair value.
   d. The par or stated value of the securities.

Questions 2 and 3 are based on the following information concerning Monahan Company's portfolio of debt securities at May 31, year 2 and May 31, year 3. All of the debt securities were purchased by Monahan during June, year 1. Prior to June, year 1, Monahan had no investments in debt or equity securities.

As of May 31, Year 2	Amortized Cost	Fair Value
Cleary Company bonds	$164,526	$168,300
Beauchamp Industry bonds	204,964	205,200
Morrow Inc. bonds	305,785	285,200
Total	$675,275	$658,700

As of May 31, Year 3	Amortized Cost	Fair Value
Cleary Company bonds	$152,565	$147,600
Beauchamp Industry bonds	193,800	204,500
Morrow Inc. bonds	289,130	291,400
Total	$635,495	$643,500

2. Assuming that the above securities are properly classified as available-for-sale securities under SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities,* the unrealized holding gain or loss as of May 31, year 3 would be
   a. recognized as an $8,005 unrealized holding gain on the income statement.
   b. recognized in other comprehensive income by a year-end credit of $8,005.
   c. recognized in other comprehensive income by a year-end debit of $8,005.
   d. not recognized.
3. Assuming that the above securities are properly classified as held-to-maturity securities under SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities,* the unrealized holding gain or loss as of May 31, year 2 would be
   a. recognized as an $8,005 unrealized holding gain on the income statement.
   b. recognized in other comprehensive income by a year-end credit of $8,005.
   c. recognized in other comprehensive income by a year-end debit of $8,005.
   d. not recognized.

E 12–21
Life insurance policy (Based on Appendix 12A)

Edible Chemicals Corporation owns a $4 million whole life insurance policy on the life of its CEO, naming Edible Chemicals as beneficiary. The annual premiums are $70,000 and are payable at the beginning of each year. The cash surrender value of the policy was $21,000 at the beginning of 2006.

Required:

1. Prepare the appropriate 2006 journal entry to record insurance expense and the increase in the investment assuming the cash surrender value of the policy increased according to the contract to $27,000.
2. The CEO died at the end of 2006. Prepare the appropriate journal entry.

E 12–22
Life insurance policy (Based on Appendix 12A)

Below are two unrelated situations relating to life insurance.

Required:

Prepare the appropriate journal entry for each situation.

1. Ford Corporation owns a whole life insurance policy on the life of its president. Ford Corporation is the beneficiary. The insurance premium is $25,000. The cash surrender value increased during the year from $2,500 to $4,600.
2. Petroleum Corporation received a $250,000 life insurance settlement when its CEO died. At that time, the cash surrender value was $16,000.

E 12–23
Impairment of securities available-for-sale; troubled debt restructuring (Based on Appendix 12B)

● LO2

At January 1, 2006, Clayton Hoists, Inc. owed Third BancCorp $12 million, under a 10% note due December 31, 2007. Interest was paid last on December 31, 2004. Clayton was experiencing severe financial difficulties and asked Third BancCorp to modify the terms of the debt agreement. After negotiation Third BancCorp agreed to:

- Forgive the interest accrued for the year just ended.
- Reduce the remaining two years' interest payments to $1 million each.
- Reduce the principal amount to $11 million.

Required:

Prepare the journal entries by Third BancCorp necessitated by the restructuring of the debt at

1. January 1, 2006.
2. December 31, 2006.
3. December 31, 2007.

E 12–24
Impairment of securities available-for-sale; troubled debt restructuring (Based on Appendix 12B)

● LO2

At January 1, 2006, NCI Industries, Inc. was indebted to First Federal Bank under a $240,000, 10% unsecured note. The note was signed January 1, 2002, and was due December 31, 2007. Annual interest was last paid on December 31, 2004. NCI was experiencing severe financial difficulties and negotiated a restructuring of the terms of the debt agreement. First Federal agreed to reduce last year's interest and the remaining two years' interest payments to $11,555 each and delay all payments until December 31, 2007, the maturity date.

Required:

Prepare the journal entries by First Federal Bank necessitated by the restructuring of the debt at

1. January 1, 2006.
2. December 31, 2006.
3. December 31, 2007.

PROBLEMS

available with McGraw-Hill's Homework Manager www.mhhe.com/spiceland4e

An alternate exercise and problem set is available on the text website: www.mhhe.com/spiceland4e

P 12–1
Securities held-to-maturity; bond investment; effective interest

● LO1

Fuzzy Monkey Technologies, Inc. purchased as a long-term investment $80 million of 8% bonds, dated January 1, on January 1, 2006. Management has the positive intent and ability to hold the bonds until maturity. For bonds of similar risk and maturity the market yield was 10%. The price paid for the bonds was $66 million. Interest is received semiannually on June 30 and December 31. Due to changing market conditions, the fair value of the bonds at December 31, 2006, was $70 million.

Required:

1. Prepare the journal entry to record Fuzzy Monkey's investment on January 1, 2006.
2. Prepare the journal entry by Fuzzy Monkey to record interest on June 30, 2006 (at the effective rate).
3. Prepare the journal entries by Fuzzy Monkey to record interest on December 31, 2006 (at the effective rate).
4. At what amount will Fuzzy Monkey report its investment in the December 31, 2006, balance sheet? Why?

P 12–2
Securities available-for-sale; bond investment; effective interest

● LO2

(Note: This problem is a variation of the preceding problem, modified to cause the investment to be in securities available-for-sale.)

Fuzzy Monkey Technologies, Inc. purchased as a long-term investment $80 million of 8% bonds, dated January 1, on January 1, 2006. Management intends to have the investment available for sale when circumstances warrant. For bonds of similar risk and maturity the market yield was 10%. The price paid for the bonds was $66 million. Interest is received semiannually on June 30 and December 31. Due to changing market conditions, the fair value of the bonds at December 31, 2006, was $70 million.

Required:

1. Prepare the journal entry to record Fuzzy Monkey's investment on January 1, 2006.
2. Prepare the journal entry by Fuzzy Monkey to record interest on June 30, 2006 (at the effective rate).
3. Prepare the journal entries by Fuzzy Monkey to record interest on December 31, 2006 (at the effective rate).
4. At what amount will Fuzzy Monkey report its investment in the December 31, 2006, balance sheet? Why? Prepare any entry necessary to achieve this reporting objective.

P 12–3
Various transactions related to securities available-for-sale

● LO2

The following selected transactions relate to investment activities of Ornamental Insulation Corporation. The company buys securities, *not* intending to profit from short-term differences in price and *not* necessarily to hold debt securities to maturity, but to have them available for sale when circumstances warrant. Ornamental's fiscal year ends on December 31. No investments were held by Ornamental on December 31, 2005.

2006

Feb. 21	Acquired Distribution Transformers Corporation common shares costing $400,000.
Mar. 18	Received cash dividends of $8,000 on the investment in Distribution Transformers common shares.
Sep. 1	Acquired $900,000 of American Instruments' 10% bonds at face value.
Oct. 20	Sold the Distribution Transformers shares for $425,000.
Nov. 1	Purchased M&D Corporation common shares costing $1,400,000.
Dec. 31	Recorded any necessary adjusting entry(s) relating to the investments. The market prices of the investments are:

American Instruments bonds	$ 850,000
M&D Corporation shares	$1,460,000

(Hint: Interest must be accrued for the American Instruments' bonds.)

2007

Jan. 20	Sold the M&D Corporation shares for $1,485,000.
Mar. 1	Received semiannual interest of $45,000 on the investment in American Instruments bonds.
Aug. 12	Acquired Vast Communication common shares costing $650,000.
Sept. 1	Received semiannual interest of $45,000 on the investment in American Instruments bonds.
Dec. 31	Recorded any necessary adjusting entry(s) relating to the investments. The market prices of the investments are:

Vast Communication shares	$670,000
American Instruments bonds	$830,000

Required:

1. Prepare the appropriate journal entry for each transaction or event during 2006.
2. Indicate any amounts that Ornamental Insulation would report in its 2006 balance sheet and income statement as a result of these investments.
3. Prepare the appropriate journal entry for each transaction or event during 2007.
4. Indicate any amounts that Ornamental Insulation would report in its 2007 balance sheet and income statement as a result of these investments.

P 12–4
Various transactions relating to trading securities

● LO3

American Surety and Fidelity buys and sells securities expecting to earn profits on short-term differences in price. For the first 11 months of the year, gains from selling trading securities totaled $8 million, losses were $11 million, and the company had earned $5 million in investment revenue. The following selected transactions relate to American's trading account during December, 2006, and the first week of 2007. The company's fiscal year ends on December 31. No trading securities were held by American on December 1, 2006.

2006	
Dec. 12	Purchased FF&G Corporation bonds for $12 million.
13	Purchased 2 million Ferry Intercommunications common shares for $22 million.
15	Sold the FF&G Corporation bonds for $12.1 million.
22	Purchased U.S. Treasury bills for $56 million and Treasury bonds for $65 million.
23	Sold half the Ferry Intercommunications common shares for $10 million.
26	Sold the U.S. Treasury bills for $57 million.
27	Sold the Treasury bonds for $63 million.
28	Received cash dividends of $200,000 from the Ferry Intercommunications common shares.
31	Recorded any necessary adjusting entry(s) and closing entries relating to the investments. The market price of the Ferry Intercommunications stock was $10 per share.
2007	
Jan. 2	Sold the remaining Ferry Intercommunications common shares for $10.2 million.
5	Purchased Warehouse Designs Corporation bonds for $34 million.

Required:

1. Prepare the appropriate journal entry for each transaction or event during 2006.
2. Indicate any amounts that American would report in its 2006 balance sheet and income statement as a result of these investments.
3. Prepare the appropriate journal entry for each transaction or event during 2007.

P 12–5
Securities held-to-maturity, securities available for sale, and trading securities

● LO1 LO2 LO3

eXcel

Amalgamated General Corporation is a consulting firm that also offers financial services through its credit division. From time to time the company buys and sells securities intending to earn profits on short-term differences in price. The following selected transactions relate to Amalgamated's investment activities during the last quarter of 2006 and the first month of 2007. The only securities held by Amalgamated at October 1 were $30 million of 10% bonds of Kansas Abstractors, Inc. purchased on May 1 at face value. The company's fiscal year ends on December 31.

2006	
Oct. 18	Purchased 2 million preferred shares of Millwork Ventures Company for $58 million as a speculative investment to be sold under suitable circumstances.
31	Received semiannual interest of $1.5 million from the Kansas Abstractors bonds.
Nov. 1	Purchased 10% bonds of Holistic Entertainment Enterprises at their $18 million face value, to be held until they mature in 2013. Semiannual interest is payable April 30 and October 31.
1	Sold the Kansas Abstractors bonds for $28 million because rising interest rates are expected to cause their fair value to continue to fall.
Dec. 1	Purchased 12% bonds of Household Plastics Corporation at their $60 million face value, to be held until they mature in 2023. Semiannual interest is payable May 31 and November 30.
20	Purchased U. S. Treasury bonds for $5.6 million as trading securities, hoping to earn profits on short-term differences in prices.
21	Purchased 4 million common shares of NXS Corporation for $44 million as trading securities, hoping to earn profits on short-term differences in prices.
23	Sold the Treasury bonds for $5.7 million.
29	Received cash dividends of $3 million from the Millwork Ventures Company preferred shares.
31	Recorded any necessary adjusting entry(s) and closing entries relating to the investments. The market price of the Millwork Ventures Company preferred stock was $27.50 per share and $11.50 per share for the NXS Corporation common. The fair values of the bond investments were $58.7 million for Household Plastics Corporation and $16.7 million for Holistic Entertainment Enterprises.
2007	
Jan. 7	Sold the NXS Corporation common shares for $43 million.

Required:

Prepare the appropriate journal entry for each transaction or event.

P 12–6
Securities available-for-sale; fair value adjustment; reclassification adjustment

● LO2

At December 31, 2006, the investments in securities available-for-sale of Beale Developments were reported at $78 million:

Securities available-for-sale	$74	
Plus: Fair value adjustment	4	$78

During the year, Beale sold its investment in Schwab Pharmaceuticals, which had cost $25 million, for $28 million. Those shares had a fair value at December 31, 2006, of $27 million. No other investments were sold. At December 31, 2007, the investments in securities available-for-sale included the cost and fair value amounts shown below.

($ in millions) Securities Available-for-Sale	Cost	Fair Value	Unrealized Gain (Loss)
Daisy Theaters, Inc. shares	$40	$42	$2
Orpheum Entertainment bonds	9	12	3
Totals	$49	$54	$5

Required:

1. At what amount should Beale report its securities available-for-sale in its December 31, 2007, balance sheet?
2. What journal entry is needed to enable the investment to be reported at this amount?
3. What is the amount of the reclassification adjustment to 2007 other comprehensive income? Show how the reclassification adjustment should be reported.

P 12–7
Investment securities and equity method investments compared

● LO2 LO4 LO5 LO6

eXcel

On January 4, 2006, Runyan Bakery paid $324 million for 10 million shares of Lavery Labeling Company common stock. The investment represents a 30% interest in the net assets of Lavery and gave Runyan the ability to exercise significant influence over Lavery's operations. Runyan received dividends of $2.00 per share on December 15, 2006, and Lavery reported net income of $160 million for the year ended December 31, 2006. The market value of Lavery's common stock at December 31, 2006, was $31 per share. On the purchase date, the book value of Lavery's net assets was $800 million and:

a. The fair market value of Lavery's depreciable assets, with an average remaining useful life of six years, exceeded their book value by $80 million.
b. The remainder of the excess of the cost of the investment over the book value of net assets purchased was attributable to goodwill.

Required:

1. Prepare all appropriate journal entries related to the investment during 2006, assuming Runyan accounts for this investment by the equity method.
2. Prepare the journal entries required by Runyan, assuming that the 10 million shares represents a 10% interest in the net assets of Lavery rather than a 30% interest.

P 12–8
Equity method

● LO5 LO6

eXcel

Northwest Paperboard Company, a paper and allied products manufacturer, was seeking to gain a foothold in Canada. Toward that end, the company bought 40% of the outstanding common shares of Vancouver Timber and Milling, Inc. on January 2, 2006, for $400 million.

At the date of purchase, the book value of Vancouver's net assets was $775 million. The book values and fair values for all balance sheet items were the same except for inventory and plant facilities. The fair value exceeded book value by $5 million for the inventory and by $20 million for the plant facilities.

The estimated useful life of the plant facilities is 16 years. All inventory acquired was sold during 2006.

Vancouver reported net income of $140 million for the year ended December 31, 2006. Vancouver paid a cash dividend of $30 million.

Required:

1. Prepare all appropriate journal entries related to the investment during 2006.
2. What amount should Northwest report as its income from its investment in Vancouver for the year ended December 31, 2006?
3. What amount should Northwest report in its balance sheet as its investment in Vancouver?
4. What should Northwest report in its statement of cash flows regarding its investment in Vancouver?

P 12–9
Equity method

● LO5 LO6

On January 2, 2006, Miller Properties paid $19 million for 1 million shares of Marlon Company's 6 million outstanding common shares. Miller's CEO became a member of Marlon's board of directors during the first quarter of 2006.

The carrying amount of the Marlon's net assets was $66 million. Miller estimated the fair value of those net assets to be the same except for a patent valued at $24 million over cost. The remaining amortization period for the patent is 10 years.

Marlon reported earnings of $12 million and paid dividends of $6 million during 2006. On December 31, 2006, Marlon's common stock was trading on the NYSE at $18.50 per share.

Required:

1. When considering whether to account for its investment in Marlon under the equity method, what criteria should Miller's management apply?
2. Assume Miller accounts for its investment in Marlon using the equity method. Ignoring income taxes, determine the amounts related to the investment to be reported in its 2006:
   a. Income statement.
   b. Balance sheet.
   c. Statement of cash flows.

P 12–10
Classifying investments

● LO1 through LO5

Indicate (by letter) the way each of the investments listed below most likely should be accounted for based on the information provided.

Item	Reporting Category
____ 1. 35% of the nonvoting preferred stock of American Aircraft Company.	T. Trading securities
	M. Securities held-to-maturity
____ 2. Treasury bills to be held to maturity.	A. Securities available-for-sale
____ 3. Two-year note receivable from affiliate.	E. Equity method
____ 4. Accounts receivable.	C. Consolidation
____ 5. Treasury bond maturing in one week.	N. None of these
____ 6. Common stock held in trading account for immediate resale.	
____ 7. Bonds acquired to profit from short-term differences in price.	
____ 8. 35% of the voting common stock of Computer Storage Devices Company.	
____ 9. 90% of the voting common stock of Affiliated Peripherals, Inc.	
____ 10. Corporate bonds of Primary Smelting Company to be sold if interest rates fall ½%.	
____ 11. 25% of the voting common stock of Smith Foundries Corporation: 51% family-owned by Smith family; fair value determinable.	
____ 12. 17% of the voting common stock of Shipping Barrels Corporation: Investor's CEO on the board of directors of Shipping Barrels Corporation.	

P 12–11
Impairment of securities available-for-sale; troubled debt restructuring (Based on Appendix 12B)

● LO2

eXcel

At January 1, 2006, Rothschild Chair Company, Inc. was indebted to First Lincoln Bank under a $20 million, 10% unsecured note. The note was signed January 1, 2000, and was due December 31, 2009. Annual interest was last paid on December 31, 2004. Rothschild Chair Company was experiencing severe financial difficulties and negotiated a restructuring of the terms of the debt agreement.

Required:

Prepare all journal entries by First Lincoln Bank to record the restructuring and any remaining transactions relating to the debt under each of the independent circumstances below:

1. First Lincoln Bank agreed to settle the debt in exchange for land having a fair market value of $16 million but carried on Rothschild Chair Company's books at $13 million.
2. First Lincoln Bank agreed to (a) forgive the interest accrued from last year, (b) reduce the remaining four interest payments to $1 million each, and (c) reduce the principal to $15 million.
3. First Lincoln Bank agreed to defer all payments (including accrued interest) until the maturity date and accept $27,775,000 at that time in settlement of the debt.

BROADEN YOUR PERSPECTIVE

Apply your critical-thinking ability to the knowledge you've gained. These cases will provide you an opportunity to develop your research, analysis, judgment, and communication skills. You also will work with other students, integrate what you've learned, apply it in real world situations, and consider its global and ethical ramifications. This practice will broaden your knowledge and further develop your decision-making abilities.

Real World Case 12–1
Sprint's investments

● LO2

The following disclosure note appeared in the 2004 annual report of the **Sprint Corporation**.

Investments in Equity Securities (in part)
The cost of investments in marketable equity securities, primarily consisting of **EarthLink** common stock, was $90 million and $134 million at year-end 2004 and 2003, respectively. Accumulated unrealized holding gains were $42 million (net of $25 million tax) at year-end 2004. Comparatively, at year-end 2003, the accumulated unrealized holding gains were $38 million (net of $23 million tax). Accumulated unrealized holding gains were included in Accumulated other comprehensive income (loss) on the Consolidated Balance Sheets.

At year-end 2004, Sprint held 12.3 million shares of EarthLink common stock, down from 18.9 million shares at year-end 2003. These securities were reflected in Other assets on the Consolidated Balance Sheets.

In the 2004 fourth quarter, . . . , 5.6 million shares were used to settle . . . forward contracts. Sprint sold an additional 1.0 million shares in the open market. Sprint recognized a $10.8 million gain on these transactions.

Required:
1. From the information provided by the disclosure note, determine the amount at which Sprint reported its investment in Earthlink common stock in its 2004 balance sheet.
2. What would have been Sprint's journal entry to reflect the 2004 fair value of the investments? Ignore taxes.
3. The note indicates that Sprint sold one million shares, producing a $10.8 million gain. Does this imply that the securities involved had not previously been adjusted to fair value? Why? What would have been the journal entry to record the sale of the one million shares in 2004 if we assume that $1.5 million of the gain pertained to those shares and that Sprint used the average cost method to determine the cost of the shares sold?

Research Case 12–2
Reporting securities available-for-sale; obtain and critically evaluate an annual report

● LO2

Investments in common stocks potentially affect each of the various financial statements as well as the disclosure notes that accompany those statements.

Required:
1. Locate a recent annual report of a public company that includes a footnote that describes an investment in securities available-for-sale. You can use EdgarScan at **edgarscan.pwcglobal.com**.
2. Under what caption are the investments reported in the comparative balance sheets? Are they reported as current or noncurrent assets?
3. Are realized gains or losses reported in the comparative income statements?
4. Are unrealized gains or losses reported in the comparative statements and shareholders' equity?
5. Are unrealized gains or losses identifiable in the comparative balance sheets? If so, under what caption? Why are unrealized gains or losses reported here rather than in the income statements?
6. Are cash flow effects of these investments reflected in the company's comparative statements of cash flows? If so, what information is provided by this disclosure?
7. Does the footnote provide information not available in the financial statements?

Integrating Case 12–3
How was the adoption of *SFAS 115* an exception to the usual method of accounting for changes in accounting principle?

● LO1 LO2 LO3

In Chapter 4 you learned that most changes in accounting principle require retrospective application of the new method in years prior to the change. Some changes mandated by new FASB accounting standards require neither of those approaches, and instead require or permit *prospective* application of the new standard. An example of this exception is *SFAS 115,* "Accounting for Certain Investments in Debt and Equity Securities." Recall that the standard requires that certain investments that previously were reported at lower of cost or market were required by the new standard to be reported instead at their fair values.

Required:
Explain how *SFAS 115* is an exception to the general method of accounting for changes in accounting principle.

Trueblood Accounting Case 12–4
Equity method

● LO2

The following Trueblood case is recommended for use with this chapter. The case provides an excellent opportunity for class discussion, group projects, and writing assignments. The case, along with Professor's Discussion Material, can be obtained from the Deloitte Foundation at its website: **www.deloitte.com/us/truebloodcases**.

Case: 03–10: *Painless, Inc.*

This case gives students an opportunity to discuss whether and how the equity method should ever be applied to preferred stock investments.

International Case 12–5
Comparison of investment accounting in France and the United States

- LO1 through LO5

Renault is the largest automobile manufacturer in France. The investment disclosures accompanying financial statements in Renault's 2003 annual report are reproduced below:

Accounting Policies (in part)
N. Securities
Equity securities
Equity investments in non-consolidated companies are carried in the balance sheet at acquisition cost less any provisions. The corresponding dividends are recorded in the year of distribution.

Provisions are established when the value in use of the investments falls below acquisition cost. The value in use is determined on the basis of profitability prospects, the commercial outlets the investment represents for the Group, and the share in net assets.

Debt securities
Debt securities consist entirely of fixed-rate securities acquired to be held on a long-term basis, usually until maturity. They are hedged by interest rate futures for durable protection against foreign exchange exposure, or by long-term financing to ensure they can be held until maturity.

Discounts and premiums are spread over the remaining life of the security on a straight-line basis. Provisions for amortization are established when the issuer is likely to default.

Marketable securities
Marketable securities are valued at acquisition cost excluding related expenses and accrued interest for bonds, or at market value if this is lower.

Required:
On the basis of the information the disclosures provide, compare accounting for investments in France with that in the United States.

Research Case 12–6
Researching the way investments are reported; retrieving information from the Internet

- LO1 LO2 LO3

All publicly traded domestic companies use EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, to make the majority of their filings with the SEC. You can access EDGAR on the Internet at **www.sec.gov**, or you can use EdgarScan at **edgarscan.pwcglobal.com**.

Required:
1. Search for a public company with which you are familiar. Access its most recent 10-K filing. Search or scroll to find financial statements and related notes.
2. Answer the following questions. (If the chosen company does not report investments in the securities of other companies, choose another company.)
   a. What is the amount and classification of any investment securities reported in the balance sheet? Are unrealized gains or losses reported in the shareholders' equity section?
   b. Are any investments reported by the equity method?
   c. What amounts from these investments are reported in the comparative income statements? Has that income increased or decreased over the years reported?
   d. Are any acquisitions or disposals of investments reported in the statement of cash flows?

Real World Case 12–7
Merck's investments

- LO2

Corporations frequently invest in securities issued by other corporations. Some investments are acquired to secure a favorable business relationship with another company. On the other hand, others are intended only to earn an investment return from the dividends or interest the securities pay or from increases in the market prices of the securities—the same motivations that might cause you to invest in stocks, bonds, or other securities. This diversity in investment objectives means no single accounting method is adequate to report every investment.

Merck & Co., Inc. invests in securities of other companies. Access the most recent financial statements of Merck using EdgarScan (**edgarscan.pwcglobal.com/**).

Required:
1. What is the amount and classification of any investment securities reported on the balance sheet? In which current and noncurrent asset categories are investments reported by Merck? What criteria are used to determine the classifications?
2. How are unrealized gains or losses reported? realized gains and losses?
3. Are any investments reported by the equity method?
4. What amounts from these investments are reported in the comparative income statements?
5. Are cash flow effects of these investments reflected in the company's comparative statements of cash flows? If so, what information is provided by this disclosure?

Real World Case 12–8
Comprehensive income—Microsoft

● LO2

As required by *SFAS No. 115,* **Microsoft Corporation** reports its investments available-for-sale at the *fair value* of the investment securities. The *net* unrealized holding gain is not reported in the income statement. Instead, it's reported as part of Other comprehensive income in shareholders' equity.

Comprehensive income is a broader view of the change in shareholders' equity than traditional net income, encompassing all changes in equity from nonowner transactions. Microsoft chose to report its Other comprehensive income as a separate statement in a disclosure note in its 2004 annual report.

Other Comprehensive Income
The changes in the components of other comprehensive income are as follows:
($ in millions)

Year Ended June 30	2002	2003	2004
Net gains (losses) on derivative instruments	$ (91)	$ (102)	$ 101
Net unrealized investment gains/(losses):			
Unrealized holding gains, net of tax effect of $(955) in 2002, $610 in 2003, and $(994) in 2004	(1,774)	1,132	(1,846)
Reclassification adjustment for losses included in net income, net of tax effect of $958 in 2002, $60 in 2003, and $524 in 2004	1,779	111	973
Net unrealized investment gains/(losses)	5	1,243	(873)
Translation adjustments and other	82	116	51
Other comprehensive income/(loss)	$ (4)	$1,257	$ (721)

Required:

1. The note indicates Unrealized holding losses during 2004 in the amount of $1,846 million. Is this the amount Microsoft would include as a separate component of shareholders' equity? Explain.
2. What does Microsoft mean by the term, "Reclassification adjustment for gains included in net income"?
3. Microsoft's disclosure note refers to "Translation adjustments and other." What might the "other" components of Other comprehensive income be?

CPA SIMULATION 12–1

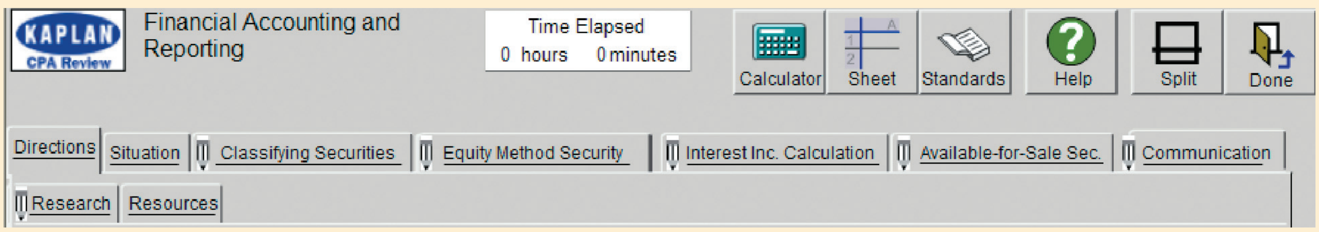
Barbados Investments
Investments

KAPLAN
CPA Review

Test your knowledge of the concepts discussed in this chapter, practice critical professional skills necessary for career success, and prepare for the computer-based CPA exam by accessing our CPA simulations at the text website: **www.mhhe.com/spiceland4e**.

The Barbados Investments simulation tests your knowledge of a) the way we classify investment securities among the categories of trading securities, available-for-sale securities, and those held-to-maturity, b) how we account for those investments, c) the way accounting for investments affects comprehensive income, and d) the appropriate use of the equity method.

As on the CPA exam itself, you will be asked to use tools including a spreadsheet, a calculator, and professional accounting standards, to conduct research, derive solutions, and communicate conclusions related to these issues in a simulated environment headed by the following interactive tabs:



Specific tasks in the simulation include:

- Analyzing various transactions involving investment securities and determining their appropriate balance sheet classification.
- Applying judgment in the application of the equity method.
- Determining the amount of interest revenue to be reported from a debt investment.
- Demonstrating an understanding of comprehensive income and how it is affected by investments in securities.
- Communicating the way we account for investments using the equity method.
- Researching the financial reporting ramifications of changing the classification of investment securities.