appendix

D

Investments

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

OPENING COMMENTS

Appendix D discusses the various ways businesses can invest excess cash with the goal of earning additional cash. These investments can include interest earned on deposits such as CDs, investment in notes and bonds, or investment in stocks. These investments can be short term or long term, depending on the need of each individual business. The motivations can range from receiving a higher return on their money than they can earn by leaving the cash in the bank to taking over the control of another company. This appendix introduces students to these various options and discusses the accounting methods for each investment.

KEY TERMS

available-for-sale securities

business combination

consolidated financial statements

debt securities

equity method

equity securities

fair value

fair value method

held-to-maturity securities

investee

investments

investor

parent company

subsidiary company

trading securities

unrealized gain or loss

STUDENT FAQS

* Why are investments in stock considered equity investments and investments in bonds considered debt investments?
* Why do the methods of accounting change for different levels of investment in another company?
* Why are there so many different rules for different investments? Wouldn’t it be easier if there were just one way to record investments?
* What does “fair value” accounting mean?
* Why do some items get “special presentation” on the income statement? It doesn’t change the bottom line, so what difference does it make?
* I thought we booked only realized activities in accounting, such as revenue being recorded when realized or realizable. So why do we now record these unrealized gains and losses? Shouldn’t we wait until they are realized?
* Aren’t we showing unrealized gains or losses twice—once under assets along with the temporary investment and again as part of comprehensive income? Isn’t this “double dipping”?
* If you can show unrealized gains on some things, why can’t you show an unrealized gain when property goes up in value?

Investments

# SYNOPSIS

A company may have excess cash at certain times of the year that are not needed for current operations. Instead of letting the cash sit idle, most companies invest their excess cash in temporary investments. Companies can invest in debt securities or equity securities. These investments are reported in the current asset section of the balance sheet. The objective of this investing is to earn interest revenue, receive dividends, and realize gains from increases in the market price of the securities. Long-term investments made by companies have other purposes, such as reduction of costs, replacement of management, expansion, and integration.

# *Key Terms and Definitions*

* **Debt Securities:** Notes and bond investments that provide interest revenue over a fixed maturity.
* **Equity Securities:** The common and preferred stock of a company that do not have a fixed maturity date.
* **Investments:** The balance sheet caption used to report long-term investments in stocks not intended as a source of cash in the normal operations of the business.

# SUGGESTED APPROACH

This section provides an overview of ways businesses can invest cash such as in current operations, short-term investments, and long-term investments.

# LECTURE AID—Why Companies Invest

Present students with the following scenario: B-Squared Textiles at year-end has $150,000 in excess cash. Ask students what they would do with this money to better the business’s financial position for the future. List the options on the board, and discuss why or why not each option might be ideal, depending on various conditions the company might be experiencing. For example, if the company is behind technologically, it may want or need to invest in current operations. If the company is heavily in debt, it may wish to pay off some of that debt. If the company is in good shape in these areas, it can choose between short-term or long-term investments to improve the future position of the business.

# GROUP LEARNING ACTIVITY—Investing Cash

Ask your students to work in groups to determine the best way to invest cash for the following companies.

| Company  | Cash | Condition |
| --- | --- | --- |
| Company 1 | $700,000 | Very competitive in industryUp to date with technologyNo major debtLacks market share |
| Company 2 | $250,000 | Outdated technology Market share goodNo major debt |
| Company 3 | $100,000 | No current operations needsConservative outlookConcerned about future economic outlook |
| Company 4 | $500,000 | Aggressive managementLeading-edge reputationNo major debtNo current operating needs |

Be prepared to discuss where to invest and why.

Equity Investments

# SYNOPSIS

A corporation sometimes purchases the stock of another corporation as an investment. The purchaser is known as the investor, and the company whose stock was purchased is called the investee. If the investor buys less than 20% of the investee’s stock, the investor has no control over the investee. It is assumed that the purchase was primarily to earn dividends and realize gains on stock price increases. Investments of less than 20% are accounted for by the fair value method. If the investor purchases between 20% and 50% of the investee’s stock, the investor is considered to have a significant influence and the transactions must be accounted for by the equity method. Under the equity method, the initial purchase is journalized the same as the cost method. However, the investor’s share of the net income and dividends received are journalized as adjustments to the investment account. If the investor purchases more than 50% of the investee’s stock, the investor is considered to control the investee and the purchase is termed a *business combination*. The investor is the parent company, and the investee is the subsidiary company. Parent and subsidiary often maintain separate records, but at the end of the year, the financial statements are combined and identified as consolidated financial statements.

# *Key Terms and Definitions*

* **Business Combination:** A business making an investment in another business by acquiring a controlling share, often greater than 50%, of the outstanding voting stock of another corporation by paying cash or exchanging stock.
* **Consolidated Financial Statements:** Financial statements resulting from combining parent and subsidiary statements.
* **Equity Method:** A method of accounting for an investment in common stock by which the investment account is adjusted for the investor’s share of periodic net income and cash dividends of the investee.
* **Fair Value Method:** A method of accounting for an equity investment of less than 20% of the investee’s outstanding stock.
* **Investee:** The company whose stock is purchased by the investor.
* **Investor:** The company investing in another company’s stock.
* **Parent Company:** The corporation owning all or a majority of the voting stock of the other corporation.
* **Subsidiary Company:** The corporation that is controlled by a parent company.

# *Relevant Exhibits*

* Exhibit 1: Stock Investments
* Exhibit 2: Investment and Dividends

# SUGGESTED APPROACH

Remind students that businesses invest in equity securities for one of the following reasons:

1. To receive a return on excess cash
2. To develop or maintain a business relationship with another company
3. To gain control of another company

Businesses invest in equity securities by buying stocks either directly from the issuing corporation or from other investors. Purchases from other investors occur through organized stock exchanges (such as the New York Stock Exchange) or over the counter. Use the following Brainstorming Activity to explore the reasons a business would want to acquire control of another business. Securities purchased by a business are classified as trading securities or available-for-sale securities.

After covering the accounting for equity investments, remind students that the sale of stock investments is treated the same in all cases. The difference between the carrying value of the investment and the cash proceeds (sales price less commissions and other selling costs) is recorded as a gain or loss and is included in determining net income.

BRAINSTORMING ACTIVITY—Reasons for Investing in Another Company

Ask your students to brainstorm reasons that a business would want to gain control of another company. While not presented in the text, at this time you may like to discuss the concepts of horizontal and vertical integration.

**Possible response:** Businesses may want to gain control over another company to increase market share, eliminate competition, expand core business, enter new markets, assure priority supply of raw materials, obtain brand name value, obtain existing goodwill, obtain patents held, advance manufacturing technology, obtain distribution channels, gain an international presence, and get personnel resources or for other reasons that would provide a competitive advantage over the competition.

DEMONSTRATION PROBLEM—Equity Investments: Less than 20% Ownership

The accounting for investments in stocks depends on whether the investor has “significant influence” over the investee. The equity method is used whenever an investor has significant influence over the operating and financing activities of another company. The general guideline to determine whether an investor (in this discussion, another company) has a significant influence is the 20% rule. If an investor owns 20–50% or more of a company’s stock, it is presumed that the investor has significant influence and uses the equity method of accounting to report its ownership. If an investor owns over 50% of a company’s stock, it has control of the company and uses the consolidation accounting method. See Exhibit 1 in the text.

If the investor does not have significant influence (owns less than 20% of a company’s stock), the stocks are reported on the balance sheet at their fair value. At the end of the accounting period, an adjusting entry is made to record the increase in the fair value of the investment.

For example, assume that on September 1, Jordan Corporation purchased 1,000 shares of Cumberland, Inc. as a long-term investment at $15 per share plus a brokerage fee of $60. Jordan’s purchase represents less than 20% of the shares of Cumberland, Inc. On October 18, Jordan received a $0.50 per share dividend. On December 31, the shares have a fair value of $18 per share. The journal entries for these events are as follows:

Sept. 1 Investment in Cumberland, Inc. Stock 15,060

 Cash…………………………. 15,060

Oct. 18 Cash………….……………………. 500

 Dividend Revenue…………… 500

Dec. 31 Valuation Allowance for Trading Investments…… 2,940

 Unrealized Gain on Trading Investments…… 2,940

DEMONSTRATION PROBLEM—Equity Investments: 20%–50% Ownership—Equity Method

When a company invests in stock and obtains between 20% and 50% of the outstanding stock of another company, it is deemed to have significant influence over the purchased company. This requires that the equity method be applied to account for this investment.

Under the equity method, the investor records a portion of the investee’s net income as an increase to the investment account. This increase is also recorded as income to the investor. As a result, cash dividends can be viewed as the receipt of the income previously recorded.

For example, assume that Jordan Corporation purchased a 30% interest in Mini-Marts, Inc. for $500,000. For the year ended December 31, Mini-Marts reported net income totaling $100,000. On January 18, Mini-Marts paid a $40,000 cash dividend.

Entry to record the purchase of Mini-Marts, Inc. stock:

 Investment in Mini-Marts, Inc. Stock ………. 500,000

 Cash…………………………………. 500,000

Note that the initial investment is recorded in the same manner whether or not the investor has significant influence over the investee.

Entry to record 30% of Mini-Marts’ net income:

 Investment in Mini-Marts, Inc. Stock ……….. 30,000

 Income of Mini-Marts, Inc. ……………. 30,000

Entry to record receipt of 30% of Mini-Marts’ cash dividend:

 Cash…………………………………………. 12,000

 Investment in Mini-Marts, Inc. Stock…. 12,000

LECTURE AID—Equity Investment: More than 50% Ownership

When a company acquires a controlling interest (normally anything over 50%) in another company through investment in the second company’s stock, it must account for this by consolidation of the statements of the two companies. The text does not pursue consolidation of statements.

However, if you desire to pursue this subject further, discuss the three methods used to combine businesses. Explain that parent–subsidiary relationships are accounted for under the consolidation method. This method accounts for the purchase of a subsidiary company similar to the purchase of other types of assets. The subsidiary’s net assets are reported in the consolidated balance sheet at their fair market values at the time of purchase. If the parent company pays more than the fair value of the subsidiary’s net assets, the difference is recorded as goodwill.

Remind students that consolidated financial statements combine the income statements, balance sheets, and other financial reports of a parent company and its subsidiaries into one set of financial statements. The combined financial statements are more meaningful because, in reality, the parent company controls the subsidiary companies. A parent company accounts for its ownership in a subsidiary using the consolidation method.

Also remind students that intercompany transactions must be eliminated when the financial statements are combined. For example, if the parent company has loaned cash to a subsidiary, the consolidated balance sheet should not show the parent’s receivable or the subsidiary’s payable.

Summarize the steps to consolidate the income statements of two companies.

Debt investments at cost

# SYNOPSIS

The purchase of bonds is recorded as a debit to Investments and a credit to Cash. If the bonds are purchased between interest dates, there may also be a debit to Interest Receivable. When interest is received, Cash is debited and Interest Revenue is credited. Interest revenue is reported on the income statement as Other Revenue. The sale of a bond investment usually results in a gain or loss. If the proceeds exceed the book value (cost) of the bonds, a gain is recorded. If the amount received at the sale is less than the book value, a loss is recorded.

# *Relevant Exhibit*

* Exhibit 3: Interest Timeline

# SUGGESTED APPROACH

Debt securities include notes and bonds available as investments. Students should be familiar with the terms *premium* and *discount* from Chapter 11 in relation to bonds. This section focuses on the journal entries to record the purchase, interest earned/accrued, and sale of bonds held for short-term investments.

DEMONSTRATION PROBLEM—Accounting for Debt Investments

On May 31, 20Y7, Bellbugg Enterprises invested $60,000 in Johnsonville municipal bonds that pay 8% interest semiannually on June 30 and December 31 each year. Journalize the entries to record the purchase of the bonds. Be sure to include the interest accrued.

Record the journal entry for the interest paid on June 30 and the interest revenue on December 31.

On March 1 of the following year, the bonds are sold for 97.5. Record the journal entry for the sale.

INTERNET ACTIVITY—Investing in Bonds

After learning all the intricacies of accounting for bonds, your students may enjoy learning about opportunities to invest in bonds. You may want to refer them to the following website:

 http://www.investinginbonds.com/

Reporting Investments

SYNOPSIS

Trading securities are purchased for their short-term profit potential and reported as current assets. At the end of the period, these assets may be adjusted to their fair market value due to the objective nature of their reported price. Any increase in their value is recorded as an unrealized gain on the income statement and as their fair market value on the balance sheet. The accounting for available-for-sale securities is similar to the accounting for trading securities. Differences include the recording of changes in the fair market value. Changes in the fair market value are recorded in a stockholder’s equity account and excluded from the income statement. A credit balance in Unrealized Gain (Loss) on Available-for-Sale Investments is added to stockholder’s equity and a debit balance is subtracted. Securities held to maturity are debt investments (bonds) that the company intends to hold until the due date. If the maturity date is within a year, it is classified as a current asset. If it is longer than a year, the asset is a noncurrent asset. Held-to-maturity bonds are reported at their amortized cost. A summary of the valuing and reporting of investments is illustrated in Exhibit 4.

# *Key Terms and Definitions*

* **Available-for-Sale Securities:** Securities that management expects to sell in the future but that are not actively traded for profit.
* **Fair Value:** The price that would be received for selling an asset or paying off a liability, often the market price for an equity or debt security.
* **Held-to-Maturity Securities:** Investments in bonds or other debt securities that management intends to hold to their maturity.
* **Trading Securities:** Securities that management intends to actively trade for profit.
* **Unrealized Gain or Loss:** Changes in the fair value of equity or debt securities for a period.

# *Relevant Exhibit*

* Exhibit 4: Summary of Valuing and Reporting of Investments

# SUGGESTED APPROACH

Exhibit 4 in the text is an excellent summary of the information provided in this section. Investments are categorized based on the intention of the investment. The three categories are as follows:

1. Trading securities
2. Available-for-sale securities
3. Held-to-maturity securities

Trading securities are current assets intended for short-term investments. The goal is to achieve a higher rate of return than otherwise available through holding cash. Typically this involves investing in stocks that can easily be converted to cash as necessary. The return is provided through dividends and increase of the stock value. The accounting for trade securities involves adjusting the asset value to reflect the true market value as it changes. Market value can easily be determined through currently traded stock prices. The value is adjusted up (unrealized gain) or down (unrealized loss) using a contra account called Valuation Allowance for Trading Investments. Gains cause the account to be debited, and losses cause the account to be credited. The Value Allowance account appears on the balance sheet and is used to adjust the value of the asset up or down to the market value on the balance sheet. Unrealized gains or losses are reported on the income statement.

DEMONSTRATION PROBLEM—Trading Securities

First, cover the difference between a short-term and a long-term investment in stocks. An investment can be considered short-term (a temporary investment) if two conditions are met: (1) the securities are readily marketable and can be sold for cash at any time and (2) management intends to sell the securities when the business needs cash for operations.

Your students will need to know how to record the purchase of short-term stock investments and the receipt of dividends. Before presenting the journal entries, ask your students to use their accounting knowledge to “guess” how the following transactions would be journalized.

Jordan Corporation purchased 1,000 shares of ATE Inc. common stock as a temporary investment on June 1 for a total cost of $38,500.

**Correct answer:**

June 1 Trading Investments—ATE Inc.……..… 38,500

 Cash………………………………. 38,500

Stress that an investment in equity securities is recorded at cost, including any broker’s commissions.

Next, ask your students to record the following transaction in their notes: On September 30, Jordan received a $1 per share cash dividend on its ATE Inc. common stock. This dividend was declared on August 15.

**Correct answer:**

Sept. 30 Cash…………………………...……..… 1,000

 Dividend Revenue.………………. 1,000

LECTURE AID—Available-for-Sale Securities

Available-for-sale securities are debt and equity securities that are neither held for trading, held to maturity, nor held for strategic reasons. The accounting for these is similar to the accounting for trading securities except for the reporting of changes in fair value. Changes in fair value of trading securities are reported on the income statement as unrealized gains or losses. Changes in fair value of available-for-sale securities are reported in the Stockholders’ Equity section of the balance sheet. Compare and contrast the differences between trading securities and available-for-sale securities. Trading securities affect stockholders’ equity by affecting net income on the income statement, while available-for-sale securities directly impact stockholders’ equity and do not affect net income. Exhibit 4 is an excellent summary of the accounting treatment for trading securities, available-for-sale securities, and held-to-maturity securities.

LECTURE AID—Held-to-Maturity Securities

Held-to-maturity securities are typically notes or bonds purchased for the interest they provide as income. The intent is to purchase the security and hold it until the maturity date. Revenue is generated through the interest payments received. The calculations for present value and interest revenue mirror those provided in Chapter 11 for issuing bonds.

When a bond is purchased as an investment, it is recorded in “Investment in Bonds,” an asset account. Interest received is recognized as interest revenue. Any premium or discount on the bond purchase must be amortized. Contrast the effect of amortizing a premium or discount on bond investments and bonds payable (Chapter 11). Use the following Demonstration Problems to illustrate journal entries for bond investments.

DEMONSTRATION PROBLEM—Investment in Bonds

Smyth Company purchased a $1,000 bond of Whitney Corporation on March 1 at 84 plus a $15 broker fee and accrued interest. The bond pays 12% interest semiannually, on December 31 and June 30.

Accrued Interest: Assuming that Smyth still owns the bond on June 30, it will receive a $60 check from Whitney Corporation for six months’ interest. However, Smyth owned the bond for only four months (March to June). The first two months’ interest should go to the person who owned the bond before Smyth.

To solve this problem, Smyth will pay the previous owner for two months of interest ($20) when purchasing the bond. When Smyth receives the full six-month interest payment at the end of June, the company will be reimbursed for the two months of interest paid to the previous bond owner.

The journal entry to record this bond purchase:

 Investment in Bonds ($840 + $15)…… 855

 Interest Revenue………………………. 20

 Cash…………………………….. 875

The journal entry to record receipt of the first interest payment:

 Cash…………………………………… 60

 Interest Revenue………………… 60

The accrued interest paid to the previous bondholder was debited to the interest revenue account, establishing a negative balance in that account. The entire six-month interest payment was credited to the interest revenue account when it was received. This leaves an account balance of $40, the four months of interest that Smyth earned by holding the bond March 1 through June 30.

 Interest Revenue

 Interest paid to

 previous owner 20

 60 Six-month interest payment

 40 Four months’ interest earned by Smyth

Amortization of the Discount: Smyth purchased the Whitney Corporation bond at a discount. Even though Smyth paid only $840 for the bond, the company will receive the full $1,000 face value if the bond is held to maturity. Therefore, the $160 discount actually represents additional interest that Smyth will earn over the term of the bond. Therefore, Smyth must amortize the discount as additional interest revenue.

Point out that discounts (and premiums) on bonds held as investments are not recorded in separate discount or premium accounts. They are included in the investment account. In addition, most companies amortize any discount or premium on bonds held as investments at the end of the year rather than when interest payments are received.

Assume that Smyth determines it should amortize $33 of the bond discount at the end of the first year. The journal entry to amortize the discount:

 Investment in Bonds…………………….. 33

 Interest Revenue…………………. 33

Notice that the amortization of the discount increases both the investment in bonds and the interest revenue accounts. The balance in the Investment in Bonds account after amortization of the discount is $888, as illustrated in the following T-account:

 Investment in Bonds

 Beginning balance 855

 Discount amortized 33

 Ending balance 888

When the discount is fully amortized, the balance in the Investment in Bonds account will be $1,000. This is the amount of principal that will be paid to Smyth at maturity.

Ask your students the following question: Does the amortization of a premium on a bond investment increase or decrease interest income? (Answer: decrease)

DEMONSTRATION PROBLEM—Sale of a Bond Investment

Assume that Smyth holds the bond purchased in the previous problem for three years. At the end of the third year, the bond is sold for $1,150 plus accrued interest of $50. The carrying value of the bond (including amortization of the premium) is $968. Note that the amortization of bond premium or discount should be brought up to date before recording the sale of a bond investment. The journal entry to record the sale:

 Cash………………………………… 1,200

 Interest Revenue……………. 50

 Investment in Bonds…….….. 968

 Gain on Sale of Investments… 182