

Financial Accounting: Tools for Business Decision Making

Eighth Edition

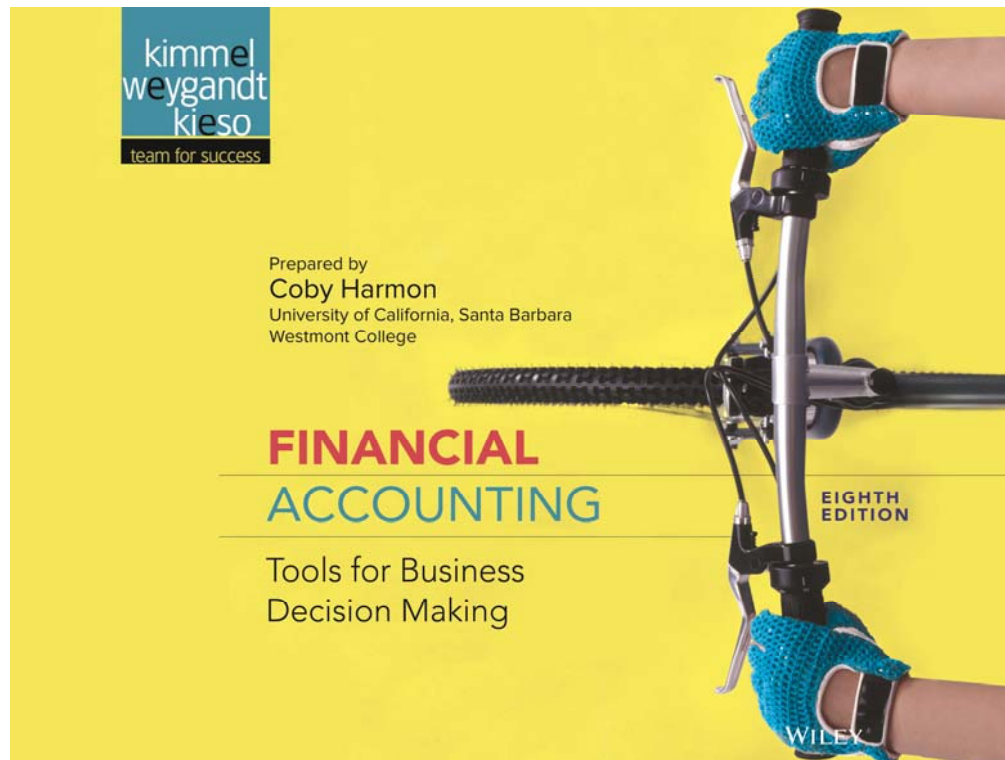
Kimmel • Weygandt • Kieso



Chapter H

Reporting and Analyzing Investments

Financial Accounting: Tools for Business Decision Making



Chapter Outline:

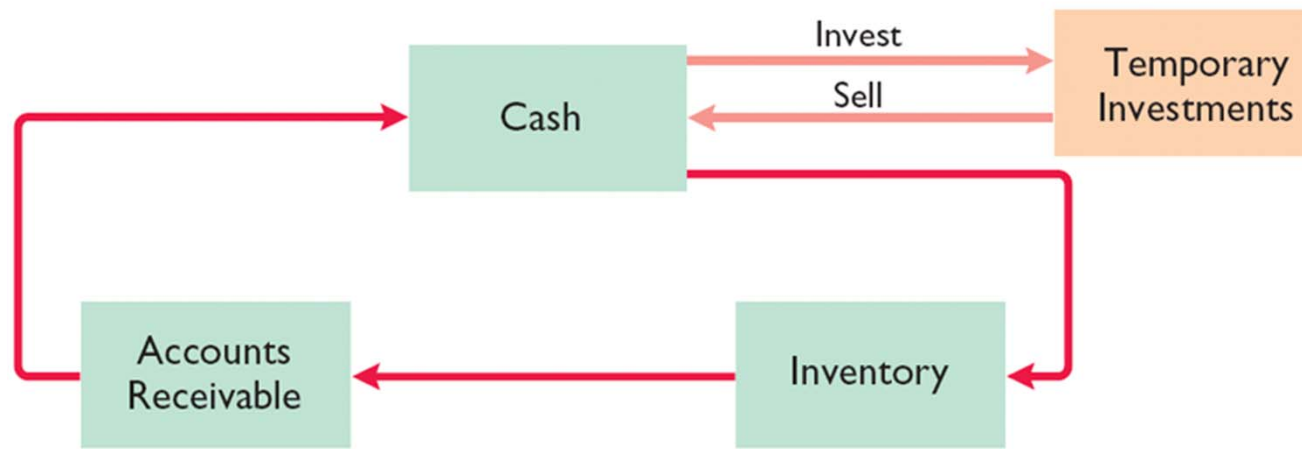
Learning Objectives

1. Explain how to account for debt investments.
2. Explain how to account for stock investments.
3. Discuss how debt and stock investments are reported in the financial statements.

LO 1: Explain How to Account for Debt Investments

Corporations purchase investments in debt or stock securities generally for one of three reasons.

1. Corporation may **have excess cash**.
2. Generate **earnings from investment income**.
3. For **strategic reasons**.



Why Corporations Invest (1 of 2)

Question

Pension funds and banks regularly invest in debt and stock securities to:

- a. house excess cash until needed.
- b. generate earnings.
- c. meet strategic goals.
- d. avoid a takeover by disgruntled investors.

Why Corporations Invest (2 of 2)

Question

Pension funds and banks regularly invest in debt and stock securities to:

- a. house excess cash until needed.
- ➔ b. generate earnings.
- c. meet strategic goals.
- d. avoid a takeover by disgruntled investors.

Accounting for Debt Investments (1 of 11)

Investments in government and corporation bonds.

Entries are made to record

1. the acquisition,
2. the interest revenue, and
3. the sale.

Recording Acquisition of Bonds

Cost includes all expenditures necessary to acquire these investments, such as the price paid plus brokerage fees (commissions), if any.

Accounting for Debt Investments (2 of 11)

Recording Bond Interest

Calculate and record interest revenue based upon the

- **carrying value** of the bond
- times the **interest rate**
- times the **portion of the year** the bond is outstanding.

Accounting for Debt Investments (3 of 11)

Recording Sale of Bonds

- Credit the investment account for the cost of the bonds.
- Record as a gain or loss
 - any difference between the net proceeds from the sale (sales price less brokerage fees) and
 - the cost of the bonds.

Accounting for Debt Investments (4 of 11)

Illustration: Kuhl Corporation acquires 50 Doan Inc. 8%, 10-year, \$1,000 bonds on January 1, 2017, for \$50,000. The entry to record the **investment** is:

Jan. 1	Debt Investments	50,000	
	Cash		50,000

Accounting for Debt Investments (5 of 11)

Kuhl Corporation acquires 50 Doan Inc. 8%, 10-year, \$1,000 bonds on January 1, 2017, for \$50,000. The bonds pay interest annually on January 1. If Kuhl Corporation's fiscal year ends on December 31, prepare the entry to accrue interest earned by December 31.

Dec. 31	Interest Receivable	4,000 *	
	Interest Revenue		4,000

* ($\$50,000 \times 8\% = \$4,000$)

Accounting for Debt Investments (6 of 11)

Kuhl reports Interest Receivable as a current asset in the balance sheet. It reports Interest Revenue under “Other revenues and gains” in the income statement. Kuhl reports receipt of the interest on January 1 as follows.

Jan. 1	Cash	4,000	
	Interest Receivable		4,000

Accounting for Debt Investments (7 of 11)

Assume that Kuhl corporation receives net proceeds of \$54,000 on the sale of the Doan Inc. bonds on January 1, 2018, after receiving the interest due. Prepare the entry to record the sale of the bonds.

Jan. 1	Cash	54,000	
	Debt Investments		50,000
	Gain on Sale of Debt Investments		4,000

Accounting for Debt Investments (8 of 11)

Question

An event related to an investment in debt securities that does **not** require a journal entry is:

- a. acquisition of the debt investment.
- b. receipt of interest revenue from the debt investment.
- c. a change in the name of the firm issuing the debt securities.
- d. sale of the debt investment.

Accounting for Debt Investments (9 of 11)

Question

An event related to an investment in debt securities that does **not** require a journal entry is:

- a. acquisition of the debt investment.
- b. receipt of interest revenue from the debt investment.
- ➔ c. a change in the name of the firm issuing the debt securities.
- d. sale of the debt investment.

Accounting for Debt Investments (10 of 11)

Question

When bonds are sold, the gain or loss on sale is the difference between the:

- a. sales price and the cost of the bonds.
- b. net proceeds and the cost of the bonds.
- c. sales price and the market value of the bonds.
- d. net proceeds and the market value of the bonds.

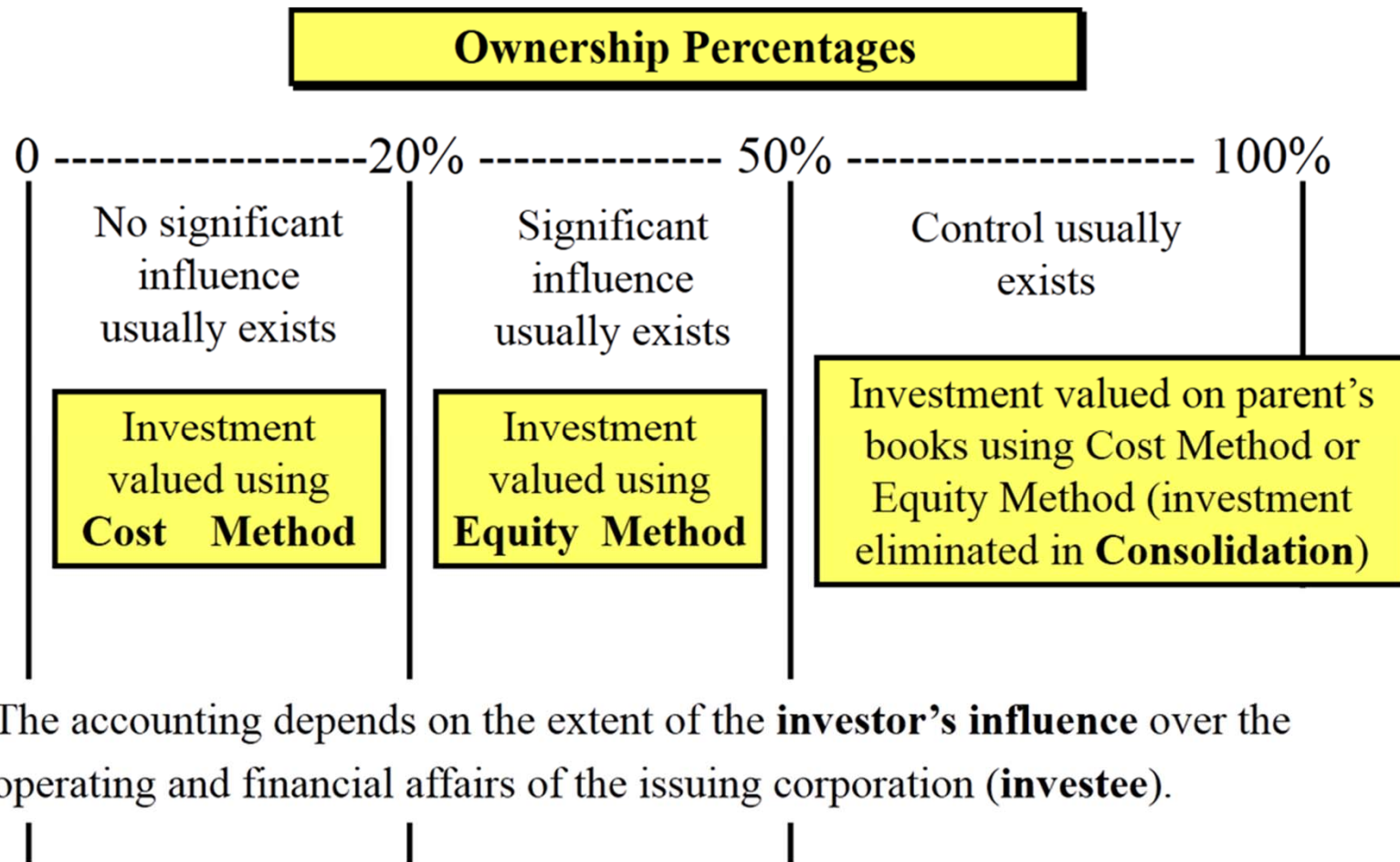
Accounting for Debt Investments (11 of 11)

Question

When bonds are sold, the gain or loss on sale is the difference between the:

- a. sales price and the cost of the bonds.
- ➔ b. net proceeds and the cost of the bonds.
- c. sales price and the market value of the bonds.
- d. net proceeds and the market value of the bonds.

LO 2: Explain How to Account for Stock Investments



Accounting for Stock Investments (1 of 3)

Holding of Less Than 20%

- Companies use the **cost method**.
- Investment is recorded at cost and revenue recognized only when cash dividends are received.
- Cost includes all expenditures necessary to acquire these investments, such as the price paid plus any brokerage fees (commissions), if any.

Holding of Less Than 20% (1 of 3)

Recording Acquisition of Stock

Illustration: On July 1, 2017, Sanchez Corporation acquires 1,000 shares (10% ownership) of Beal Corporation common stock. Sanchez pays \$40 per share. The entry for the purchase is:

July 1	Stock Investments (1,000 × \$40)	40,000	
	Cash		40,000

Holding of Less Than 20% (2 of 3)

Recording Dividends

Illustration: During the time Sanchez owns the stock it makes entries for any cash dividends received. If Sanchez receives a \$2 per share dividend on December 31, the entry is:

Dec. 31	Cash (1,000 × \$2)	2,000	
	Dividend Revenue		2,000

Holding of Less Than 20% (3 of 3)

Recording Sale of Stock

Illustration: Assume that Sanchez Corporation receives net proceeds of \$39,500 on the sale of its Beal stock on February 10, 2018. Because the stock cost \$40,000, Sanchez incurred a loss of \$500. The entry to record the sale is:

Feb. 10	Cash	39,500
	Loss on Sale of Stock Investments	500
	Stock Investments	40,000

Accounting for Stock Investments (2 of 3)

Holding between 20% and 50%

Equity Method: Investor records the investment at cost and subsequently adjust the amount each period for the

- proportionate share of the earnings (losses) and
- dividends received.

If investor's share of investee's losses exceeds the carrying amount of the investment, the investor ordinarily should discontinue applying the equity method.

Holdings between 20% and 50% (1 of 4)

Illustration: Milar Corporation acquires 30% of the common shares of Beck Company for \$120,000 on January 1, 2017. For 2017, Beck reports net income of \$100,000 and paid dividends of \$40,000. Prepare the entries for these transactions.

Jan. 1	Stock Investments	120,000	
	Cash		120,000
Dec. 31	Stock Investments ($\$100,000 \times 30\%$)	30,000	
	Revenue from Stock Investments		30,000
Dec. 31	Cash ($\$40,000 \times 30\%$)	12,000	
	Stock Investments		12,000

Holdings between 20% and 50% (2 of 4)

Illustration: Milar Corporation acquires 30% of the common shares of Beck Company for \$120,000 on January 1, 2017. For 2017, Beck reports net income of \$100,000 and paid dividends of \$40,000. Prepare the entries for these transactions.

After Milar posts the transactions for the year, its investment and revenue accounts will show the following.

Stock Investments		Revenue from Stock Investments	
Jan. 1	120,000		Dec. 31
Dec. 31	30,000		30,000
Dec. 31 Bal.	138,000		

Holdings between 20% and 50% (3 of 4)

Question

Under the equity method, the investor records dividends received by crediting:

- a. Dividend Revenue.
- b. Investment Income.
- c. Revenue from Investment.
- d. Stock Investments.

Holdings between 20% and 50% (4 of 4)

Question

Under the equity method, the investor records dividends received by crediting:

- a. Dividend Revenue.
- b. Investment Income.
- c. Revenue from Investment.
- ➔ d. Stock Investments.

Accounting for Stock Investments (3 of 3)

Holdings of More than 50%

Controlling Interest - When one corporation acquires a voting interest of more than 50 percent in another corporation

- Investor is referred to as the **parent**.
- Investee is referred to as the **subsidiary**.
- Investment in the subsidiary is reported on the parent's books as a long-term investment.
- Parent generally prepares **consolidated financial statements**.

Holdings of More Than 50%

Consolidated statements indicate the magnitude and scope of operations of the companies under common control.

PepsiCo	Cendant	The Disney Company
Frito-Lay	Howard Johnson	Capital Cities/ABC, Inc.
Tropicana	Ramada Inn	Disneyland, Disney World
Quaker Oals	Century 21	Mighty Ducks
Pepsi-Cola	Coldwell Banker	Anaheim Angels
Gatorade	Avis	ESPN

LO: 3 Discuss How Debt and Stock Investments Are Reported in the Financial Statements

Categories of Securities

Classifications of debt and stock investments:

Debt Investments	Stock Investments
Trading	Trading
Available-for-sale	Available-for-sale
Held-to-maturity	

These guidelines apply to all debt securities and all stock investments in which the holdings are less than 20%.

Categories of Securities (1 of 6)

Trading Securities

- Companies hold with intention of selling in a short period.
- **Trading** means frequent buying and selling.
- Reported at fair value.
- Changes from cost are reported in the income statement as **unrealized gains or losses**.

Categories of Securities (2 of 6)

Question

Marketable securities bought and held primarily for sale in the near term are classified as:

- a. available-for-sale securities.
- b. held-to-maturity securities.
- c. stock securities.
- d. trading securities.

Categories of Securities (3 of 6)

Question

Marketable securities bought and held primarily for sale in the near term are classified as:

- a. available-for-sale securities.
- b. held-to-maturity securities.
- c. stock securities.
- ➔ d. trading securities.

Trading Securities

Illustration: Cost and fair values for investments of Pace Corporation classified as trading securities on December 31, 2017.

Trading Securities, December 31, 2017

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Yorkville Company bonds	\$ 50,000	\$ 48,000	\$(2,000)
Kodak Company stock	90,000	99,000	9,000
Total	<u>\$140,000</u>	<u>\$147,000</u>	<u>\$7,000</u>

The adjusting entry for Pace Corporation is:

Dec. 31	Fair Value Adjustment—Trading	7,000	
	Unrealized Gain—Income		7,000

Categories of Securities (4 of 6)

Available-for-sale Securities

- Held with the **intent of selling** sometime in the future.
- Classified as **current assets** or as **long-term assets**, depending on the intent of management.
- **Reported at fair value.**
- Changes from cost are reported in stockholders' equity as **unrealized gains or losses.**

Available-for-sale Securities

Illustration: Assume that Ingrao Corporation has two securities that it classifies as available-for-sale.

Available-for-Sale Securities, December 31, 2017

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Campbell Soup Corporation 8% bonds	\$ 93,537	\$ 103,600	\$10,063
Hershey Company stock	200,000	180,400	(19,600)
Total	<u>\$293,537</u>	<u>\$284,000</u>	<u>\$ (9,537)</u>

The adjusting entry is:

Dec. 31	Unrealized Gain or Loss—Equity	9,537	
	Fair Value Adjustment—AFS		9,537

Categories of Securities (5 of 6)

Question

An unrealized loss on available-for-sale securities is:

- a. reported under Other Expenses and Losses in the income statement.
- b. closed-out at the end of the accounting period.
- c. reported as a separate component of stockholders' equity.
- d. deducted from the cost of the investment.

Categories of Securities (6 of 6)

Question

An unrealized loss on available-for-sale securities is:

- a. reported under Other Expenses and Losses in the income statement.
- b. closed-out at the end of the accounting period.
- ➔ c. reported as a separate component of stockholders' equity.
- d. deducted from the cost of the investment.

Balance Sheet Presentation (1 of 3)

Short-Term Investments

Also called **marketable securities**, are securities held by a company that are

- 1) **readily marketable** and
- 2) **intended to be converted** into cash within the next year or operating cycle, whichever is longer.

Short-term investments are reported at **fair value**.

Investments that do not meet **both criteria** are classified as **long-term investments**.

Helpful Hint

Trading securities are always classified as short-term.

Available-for-sale securities can be either short-term or long-term.

Balance Sheet Presentation (2 of 3)

Short-Term Investments

Also called **marketable securities**, are securities held by a company that are

- 1) **readily marketable** and
- 2) **intended to be converted** into cash within the next year or operating cycle, whichever is longer.

WEBER CORPORATION	
Balance Sheet (partial)	
Current assets	
Cash	\$21,000
Short-term investments, at fair value	60,000

Balance Sheet Presentation (3 of 3)

Long-Term Investments

Long-term investments in available-for-sale securities are reported at fair value. Investments in common stock accounted for under the equity method are reported at equity.

WEBER CORPORATION		
Balance Sheet (partial)		
Investments		
Bond sinking fund	\$100,000	
Investments in stock of less than 20% owned		
companies, at fair value	50,000	
Investment in stock of 20%–50% owned		
company, at equity	<u>150,000</u>	
Total investments		\$300,000

Presentation of Realized and Unrealized Gain or Loss (1 of 2)

Other Revenue and Gains

Interest Revenue

Dividend Revenue

Gain on Sale of Investments

Unrealized Gain—Income

Other Expenses and Losses

Loss on Sale of Investments

Unrealized Loss—Income

Presentation of Realized and Unrealized Gain or Loss (2 of 2)

Unrealized gains or losses on **available-for-sale** securities are reported as a separate component of stockholders' equity.

MUZZILLO INC. Balance Sheet (partial)	
Stockholders' equity	
Common stock	\$3,000,000
Retained earnings	<u>1,500,000</u>
Total paid-in capital and retained earnings	4,500,000
Accumulated other comprehensive loss	<u>(100,000)</u>
Total stockholders' equity	<u><u>\$4,400,000</u></u>

Statement of Cash Flows

The “**Investing activities**” section of the statement of cash flows reports the cash inflows and outflows during the period that resulted from **investment transactions**.

<div>Real World</div> <div>THE WALT DISNEY COMPANY</div> <div>Statement of Cash Flows (partial)</div> <div>(in millions)</div>		
Investing Activities		
Investments in parks, resorts and other property		\$(1,566)
Acquisitions		(588)
Dispositions		—
Proceeds from sale of investments		1,530
Other		6
Cash used by investing activities		<u><u>\$ (618)</u></u>

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