

# CHAPTER 17



1. Understand the difference between "FAS 115", "equity" and "consolidated" investments.
2. Understand how to account for each of the above three types of investments.
3. Understand accounting for equity securities under SFAS No. 115.
  1. Held to maturity
  2. Available for sale
  3. Trading

## 3 Types of Investments- Overview

When one entity invests in another, the way we account for that investment is principally based on the level of control gained by making the investment:

- |               |   |
|---------------|---|
| FAS 115-      | NOT Significant influence.                                  |
| EQUITY-       | Significant influence or shared control, but NOT controlled |
| CONSOLIDATED- | CONTROLLED  |

## FAS 115 METHOD- HOW TO ACCOUNT

Put on the balance sheet at historical cost. If you receive cash back (dividend) report as income when received. If you make additional investments, treat as an increase in the investment. BUT on a more complicated note, deal with changes in value...

You have seen it before in 136A- we account for the cost method investments in debt and equity securities using FAS 115. The accounting depends on what type of cost investment it is (one of the following):

- HELD TO MATURITY
- AVAILABLE FOR SALE
- TRADING

## FAS 115 DISTINCTION:

### Held to Maturity:

Entity has the intent and the ability to hold until it's maturity.

### Trading:

Entity regularly buys and sells with intent to sell in the near-term for income on price fluctuations

### Available For Sale:

Entity not invested as a "Trader" and there is either no maturity, or is not expected to hold to maturity. In other words- if not a Held to Maturity or Trading, then Available For Sale

## SFAS 115- How to:

### When a Company holds:

- an equity interest with a readily available market value and it is not consolidated or an equity investment or
- any debt security

### IT IS ACCOUNTED FOR UNDER FAS 115\*:

- Held to maturity
  - Current or long-term, depending on maturity;
  - Reported at cost.
  - Company must have intent and ability to hold until maturity to classify as "held to maturity"
- Trading
  - Always current;
  - Reported at fair value with gains and losses flowing through the income statement.
- Available for sale
  - Current or long-term, depending on circumstances/ management intent;
  - Reported at fair value with gains and losses flowing through "other comprehensive income".
- ALL: DIVIDENDS RECEIVED ARE INCOME WHEN RECEIVED!!

\* NOTE: Applies equally to equity securities with readily available market values and debt securities. If a debt security, have to record interest as well.

### FAS 115 Illustrated

**Purchase Investment for \$100,000**

**Entry to record purchase is the same for all three methods:**

Investments	100,000	
Cash		100,000

**UNREALIZED LOSS OF \$10K:**

**Held to Maturity**  
No entry

**Trading**

Unrealized loss (P&L)	10,000	
Investment		10,000

**Available for Sale - assuming tax-free entity**

Other comprehensive loss	10,000	
Investment		10,000

Receive a \$2,500 dividend, all three methods:

Cash	2,500	
Dividend income		2,500

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### What happens to AOCI?

What happens when a company has an AFS security which is worth \$150,000 that they paid \$100,000 for? (we'll ignore tax effect for purposes of illustration)

- The \$50,000 that is sitting in AOCI goes away
  - How? It becomes "realized" on the income statement.

Cash	150,000	
AFS Investment		150,000
AOCI	50,000	
Realized gain on AFS security		50,000

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### EQUITY METHOD ACCOUNTING

- Report the historical cost as an "investment" when purchased;
- Any additional purchases (contributions) of the equity of the investee increase the investment;
- Report any cash received as a reduction to the investment
- Report the ownership % of any income or loss during the period as an increase to the investment
- Investment should not fall below zero UNLESS the investor has created such a "liability" by guarantee or otherwise.

*NOTE: In a perfect world, this results in the equity investment being maintained at the original ownership %! I'll show you see next slide!!!*

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### EQUITY ACCOUNTING EXAMPLE

Xyz, Inc. enters into a joint venture by contributing \$300,000 of the total \$1M of opening equity. It is deemed an equity investment. During the year (1) they contribute an additional \$30,000 of equity and other investors contribute \$70,000 (2) they receive a \$3,000 dividend (3) the joint venture reports \$200,000 of net income.

**JOURNAL ENTRIES:**

Purchase date:

Investment	\$300,000	
Cash		\$300,000

(1) Contribute additional \$30,000:

Investment	\$30,000	
Cash		\$30,000

(2) Receive \$3,000 dividend:

Cash	\$3,000	
Investment		\$3,000

(3) JV reports \$200,000 of net income (our share is 30%):

Investment	\$60,000	
Equity in income of JV		\$60,000

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### I PROMISED WOULD MAINTAIN OWNERSHIP %

	<u>Investment Balance</u>	
Purchase	300,000	
Additional Contribution	30,000	
Dividend	(3,000)	
Equity in income of JV	60,000	
Our ending investment balance	387,000	
	<u>JV EQUITY</u>	
Opening contributions	1,000,000	
Additional contributions	100,000	
Dividends paid	(10,000)	
Close-out net income to ret. Earnings	200,000	
	1,290,000	
Our ownership %	30%	
	387,000	

→ Pretty Cool?

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### THE FAIR VALUE OPTION

Under what was FAS 159, companies may "elect" to account for financial instruments and equity method investments at fair value!!!

- Once the election is made, they are stuck with it;
- Applied on an instrument by instrument basis (cherry picking is perfectly acceptable!)

**IMPACT:**

- If an available for sale security, the accounting is the same (already at fair value), but the unrealized gains and losses go to the income statement instead of OCI
- If equity method, the whole process we just discussed is gone, treat just like an available for sale security with unrealized gains and losses on the income statement.

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## CONSOLIDATE

Covered in depth in advanced accounting. Here is the gist of it:

- You add the balance sheet and income statement of the investee to those of the investor just like you owned the whole thing (if Investor has \$100,000 of cash and investee has \$10,000, would show \$110,000 of cash.)
- But wait- what if we consolidated it but only own 75%, wouldn't the above cause us to overstate our net assets and net income by 25% of the investees net assets and net income? YES!
  - The fix is called "minority interest". It represents the portion of the net assets and income we reported which belong to those holding the "minority interest" in what we have consolidated.
  - It is shown as a single line on the balance sheet and income statement;
    - On balance sheet usually just below liabilities but before equity as "minority interest in equity of consolidated investment"
    - On income statement usually as an expense before the tax provision as "minority interest in earnings of consolidated investment"
- **EXAMPLE:**

## MAKING THE DISTINCTION

Entity purchases 5,000 shares of Microsoft. There are 10,813,984,831 shares outstanding. Does this grant control?

NO

- Does this grant significant influence? NO
- Is this a FAS 115, equity or consolidated investment? FAS 115
- If the entity paid \$130,000 for these shares, can you guess the accounting entry?

Investment (at cost)	\$130,000
Cash	\$130,000

## MAKING THE DISTINCTION CONT'D

Entity purchases 30% of the outstanding common stock of a corporation. (HINT 20% is a general guideline and you have determined that they do not have "Control" but do exert significant influence)

Is this a "FAS 115", "equity", or "consolidated" investment?

EQUITY

## MAKING THE DISTINCTION CONT'D

REAL WORLD:

Company "XYZ" enters into a joint venture as the general partner by contributing 1% of the total capital (a group of investors contributes the remaining 99%). XYZ gets 2 votes for this investment. Collectively the remaining investors control 3 votes. Significant decisions require majority vote. As the GP, XYZ carries out the activities of the joint venture. Does XYZ have significant influence?

YES

- Do they control the JV? NO
- Is this a "FAS 115", "equity" or "consolidated" joint venture?

EQUITY

## MAKING THE DISTINCTION CONT'D

Say in the above, that XYZ got 2 votes as the GP and the other investors collectively have 2 votes. Significant decisions still require majority vote.

- Does XYZ have significant influence? YES
- Do they control the JV? NO- THIS IS CALLED "SHARED CONTROL"
- Is this a "FAS 115", "equity" or "consolidated" joint venture? STILL EQUITY

*YOU SEE THAT THE GUIDING ISSUE IS CONTROL- NOT SO MUCH WHAT % IS OWNED. HOWEVER, OFTEN THE % OWNED IS A STRONG INDICATION. THAT IS WHY YOUR TEXT SHOWS—0-20% COST, 20-50% EQUITY AND 51% AND MORE CONSOLIDATION. THAT MATCHES THE INITIAL FASB STATEMENT BUT AS YOU CAN SEE ABOVE- IT IS NOT BY ANY MEANS AN ABSOLUTE- YOU MUST LOOK AT THE CONTROL!*

## STUDY SLIDE

Company makes an equity investment:

No significant influence (<20% guideline\*)

Account for under FAS 115 ("trading" "held to maturity" or "available for sale")

Significant influence (20-50% guideline\*)

Account for as an equity investment

Control (50+% guideline\*)

Account for as a consolidated entity

\* Control overrides % ownership (i.e if can control with only a 25% ownership, then account for as consolidated as "control" overrides the need to have 50% ownership).

## OTHER MATTERS:

Equity securities disclose:

- Name of each investee and % owned
- Accounting policies
- Any difference between investment and underlying ownership in equity of investee
- If available, the aggregate mkt value of each investment
- If the investment is material, then summarized financial data of the investee.

↑  
ENRON: See above... Was the info. disclosed?



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## IMPAIRMENTS

- Remember that available for sale securities are carried at fair value. If they are deemed to have a permanent impairment, then there is a change from "unrealized" loss to a realized "impairment" and the unrealized comprehensive loss flips from equity to the income statement.
- Equity and consolidated investments must ALWAYS be monitored for impairment. Generally look at it under the same criteria as any other long-lived asset, which we covered in 136A (undiscounted cash flow analysis, etc.)



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## RECENT UPDATE: FIN 46

Everything previously presented re: consolidation/ equity/ cost assumes that FIN 46 does NOT apply. FIN 46 applies to "variable interest entities" and has been superseded by FAS 167.

What is a "variable interest entity"?

Complex definition, and you need to reference to the literature whenever any possibility exists. However, key items to look for (ANY ONE, NOT ALL):

- Investee is under-capitalized- or
- Investee is controlled by parties other than those with substantial ownership- or
- Owners share in profits and losses at rates which vary, or are not commensurate with their ownership percentages.

If it is a "variable interest entity", then what?:

The owner with the greatest control consolidates? HUH!!! ISNT THAT JUST A BIG CIRCLE- YEP. IF CLASS TIME PERMITS I WILL EXPLAIN THE POLITICAL NONSENSE AT PLAY HERE!!!



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