Reporting and Analyzing Investments

Study Objectives

1. Identify the reasons corporations invest in debt and stock securities.
2. Explain the accounting for debt investments.
3. Explain the accounting for stock investments.
4. Describe the purpose and usefulness of consolidated financial statements.
5. Indicate how debt and stock investments are valued and reported in financial statements.
6. Distinguish between short-term and long-term investments.

Why Corporations Invest

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

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

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 Instruments

**Recording Acquisition of Bonds**

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

**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.

**Sale of Bonds**

Credit the investment account for the cost of the bonds and 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.

**Illustration:**

Kuhl Corporation acquires 50 Doan Inc. 12%, 10-year, $1,000 bonds on January 1, 2010, for $54,000, including brokerage fees of $1,000. The entry to record the investment is:

**Jan. 1**

Illustration:

Kuhl Corporation acquires 50 Doan Inc. 12%, 10-year, $1,000 bonds on January 1, 2010, for $54,000, including brokerage fees of $1,000. The bonds pay interest semiannually on July 1 and January 1. The entry for the receipt of interest on July 1 is:

**July 1**

\[ * (\$50,000 \times 12\% \times \frac{1}{2} = \$3,000) \]
Illustration: If Kuhl Corporation’s fiscal year ends on December 31, prepare the entry to accrue interest since July 1.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Kuhl reports receipt of the interest on January 1 as follows.</td>
</tr>
<tr>
<td>Jan. 1</td>
<td></td>
</tr>
</tbody>
</table>

Accounting for Debt Investments

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 Stock Investments

<table>
<thead>
<tr>
<th>Ownership Percentages</th>
<th>0%</th>
<th>20%</th>
<th>50%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>No significant influence usually exists</td>
<td>Significant influence usually exists</td>
<td>Control usually exists</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment valued using Cost Method</td>
<td>Investment valued using Equity Method</td>
<td>Investment valued on parent’s books using Cost Method or Equity Method (investment eliminated in Consolidation)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The accounting depends on the extent of the investor’s influence over the operating and financial affairs of the issuing corporation.

Holdings of Less than 20%

Companies use the cost method. Under the cost method, companies record the investment at cost, and recognize revenue 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).

Illustration: On July 1, 2010, Sanchez Corporation acquires 1,000 shares (10% ownership) of Beal Corporation common stock. Sanchez pays $40 per share plus brokerage fees of $500. The entry for the purchase is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1</td>
<td></td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td></td>
</tr>
</tbody>
</table>

Illustration: Assume that Sanchez Corporation receives net proceeds of $39,500 on the sale of its Beal stock on February 10, 2011. Because the stock cost $40,500, Sanchez incurred a loss of $1,000. The entry to record the sale is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb. 10</td>
<td></td>
</tr>
</tbody>
</table>
Holdings Between 20% and 50%

Equity Method

Record the investment at cost and subsequently adjust the amount each period for
- the investor's proportionate share of the earnings (losses) and
- dividends received by the investor.

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

Illustration: Milar Corporation acquires 30% of the common shares of Beck Company for $120,000 on January 1, 2010. For 2010, Beck reports net income of $100,000 and paid dividends of $40,000. Prepare the entries for these transactions.

Jan. 1

Dec. 31

Dec. 31

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.

Valuing and Reporting Investments

Categories of Securities

Companies classify debt and stock investments into three categories:
- Trading securities
- Available-for-sale securities
- Held-to-maturity securities

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

Trading Securities

- Companies hold trading securities with the intention of selling them in a short period.
- Trading means frequent buying and selling.
- Companies report trading securities at fair value, and report changes from cost as part of net income.

Available-for-Sale Securities

- Companies hold available-for-sale securities with the intent of selling these investments sometime in the future.
- These securities can be classified as current assets or as long-term assets, depending on the intent of management.
- Companies report securities at fair value, and report changes from cost as a component of the stockholders' equity section.

Question

Marketable securities bought and held primarily for sale in the near term are classified as:
- available-for-sale securities.
- held-to-maturity securities.
- stock securities.
- trading securities
Trading Securities

**Illustration:** Investment of Pace classified as trading securities on December 31, 2010.

<table>
<thead>
<tr>
<th>Investments</th>
<th>Cost</th>
<th>Fair Value</th>
<th>Unrealized Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yorkville Company bonds</td>
<td>$50,000</td>
<td>$40,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Kodak Company stock</td>
<td>90,000</td>
<td>90,000</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$140,000</td>
<td>$130,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

The adjusting entry for Pace Corporation is: \(\text{Dec. 31}\)

Available-for-Sale Securities

**Problem:** How would the entries change if the securities were classified as available-for-sale?

The entries would be the same except that the
- Unrealized Gain or Loss—Equity account is used instead of Unrealized Gain or Loss—Income.
- The unrealized loss would be deducted from the stockholders’ equity section rather than charged to the income statement.

**Available-for-Sale Securities**

**Balance Sheet Presentation**

**Question**

An unrealized loss on available-for-sale securities is:
- reported under Other Expenses and Losses in the income statement.
- closed-out at the end of the accounting period.
- reported as a separate component of stockholders’ equity.
- deducted from the cost of the investment.

**Available-for-Sale Securities**

**Statement of Cash Flows Presentation**

<table>
<thead>
<tr>
<th>Investing Activities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments in parks, resorts and other property</td>
<td>$(1,506)</td>
</tr>
<tr>
<td>Acquisitions</td>
<td>$(508)</td>
</tr>
<tr>
<td>Dispositions</td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of investments</td>
<td>1,530</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
<tr>
<td>Cash used by investing activities</td>
<td>$(630)</td>
</tr>
</tbody>
</table>

**Presentation of Realized and Unrealized Gain or Loss**

Nonoperating items related to investments

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