Lectures

Chapter 12 – Part 1

Accounting
351

California State University, Northridge

Investments

Less than 20%	20-50%	Over 50%
ASC 320-10-25	ASC 323-10-15 and 35	
	Equity Method	Consolidation
	Significant influence	Control

For investments with less than a 20% ownership, what was management's intent when making the investment?

Trading Securities	Available for Sale	Held to Maturity
Mark to Market	Mark to Market	Amortized Cost
Expected to be traded within 3 months.	Not held-to-maturity or trading securities.	Debt securities

2

Held to Maturity

Alpha purchased 10%, 10-year $100,000 Beta bonds on July 1 for $88,530 when other bonds are paying 12%. Interest is paid on June 30 and December 31.

$5,000 x 11.46992 = $57,350
$100,000 x .31180 = 31,180
$88,530

Discount = $100,000 - $88,530 = $11,470 (future interest revenue)

The bonds sell for $88,530 or 88.53 (88.53% of $100,000)

Investment in Held-to-Maturity Securities	100,000	
Discount on Bond Investment		11,470
Cash		88,530

Cash	88,530	
Discount on Bonds Payable	11,470	
Bonds Payable		100,000

3

If purchased on April 1 (in between interest payment dates):

On June 30, Alpha will receive $5,000 (6 months) of interest but will have earned only $2,500 (3 months) of interest. [$100,000 x 10% x $\frac{6}{12}$ = $5,000]

Alpha will prepay the interest ($2,500) that won't be earned by June 30.

April 1

Investment in Held-to-Maturity Securities	100,000	
Interest Receivable ($100,000 x 10% x $\frac{1}{4}$)	2,500	
Discount on Bond Investment		11,470
Cash		91,030*

*$88,530 + $2,500 = $91,030

June 30

Cash	5,000	
Interest Receivable		2,500
Interest Revenue		2,500

4

Balance Sheet

Investment in HTM Securities	$100,000
Less: Discount on Bond Investment	11,470
	$ 88,530

(Straight-line Method) $11,470 discount/20 periods = $574 Rounded

(Effective Interest Method) $88,530 x 6% = $5,312 - $5,000 = $312 Rounded

Dec 31

Discount on Bond Investment	312	
Interest Revenue		312

Cash	5,000	
Interest Revenue		5,000

Or the following compound entry:

Cash	5,000	
Discount on Bond Investment	312	
Interest Revenue		5,312

5

Bond interest rate = 10%
Market interest rate = 12%

Investment in HTMS	100,000	
Discount on Bond Inv		11,470
Cash		88,530

$88,530x6%-$5,000 = $312 Rounded

Discount on Bond Inv	312	
Interest Revenue		312

Cash	5,000	
Interest Revenue		5,000

In 6 months

($88,530+312)x6%-$5,000 = $331

Discount on Bond Inv	331	
Interest Revenue		331

Bond interest rate = 12%
Market interest rate = 10%

Investment in HTMS	100,000	
Premium on Bond Inv	12,463	
Cash		112,463

$6,000-($112,463x5%) = $377 Rounded

Interest Revenue	377	
Premium on Bond Inv		377

Cash	6,000	
Interest Revenue		6,000

In 6 months

$6,000 - ($112,463-377)x5% = $396

Interest Revenue	396	
Premium on Bond Inv		396

6

Issuer Name	Symbol	Coupon	Maturity	Rating Moody's/S&P/ Fitch	High	Low	Last	Change	Yield %
GENERAL ELECTRIC CAPITAL	GE.HIH	2.125%	Dec 2012	Aaa/AAA/--	102.210	100.950	101.736	0.023	1.544
FREEPORT-MCMORAN COPPER & GOLD	FCX.GK	8.250%	Apr 2015	Ba2/BBB-/BBB-	109.204	106.400	107.750	0.250	5.211
Union Carbide	DOW.HG	7.750%	Oct 2096	Ba2/BBB-/BBB-	74.500	72.500	74.500	-5.000	10.400
SVENSK EXPORTKREDIT AB	SWEX.HB	5.125%	Mar 2017	Aa1/AA+/--	108.820	108.820	108.820	-2.250	3.728
GENERAL ELECTRIC CAPITAL	GE.HJF	2.000%	Sep 2012	Aaa/AAA/--	101.619	101.288	101.479	0.034	1.466
DEVON ENERGY CORP	DVN.GQ	6.300%	Jan 2019	Baa1/BBB+/BBB+	113.030	111.212	112.172	-0.551	4.649
APACHE CORP	APA.GR	6.900%	Sep 2018	A3/A-/A-	119.988	119.467	119.988	-0.161	4.164
VIACOM (NEW)	VIA.HM	5.625%	Sep 2019	Baa2/BBB/BBB	106.659	105.213	106.659	1.278	4.765
PROCTER & GAMBLE CO	PG.HN	4.700%	Feb 2019	Aa3/AA-/--	105.808	103.923	104.797	-0.199	4.070
GE GLOBAL INSURANCE HLD	GE.GO	7.750%	Jun 2030	A3/A-/A	106.237	100.450	106.192	-3.676	7.169

7

Trading Securities

Purchased the following equity securities.

Company	Cost
A	$15,000
B	8,000
C	10,000
Total	$33,000

Investment in Trading Securities	33,000	
Cash		33,000

End of year 1

Company	Cost	Market Value
A	$15,000	$13,000
B	8,000	5,000
C	10,000	12,000
Total	$33,000	$30,000

Unrealized Loss on Trading Securities	3,000	
Fair Value Adjustment – Trading Securities		3,000

8

In year 2, sold the B securities for $7,000

Cash	7,000	
Loss on Sale of Trading Securities	1,000	
Investment in Trading Securities		8,000

End of year 2

Company	Cost	Market Value
A	$15,000	$19,000
C	10,000	8,000
Total	$25,000	$27,000

Fair Value Adjustment – Trading Securities

	Debit	Credit	
		3,000	Year 1 Ending Balance
Required entry in Year 2	5,000		
Year 2 Ending Balance	2,000		

Fair Value Adjustment – Trading Securities	5,000	
Unrealized Gain on Trading Securities		5,000

9

Income Statement (Year 1)

Other expenses and losses:

Unrealized loss on trading securities	$3,000

Balance Sheet (Year 1)

Assets

Investment in trading securities	$33,000
Less: FV adjustment – trading securities	3,000

10

Income Statement (Year 2)

Other revenues and gains:	
Unrealized gain on trading securities	$5,000
Other expenses and losses:	
Loss on sale of trading securities	$1,000

Balance Sheet (Year 2)

Assets

Investment in trading securities	$25,000
Add: FV adjustment – trading securities	2,000

11

Available for Sale

Purchased the following equity securities.

Company	Cost
A	$15,000
B	8,000
C	10,000
Total	$33,000

Investment in Available-for-Sale Securities	33,000	
Cash		33,000

End of year 1

Company	Cost	Market Value
A	$15,000	$13,000
B	8,000	5,000
C	10,000	12,000
Total	$33,000	$30,000

Unrealized Loss on Available-for-Sale Securities	3,000	
Fair Value Adjustment – Available-for-Sale Securities		3,000

12

In year 2, sold the B securities for $7,000

Cash	7,000	
Loss on Sale of Available-for-Sale Securities	1,000	
Investment in Available-for-Sale Securities		8,000

End of year 2

Company	Cost	Market Value
A	$15,000	$19,000
C	10,000	8,000
Total	$25,000	$27,000

Fair Value Adjustment – Available-for-Sale Securities

	Debit	Credit
Year 1 Ending Balance		3,000
Required entry in Year 2	5,000	
Year 2 Ending Balance	2,000	

Fair Value Adjustment – Available-for-Sale Securities	5,000	
Unrealized Gain on Available-for-Sale Securities		5,000

13

Comprehensive Income

All changes in equity (net assets) except those resulting from investments by and distributions to owners.

Controlled by external market conditions, not a result of operations.

Net income
+ Other Comprehensive Income (OCI)
Comprehensive Income

Net Income
Foreign Currency Translation Adjustment
Unrealized Gains/Losses on Available-for-Sale Securities
Impairment of Investment in Debt Securities
Deferred Gains/Losses on Derivative Financial Instruments
Minimum Pension Liability
Comprehensive Income

14

Statement of Comprehensive Income (Year 1)

Net income	xxxxx
Other comprehensive income	
Unrealized loss on available-for-sale securities	$3,000

Balance Sheet (Year 1)

Assets	
Investment in available-for-sale securities	$33,000
Less: FV adjustment – available-for-sale securities	3,000
	$30,000
Stockholders' Equity	
Capital stock	xxxxxx
Retained earnings	xxxxxx
Accumulated other comprehensive income:	
Less: Unrealized loss on available-for-sale securities	$3,000

15

Income Statement (Year 2)

Other expenses and losses:

Loss on sale of available-for-sale securities	$1,000

Statement of Comprehensive Income (Year 1)

Net income	xxxxx
Other comprehensive income	
Unrealized gain on available-for-sale securities	$5,000

Balance Sheet (Year 2)

Assets	
Investment in available-for-sale securities	$25,000
Add: FV adjustment – available-for-sale securities	2,000
	$27,000
Stockholders' Equity	
Capital stock	xxxxxx
Retained earnings	xxxxxx
Accumulated other comprehensive income:	
Add: Unrealized gain on available-for-sale securities	$2,000

16

Facts: Purchased an equity security for **$10**.

Investment – TS	10		Investment – AFSS	10		
Cash		10	Cash		10	

At year-end, the value is **$15**.

FV Adjustment – TS	5			FV Adjustment – AFSS	5		
Unrealized Gain		5	NI	Unrealized Gain		5	OCI

The security is sold for **$12**.

Cash	12			Cash	12		
Investment – TS		10		Investment – AFSS		10	
Gain on Sale		2	NI	Gain on Sale		2	NI
Unrealized Loss – TS	5		NI	Unrealized Loss	5		OCI
FV Adjustment – TS		5		FV Adjustment – AFSS		5	

or

Unrealized Loss – TS	5		Unrealized Loss	5	
Cash	12		Cash	12	
FV Adjustment – TS		5	FV Adjustment – AFSS		5
Investment – TS		10	Investment – AFSS		10
Gain on Sale		2	Gain on Sale		2

17

Lectures

Chapter 12 – Part 2

Accounting 351

California State University, Northridge

Equity Method

Used when the investor is able to exercise significant control or influence over the investee (20-50% guideline).

Alpha purchased 25% of the common stock of Beta for $200,000.

Investment in Beta Stock	200,000	
Cash		200,000

Beta reported net income for the year of $240,000.

Investment in Beta Stock	60,000	
Investment Revenue		60,000

Beta paid a dividend of $36,000.

Cash	9,000	
Investment in Beta Stock		9,000

18

At the time of purchase, Beta's FV = $600,000 and BV = $540,000.

Cost	$200,000	$50,000	Goodwill
FV ($600,000 x 25%)	$150,000		
BV ($540,000 x 25%)	$135,000	$15,000	

Inventory	Depreciable Assets
$5,000	$10,000/ 5-year life

Investment Revenue	5,000	
Investment in Beta Stock		5,000

Investment Revenue	2,000	
Investment in Beta Stock		2,000

19

Fair Value Option – ASC 825-10-25

Available-for-Sale Securities → Elect Fair Value Option

Held-to-Maturity Securities → Elect Fair Value Option

Equity Method Securities → Elect Fair Value Option

Equity Method Securities ↓ Classified as Equity Method Securities

Elect Fair Value Option

↓ Election is Irrevocable

↓ Classified as Trading Securities

↓
- Reported at Fair Value
- Unrealized Gains/Losses reported as net income

↓ Convergence

20

Alpha purchased 25% of Beta for $200,000 and elected the fair value option. Both the fair value and book value of Beta's net assets were $800,000. At year-end, Beta reported the following:

Net income = $240,000 ($240,000x25%=$60,000)

Dividends paid = $36,000 ($36,000x25%=$9,000)

Fair value of Beta stock = $1,100,000 ($1,100,000x25%=$275,000)

Use the equity method for the entire year and make the fair value adjustment at year-end.

(1) Compute the carrying value at year-end.

Cost	$200,000
Share of Beta's income	+60,000
Share of Dividends	-9,000
Carrying value	$251,000

21

---

(2) Compute the unrealized gain or loss.

Unrealized gain = $275,000 - 251,000 = $24,000

Fair Value Adjustment	24,000	
Unrealized Gain		24,000

(3) Compute what is included in net income.

Share of Beta's income	$60,000
Unrealized gain	24,000
Included in net income	**$84,000**

22

Treat as a trading security for the entire year and make the fair value adjustment at year-end.

(1) Compute the unrealized gain or loss.

Unrealized gain = $275,000 - 200,000 = $75,000

Fair Value Adjustment	75,000	
Unrealized Gain		75,000

(2) Compute what is included in net income.

Dividend revenue	$ 9,000
Unrealized gain	75,000
Included in net income	**$84,000**

23

Impairment of Investments ASC 320-10-35

Impairment = FV is less than (amortized) cost.

Other than Temporary Impairment (OTTI)

AFS Equity Securities (not trading securities)

- **Cannot assert the intent and ability to hold for recovery.**
- **Severity, duration, & financial condition are factors.**

Recognize in earnings

HTM or AFS Debt Securities

- **Intent to sell** (at a loss)
- **Required to sell** (more likely than not)
- **Non-Recovery** (before selling)
  - Credit loss **(recognize in earnings)**

Recognize in earnings

- **Credit loss** = amortized cost basis minus PV of expected future cash flow.
- Non-credit loss (recognize in OCI)

24

Facts:

5%, 10-year, $10,000 bond
Cost = $10,000
Interest = $500 per year
After 5 years, FV = $6,000

Loss = $10,000 - $6,000 = $4,000

Future cash flow:
Principal = $7,000
Interest = 4% or $400

PV of principal = $7,000 x .78353 = $5,485
PV of interest = $400 x 4.32948 = 1,732
PV of future cash flow = $7,217

Credit loss = $10,000 - $7,217 = **$2,783** → Earnings

Non-credit loss = $4,000 - $2,783 = **$1,217** → ***OCI***

25