


# Chapter 16












## Investments

### STUDY OBJECTIVES

After studying this chapter, you should be able to:

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

### The Navigator

Scan <b>Study Objectives</b>	
Read <b>Feature Story</b>	
Read <b>Preview</b>	
Read text and answer <b>DO IT!</b> p. 699  p. 704  p. 707  p. 710 	
Work <b>Comprehensive DO IT!</b> p. 712	
Review <b>Summary of Study Objectives</b>	
Answer <b>Self-Study Questions</b>	
Complete <b>Assignments</b>	

### Feature Story

#### "IS THERE ANYTHING ELSE WE CAN BUY?"

In a rapidly changing world you must change rapidly or suffer the consequences. In business, change requires investment.

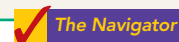
A case in point is found in the entertainment industry. Technology is bringing about innovations so quickly that it is nearly impossible to guess which technologies will last and which will soon fade away. For example, will both satellite TV and cable TV survive, or will just one succeed, or will both be replaced by something else? Or consider the publishing industry. Will paper newspapers and magazines be replaced by online news via the World Wide Web? If you are a publisher, you have to make your best guess about what the future holds and invest accordingly.

**Time Warner, Inc.** ([www.timewarner.com](http://www.timewarner.com)) lives at the center of this arena. It is not an environment for the timid, and Time Warner's philosophy is anything



but timid. It might be characterized as, "If we can't beat you, we will buy you." Its mantra is "invest, invest, invest." A list of Time Warner's holdings gives an idea of its reach. Magazines: *People*, *Time*, *Life*, *Sports Illustrated*, *Fortune*. Book publishers: Time-Life Books, Book-of-the-Month Club, Little, Brown & Co, Sunset Books. Television and movies: Warner Bros. ("ER," "Without a Trace," the WB Network), HBO, and movies like *Harry Potter and the Goblet of Fire*, and *Batman Begins*. Broadcasting: TNT, CNN news, and Turner's library of thousands of classic movies. Internet: America Online, and AOL Anywhere. Time Warner owns more information and entertainment copyrights and brands than any other company in the world.

The merger of **America Online (AOL)** with Time Warner, one of the biggest mergers ever, was originally perceived by many as the gateway to the future. In actuality, it was a financial disaster. It is largely responsible for much of the decline in Time Warner's stock price, from a high of \$95.80 to a recent level of \$14.07. Ted Turner, who was at one time Time Warner's largest shareholder, lost billions of dollars on the deal and eventually sold most of his shares.



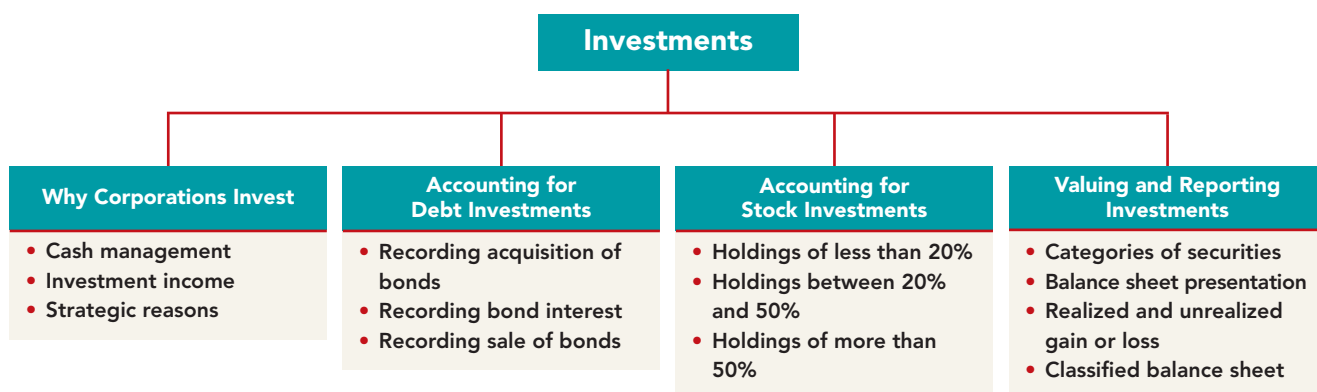
### **Inside Chapter 16...**

- **How Procter & Gamble Accounts for Gillette** (p. 703)
- **And the Correct Way to Report Investments Is...?** (p. 706)

## Preview of Chapter 16

Time Warner's management believes in aggressive growth through investing in the stock of existing companies. Besides purchasing stock, companies also purchase other securities such as bonds issued by corporations or by governments. Companies can make investments for a short or long period of time, as a passive investment, or with the intent to control another company. As you will see in this chapter, the way in which a company accounts for its investments is determined by a number of factors.

The content and organization of Chapter 16 are as follows.



## WHY CORPORATIONS INVEST

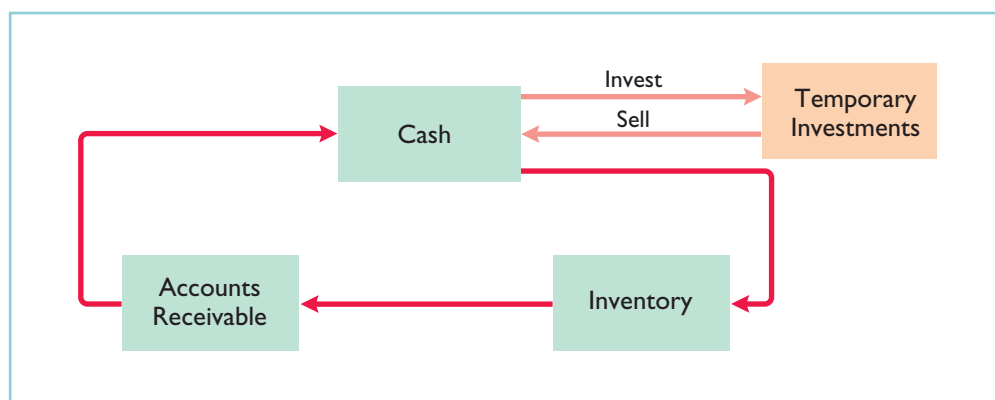
### STUDY OBJECTIVE 1

Discuss why corporations invest in debt and stock securities.

Corporations purchase investments in debt or stock securities generally for one of three reasons. First, a corporation may **have excess cash** that it does not need for the immediate purchase of operating assets. For example, many companies experience seasonal fluctuations in sales. A Cape Cod marina has more sales in the spring and summer than in the fall and winter. At the end of an operating cycle, the marina may have cash on hand that is temporarily idle until the start of another operating cycle. It may invest the excess funds to earn a greater return than it would get by just holding the funds in the bank. Illustration 16-1 depicts the role that such temporary investments play in the operating cycle.

Illustration 16-1

Temporary investments and the operating cycle



Excess cash may also result from economic cycles. For example, when the economy is booming, **General Electric** generates considerable excess cash. It uses some of this cash to purchase new plant and equipment and pays out some of the cash in dividends. But it may also invest excess cash in liquid assets in anticipation of a future downturn in the economy. It can then liquidate these investments during a recession, when sales slow and cash is scarce.

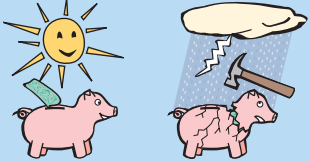
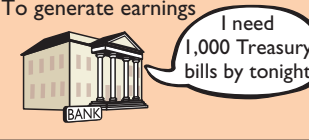
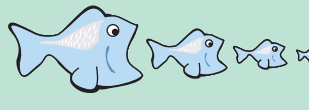
When investing excess cash for short periods of time, corporations invest in low-risk, highly liquid securities—most often short-term government securities. It is generally not wise to invest short-term excess cash in shares of common stock because stock investments can experience rapid price changes. If you did invest your short-term excess cash in stock and the price of the stock declined significantly just before you needed cash again, you would be forced to sell your stock investment at a loss.

A second reason some companies purchase investments is to generate **earnings from investment income**. For example, banks make most of their earnings by lending money, but they also generate earnings by investing in debt. Conversely, mutual stock funds invest primarily in equity securities in order to benefit from stock-price appreciation and dividend revenue.

Third, companies also invest for **strategic reasons**. A company can exercise some influence over a customer or supplier by purchasing a significant, but not controlling, interest in that company. Or, a company may purchase a noncontrolling interest in another company in a related industry in which it wishes to establish a presence. For example, **Time Warner** initially purchased an interest of less than 20% in **Turner Broadcasting** to have a stake in Turner’s expanding business opportunities. At a later date **Time Warner** acquired the remaining 80%. Subsequently, Time Warner merged with **AOL** and became **AOL Time Warner, Inc.** Now, it is again just **Time Warner, Inc.**, having dropped the “AOL” from its name in late 2003.

A corporation may also choose to purchase a controlling interest in another company. For example, as the *Accounting Across the Organization* box on page 703 shows, **Procter & Gamble** purchased **Gillette**. Such purchases might be done to enter a new industry without incurring the tremendous costs and risks associated with starting from scratch. Or a company might purchase another company in its same industry.

In summary, businesses invest in other companies for the reasons shown in Illustration 16-2.

Reason	Typical Investment
<p>To hold excess cash until needed</p> 	<p>Low-risk, high-liquidity, short-term securities such as government-issued securities</p>
<p>To generate earnings</p> 	<p>Debt securities (banks and other financial institutions); and stock securities (mutual funds and pension funds)</p>
<p>To meet strategic goals</p> 	<p>Stocks of companies in a related industry or in an unrelated industry that the company wishes to enter</p>

**Illustration 16-2**  
Why corporations invest

## ACCOUNTING FOR DEBT INVESTMENTS

### STUDY OBJECTIVE 2

Explain the accounting for debt investments.


**Debt investments** are investments in government and corporation bonds. In accounting for debt investments, companies make entries to record (1) the acquisition, (2) the interest revenue, and (3) the sale.

### Recording Acquisition of Bonds

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

Assume, for example, that Kuhl Corporation acquires 50 Doan Inc. 8%, 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:

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+54,000				
-54,000				
<b>Cash Flows</b>				
-54,000				




Jan. 1	Debt Investments	54,000	
	Cash		54,000
	(To record purchase of 50 Doan Inc. bonds)		

### Recording Bond Interest

The Doan, Inc. bonds pay interest of \$2,000 semiannually on July 1 and January 1 ( $\$50,000 \times 8\% \times \frac{1}{2}$ ). The entry for the receipt of interest on July 1 is:

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+2,000				
		+2,000 Rev		
<b>Cash Flows</b>				
+2,000				



July 1	Cash	2,000	
	Interest Revenue		2,000
	(To record receipt of interest on Doan Inc. bonds)		

If Kuhl Corporation's fiscal year ends on December 31, it accrues the interest of \$2,000 earned since July 1. The adjusting entry is:


<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+2,000				
		+2,000 Rev		
<b>Cash Flows</b>				
no effect				

Dec. 31	Interest Receivable	2,000	
	Interest Revenue		2,000
	(To accrue interest on Doan Inc. bonds)		

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.

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+2,000				
-2,000				
<b>Cash Flows</b>				
+2,000				



Jan. 1	Cash	2,000	
	Interest Receivable		2,000
	(To record receipt of accrued interest)		

A credit to Interest Revenue at this time is incorrect because the company earned and accrued interest revenue in the *preceding* accounting period.

### Recording Sale of Bonds


When Kuhl sells the bonds, it credits the investment account for the cost of the bonds. Kuhl records 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.

Assume, for example, that Kuhl Corporation receives net proceeds of \$58,000 on the sale of the Doan Inc. bonds on January 1, 2011, after receiving the interest

due. Since the securities cost \$54,000, the company realizes a gain of \$4,000. It records the sale as:

Jan. 1	Cash	58,000	
	Debt Investments		54,000
	Gain on Sale of Debt Investments		4,000
	(To record sale of Doan Inc. bonds)		

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+58,000				
-54,000				
				+4,000 Rev
<b>Cash Flows</b>				
+58,000				



Kuhl reports the gain on sale of debt investments under “Other revenues and gains” in the income statement and reports losses under “Other expenses and losses.”

## DO IT!

Waldo Corporation had the following transactions pertaining to debt investments.

- Jan. 1 Purchased 30, \$1,000 Hillary Co. 10% bonds for \$30,000, plus brokerage fees of \$900. Interest is payable semiannually on July 1 and January 1.
- July 1 Received semiannual interest on Hillary Co. bonds.
- July 1 Sold 15 Hillary Co. bonds for \$15,000, less \$400 brokerage fees.

(a) Journalize the transactions, and (b) prepare the adjusting entry for the accrual of interest on December 31.

### DEBT INVESTMENTS

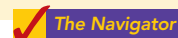
#### action plan

- ✓ Record bond investments at cost.
- ✓ Record interest when received and/or accrued.
- ✓ When bonds are sold, credit the investment account for the cost of the bonds.
- ✓ Record any difference between the cost and the net proceeds as a gain or loss.

#### Solution

(a) Jan. 1	Debt Investments	30,900	
	Cash		30,900
	(To record purchase of 30 Hillary Co. bonds)		
July 1	Cash	1,500	
	Interest Revenue ( $\$30,000 \times .10 \times 6/12$ )		1,500
	(To record receipt of interest on Hillary Co. bonds)		
July 1	Cash	14,600	
	Loss on Sale of Debt Investments	850	
	Debt Investments ( $\$30,900 \times 15/30$ )		15,450
	(To record sale of 15 Hillary Co. bonds)		
(b) Dec. 31	Interest Receivable	750	
	Interest Revenue ( $\$15,000 \times .10 \times 6/12$ )		750
	(To accrue interest on Hillary Co. bonds)		

Related exercise material: BE16-1, E16-2, E16-3, and DO IT! 16-1.



## ACCOUNTING FOR STOCK INVESTMENTS

**Stock investments** are investments in the capital stock of other corporations. When a company holds stock (and/or debt) of several different corporations, the group of securities is identified as an **investment portfolio**.

The accounting for investments in common stock depends on the extent of the investor’s influence over the operating and financial affairs of the issuing corporation (the **investee**). Illustration 16-3 (page 700) shows the general guidelines.




### STUDY OBJECTIVE 3

Explain the accounting for stock investments.

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**Illustration 16-3**

Accounting guidelines for stock investments

<u>Investor's Ownership Interest in Investee's Common Stock</u>	<u>Presumed Influence on Investee</u>	<u>Accounting Guidelines</u>
 Less than 20%	Insignificant	Cost method
 Between 20% and 50%	Significant	Equity method
 More than 50%	Controlling	Consolidated financial statements

Companies are required to use judgment instead of blindly following the guidelines.<sup>1</sup> On the following pages we will explain the application of each guideline.

### Holdings of Less than 20%

In accounting for stock investments 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.

#### RECORDING ACQUISITION OF STOCK INVESTMENTS

At acquisition, the cost principle applies. Cost includes all expenditures necessary to acquire these investments, such as the price paid plus any brokerage fees (commissions).

Assume, for example, that 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:

$$\text{A} = \text{L} + \text{SE}$$

+40,500  
-40,500

Cash Flows  
-40,500



July 1	Stock Investments	40,500	
	Cash		40,500
	(To record purchase of 1,000 shares of Beal Corporation common stock)		

#### RECORDING DIVIDENDS

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:

$$\text{A} = \text{L} + \text{SE}$$

+2,000

+2,000 Rev

Cash Flows  
+2,000



Dec. 31	Cash (1,000 × \$2)	2,000	
	Dividend Revenue		2,000
	(To record receipt of a cash dividend)		

Sanchez reports Dividend Revenue under “Other revenues and gains” in the income statement. Unlike interest on notes and bonds, dividends do not accrue. Therefore, companies do not make adjusting entries to accrue dividends.

<sup>1</sup> Among the questions that are considered in determining an investor's influence are these: (1) Does the investor have representation on the investee's board? (2) Does the investor participate in the investee's policy-making process? (3) Are there material transactions between the investor and investee? (4) Is the common stock held by other stockholders concentrated or dispersed?

## RECORDING SALE OF STOCK

When a company sells a stock investment, it recognizes as a gain or a loss the difference between the net proceeds from the sale (sales price less brokerage fees) and the cost of the stock.

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:

Feb. 10	Cash	39,500	
	Loss on Sale of Stock Investments	1,000	
	Stock Investments		40,500
	(To record sale of Beal common stock)		

Sanchez reports the loss under “Other expenses and losses” in the income statement. It would show a gain on sale under “Other revenues and gains.”

A	=	L	+	SE
+39,500				-1,000 Exp
-40,500				
Cash Flows				
+39,500				

## Holdings Between 20% and 50%

When an investor company owns only a small portion of the shares of stock of another company, the investor cannot exercise control over the investee. But, when an investor owns between 20% and 50% of the common stock of a corporation, it is presumed that the investor has significant influence over the financial and operating activities of the investee. The investor probably has a representative on the investee’s board of directors, and through that representative, may exercise some control over the investee. The investee company in some sense becomes part of the investor company.

For example, even prior to purchasing all of **Turner Broadcasting, Time Warner** owned 20% of Turner. Because it exercised significant control over major decisions made by Turner, Time Warner used an approach called the equity method. Under the **equity method, the investor records its share of the net income of the investee in the year when it is earned.** An alternative might be to delay recognizing the investor’s share of net income until the investee declares a cash dividend. But that approach would ignore the fact that the investor and investee are, in some sense, one company, making the investor better off by the investee’s earned income.

Under the equity method, the investor company initially records the investment in common stock at cost. After that, it **annually adjusts** the investment account to show the investor’s equity in the investee. Each year, the investor does the following: (1) It increases (debits) the investment account and increases (credits) revenue for its share of the investee’s net income.<sup>2</sup> (2) The investor also decreases (credits) the investment account for the amount of dividends received. The investment account is reduced for dividends received, because payment of a dividend decreases the net assets of the investee.

### HELPFUL HINT

Under the equity method, the investor recognizes revenue on the accrual basis—i.e., when it is earned by the investee.

## RECORDING ACQUISITION OF STOCK INVESTMENTS

Assume that Milar Corporation acquires 30% of the common stock of Beck Company for \$120,000 on January 1, 2010. Milar records this transaction as:

Jan. 1	Stock Investments	120,000	
	Cash		120,000
	(To record purchase of Beck common stock)		

A	=	L	+	SE
+120,000				
-120,000				
Cash Flows				
-120,000				

<sup>2</sup>Or, the investor increases (debits) a loss account and decreases (credits) the investment account for its share of the investee’s net loss.



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**RECORDING REVENUE AND DIVIDENDS**

For 2010, Beck reports net income of \$100,000. It declares and pays a \$40,000 cash dividend. Milar records (1) its share of Beck's income, \$30,000 (30% × \$100,000) and (2) the reduction in the investment account for the dividends received, \$12,000 (\$40,000 × 30%). The entries are:

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+30,000				+30,000 Rev
<b>Cash Flows</b>				
no effect				

Dec. 31	Stock Investments	30,000	30,000
	Revenue from Investment in Beck Company (To record 30% equity in Beck's 2010 net income)		

(1)

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+12,000				
-12,000				
<b>Cash Flows</b>				
+12,000				

Dec. 31	Cash	12,000	12,000
	Stock Investments (To record dividends received)		

(2)

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

**Illustration 16-4**  
Investment and revenue accounts after posting

Stock Investments		Revenue from Investment in Beck Company	
Jan. 1	120,000	Dec. 31	12,000
Dec. 31	30,000	Dec. 31	30,000
Dec. 31 Bal.	138,000		

During the year, the net increase in the investment account was \$18,000. As indicated above, the investment account increased by \$30,000 due to Milar's share of Beck's income, and it decreased by \$12,000 due to dividends received from Beck. In addition, Milar reports \$30,000 of revenue from its investment, which is 30% of Beck's net income of \$100,000.

Note that the difference between reported revenue under the cost method and reported revenue under the equity method can be significant. For example, Milar would report only \$12,000 of dividend revenue (30% × \$40,000) if it used the cost method.

**Holdings of More than 50%**

**STUDY OBJECTIVE 4**

Describe the use of consolidated financial statements.

A company that owns more than 50% of the common stock of another entity is known as the **parent company**. The entity whose stock the parent company owns is called the **subsidiary (affiliated) company**. Because of its stock ownership, the parent company has a **controlling interest** in the subsidiary.

**HELPFUL HINT**

If parent (A) has three wholly owned subsidiaries (B, C, & D), there are four separate legal entities. From the viewpoint of the shareholders of the parent company, there is only one economic entity.

When a company owns more than 50% of the common stock of another company, it usually prepares **consolidated financial statements**. These statements present the total assets and liabilities controlled by the parent company. They also present the total revenues and expenses of the subsidiary companies. Companies prepare consolidated statements **in addition to** the financial statements for the parent and individual subsidiary companies.

As noted earlier, when Time Warner had a 20% investment in Turner, it reported this investment in a single line item—Other Investments. After the merger, Time Warner instead consolidated Turner's results with its own. Under this

approach, Time Warner included Turner’s individual assets and liabilities with its own: its plant and equipment were added to Time Warner’s plant and equipment, its receivables were added to Time Warner’s receivables, and so on.

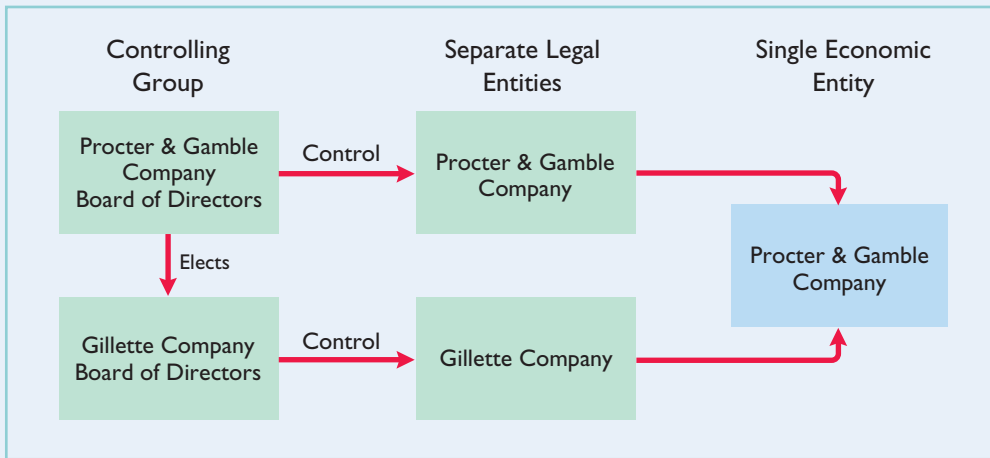
## ACCOUNTING ACROSS THE ORGANIZATION



### How Procter & Gamble Accounts for Gillette

Recently, **Procter & Gamble Company** acquired **Gillette Company** for \$53.4 billion.

The common stockholders of Procter & Gamble elect the board of directors of the company, who, in turn, select the officers and managers of the company. Procter & Gamble’s board of directors controls the property owned by the corporation, which includes the common stock of Gillette. Thus, they are in a position to elect the board of directors of Gillette and, in effect, control its operations. These relationships are graphically illustrated here.



Where on Procter & Gamble’s balance sheet will you find its investment in Gillette Company?

**Consolidated statements are useful to the stockholders, board of directors, and managers of the parent company. These statements indicate the magnitude and scope of operations of the companies under common control.** For example, regulators and the courts undoubtedly used the consolidated statements of **AT&T** to determine whether a breakup of AT&T was in the public interest. Listed below are three companies that prepare consolidated statements and some of the companies they have owned. One, **Disney**, is Time Warner’s arch rival.

#### Toys “R” Us, Inc.

Kids “R” Us  
Babies “R” Us  
Imaginarium  
Toysrus.com

#### Cendant

Howard Johnson  
Ramada Inn  
Century 21  
Coldwell Banker  
Avis

#### The Disney Company

Capital Cities/ABC, Inc.  
Disneyland, Disney World  
Mighty Ducks  
Anaheim Angels  
ESPN

#### Illustration 16-5

Examples of consolidated companies and their subsidiaries

**DO IT!**

## STOCK INVESTMENTS

Presented below are two independent situations.

1. Rho Jean Inc. acquired 5% of the 400,000 shares of common stock of Stillwater Corp. at a total cost of \$6 per share on May 18, 2010. On August 30, Stillwater declared and paid a \$75,000 dividend. On December 31, Stillwater reported net income of \$244,000 for the year.
2. Debbie, Inc. obtained significant influence over North Sails by buying 40% of North Sails' 60,000 outstanding shares of common stock at a cost of \$12 per share on January 1, 2010. On April 15, North Sails declared and paid a cash dividend of \$45,000. On December 31, North Sails reported net income of \$120,000 for the year.

Prepare all necessary journal entries for 2010 for (1) Rho Jean Inc. and (2) Debbie, Inc.

**action plan**

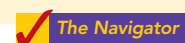
✓ Presume that the investor has relatively little influence over the investee when an investor owns less than 20% of the common stock of another corporation. In this case, net income earned by the investee is not considered a proper basis for recognizing income from the investment by the investor.

✓ Presume significant influence for investments of 20%–50%. Therefore, record the investor's share of the net income of the investee.

**Solution**

(1) May 18	Stock Investments (20,000 × \$6)	120,000	
	Cash (To record purchase of 20,000 shares of Stillwater Co. stock)		120,000
Aug. 30	Cash	3,750	
	Dividend Revenue (\$75,000 × 5%) (To record receipt of cash dividend)		3,750
(2) Jan. 1	Stock Investments (60,000 × 40% × \$12)	288,000	
	Cash (To record purchase of 24,000 shares of North Sails' stock)		288,000
Apr. 15	Cash	18,000	
	Stock Investments (\$45,000 × 40%) (To record receipt of cash dividend)		18,000
Dec. 31	Stock Investments (\$120,000 × 40%)	48,000	
	Revenue from Investment in North Sails (To record 40% equity in North Sails' net income)		48,000

Related exercise material: BE16-2, BE16-3, E16-4, E16-5, E16-6, E16-7, E16-8, and **DO IT!** 16-2.

**VALUING AND REPORTING INVESTMENTS****STUDY OBJECTIVE 5**

Indicate how debt and stock investments are reported in financial statements.

The value of debt and stock investments may fluctuate greatly during the time they are held. For example, in one 12-month period, the stock price of **Dell Computer Corp.** hit a high of \$30.77 and a low of \$18.87. In light of such price fluctuations, how should companies value investments at the balance sheet date? Valuation could be at cost, at fair value (market value), or at the lower-of-cost-or-market value.

Many people argue that fair value offers the best approach because it represents the expected cash realizable value of securities. **Fair value** is the amount for which a security could be sold in a normal market. Others counter that, unless a

security is going to be sold soon, the fair value is not relevant because the price of the security will likely change again.

## Categories of Securities

For purposes of valuation and reporting at a financial statement date, companies classify debt and stock investments into three categories:

1. **Trading securities** are bought and held primarily for sale in the near term to generate income on short-term price differences.
2. **Available-for-sale securities** are held with the intent of selling them sometime in the future.
3. **Held-to-maturity securities** are debt securities that the investor has the intent and ability to hold to maturity.<sup>3</sup>

Illustration 16-6 shows the valuation guidelines for these securities. **These guidelines apply to all debt securities and all stock investments in which the holdings are less than 20%.**

**INTERNATIONAL NOTE**  
A recent U.S. accounting standard gives companies the "option" of applying fair value accounting, rather than historical cost, to certain types of assets and liabilities. This makes U.S. accounting more similar to international standards.

Illustration 16-6  
Valuation guidelines



## TRADING SECURITIES

Companies hold trading securities with the intention of selling them in a short period (generally less than a month). *Trading* means frequent buying and selling. Companies report trading securities at fair value, and report changes from cost as part of net income. The changes are reported as **unrealized gains or losses** because the securities have not been sold. The unrealized gain or loss is the difference between the **total cost** of trading securities and their **total fair value**. Companies classify trading securities as current assets.

Illustration 16-7 shows the cost and fair values for investments Pace Corporation classified as trading securities on December 31, 2010. Pace has an unrealized gain of \$7,000 because total fair value of \$147,000 is \$7,000 greater than total cost of \$140,000.

## HELPFUL HINT

The fact that trading securities are short-term investments increases the likelihood that they will be sold at fair value (the company may not be able to time their sale) and the likelihood that there will be realized gains or losses.

Trading Securities, December 31, 2010			
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>

Illustration 16-7  
Valuation of trading securities

<sup>3</sup>This category is provided for completeness. The accounting and valuation issues related to held-to-maturity securities are discussed in more advanced accounting courses.

706 Chapter 16 Investments

Pace records fair value and unrealized gain or loss through an adjusting entry at the time it prepares financial statements. In this entry, the company uses a valuation allowance account, Market Adjustment—Trading, to record the difference between the total cost and the total fair value of the securities. The adjusting entry for Pace Corporation is:

A	=	L	+	SE
+7,000				+7,000 Rev
<b>Cash Flows</b>				
no effect				

Dec. 31	Market Adjustment—Trading Unrealized Gain—Income (To record unrealized gain on trading securities)	7,000		7,000
---------	--	-------	--	-------

Use of a Market Adjustment—Trading account enables Pace to maintain a record of the investment cost. It needs actual cost to determine the gain or loss realized when it sells the securities. Pace adds the Market Adjustment—Trading balance to the cost of the investments to arrive at a fair value for the trading securities.

**The fair value of the securities is the amount Pace reports on its balance sheet.** It reports the unrealized gain in the income statement in the “Other revenues and gains” section. The term “Income” in the account title indicates that the gain affects net income.

If the total cost of the trading securities is greater than total fair value, an unrealized loss has occurred. In such a case, the adjusting entry is a debit to Unrealized Loss—Income and a credit to Market Adjustment—Trading. Companies report the unrealized loss under “Other expenses and losses” in the income statement.

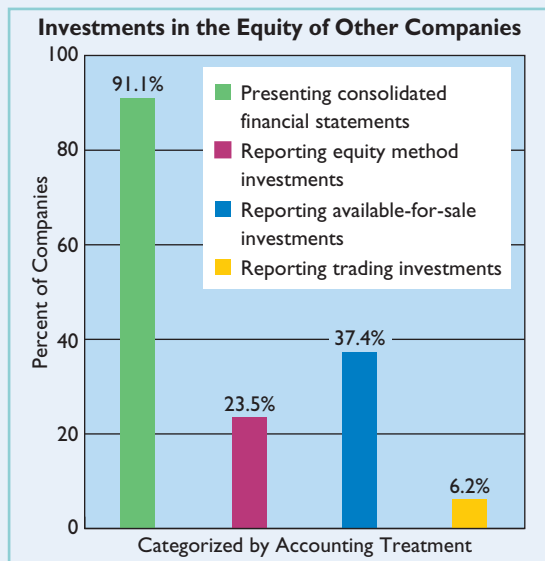
The market adjustment account is carried forward into future accounting periods. The company does not make any entry to the account until the end of each reporting period. At that time, the company adjusts the balance in the account to the difference between cost and fair value. For trading securities, it closes the Unrealized Gain (Loss)—Income account at the end of the reporting period.

## ACCOUNTING ACROSS THE ORGANIZATION



### And the Correct Way to Report Investments Is...?

The accompanying graph presents an estimate of the percentage of companies on the major exchanges that have investments in the equity of other entities.



As the graph indicates, many companies have equity investments of some type. These investments can be substantial. For example, the total amount of equity-method investments appearing on company balance sheets is approximately \$403 billion, and the amount shown in the income statements in any one year for all companies is approximately \$38 billion.

**Source:** “Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers,” United States Securities and Exchange Commission—Office of Chief Accountant, Office of Economic Analyses, Division of Corporation Finance (June 2005), pp. 36–39.




Why might the use of the equity method not lead to full disclosure in the financial statements?

### AVAILABLE-FOR-SALE SECURITIES

As indicated earlier, companies hold available-for-sale securities with the intent of selling these investments sometime in the future. If the intent is to sell the securities within the next year or operating cycle, the investor classifies the securities as current assets in the balance sheet. Otherwise, it classifies them as long-term assets in the investments section of the balance sheet.

Companies report available-for-sale securities at fair value. The procedure for determining fair value and the unrealized gain or loss for these securities is the same as for trading securities. To illustrate, assume that Ingrao Corporation has two securities that it classifies as available-for-sale. Illustration 16-8 provides information on their valuation. There is an unrealized loss of \$9,537 because total cost of \$293,537 is \$9,537 more than total fair value of \$284,000.

 **ETHICS NOTE**  
Some managers seem to hold their available-for-sale securities that have experienced losses, while selling those that have gains, thus increasing income. Do you think this is ethical?

Available-for-Sale Securities, December 31, 2010			
Investments	Cost	Fair Value	Unrealized Gain (Loss)
Campbell Soup Corporation 8% bonds	\$ 93,537	\$103,600	\$10,063
Hershey Corporation stock	200,000	180,400	(19,600)
Total	<u>\$293,537</u>	<u>\$284,000</u>	<u><b>\$(9,537)</b></u>

**Illustration 16-8**  
Valuation of available-for-sale securities

Both the adjusting entry and the reporting of the unrealized gain or loss for Ingrao's available-for-sale securities differ from those illustrated for trading securities. The differences result because Ingrao does not expect to sell these securities in the near term. Thus, prior to actual sale it is more likely that changes in fair value may change either unrealized gains or losses. Therefore, Ingrao does not report an unrealized gain or loss in the income statement. Instead, it reports it as a **separate component of stockholders' equity**.


In the adjusting entry, Ingrao identifies the market adjustment account with available-for-sale securities, and it identifies the unrealized gain or loss account with stockholders' equity. Ingrao records the unrealized loss of \$9,537 as follows:

Dec. 31	Unrealized Gain or Loss—Equity	9,537	9,537
	Market Adjustment—Available-for-Sale (To record unrealized loss on available-for-sale securities)		9,537

A	=	L	+	SE	
					-9,537 Exp
					-9,537
<b>Cash Flows</b>					
no effect					

If total fair value exceeds total cost, Ingrao debits Market Adjustment—Available for Sale and credits Unrealized Gain or Loss—Equity.

For available-for-sale securities, the company carries forward the Unrealized Gain or Loss—Equity account to future periods. At each future balance sheet date, Ingrao adjusts the market adjustment account to show the difference between cost and fair value at that time.

 **ETHICS NOTE**  
Recently the SEC accused investment bank **Morgan Stanley** of overstating the value of certain bond investments by \$75 million. The SEC stated that, in applying market value accounting, Morgan Stanley used its own more-optimistic assumptions rather than relying on external pricing sources.

### DO IT!

Some of Powderhorn Corporation's investment securities are classified as trading securities and some are classified as available-for-sale. The cost and market value of each category at December 31, 2010, are shown on page 708.

### TRADING AND AVAILABLE-FOR-SALE SECURITIES

	<u>Cost</u>	<u>Fair Value</u>	<u>Unrealized Gain (Loss)</u>
Trading securities	\$93,600	\$94,900	\$1,300
Available-for-sale securities	\$48,800	\$51,400	\$2,600

At December 31, 2009, the Market Adjustment—Trading account had a debit balance of \$9,200, and the Market Adjustment—Available-for-Sale account had a credit balance of \$5,750. Prepare the required journal entries for each group of securities for December 31, 2010.

### action plan

- ✓ Mark trading securities to fair value and report the adjustment in current-period income.
- ✓ Mark available-for-sale securities to fair value and report the adjustment as a separate component of stockholders' equity.

### Solution

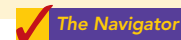
*Trading securities:*

Unrealized Loss—Income	7,900*	
Market Adjustment—Trading		7,900
(To record unrealized loss on trading securities)		
*\$9,200 – \$1,300		

*Available-for-sale securities:*

Market Adjustment—Available-for-Sale	8,350**	
Unrealized Gain or Loss—Equity		8,350
(To record unrealized gain on available-for-sale securities)		
**\$5,750 + \$2,600		

Related exercise material: BE16-4, BE16-5, BE16-6, BE16-7, E16-10, E16-11, E16-12, and **DO IT!** 16-3.



## Balance Sheet Presentation

In the balance sheet, companies classify investments as either short-term or long-term.

### SHORT-TERM INVESTMENTS

#### STUDY OBJECTIVE 6

Distinguish between short-term and long-term investments.

**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. 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.

**Readily Marketable.** An investment is readily marketable when it can be sold easily whenever the need for cash arises. Short-term paper<sup>4</sup> meets this criterion. It can be readily sold to other investors. Stocks and bonds traded on organized securities exchanges, such as the New York Stock Exchange, are readily marketable. They can be bought and sold daily. In contrast, there may be only a limited market for the securities issued by small corporations, and no market for the securities of a privately held company.

**Intent to Convert.** Intent to convert means that management intends to sell the investment within the next year or operating cycle, whichever is longer. Generally, this criterion is satisfied when the investment is considered a resource that the investor will use whenever the need for cash arises. For example, a ski resort may invest idle cash during the summer months with the intent to sell the securities to buy supplies and equipment shortly before the winter season. This investment is

<sup>4</sup>Short-term paper includes (1) certificates of deposit (CDs) issued by banks, (2) money market certificates issued by banks and savings and loan associations, (3) Treasury bills issued by the U.S. government, and (4) commercial paper (notes) issued by corporations with good credit ratings.

considered short-term even if lack of snow cancels the next ski season and eliminates the need to convert the securities into cash as intended.

Because of their high liquidity, short-term investments appear immediately below Cash in the “Current assets” section of the balance sheet. They are reported at fair value. For example, Pace Corporation would report its trading securities as shown in Illustration 16-9.

PACE CORPORATION		
Balance Sheet (partial)		
Current assets		
Cash		\$ 21,000
Short-term investments, at fair value		147,000

**Illustration 16-9**  
Presentation of short-term investments

**HELPFUL HINT**

In a recent survey of 600 large U.S. companies, 242 reported short-term investments.

**LONG-TERM INVESTMENTS**

Companies generally report long-term investments in a separate section of the balance sheet immediately below “Current assets,” as shown later in Illustration 16-12 (page 711). 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 their equity value.

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

Companies must present in the financial statements gains and losses on investments, whether realized or unrealized. In the income statement, companies report gains and losses in the nonoperating activities section under the categories listed in Illustration 16-10. Interest and dividend revenue are also reported in that section.

<u>Other Revenue and Gains</u>	<u>Other Expenses and Losses</u>
Interest Revenue	Loss on Sale of Investments
Dividend Revenue	Unrealized Loss—Income
Gain on Sale of Investments	
Unrealized Gain—Income	

**Illustration 16-10**  
Nonoperating items related to investments

As indicated earlier, companies report an unrealized gain or loss on available-for-sale securities as a separate component of stockholders’ equity. To illustrate, assume that Dawson Inc. has common stock of \$3,000,000, retained earnings of \$1,500,000, and an unrealized loss on available-for-sale securities of \$100,000. Illustration 16-11 shows the balance sheet presentation of the unrealized loss.

DAWSON INC.		
Balance Sheet (partial)		
Stockholders’ equity		
Common stock		\$3,000,000
Retained earnings		1,500,000
Total paid-in capital and retained earnings		4,500,000
<b>Less: Unrealized loss on available-for-sale securities</b>		<b>(100,000)</b>
Total stockholders’ equity		<u>\$4,400,000</u>

**Illustration 16-11**  
Unrealized loss in stockholders’ equity section



Note that the loss decreases stockholders' equity. An unrealized gain is added to stockholders' equity. Reporting the unrealized gain or loss in the stockholders' equity section serves two purposes: (1) It reduces the volatility of net income due to fluctuations in fair value. (2) It informs the financial statement user of the gain or loss that would occur if the securities were sold at fair value.

Companies must report items such as this, which affect stockholders' equity but are not included in the calculation of net income, as part of a more inclusive measure called *comprehensive income*. We discuss comprehensive income briefly in Chapter 18.

## Classified Balance Sheet

We have presented many sections of classified balance sheets in this and preceding chapters. The classified balance sheet in Illustration 16-12 includes, in one place, key topics from previous chapters: the issuance of par value common stock, restrictions of retained earnings, and issuance of long-term bonds. From this chapter, the statement includes (highlighted in red) short-term and long-term investments. The investments in short-term securities are considered trading securities. The long-term investments in stock of less than 20% owned companies are considered available-for-sale securities. Illustration 16-12 also includes a long-term investment reported at equity and descriptive notations within the statement, such as the basis for valuing merchandise inventory and one note to the statement.

### DO IT!

#### FINANCIAL STATEMENT PRESENTATION OF INVESTMENTS

Identify where each of the following items would be reported in the financial statements.

1. Interest earned on investments in bonds.
2. Market adjustment—available-for-sale.
3. Unrealized loss on available-for-sale securities.
4. Gain on sale of investments in stock.
5. Unrealized gain on trading securities.

Use the following possible categories:

*Balance sheet:*

Current assets	Current liabilities
Investments	Long-term liabilities
Property, plant, and equipment	Stockholders' equity
Intangible assets	

*Income statement:*

Other revenues and gains	Other expenses and losses
--------------------------	---------------------------

#### action plan

- ✓ Classify investments as current assets if they will be held for less than one year.
- ✓ Report unrealized gains or losses on trading securities in income.
- ✓ Report unrealized gains or losses on available-for-sale securities in equity.
- ✓ Report realized earnings on investments in the income statement as "Other revenues and gains" or as "Other expenses and losses."

#### Solution

Item	Financial Statement	Category
1. Interest earned on investments in bonds.	Income statement	Other revenues and gains
2. Market adjustment—available-for-sale	Balance sheet	Investments
3. Unrealized loss on available-for-sale securities	Balance sheet	Stockholders' equity
4. Gain on sale of investments in stock	Income statement	Other revenues and gains
5. Unrealized gain on trading securities	Income statement	Other revenues and gains

Related exercise material: BE16-6, BE16-7, BE16-8, E16-10, E16-11, E16-12, and **DO IT!** 16-4.

## PACE CORPORATION

Balance Sheet  
December 31, 2010Illustration 16-12  
Classified balance sheet

<u>Assets</u>		
Current assets		
Cash		\$ 21,000
<b>Short-term investments, at fair value</b>		<b>147,000</b>
Accounts receivable	\$ 84,000	
Less: Allowance for doubtful accounts	4,000	80,000
Merchandise inventory, at FIFO cost		43,000
Prepaid insurance		23,000
Total current assets		314,000
Investments		
<b>Investments in stock of less than 20% owned companies, at fair value</b>	<b>50,000</b>	
<b>Investment in stock of 20–50% owned company, at equity</b>	<b>150,000</b>	
Total investments		200,000
Property, plant, and equipment		
Land	200,000	
Buildings	\$800,000	
Less: Accumulated depreciation	200,000	600,000
Equipment	180,000	
Less: Accumulated depreciation	54,000	126,000
Total property, plant, and equipment		926,000
Intangible assets		
Goodwill		270,000
Total assets		<u>\$1,710,000</u>
<u>Liabilities and Stockholders' Equity</u>		
Current liabilities		
Accounts payable		\$ 185,000
Federal income taxes payable		60,000
Bond interest payable		10,000
Total current liabilities		255,000
Long-term liabilities		
Bonds payable, 10%, due 2021	\$ 300,000	
Less: Discount on bonds	10,000	
Total long-term liabilities		290,000
Total liabilities		545,000
Stockholders' equity		
Paid-in capital		
Common stock, \$10 par value, 200,000 shares authorized, 80,000 shares issued and outstanding	800,000	
Paid-in capital in excess of par value	100,000	
Total paid-in capital	900,000	
Retained earnings (Note 1)	255,000	
Total paid-in capital and retained earnings	1,155,000	
<b>Add: Unrealized gain on available-for-sale securities</b>	<b>10,000</b>	
Total stockholders' equity		1,165,000
Total liabilities and stockholders' equity		<u>\$1,710,000</u>

**Note 1.** Retained earnings of \$100,000 is restricted for plant expansion.

**Comprehensive DO IT!**



In its first year of operations, DeMarco Company had the following selected transactions in stock investments that are considered trading securities.

- June 1 Purchased for cash 600 shares of Sanburg common stock at \$24 per share, plus \$300 brokerage fees.
  - July 1 Purchased for cash 800 shares of Cey common stock at \$33 per share, plus \$600 brokerage fees.
  - Sept. 1 Received a \$1 per share cash dividend from Cey Corporation.
  - Nov. 1 Sold 200 shares of Sanburg common stock for cash at \$27 per share, less \$150 brokerage fees.
  - Dec. 15 Received a \$0.50 per share cash dividend on Sanburg common stock.
- At December 31, the fair values per share were: Sanburg \$25 and Cey \$30.

**Instructions**

- (a) Journalize the transactions.
- (b) Prepare the adjusting entry at December 31 to report the securities at fair value.

**action plan**

- ✓ Include the price paid plus brokerage fees in the cost of the investment.
- ✓ Compute the gain or loss on sales as the difference between net selling price and the cost of the securities.
- ✓ Base the adjustment to fair value on the total difference between the cost and the fair value of the securities.

**Solution to Comprehensive DO IT!**

(a) June 1	Stock Investments Cash (600 × \$24) + \$300 (To record purchase of 600 shares of Sanburg common stock)	14,700	14,700
July 1	Stock Investments Cash (800 × \$33) + \$600 (To record purchase of 800 shares of Cey common stock)	27,000	27,000
Sept. 1	Cash (800 × \$1.00) Dividend Revenue (To record receipt of \$1 per share cash dividend from Cey Corporation)	800	800
Nov. 1	Cash (200 × \$27) – \$150 Stock Investments (\$14,700 × 200/600) Gain on Sale of Stock Investments (To record sale of 200 shares of Sanburg common stock)	5,250	4,900 350
Dec. 15	Cash (600 – 200) × \$0.50 Dividend Revenue (To record receipt of \$0.50 per share dividend from Sanburg Corporation)	200	200
(b) Dec. 31	Unrealized Loss—Income Market Adjustment—Trading (To record unrealized loss on trading securities)	2,800	2,800

<u>Investment</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Unrealized Gain (Loss)</u>
Sanburg common stock	\$ 9,800	\$10,000	\$ 200
Cey common stock	27,000	24,000	(3,000)
Totals	<u>\$36,800</u>	<u>\$34,000</u>	<u>\$(2,800)</u>

## SUMMARY OF STUDY OBJECTIVES



- 1 Discuss why corporations invest in debt and stock securities.** Corporations invest for three primary reasons: (a) They have excess cash. (b) They view investments as a significant revenue source. (c) They have strategic goals such as gaining control of a competitor or moving into a new line of business.
- 2 Explain the accounting for debt investments.** Companies record investments in debt securities when they purchase bonds, receive or accrue interest, and sell the bonds. They report gains or losses on the sale of bonds in the “Other revenues and gains” or “Other expenses and losses” sections of the income statement.
- 3 Explain the accounting for stock investments.** Companies record investments in common stock when they purchase the stock, receive dividends, and sell the stock. When ownership is less than 20%, the cost method is used. When ownership is between 20% and 50%, the equity method should be used. When ownership is more than 50%, companies prepare consolidated financial statements.
- 4 Describe the use of consolidated financial statements.** When a company owns more than 50% of the common

stock of another company, it usually prepares consolidated financial statements. These statements indicate the magnitude and scope of operations of the companies under common control.

- 5 Indicate how debt and stock investments are reported in financial statements.** Investments in debt and stock securities are classified as trading, available-for-sale, or held-to-maturity securities for valuation and reporting purposes. Trading securities are reported as current assets at fair value, with changes from cost reported in net income. Available-for-sale securities are also reported at fair value, with the changes from cost reported in stockholders’ equity. Available-for-sale securities are classified as short-term or long-term depending on their expected future sale date.
- 6 Distinguish between short-term and long-term investments.** Short-term investments are securities that are (a) readily marketable and (b) intended to be converted to cash within the next year or operating cycle, whichever is longer. Investments that do not meet both criteria are classified as long-term investments.



## GLOSSARY



- Available-for-sale securities** Securities that are held with the intent of selling them sometime in the future. (p. 705).
- Consolidated financial statements** Financial statements that present the assets and liabilities controlled by the parent company and the total revenues and expenses of the subsidiary companies. (p. 702).
- Controlling interest** Ownership of more than 50% of the common stock of another entity. (p. 702).
- Cost method** An accounting method in which the investment in common stock is recorded at cost, and revenue is recognized only when cash dividends are received. (p. 700).
- Debt investments** Investments in government and corporation bonds. (p. 698).
- Equity method** An accounting method in which the investment in common stock is initially recorded at cost, and the investment account is then adjusted annually to show the investor’s equity in the investee. (p. 701).
- Fair value** Amount for which a security could be sold in a normal market. (p. 704).
- Held-to-maturity securities** Debt securities that the investor has the intent and ability to hold to their maturity date. (p. 705).
- Investment portfolio** A group of stocks and/or debt securities in different corporations held for investment purposes. (p. 699).
- Long-term investments** Investments that are not readily marketable or that management does not intend to convert into cash within the next year or operating cycle, whichever is longer. (p. 708).
- Parent company** A company that owns more than 50% of the common stock of another entity. (p. 702).
- Short-term investments** Investments that are readily marketable and intended to be converted into cash within the next year or operating cycle, whichever is longer. (p. 708).
- Stock investments** Investments in the capital stock of other corporations. (p. 699).
- Subsidiary (affiliated) company** A company in which more than 50% of its stock is owned by another company. (p. 702).
- Trading securities** Securities bought and held primarily for sale in the near term to generate income on short-term price differences. (p. 705).



## SELF-STUDY QUESTIONS


Answers are at the end of the chapter.

- (SO 1) 1. Which of the following is *not* a primary reason why corporations invest in debt and equity securities?
- They wish to gain control of a competitor.
  - They have excess cash.
  - They wish to move into a new line of business.
  - They are required to by law.
- (SO 2) 2. Debt investments are initially recorded at:
- cost.
  - cost plus accrued interest.
  - fair value.
  - None of the above.
- (SO 2) 3. Hanes Company sells debt investments costing \$26,000 for \$28,000, plus accrued interest that has been recorded. In journalizing the sale, credits are to:
- Debt Investments and Loss on Sale of Debt Investments.
  - Debt Investments, Gain on Sale of Debt Investments, and Bond Interest Receivable.
  - Stock Investments and Bond Interest Receivable.
  - No correct answer given.
- (SO 3) 4. Pryor Company receives net proceeds of \$42,000 on the sale of stock investments that cost \$39,500. This transaction will result in reporting in the income statement a:
- loss of \$2,500 under “Other expenses and losses.”
  - loss of \$2,500 under “Operating expenses.”
  - gain of \$2,500 under “Other revenues and gains.”
  - gain of \$2,500 under “Operating revenues.”
- (SO 3) 5. The equity method of accounting for long-term investments in stock should be used when the investor has significant influence over an investee and owns:
- between 20% and 50% of the investee’s common stock.
  - 20% or more of the investee’s common stock.
  - more than 50% of the investee’s common stock.
  - less than 20% of the investee’s common stock.
- (SO 3) 6. Assume that Horicon Corp acquired 25% of the common stock of Sheboygan Corp. on January 1, 2010, for \$300,000. During 2008 Sheboygan Corp. reported net income of \$160,000 and paid total dividends of \$60,000. If Horicon uses the equity method to account for its investment, the balance in the investment account on December 31, 2010, will be:
- \$300,000.
  - \$325,000.
  - \$400,000.
  - \$340,000.
- (SO 3) 7. Using the information in question 6, what entry would Horicon make to record the receipt of the dividend from Sheboygan?
- Debit Cash and credit Revenue from Investment in Sheboygan Corp.
  - Debit Dividends and credit Revenue from Investment in Sheboygan Corp.
  - Debit Cash and credit Stock Investments.
  - Debit Cash and credit Dividend Revenue.
- (SO 3) 8. You have a controlling interest if:
- you own more than 20% of a company’s stock.
  - you are the president of the company.
  - you use the equity method.
  - you own more than 50% of a company’s stock.
9. Which of the following statements is *not true*? Consolidated financial statements are useful to:
- determine the profitability of specific subsidiaries.
  - determine the total profitability of enterprises under common control.
  - determine the breadth of a parent company’s operations.
  - determine the full extent of total obligations of enterprises under common control.
10. At the end of the first year of operations, the total cost of the trading securities portfolio is \$120,000. Total fair value is \$115,000. The financial statements should show:
- a reduction of an asset of \$5,000 and a realized loss of \$5,000.
  - a reduction of an asset of \$5,000 and an unrealized loss of \$5,000 in the stockholders’ equity section.
  - a reduction of an asset of \$5,000 in the current assets section and an unrealized loss of \$5,000 in “Other expenses and losses.”
  - a reduction of an asset of \$5,000 in the current assets section and a realized loss of \$5,000 in “Other expenses and losses.”
11. At December 31, 2010, the fair value of available-for-sale securities is \$41,300 and the cost is \$39,800. At January 1, 2010, there was a credit balance of \$900 in the Market Adjustment—Available-for-Sale account. The required adjusting entry would be:
- Debit Market Adjustment—Available-for-Sale for \$1,500 and credit Unrealized Gain or Loss—Equity for \$1,500.
  - Debit Market Adjustment—Available-for-Sale for \$600 and credit Unrealized Gain or Loss—Equity for \$600.
  - Debit Market Adjustment—Available-for-Sale for \$2,400 and credit Unrealized Gain or Loss—Equity for \$2,400.
  - Debit Unrealized Gain or Loss—Equity for \$2,400 and credit Market Adjustment—Available-for-Sale for \$2,400.
12. In the balance sheet, a debit balance in Unrealized Gain or Loss—Equity is reported as a(n):
- increase to stockholders’ equity.
  - decrease to stockholders’ equity.
  - loss in the income statement.
  - loss in the retained earnings statement.
13. Short-term debt investments must be readily marketable and expected to be sold within:
- 3 months from the date of purchase.
  - the next year or operating cycle, whichever is shorter.
  - the next year or operating cycle, whichever is longer.
  - the operating cycle.

Go to the book’s companion website,  
[www.wiley.com/college/weygandt](http://www.wiley.com/college/weygandt),  
 for Additional Self-Study questions.



## QUESTIONS

- What are the reasons that corporations invest in securities?
- (a) What is the cost of an investment in bonds?  
(b) When is interest on bonds recorded?
- Tino Martinez is confused about losses and gains on the sale of debt investments. Explain to Tino (a) how the gain or loss is computed, and (b) the statement presentation of the gains and losses.
- Olindo Company sells Gish's bonds costing \$40,000 for \$45,000, including \$500 of accrued interest. In recording the sale, Olindo books a \$5,000 gain. Is this correct? Explain.
- What is the cost of an investment in stock?
- To acquire Kinston Corporation stock, R. Neal pays \$62,000 in cash, plus \$1,200 broker's fees. What entry should be made for this investment?
- (a) When should a long-term investment in common stock be accounted for by the equity method? (b) When is revenue recognized under this method?
- Rijo Corporation uses the equity method to account for its ownership of 30% of the common stock of Pippen Packing. During 2010 Pippen reported a net income of \$80,000 and declares and pays cash dividends of \$10,000. What recognition should Rijo Corporation give to these events?
- What constitutes "significant influence" when an investor's financial interest is below the 50% level?
- Distinguish between the cost and equity methods of accounting for investments in stocks.
- What are consolidated financial statements?
- What are the valuation guidelines for investments at a balance sheet date?
- Tina Eddings is the controller of Mendez Inc. At December 31, the company's investments in trading securities cost \$74,000. They have a fair value of \$70,000. Indicate how Tina would report these data in the financial statements prepared on December 31.
- Using the data in question 13, how would Tina report the data if the investment were long-term and the securities were classified as available-for-sale?
- Hashmi Company's investments in available-for-sale securities at December 31 show total cost of \$195,000 and total fair value of \$205,000. Prepare the adjusting entry.
- Using the data in question 15, prepare the adjusting entry assuming the securities are classified as trading securities.
- What is the proper statement presentation of the account Unrealized Loss—Equity?
- What purposes are served by reporting Unrealized Gains (Losses)—Equity in the stockholders' equity section?
- Altoona Wholesale Supply owns stock in Key Corporation. Altoona intends to hold the stock indefinitely because of some negative tax consequences if sold. Should the investment in Key be classified as a short-term investment? Why or why not?
-  **PEPSICO** What does PepsiCo's state regarding its accounting policy involving consolidated financial statements?

## BRIEF EXERCISES



- BE16-1** Coffey Corporation purchased debt investments for \$52,000 on January 1, 2010. On July 1, 2010, Coffey received cash interest of \$2,340. Journalize the purchase and the receipt of interest. Assume that no interest has been accrued. *Journalize entries for debt investments.*  
(SO 2)
- BE16-2** On August 1, Wade Company buys 1,000 shares of Morgan common stock for \$35,000 cash, plus brokerage fees of \$700. On December 1, Wade sells the stock investments for \$40,000 in cash. Journalize the purchase and sale of the common stock. *Journalize entries for stock investments.*  
(SO 3)
- BE16-3** Kayser Company owns 25% of Fort Company. For the current year Fort reports net income of \$180,000 and declares and pays a \$50,000 cash dividend. Record Kayser's equity in Fort's net income and the receipt of dividends from Fort. *Record transactions under the equity method of accounting.*  
(SO 3)
- BE16-4** The cost of the trading securities of Cepeda Company at December 31, 2010, is \$62,000. At December 31, 2010, the fair value of the securities is \$59,000. Prepare the adjusting entry to record the securities at fair value. *Prepare adjusting entry using fair value.*  
(SO 5)
- BE16-5** For the data presented in BE16-4, show the financial statement presentation of the trading securities and related accounts. *Indicate statement presentation using fair value.*  
(SO 5, 6)
- BE16-6** Garrett Corporation holds as a long-term investment available-for-sale stock securities costing \$72,000. At December 31, 2010, the fair value of the securities is \$66,000. Prepare the adjusting entry to record the securities at fair value. *Prepare adjusting entry using fair value.*  
(SO 5)

## 716 Chapter 16 Investments

Indicate statements presentation using fair value.

(SO 5, 6)

Prepare investments section of balance sheet.

(SO 5, 6)

**BE16-7** For the data presented in BE16-6, show the financial statement presentation of the available-for-sale securities and related accounts. Assume the available-for-sale securities are noncurrent.

**BE16-8** Gowdy Corporation has the following long-term investments: (1) Common stock of Dixen Co. (10% ownership) held as available-for-sale securities, cost \$108,000, fair value \$115,000. (2) Common stock of Ely Inc. (30% ownership), cost \$210,000, equity \$270,000. Prepare the investments section of the balance sheet.

### DO IT! REVIEW

Make journal entry for bond purchase and adjusting entry for interest accrual.

(SO 2)

**DO IT! 16-1** Odlaw Corporation had the following transactions relating to debt investments:

- Jan. 1 Purchased 50, \$1,000, 12% Clinton Company bonds for \$50,000 plus broker's fees of \$1,500. Interest is payable semiannually on January 1 and July 1.
- July 1 Received semiannual interest from Clinton Company bonds.
- July 1 Sold 30 Clinton Company bonds for \$30,000, less \$800 broker's fees.

(a) Journalize the transactions, and (b) prepare the adjusting entry for the accrual of interest on December 31.

Make journal entries for stock investments.

(SO 3)

**DO IT! 16-2** Presented below are two independent situations:

1. Potomac Inc. acquired 10% of the 500,000 shares of common stock of Maryland Corporation at a total cost of \$11 per share on June 17, 2010. On September 3, Maryland declared and paid a \$160,000 dividend. On December 31, Maryland reported net income of \$550,000 for the year.
2. Andy Fisher Corporation obtained significant influence over Bandit Company by buying 30% of Bandit's 100,000 outstanding shares of common stock at a cost of \$18 per share on January 1, 2010. On May 15, Bandit declared and paid a cash dividend of \$150,000. On December 31, Bandit reported net income of \$270,000 for the year.

Prepare all necessary journal entries for 2010 for (1) Potomac and (2) Andy Fisher.

Make journal entries for trading and available-for-sale securities.

(SO 5)

**DO IT! 16-3** Some of Grand Junction Corporation's investment securities are classified as trading securities and some are classified as available-for-sale. The cost and market value of each category at December 31, 2010, was as follows.

	Cost	Fair Value	Unrealized Gain (Loss)
Trading securities	\$96,300	\$84,900	\$(11,400)
Available-for-sale securities	\$59,000	\$63,200	\$ 4,200

At December 31, 2009, the Market Adjustment—Trading account had a debit balance of \$2,200, and the Market Adjustment—Available-for-Sale account had a credit balance of \$7,750. Prepare the required journal entries for each group of securities for December 31, 2010.

Indicate financial statement presentation of investments.

(SO 6)

**DO IT! 16-4** Identify where each of the following items would be reported in the financial statements.

1. Loss on sale of investments in stock.
2. Unrealized gain on available-for-sale securities.
3. Market adjustment—trading.
4. Interest earned on investments in bonds.
5. Unrealized loss on trading securities.

Use the following possible categories:

*Balance sheet:*

Current assets	Current liabilities
Investments	Long-term liabilities
Property, plant, and equipment	Stockholders' equity
Intangible assets	

*Income statement:*

Other revenues and gains	Other expenses and losses
--------------------------	---------------------------

## EXERCISES



**E16-1** Max Weinberg is studying for an accounting test and has developed the following questions about investments.

1. What are three reasons why companies purchase investments in debt or stock securities?
2. Why would a corporation have excess cash that it does not need for operations?
3. What is the typical investment when investing cash for short periods of time?
4. What are the typical investments when investing cash to generate earnings?
5. Why would a company invest in securities that provide no current cash flows?
6. What is the typical stock investment when investing cash for strategic reasons?

*Understand debt and stock investments.*

(SO 1)

**Instructions**

Provide answers for Max.

**E16-2** Foren Corporation had the following transactions pertaining to debt investments.

- Jan. 1 Purchased 50 8%, \$1,000 Choate Co. bonds for \$50,000 cash plus brokerage fees of \$900. Interest is payable semiannually on July 1 and January 1.  
 July 1 Received semiannual interest on Choate Co. bonds.  
 July 1 Sold 30 Choate Co. bonds for \$34,000 less \$500 brokerage fees.

*Journalize debt investment transactions and accrue interest.*

(SO 2)

**Instructions**

- (a) Journalize the transactions.
- (b) Prepare the adjusting entry for the accrual of interest at December 31.

**E16-3** EmmyLou Company purchased 70 Harris Company 12%, 10-year, \$1,000 bonds on January 1, 2010, for \$73,000. EmmyLou Company also had to pay \$500 of broker's fees. The bonds pay interest semiannually on July 1 and January 1. On January 1, 2011, after receipt of interest, EmmyLou Company sold 40 of the bonds for \$40,100.

*Journalize debt investment transactions, accrue interest, and record sale.*

(SO 2)

**Instructions**

Prepare the journal entries to record the transactions described above.

**E16-4** Dossett Company had the following transactions pertaining to stock investments.

- Feb. 1 Purchased 600 shares of Goetz common stock (2%) for \$6,000 cash, plus brokerage fees of \$200.  
 July 1 Received cash dividends of \$1 per share on Goetz common stock.  
 Sept. 1 Sold 300 shares of Goetz common stock for \$4,400, less brokerage fees of \$100.  
 Dec. 1 Received cash dividends of \$1 per share on Goetz common stock.

*Journalize stock investment transactions.*

(SO 3)

**Instructions**

- (a) Journalize the transactions.
- (b) Explain how dividend revenue and the gain (loss) on sale should be reported in the income statement.

**E16-5** Wyrick Inc. had the following transactions pertaining to investments in common stock.

- Jan. 1 Purchased 2,500 shares of Murphy Corporation common stock (5%) for \$140,000 cash plus \$2,100 broker's commission.  
 July 1 Received a cash dividend of \$3 per share.  
 Dec. 1 Sold 500 shares of Murphy Corporation common stock for \$32,000 cash, less \$800 broker's commission.  
 Dec. 31 Received a cash dividend of \$3 per share.

*Journalize transactions for investments in stocks.*

(SO 3)

**Instructions**

Journalize the transactions.

**E16-6** On February 1, Neil Company purchased 500 shares (2% ownership) of Young Company common stock for \$30 per share plus brokerage fees of \$400. On March 20, Neil Company sold 100 shares of Young stock for \$2,900, less a \$50 brokerage fee. Neil received a dividend of \$1.00 per share on April 25. On June 15, Neil sold 200 shares of Young stock for \$7,400, less a \$90 brokerage fee. On July 28, Neil received a dividend of \$1.25 per share.

*Journalize transactions for investments in stocks.*

(SO 3)

**Instructions**

Prepare the journal entries to record the transactions described above.



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Journalize and post transactions, and contrast cost and equity method results.

(SO 3)

**E16-7** On January 1 Kwun Corporation purchased a 25% equity in Connors Corporation for \$180,000. At December 31 Connors declared and paid a \$60,000 cash dividend and reported net income of \$200,000.

### Instructions

- Journalize the transactions.
- Determine the amount to be reported as an investment in Connors stock at December 31.

Journalize entries under cost and equity methods.

(SO 3, 5)

**E16-8** Presented below are two independent situations.

- Heath Cosmetics acquired 15% of the 200,000 shares of common stock of Van Fashion at a total cost of \$13 per share on March 18, 2010. On June 30, Van declared and paid a \$60,000 dividend. On December 31, Van reported net income of \$122,000 for the year. At December 31, the market price of Van Fashion was \$15 per share. The stock is classified as available-for-sale.
- Yoder, Inc., obtained significant influence over Parks Corporation by buying 30% of Parks 30,000 outstanding shares of common stock at a total cost of \$9 per share on January 1, 2010. On June 15, Parks declared and paid a cash dividend of \$30,000. On December 31, Parks reported a net income of \$80,000 for the year.

### Instructions

Prepare all the necessary journal entries for 2010 for (1) Heath Cosmetics and (2) Yoder, Inc.

Understand the usefulness of consolidated statements.

(SO 4)

**E16-9** Ryan Company purchased 70% of the outstanding common stock of Wayne Corporation.

### Instructions

- Explain the relationship between Ryan Company and Wayne Corporation.
- How should Ryan account for its investment in Wayne?
- Why is the accounting treatment described in (b) useful?

Prepare adjusting entry to record fair value, and indicate statement presentation.

(SO 5, 6)



**E16-10** At December 31, 2010, the trading securities for Natoli, Inc. are as follows.

<u>Security</u>	<u>Cost</u>	<u>Fair Value</u>
A	\$17,500	\$16,000
B	12,500	14,000
C	23,000	19,000
	<u>\$53,000</u>	<u>\$49,000</u>

### Instructions


- Prepare the adjusting entry at December 31, 2010, to report the securities at fair value.
- Show the balance sheet and income statement presentation at December 31, 2010, after adjustment to fair value.

Prepare adjusting entry to record fair value, and indicate statement presentation.

(SO 5, 6)

**E16-11** Data for investments in stock classified as trading securities are presented in E16-10. Assume instead that the investments are classified as available-for-sale securities. They have the same cost and fair value. The securities are considered to be a long-term investment.

### Instructions

- Prepare the adjusting entry at December 31, 2010, to report the securities at fair value.
- Show the statement presentation at December 31, 2010, after adjustment to fair value.
-  M. Linquist, a member of the board of directors, does not understand the reporting of the unrealized gains or losses. Write a letter to Mr. Linquist explaining the reporting and the purposes that it serves.

Prepare adjusting entries for fair value, and indicate statement presentation for two classes of securities.

(SO 5, 6)

**E16-12** McGee Company has the following data at December 31, 2010.

<u>Securities</u>	<u>Cost</u>	<u>Fair Value</u>
Trading	\$120,000	\$124,000
Available-for-sale	100,000	94,000

The available-for-sale securities are held as a long-term investment.

### Instructions

- Prepare the adjusting entries to report each class of securities at fair value.
- Indicate the statement presentation of each class of securities and the related unrealized gain (loss) accounts.



## EXERCISES: SET B

Visit the book's companion website at [www.wiley.com/college/veygandt](http://www.wiley.com/college/veygandt), and choose the Student Companion site, to access Exercise Set B.

## PROBLEMS: SET A



**P16-1A** Davison Carecenters Inc. provides financing and capital to the health-care industry, with a particular focus on nursing homes for the elderly. The following selected transactions relate to bonds acquired as an investment by Davison, whose fiscal year ends on December 31.

*Journalize debt investment transactions and show financial statement presentation.*

(SO 2, 5, 6)

### 2010

- Jan. 1 Purchased at face value \$2,000,000 of Hannon Nursing Centers, Inc., 10-year, 8% bonds dated January 1, 2010, directly from Hannon.
- July 1 Received the semiannual interest on the Hannon bonds.
- Dec. 31 Accrual of interest at year-end on the Hannon bonds.

(Assume that all intervening transactions and adjustments have been properly recorded and that the number of bonds owned has not changed from December 31, 2010, to December 31, 2012.)

### 2013

- Jan. 1 Received the semiannual interest on the Hannon bonds.
- Jan. 1 Sold \$1,000,000 Hannon bonds at 106. The broker deducted \$6,000 for commissions and fees on the sale.
- July 1 Received the semiannual interest on the Hannon bonds.
- Dec. 31 Accrual of interest at year-end on the Hannon bonds.

### Instructions

- (a) Journalize the listed transactions for the years 2010 and 2013.
- (b) Assume that the fair value of the bonds at December 31, 2010, was \$2,200,000. These bonds are classified as available-for-sale securities. Prepare the adjusting entry to record these bonds at fair value.
- (c) Based on your analysis in part (b), show the balance sheet presentation of the bonds and interest receivable at December 31, 2010. Assume the investments are considered long-term. Indicate where any unrealized gain or loss is reported in the financial statements.

(a) Gain on sale of debt investment \$54,000

**P16-2A** In January 2010, the management of Noble Company concludes that it has sufficient cash to permit some short-term investments in debt and stock securities. During the year, the following transactions occurred.

*Journalize investment transactions, prepare adjusting entry, and show statement presentation.*

(SO 2, 3, 5, 6)

- Feb. 1 Purchased 600 shares of Hiens common stock for \$31,800, plus brokerage fees of \$600.
- Mar. 1 Purchased 800 shares of Pryce common stock for \$20,000, plus brokerage fees of \$400.
- Apr. 1 Purchased 50 \$1,000, 7% Roy bonds for \$50,000, plus \$1,000 brokerage fees. Interest is payable semiannually on April 1 and October 1.
- July 1 Received a cash dividend of \$0.60 per share on the Hiens common stock.
- Aug. 1 Sold 200 shares of Hiens common stock at \$58 per share less brokerage fees of \$200.
- Sept. 1 Received a \$1 per share cash dividend on the Pryce common stock.
- Oct. 1 Received the semiannual interest on the Roy bonds.
- Oct. 1 Sold the Roy bonds for \$50,000 less \$1,000 brokerage fees.

At December 31, the fair value of the Hiens common stock was \$55 per share. The fair value of the Pryce common stock was \$24 per share.



### Instructions

- (a) Journalize the transactions and post to the accounts Debt Investments and Stock Investments. (Use the T-account form.)
- (b) Prepare the adjusting entry at December 31, 2010, to report the investment securities at fair value. All securities are considered to be trading securities.
- (c) Show the balance sheet presentation of investment securities at December 31, 2010.
- (d) Identify the income statement accounts and give the statement classification of each account.

(a) Gain on stock sale \$600

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Journalize transactions and adjusting entry for stock investments.

(SO 3, 5, 6)



**P16-3A** On December 31, 2010, Ramey Associates owned the following securities, held as a long-term investment. The securities are not held for influence or control of the investee.

<u>Common Stock</u>	<u>Shares</u>	<u>Cost</u>
Hurst Co.	2,000	\$60,000
Pine Co.	5,000	45,000
Scott Co.	1,500	30,000

On December 31, 2010, the total fair value of the securities was equal to its cost. In 2011, the following transactions occurred.

- July 1 Received \$1 per share semiannual cash dividend on Pine Co. common stock.
- Aug. 1 Received \$0.50 per share cash dividend on Hurst Co. common stock.
- Sept. 1 Sold 1,500 shares of Pine Co. common stock for cash at \$8 per share, less brokerage fees of \$300.
- Oct. 1 Sold 800 shares of Hurst Co. common stock for cash at \$33 per share, less brokerage fees of \$500.
- Nov. 1 Received \$1 per share cash dividend on Scott Co. common stock.
- Dec. 15 Received \$0.50 per share cash dividend on Hurst Co. common stock.
- 31 Received \$1 per share semiannual cash dividend on Pine Co. common stock.

At December 31, the fair values per share of the common stocks were: Hurst Co. \$32, Pine Co. \$8, and Scott Co. \$18.

### Instructions

- (a) Journalize the 2011 transactions and post to the account Stock Investments. (Use the T-account form.)
- (b) Prepare the adjusting entry at December 31, 2011, to show the securities at fair value. The stock should be classified as available-for-sale securities.
- (c) Show the balance sheet presentation of the investments at December 31, 2011. At this date, Ramey Associates has common stock \$1,500,000 and retained earnings \$1,000,000.

(b) Unrealized loss \$4,100

Prepare entries under the cost and equity methods, and tabulate differences.

(SO 3)

**P16-4A** Glaser Services acquired 30% of the outstanding common stock of Nickels Company on January 1, 2010, by paying \$800,000 for the 45,000 shares. Nickels declared and paid \$0.30 per share cash dividends on March 15, June 15, September 15, and December 15, 2010. Nickels reported net income of \$320,000 for the year. At December 31, 2010, the market price of Nickels common stock was \$24 per share.

### Instructions

- (a) Prepare the journal entries for Glaser Services for 2010 assuming Glaser cannot exercise significant influence over Nickels. (Use the cost method and assume that Nickels common stock should be classified as a trading security.)
- (b) Prepare the journal entries for Glaser Services for 2010, assuming Glaser can exercise significant influence over Nickels. Use the equity method.
- (c) Indicate the balance sheet and income statement account balances at December 31, 2010, under each method of accounting.

(a) Total dividend revenue \$54,000

(b) Revenue from investments \$96,000

Journalize stock investment transactions and show statement presentation.

(SO 3, 5, 6)

**P16-5A** The following securities are in Pascual Company's portfolio of long-term available-for-sale securities at December 31, 2010.

	<u>Cost</u>
1,000 shares of Abel Corporation common stock	\$52,000
1,400 shares of Frey Corporation common stock	84,000
1,200 shares of Weiss Corporation preferred stock	33,600

On December 31, 2010, the total cost of the portfolio equaled total fair value. Pascual had the following transactions related to the securities during 2011.

- Jan. 20 Sold 1,000 shares of Abel Corporation common stock at \$55 per share less brokerage fees of \$600.
- 28 Purchased 400 shares of \$70 par value common stock of Rosen Corporation at \$78 per share, plus brokerage fees of \$480.
- 30 Received a cash dividend of \$1.15 per share on Frey Corp. common stock.
- Feb. 8 Received cash dividends of \$0.40 per share on Weiss Corp. preferred stock.
- 18 Sold all 1,200 shares of Weiss Corp. preferred stock at \$27 per share less brokerage fees of \$360.

- July 30 Received a cash dividend of \$1.00 per share on Frey Corp. common stock.  
 Sept. 6 Purchased an additional 900 shares of \$10 par value common stock of Rosen Corporation at \$82 per share, plus brokerage fees of \$1,200.  
 Dec. 1 Received a cash dividend of \$1.50 per share on Rosen Corporation common stock.

At December 31, 2011, the fair values of the securities were:

Frey Corporation common stock	\$64 per share
Rosen Corporation common stock	\$72 per share

Pascual Company uses separate account titles for each investment, such as “Investment in Frey Corporation Common Stock.”

**Instructions**

- (a) Prepare journal entries to record the transactions.  
 (b) Post to the investment accounts. (Use T accounts.)  
 (c) Prepare the adjusting entry at December 31, 2011 to report the portfolio at fair value.  
 (d) Show the balance sheet presentation at December 31, 2011, for the investment-related accounts.

(a) Loss on sale of preferred stock \$1,560  
 (c) Unrealized loss \$7,480

**P16-6A** The following data, presented in alphabetical order, are taken from the records of Urbina Corporation.

Prepare a balance sheet.  
 (SO, 5, 6)

Accounts payable	\$ 240,000
Accounts receivable	140,000
Accumulated depreciation—building	180,000
Accumulated depreciation—equipment	52,000
Allowance for doubtful accounts	6,000
Bonds payable (10%, due 2018)	500,000
Buildings	950,000
Cash	42,000
Common stock (\$10 par value; 500,000 shares authorized, 150,000 shares issued)	1,500,000
Dividends payable	80,000
Equipment	275,000
Goodwill	200,000
Income taxes payable	120,000
Investment in Flott common stock (10% ownership), at cost	278,000
Investment in Portico common stock (30% ownership), at equity	380,000
Land	390,000
Market adjustment—available-for-sale securities (Dr)	8,000
Merchandise inventory	170,000
Notes payable (due 2011)	70,000
Paid-in capital in excess of par value	130,000
Premium on bonds payable	40,000
Prepaid insurance	16,000
Retained earnings	103,000
Short-term stock investment, at fair value (and cost)	180,000
Unrealized gain—available-for-sale securities	8,000

The investment in Flott common stock is considered to be a long-term available-for-sale security.

**Instructions**

Prepare a classified balance sheet at December 31, 2010.

Total assets \$2,791,000

**PROBLEMS: SET B**

**P16-1B** Groneman Farms is a grower of hybrid seed corn for Ogleby Genetics Corporation. It has had two exceptionally good years and has elected to invest its excess funds in bonds. The following selected transactions relate to bonds acquired as an investment by Groneman Farms, whose fiscal year ends on December 31.

Journalize debt investment transactions and show financial statement presentation.  
 (SO 2, 5, 6)

**2010**

- Jan. 1 Purchased at face value \$400,000 of Ziemer Corporation 10-year, 9% bonds dated January 1, 2010, directly from the issuing corporation.

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- July 1 Received the semiannual interest on the Ziemer bonds.
- Dec. 31 Accrual of interest at year-end on the Ziemer bonds.

(Assume that all intervening transactions and adjustments have been properly recorded and the number of bonds owned has not changed from December 31, 2010, to December 31, 2012.)

**2013**

- Jan. 1 Received the semiannual interest on the Ziemer bonds.
- Jan. 1 Sold \$200,000 of Ziemer bonds at 114. The broker deducted \$7,000 for commissions and fees on the sale.
- July 1 Received the semiannual interest on the Ziemer bonds.
- Dec. 31 Accrual of interest at year-end on the Ziemer bonds.

**Instructions**

- (a) Journalize the listed transactions for the years 2010 and 2013.
- (b) Assume that the fair value of the bonds at December 31, 2010, was \$385,000. These bonds are classified as available-for-sale securities. Prepare the adjusting entry to record these bonds at fair value.
- (c) Based on your analysis in part (b) show the balance sheet presentation of the bonds and interest receivable at December 31, 2010. Assume the investments are considered long-term. Indicate where any unrealized gain or loss is reported in the financial statements.

(a) Gain on sale of debt investments \$21,000

*Journalize investment transactions, prepare adjusting entry, and show statement presentation.*

(SO 2, 3, 5, 6)



**P16-2B** In January 2010, the management of Prasad Company concludes that it has sufficient cash to purchase some short-term investments in debt and stock securities. During the year, the following transactions occurred.

- Feb. 1 Purchased 500 shares of DET common stock for \$30,000, plus brokerage fees of \$800.
- Mar. 1 Purchased 600 shares of STL common stock for \$20,000, plus brokerage fees of \$300.
- Apr. 1 Purchased 40 \$1,000, 9% CIN bonds for \$40,000, plus \$1,200 brokerage fees. Interest is payable semiannually on April 1 and October 1.
- July 1 Received a cash dividend of \$0.60 per share on the DET common stock.
- Aug. 1 Sold 300 shares of DET common stock at \$69 per share, less brokerage fees of \$350.
- Sept. 1 Received a \$1 per share cash dividend on the STL common stock.
- Oct. 1 Received the semiannual interest on the CIN bonds.
- Oct. 1 Sold the CIN bonds for \$45,000, less \$1,000 brokerage fees.

At December 31, the fair value of the DET common stock was \$66 per share. The fair value of the STL common stock was \$29 per share.

**Instructions**

- (a) Journalize the transactions and post to the accounts Debt Investments and Stock Investments. (Use the T-account form.)
- (b) Prepare the adjusting entry at December 31, 2010, to report the investments at fair value. All securities are considered to be trading securities.
- (c) Show the balance sheet presentation of investment securities at December 31, 2010.
- (d) Identify the income statement accounts and give the statement classification of each account.

(b) Unrealized loss \$2,020

*Journalize transactions and adjusting entry for stock investments.*

(SO 3, 5, 6)



**P16-3B** On December 31, 2010, Sauder Associates owned the following securities, held as long-term investments.

<u>Common Stock</u>	<u>Shares</u>	<u>Cost</u>
Adel Co.	4,000	\$100,000
Beran Co.	5,000	30,000
Caren Co.	3,000	60,000

On this date, the total fair value of the securities was equal to its cost. The securities are not held for influence or control over the investees. In 2011, the following transactions occurred.

- July 1 Received \$1 per share semiannual cash dividend on Beran Co. common stock.
- Aug. 1 Received \$0.50 per share cash dividend on Adel Co. common stock.
- Sept. 1 Sold 1,500 shares of Beran Co. common stock for cash at \$8 per share, less brokerage fees of \$300.
- Oct. 1 Sold 600 shares of Adel Co. common stock for cash at \$30 per share, less brokerage fees of \$600.
- Nov. 1 Received \$1 per share cash dividend on Caren Co. common stock.

- Dec. 15 Received \$0.50 per share cash dividend on Adel Co. common stock.  
 31 Received \$1 per share semiannual cash dividend on Beran Co. common stock.

At December 31, the fair values per share of the common stocks were: Adel Co. \$23, Beran Co. \$7, and Caren Co. \$19.

**Instructions**

- (a) Journalize the 2011 transactions and post to the account Stock Investments. (Use the T-account form.)  
 (b) Prepare the adjusting entry at December 31, 2011, to show the securities at fair value. The stock should be classified as available-for-sale securities.  
 (c) Show the balance sheet presentation of the investment-related accounts at December 31, 2011. At this date, Sauder Associates has common stock \$2,000,000 and retained earnings \$1,200,000.

(a) Gain on sale, \$2,700 and \$2,400

**P16-4B** Terry's Concrete acquired 20% of the outstanding common stock of Blakeley, Inc. on January 1, 2010, by paying \$1,100,000 for 40,000 shares. Blakeley declared and paid a \$0.50 per share cash dividend on June 30 and again on December 31, 2010. Blakeley reported net income of \$600,000 for the year. At December 31, 2010, the market price of Blakeley's common stock was \$30 per share.

Prepare entries under the cost and equity methods, and tabulate differences.

(SO 3)

**Instructions**

- (a) Prepare the journal entries for Terry's Concrete for 2010 assuming Terry's cannot exercise significant influence over Blakeley. (Use the cost method and assume Blakeley common stock should be classified as available-for-sale.)  
 (b) Prepare the journal entries for Terry's Concrete for 2010, assuming Terry's can exercise significant influence over Blakeley. (Use the equity method.)  
 (c) Indicate the balance sheet and income statement account balances at December 31, 2010, under each method of accounting.

(a) Total dividend revenue \$40,000

(b) Revenue from investment \$120,000

**P16-5B** The following are in Jamison Company's portfolio of long-term available-for-sale securities at December 31, 2010.

Journalize stock investment transactions and show statement presentation.

(SO 3, 5, 6)

	<u>Cost</u>
700 shares of Adler Corporation common stock	\$35,000
900 shares of Lynn Corporation common stock	42,000
800 shares of Swanson Corporation preferred stock	22,400

On December 31, the total cost of the portfolio equaled total fair value. Jamison Company had the following transactions related to the securities during 2011.

- Jan. 7 Sold 700 shares of Adler Corporation common stock at \$56 per share, less brokerage fees of \$700.  
 10 Purchased 300 shares, \$70 par value common stock of Pesavento Corporation at \$78 per share, plus brokerage fees of \$240.  
 26 Received a cash dividend of \$1.15 per share on Lynn Corporation common stock.  
 Feb. 2 Received cash dividends of \$0.40 per share on Swanson Corporation preferred stock.  
 10 Sold all 800 shares of Swanson Corporation preferred stock at \$26 per share less brokerage fees of \$180.  
 July 1 Received a cash dividend of \$1.00 per share on Lynn Corporation common stock.  
 Sept. 1 Purchased an additional 800 shares of the \$70 par value common stock of Pesavento Corporation at \$75 per share, plus brokerage fees of \$900.  
 Dec. 15 Received a cash dividend of \$1.50 per share on Pesavento Corporation common stock.

At December 31, 2011, the fair values of the securities were:

Lynn Corporation common stock	\$48 per share
Pesavento Corporation common stock	\$72 per share

Jamison uses separate account titles for each investment, such as Investment in Lynn Corporation Common Stock.

**Instructions**

- (a) Prepare journal entries to record the transactions.  
 (b) Post to the investment accounts. (Use T accounts.)  
 (c) Prepare the adjusting entry at December 31, 2011, to report the portfolio at fair value.  
 (d) Show the balance sheet presentation at December 31, 2011, for the investment-related accounts.

(a) Loss on sale \$1,780

(c) Unrealized loss \$4,140

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Prepare a balance sheet.  
(SO 5, 6)

**P16-6B** The following data, presented in alphabetical order, are taken from the records of Nichols Corporation.

Accounts payable	\$ 375,000
Accounts receivable	135,000
Accumulated depreciation—building	270,000
Accumulated depreciation—equipment	80,000
Allowance for doubtful accounts	10,000
Bonds payable (10%, due 2020)	600,000
Buildings	1,350,000
Cash	210,000
Common stock (\$5 par value; 500,000 shares authorized, 440,000 shares issued)	2,200,000
Discount on bonds payable	30,000
Dividends payable	75,000
Equipment	415,000
Goodwill	300,000
Income taxes payable	180,000
Investment in Givens Inc. stock (30% ownership), at equity	900,000
Land	780,000
Merchandise inventory	255,000
Notes payable (due 2011)	110,000
Paid-in capital in excess of par value	300,000
Prepaid insurance	25,000
Retained earnings	480,000
Short-term stock investment, at fair value (and cost)	280,000

Total assets \$4,290,000

### Instructions

Prepare a classified balance sheet at December 31, 2010.



## PROBLEMS: SET C

Visit the book's companion website at [www.wiley.com/college/veygandt](http://www.wiley.com/college/veygandt), and choose the Student Companion site, to access Problem Set C.

## COMPREHENSIVE PROBLEM: CHAPTERS 12 TO 16

**Part I** Mindy Feldkamp and her two colleagues, Oscar Lopez and Lori Melton, are personal trainers at an upscale health spa/resort in Tampa, Florida. They want to start a health club that specializes in health plans for people in the 50+ age range. The growing population in this age range and strong consumer interest in the health benefits of physical activity have convinced them they can profitably operate their own club. In addition to many other decisions, they need to determine what type of business organization they want. Oscar believes there are more advantages to the corporate form than a partnership, but he hasn't yet convinced Mindy and Lori. They have come to you, a small business consulting specialist, seeking information and advice regarding the choice of starting a partnership versus a corporation.

### Instructions

(a) Prepare a memo (dated May 26, 2009) that describes the advantages and disadvantages of both partnerships and corporations. Advise Mindy, Oscar, and Lori regarding which organizational form you believe would better serve their purposes. Make sure to include reasons supporting your advice.

**Part II** After deciding to incorporate, each of the three investors receives 20,000 shares of \$2 par common stock on June 12, 2009, in exchange for their co-owned building (\$200,000 market value) and \$100,000 total cash they contributed to the business. The next decision that Mindy, Oscar, and Lori need to make is how to obtain financing for renovation and equipment. They understand the difference between equity securities and debt securities, but do not understand the tax, net income, and earnings per share consequences of equity versus debt financing on the future of their business.

**Instructions**

(b) Prepare notes for a discussion with the three entrepreneurs in which you will compare the consequences of using equity versus debt financing. As part of your notes, show the differences in interest and tax expense assuming \$1,400,000 is financed with common stock, and then alternatively with debt. Assume that when common stock is used, 140,000 shares will be issued. When debt is used, assume the interest rate on debt is 9%, the tax rate is 32%, and income before interest and taxes is \$300,000. (You may want to use an electronic spreadsheet.)

**Part III** During the discussion about financing, Lori mentions that one of her clients, Roberto Marino, has approached her about buying a significant interest in the new club. Having an interested investor sways the three to issue equity securities to provide the financing they need. On July 21, 2009, Mr. Marino buys 90,000 shares at a price of \$10 per share.

The club, LifePath Fitness, opens on January 12, 2010, and after a slow start, begins to produce the revenue desired by the owners. The owners decide to pay themselves a stock dividend, since cash has been less than abundant since they opened their doors. The 10% stock dividend is declared by the owners on July 27, 2010. The market value of the stock is \$3 on the declaration date. The date of record is July 31, 2010 (there have been no changes in stock ownership since the initial issuance), and the issue date is August 15, 2010. By the middle of the fourth quarter of 2010, the cash flow of LifePath Fitness has improved to the point that the owners feel ready to pay themselves a cash dividend. They declare a \$0.05 cash dividend on December 4, 2010. The record date is December 14, 2010, and the payment date is December 24, 2010.

**Instructions**

(c) (1) Record all of the transactions related to the common stock of LifePath Fitness during the years 2009 and 2010. (2) Indicate how many shares are issued and outstanding after the stock dividend is issued.

**Part IV** Since the club opened, a major concern has been the pool facilities. Although the existing pool is adequate, Mindy, Oscar, and Lori all desire to make LifePath a cutting-edge facility. Until the end of 2010, financing concerns prevented this improvement. However, because there has been steady growth in clientele, revenue, and income since the fourth quarter of 2010, the owners have explored possible financing options. They are hesitant to issue stock and change the ownership mix because they have been able to work together as a team with great effectiveness. They have formulated a plan to issue secured term bonds to raise the needed \$600,000 for the pool facilities. By the end of April 2011 everything was in place for the bond issue to go ahead. On June 1, 2011, the bonds were issued for \$548,000. The bonds pay semiannual interest of 3% (6% annual) on December 1 and June 1 of each year. The bonds mature in 10 years, and amortization is computed using the straight-line method.

**Instructions**

(d) Record (1) the issuance of the secured bonds, (2) the interest payment made on December 1, 2011, (3) the adjusting entry required at December 31, 2011, and (4) the interest payment made on June 1, 2012.

**Part V** Mr. Marino's purchase of LifePath Fitness was done through his business. The investment has always been accounted for using the cost method on his firm's books. However, early in 2012 he decided to take his company public. He is preparing an IPO (initial public offering), and he needs to have the firm's financial statements audited. One of the issues to be resolved is to restate the investment in LifePath Fitness using the equity method, since Mr. Marino's ownership percentage is greater than 20%.

**Instructions**

(e) (1) Give the entries that would have been made on Marino's books if the equity method of accounting for investments had been used since the initial investment. Assume the following data for LifePath.

	<u>2009</u>	<u>2010</u>	<u>2011</u>
Net income	\$30,000	\$70,000	\$105,000
Total cash dividends	\$ 2,100	\$20,000	\$ 50,000

(2) Compute the balance in the LifePath Investment account at the end of 2011.



## CONTINUING COOKIE CHRONICLE

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 15.)

**CCC 16** Natalie has been approached by Ken Thornton, a shareholder of The Beanery Coffee Inc. Ken wants to retire and would like to sell his 1,000 shares in The Beanery Coffee, which represents 20% of all shares issued. The Beanery is currently operated by Ken's twin daughters, who each own 40% of the common shares. The Beanery not only operates a coffee shop but also roasts and sells beans to retailers, under the name "Rocky Mountain Beanery."

Ken has met with Curtis and Natalie to discuss the business operation. All have concluded that there would be many advantages for Cookie & Coffee Creations Inc. to acquire an interest in The Beanery Coffee. Despite the apparent advantages, Natalie and Curtis are still not convinced that they should participate in this business venture.



Go to the book's companion website,  
[www.wiley.com/college/veygandt](http://www.wiley.com/college/veygandt),  
to see the completion of this problem.

## BROADENING YOUR PERSPECTIVE

### FINANCIAL REPORTING AND ANALYSIS

#### Financial Reporting Problem: PepsiCo, Inc.



**BYP16-1** The annual report of **PepsiCo** is presented in Appendix A.

##### Instructions

- See Note 1 to the financial statements and indicate what the consolidated financial statements include.
- Using **PepsiCo**'s consolidated statement of cash flows, determine how much was spent for capital acquisitions during the current year.

#### Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company



**BYP16-2** **PepsiCo**'s financial statements are presented in Appendix A. Financial statements of **The Coca-Cola Company** are presented in Appendix B.

##### Instructions

- Based on the information contained in these financial statements, determine each of the following for each company.
  - Net cash used for investing (investment) activities for the current year (from the statement of cash flows).
  - Cash used for capital expenditures during the current year.
- Each of **PepsiCo**'s financial statements is labeled "consolidated." What has been consolidated? That is, from the contents of **PepsiCo**'s annual report, identify by name the corporations that have been consolidated (parent and subsidiaries).

#### Exploring the Web



**BYP16-3** Most publicly traded companies are analyzed by numerous analysts. These analysts often don't agree about a company's future prospects. In this exercise you will find analysts' ratings about companies and make comparisons over time and across companies in the same industry. You will also see to what extent the analysts experienced "earnings surprises." Earnings surprises can cause changes in stock prices.

Address: [biz.yahoo.com/i](http://biz.yahoo.com/i), or go to [www.wiley.com/college/weygandt](http://www.wiley.com/college/weygandt)

### Steps

1. Choose a company.
2. Use the index to find the company's name.
3. Choose **Research**.

### Instructions

- (a) How many analysts rated the company?
- (b) What percentage rated it a strong buy?
- (c) What was the average rating for the week?
- (d) Did the average rating improve or decline relative to the previous week?
- (e) How do the analysts rank this company among all the companies in its industry?
- (f) What was the amount of the earnings surprise percentage during the last quarter?

## CRITICAL THINKING

### Decision Making Across the Organization



**BYP16-4** At the beginning of the question and answer portion of the annual stockholders' meeting of Kemper Corporation, stockholder Mike Kerwin asks, "Why did management sell the holdings in UMW Company at a loss when this company has been very profitable during the period its stock was held by Kemper?"

Since president Tony Chavez has just concluded his speech on the recent success and bright future of Kemper, he is taken aback by this question and responds, "I remember we paid \$1,300,000 for that stock some years ago, and I am sure we sold that stock at a much higher price. You must be mistaken."

Kerwin retorts, "Well, right here in footnote number 7 to the annual report it shows that 240,000 shares, a 30% interest in UMW, were sold on the last day of the year. Also, it states that UMW earned \$520,000 this year and paid out \$160,000 in cash dividends. Further, a summary statement indicates that in past years, while Kemper held UMW stock, UMW earned \$1,240,000 and paid out \$440,000 in dividends. Finally, the income statement for this year shows a loss on the sale of UMW stock of \$180,000. So, I doubt that I am mistaken."

Red-faced, president Chavez turns to you.

### Instructions

With the class divided into groups, answer the following.

- (a) What dollar amount did Kemper receive upon the sale of the UMW stock?
- (b) Explain why both stockholder Kerwin and president Chavez are correct.

### Communication Activity

**BYP16-5** Bunge Corporation has purchased two securities for its portfolio. The first is a stock investment in Longley Corporation, one of its suppliers. Bunge purchased 10% of Longley with the intention of holding it for a number of years, but has no intention of purchasing more shares. The second investment was a purchase of debt securities. Bunge purchased the debt securities because its analysts believe that changes in market interest rates will cause these securities to increase in value in a short period of time. Bunge intends to sell the securities as soon as they have increased in value.

### Instructions

Write a memo to Max Scholes, the chief financial officer, explaining how to account for each of these investments. Explain what the implications for reported income are from this accounting treatment.

### Ethics Case

**BYP16-6** Bartlet Financial Services Company holds a large portfolio of debt and stock securities as an investment. The total fair value of the portfolio at December 31, 2010, is greater than total cost. Some securities have increased in value and others have decreased. Deb Faust, the

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financial vice president, and Jan McCabe, the controller, are in the process of classifying for the first time the securities in the portfolio.

Faust suggests classifying the securities that have increased in value as trading securities in order to increase net income for the year. She wants to classify the securities that have decreased in value as long-term available-for-sale securities, so that the decreases in value will not affect 2010 net income.

McCabe disagrees. She recommends classifying the securities that have decreased in value as trading securities and those that have increased in value as long-term available-for-sale securities. McCabe argues that the company is having a good earnings year and that recognizing the losses now will help to smooth income for this year. Moreover, for future years, when the company may not be as profitable, the company will have built-in gains.

### Instructions

- (a) Will classifying the securities as Faust and McCabe suggest actually affect earnings as each says it will?
- (b) Is there anything unethical in what Faust and McCabe propose? Who are the stakeholders affected by their proposals?
- (c) Assume that Faust and McCabe properly classify the portfolio. Assume, at year-end, that Faust proposes to sell the securities that will increase 2010 net income, and that McCabe proposes to sell the securities that will decrease 2010 net income. Is this unethical?



## "All About You" Activity

**BYP16-7** The **Securities and Exchange Commission** (SEC) is the primary regulatory agency of U.S. financial markets. Its job is to ensure that the markets remain fair for all investors. The following SEC sites provide useful information for investors.

**Address:** [www.sec.gov/answers.shtml](http://www.sec.gov/answers.shtml) and <http://www.sec.gov/investor/tools/quiz.htm>, or go to [www.wiley.com/college/weygandt](http://www.wiley.com/college/weygandt).

### Instructions

- (a) Go to the first SEC site and find the definition of the following terms.
  - (i) Ask price.
  - (ii) Margin account.
  - (iii) Prospectus.
  - (iv) Index fund.
- (b) Go to the second SEC site and take the short quiz.



## Answers to Insight and Accounting Across the Organization Questions

### p. 703 How Procter & Gamble Accounts for Gillette

Q: Where on Procter & Gamble's balance sheet will you find its investment in Gillette Company?

A: *Because Procter & Gamble owns 9% of Gillette, Procter & Gamble does not report Gillette in the investment section of its balance sheet. Instead, Gillette's assets and liabilities are included and commingled with the assets and liabilities of Procter & Gamble.*

### p. 706 And the Correct Way to Report Investments Is ... ?

Q: Why might the use of the equity method not lead to full disclosure in the financial statements?

A: *Under the equity method, the investment in common stock of another company is initially recorded at cost. After that, the investment account is adjusted at each reporting date to show the investor's equity in the investee. However, on the investor's balance sheet, only the investment account is shown. The pro-rata share of the investee's assets and liabilities are not reported. Because the pro-rata share of the investee's assets and liabilities are not shown, some argue that the full disclosure principle is violated.*

## Answers to Self-Study Questions

1. d   2. a   3. b   4. c   5. a   6. b   7. c   8. d   9. a   10. c   11. c   12. b   13. c