Long-Term Investments

Part 1

Your goals for this "long-term investments" chapter are to learn about:

- How intent influences the accounting for investments.
- The correct accounting for "available for sale" securities.
- Accounting for securities that are to be "held to maturity."
- Special accounting for certain long-term equity investments that require use of the equity method.
- Special accounting for certain long-term equity investments that require consolidation.

1. Intent-Based Accounting

In an earlier chapter you learned about accounting for "trading securities." Recall that trading securities are investments that were made with the intent of reselling them in the very near future, hopefully at a profit. Such investments are considered highly liquid and are classified on the balance sheet as current assets. They are carried at fair market value, and the changes in value are measured and included in the operating income of each period.

However, not all investments are made with the goal of turning a quick profit. Many investments are acquired with the intent of holding them for an extended period of time. The appropriate accounting methodology depends on obtaining a deeper understanding of the nature/intent of the particular investment. You have already seen the accounting for "trading securities" where the intent was near future resale for profit. But, many investments are acquired with longer-term goals in mind.

For example, one company may acquire a majority (more than 50%) of the stock of another. In this case, the acquirer (known as the parent) must consolidate the accounts of the subsidiary. At the end of this chapter we will briefly illustrate the accounting for such "control" scenarios.

Sometimes, one company may acquire a substantial amount of the stock of another without obtaining control. This situation generally arises when the ownership level rises above 20%, but stays below the 50% level that will trigger consolidation. In these cases, the investor is deemed to have the ability to significantly influence the investee company. Accounting rules specify the "equity method" of accounting for such investments. This, too, will be illustrated within this chapter.

Not all investments are in stock. Sometimes a company may invest in a "bond" (you have no doubt heard the term "stocks and bonds"). A bond payable is a mere "promise" (i.e., bond) to "pay" (i.e., payable). Thus, the issuer of a bond payable receives money today from an investor in exchange for the issuer's promise to repay the money in the future (as you would expect, repayments will include not only amounts borrowed, but will also have added interest). In a later chapter, we will have a detailed look at Bonds Payable from the issuer's perspective. In this chapter, we will undertake a preliminary examination of bonds from the investor's perspective. Although investors may acquire bonds for "trading purposes," they are more apt to be obtained for the long-pull. In the latter case, the bond investment would be said to be acquired with the intent of holding it to maturity (its final payment date) -- thus, earning the name "held-to-maturity" investments. Held-to-maturity investments are afforded a special treatment, which is generally known as the amortized cost approach.

By default, the final category for an investment is known as the "available for sale" category. When an investment is not trading, not held-to-maturity, not involving consolidation, and not involving the equity method, by default, it is considered to be an "available for sale" investment. Even though this is a default category, do not assume it to be unimportant. Massive amounts of investments are so classified within typical corporate accounting records. We will begin our look at long-term investments by examining this important category of investments. The following table recaps the methods you will be familiar with by the conclusion of this chapter:

TYPE OF INVESTMENT	BASIC ACCOUNTING APPROACH *	GUIDELINES FOR ASSESSMENT
Trading	Fair Value Unrealized Gains and Losses to Operating Income	Intent to buy/sell for short-term profits
Available for Sale	Fair Value Unrealized Gains and Losses to Equity via Other Comprehensive Income	Default category
Held to Maturity	Amortized Cost	Intent to buy and hold until fixed maturity date
Significant Influence	Equity Method	Stock investments generally ranging from 20-50%
Control	Consolidation	Stock investments generally exceeding 50%

* These approaches apply to investments that continue to be held. When any type of investment is sold, the "realized" gain or loss is included in operating income.

1.1 The Fair Value Measurement Option

The Financial Accounting Standards Board recently issued a new standard, "The Fair Value Option for Financial Assets and Financial Liabilities." Companies may now elect to measure certain financial assets at fair value. This new ruling essentially allows many "available for sale" and "held to maturity" investments to instead be measured at fair value (with unrealized gains and losses reported in earnings), similar to the approach previously limited to trading securities. It is difficult to predict how many companies will select this new accounting option, but it is indicative of a continuing evolution toward valued-based accounting in lieu of traditional historical cost-based approaches.