**Introduction to Accounting 2**

**Modul 8**

**Chapter 17**

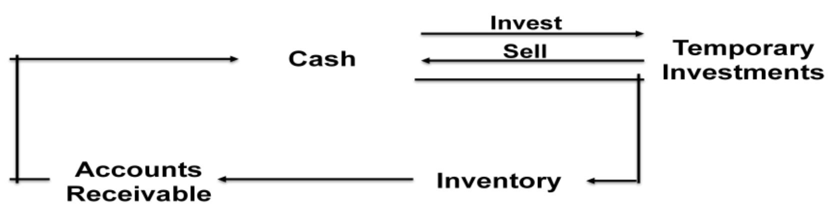
# Investments

After studying this chapter, you should be able to:

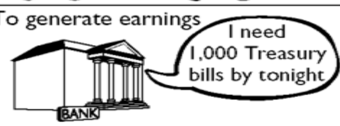
1. Discuss why corporations invest in debt and stock securities.
2. Explain the accounting for debt investments.
3. Explain the accounting for stock investments.
4. Describe the use of consolidated financial statements.
5. Indicate how debt and stock investments are valued and reported on the financial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

## TEMPORARY INVESTMENTS AND THE OPERATING CYCLE (STUDY OBJECTIVE 1)

- At the end of the operating cycle
  - Temporary idle cash on hand available until the start of the next operating cycle.
  - Invest the excess funds to earn a greater return.
- The relationship of temporary investments to the operating cycle is depicted below.




## WHY CORPORATIONS INV*E*ST

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

**ACCOUNTING FOR DEBT INVESTMENTS RECORDING AQUISITION OF BONDS (STUDY OBJECTIVE 2)**

Debt investments are investments in government and corporation bonds. Three entries required:

1. acquisition- the cost principle applies
2. interest revenue
3. sale

Kuhl Corporation acquires 50 Doan Inc. 8%, 10-year, $1,000 bonds on January 1, 2005, for $54,000, including brokerage fees of $1,000.

The entry to record the investment is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Jan. 1 | Debt Investments | 54,000 | |
| | Cash | | 54,000 |
| | (To record purchase of 50 Doan Inc. bonds) | | |

**ACCOUNTING FOR DEBT INVESTMENTS RECORDING BOND INTEREST**

The bonds pay $3,000 interest on July 1 and January 1 ($50,000 x 8% x ½). The July 1 entry is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| July 1 | Cash | 2,000 | |
| | Interest Revenue | | 2,000 |
| | (To record receipt of interest on Doan Inc. bonds) | | |

It is necessary to accrue $2,000 interest earned since July 1 at year-end. The December 31 entry is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Dec. 31 | Interest Receivable | 2,000 | |
| | Interest Revenue | | 2,000 |
| | (To accrue interest on Doan Inc. bonds) | | |

## ACCOUNTING FOR DEBT INVESTMENTS RECORDING BOND INTEREST

When the interest is received on January 1, the entry is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Jan. 1 | Cash | 2,000 | |
| | Interest Receivable | | 2,000 |
| | (To record receipt of accrued interest) | | |

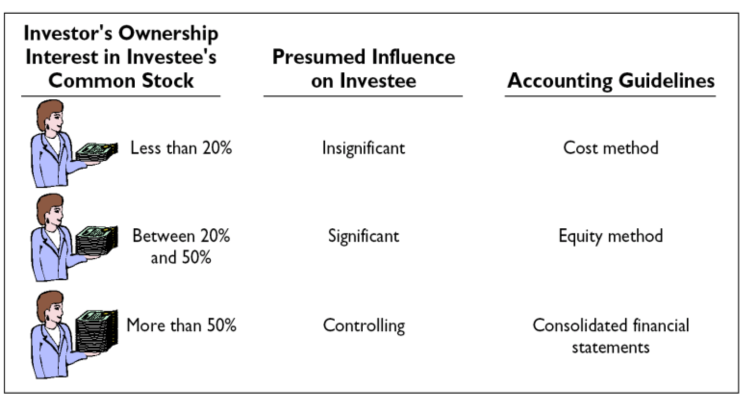
## ACCOUNTING FOR DEBT INVESTMENTS RECORDING SALE OF BONDS

Any difference between the net proceeds from the sale (sales price less brokerage fees) and the cost of the bonds is recorded as a gain or loss. Kuhl Corporation receives net proceeds of $58,000 on the sale of the Doan Inc. bonds on January 1, 2006, after receiving the interest due. Since the securities cost $54,000, a gain of $4,000 has been realized.

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| **Jan. 1** | **Cash** | | |
| | **Debt Investments** | | |
| | **Gain on Sale of Debt Investments** | | |
| | **(To record sale of Doan Inc. bonds)** | | |

## ACCOUNTING GUIDELINES FOR STOCK INVESTMENTS (STUDY OBJECTIVE 3)

Stock investments are investments in the capital stock of corporations



## RECORDING STOCK INVESTMENTS HOLDINGS LESS THAN 20%

Cost Method: Stock investments of less than 20%

- investment recorded at cost
- revenue recognized only when cash dividends are received

On July 1, 2005, 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:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| **July 1** | **Stock Investments** | | |
| | **Cash** | | |
| | **(To record purchase of 1,000 shares of Beal Corporation common stock)** | | |

Entries are required for any cash dividends received during the time the stock is held. If a $2 per share dividend is received by Sanchez Corporation on December 31, the entry is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Dec. 31 | Cash (1,000 x $2) | 2,000 | |
| | Dividend Revenue | | 2,000 |
| | (To record receipt of a cash dividend) | | |

Dividend Revenue is reported under Other Revenue and Gains in the income statement. Since dividends do not accrue, adjusting entries are not made to accrue dividends.

## RECORDING STOCK INVESTMENTS HOLDINGS LESS THAN 20%

- Stock is sold
  - Difference between the net proceeds from the sale and the cost of the stock is recognized as a gain or loss.
- Sanchez Corporation receives net proceeds of $39,500 on the sale of its Beal Corporation common stock on February 10, 2006.
- Because the stock cost $40,500, a loss of $1,000 has been incurred. The entry to record the sale is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| **Feb. 10** | **Cash** | 39,500 | |
| | **Loss on Sale of Stock Investments** | 1,000 | |
| | **Stock Investments** | | 40,500 |
| | **(To record sale of Beal common stock)** | | |

## ACCOUNTING FOR STOCK INVESTMENTS HOLDINGS BETWEEN 20% AND 50%

- Investor has significant influence over the financial and operating activities of the investee.
- Equity method
  - Investment in common stock is recorded at cost
  - Investment account adjusted annually to show the investor's equity in the investee
- The investor
  1. Debits the investment account and credits revenue for its share of the investee's net income
  2. Credits dividends received to the investment account

## ACCOUNTING FOR STOCK INVESTMENTS HOLDINGS BETWEEN 20% AND 50%

Milar Corporation acquires 30% of the common stock of Beck Company for $120,000 on January 1, 2005. The entry to record this transaction is:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Jan. 1 | **Stock Investments** | | |
| | **Cash** | | |
| | **(To record purchase of Beck common stock)** | | |

Beck reports 2005 net income of $100,000 and declares and pays a $40,000 cash dividend. Milar is required to record:

1. its share of Beck's net income, $30,000 (30% X $100,000)
2. and the reduction in the investment account for the dividends received, $12,000 ($40,000 X 30%). The entries are:

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Dec. 31 | **Stock Investments** | | |
| | **Revenue from Investment in Beck Company** | | |
| | **(To record 30% equity in Beck's 2005 net income)** | | |

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|
| Dec. 31 | **Cash** | | |
| | **Stock Investments** | | |
| | **(To record dividends received)** | | |

## INVESTMENT AND REVENUE ACCOUNTS AFTER POSTING

**Stock Investments**

| | | | |
|---|---|---|---|
| **January 1** | **120,000** | **December 31** | **12,000** |
| **December 31** | **30,000** | | |
| **December 31 Balance** | **138,000** | | |

**Revenue from Investment in Beck Company**

| | | | |
|---|---|---|---|
| | | **December 31** | **30,000** |

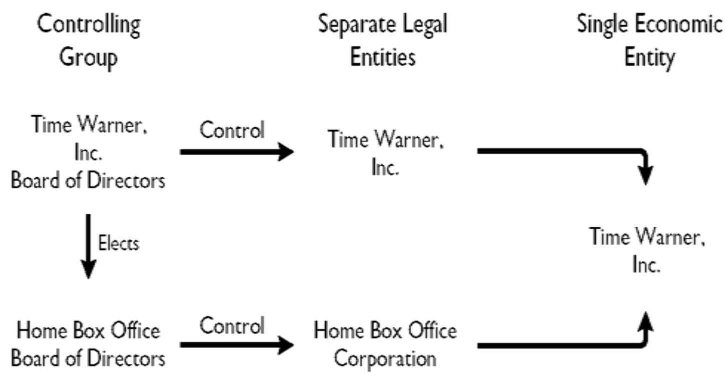
Investment and revenue accounts will show the above results. The investment account has increased by $18,000 which represents Milar's 30% equity in the $60,000 increase in Beck's retained earnings ($100,000 - $40,000). Milar will also report $30,000 of revenue from its investment, which is 30% of Beck's net income of $100,000. Milar would report only $12,000 (30% X $40,000) of dividend revenue if the cost method were used.

## RECORDING STOCK INVESTMENTS HOLDINGS OF MORE THAN 50% (STUDY OBJECTIVE 4)

- Company owns more than 50% of the common stock of another entity is known as a parent company
- Entity whose stock is owned by the parent company is the subsidiary (affiliated) company
- The parent company
  - Controlling interest in the subsidiary due to its stock ownership
  - Prepares consolidated financial statements

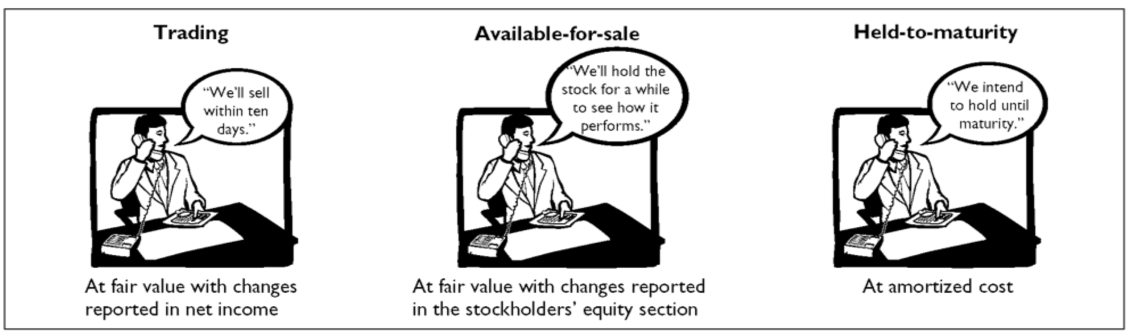
## RECORDING STOCK INVESTMENTS MANAGEMENT PERSPECTIVE

Time Warner, Inc. own 100% of the common stock of Home Box Office (HBO). The common stockholders of Time Warner elect the board of directors of the company, who, in turn, select the officers and managers of the company. The Board of Directors controls the property owned by the corporation, which includes the common stock of HBO.




## VALUATION GUIDELINES (STUDY OBJECTIVE 5)

Fair value is the amount for which a security could be sold in a normal market and offers the best approach at investment valuation since it represents the expected cash realizable value of the securities.




## CATEGORIES OF SECURITIES

- Trading securities
  Bought and held primarily for sale in the near term to generate income on short-term price differences
- Available-for-sale securities
  May be sold in the future
- Held-to-maturity securities
  Debt securities that the investor has intent and ability to hold to maturity

## VALUATION OF TRADING SECURITIES

- Trading securities (generally less than a month)

- Reported at fair value, and changes from cost are reported as part of net income.

- Changes reported as unrealized gains or losses since the securities have not been sold
  - Difference between the total cost of trading securities and their total fair value.
- Pace corporation has the following costs and fair values for its investments classified as trading securities:

**Trading Securities, December 31, 2005**

| **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 | $ 140,000 | $ 147,000 | $ 7,000 |

**VALUATION AND REPORTING OF INVESTMENTS — TRADING SECURITIES**

- Unrealized gain of $7,000
  - Total fair value ($147,000) is $7,000 greater than total cost ($140,000)
- Fair value and the unrealized gain or loss
  - Adjusting entry at the time financial statements are prepared
- Valuation allowance account-market adjustment–trading
  - Records the difference between the total cost and the total fair value of the securities

| **Date** | **Account Titles and Explanation** | **Debit** | **Credit** |
|---|---|---|---|
| Dec. 31 | Market Adjustment — Trading | 7,000 | |
| | Unrealized Gain — Income | | 7,000 |
| | (To record unrealized gain on trading securities) | | |

**VALUATION AND REPORTING OF INVESTMENTS — TRADING SECURITIES**

1 Fair value
  – On the balance sheet

2 Unrealized gain
- Income statement

3 Unrealized loss
- Income statement

### VALUATION OF AVAILABLE-FOR-SALE SECURITIES

- Available-for-sale securities (the intention of selling them in the near future is not for certain)
- Reported at fair value, and changes from cost are reported as part of stockholders' equity.
- Changes reported as unrealized gains or losses since the securities have not been sold.
- The unrealized gain or loss is the difference between the total cost of the securities in the category and their total fair value.
- Elbert corporation has the following costs and fair values for its investments classified as available-for-sale securities:

**Available-for-Sale Securities, December 31, 2005**

| Investments | Cost | Fair Value | Unrealized Gain (Loss) |
|---|---|---|---|
| Campbell Soup Corporation 8% bonds | $ 93,537 | $ 103,600 | $ 10,063 |
| Hersey Corporation stock | 200,000 | 180,400 | (19,600) |
| Total | $ 293,537 | $ 284,000 | $ ( 9,537) |

### VALUATION AND REPORTING OF INVESTMENTS AVAILABLE-FOR-SALE SECURITIES

Elbert Corporation has an unrealized loss of $9,537, total fair value of $284,000 - total cost of $293,537.

Fair value and the unrealized gain or loss

- recorded through an adjusting entry at the time financial statements are prepared

**The adjusting entry for Elbert Corporation is:**

| Date | Account Titles and Explanation | Debit | Credit |
|---|---|---|---|

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

**VALUATION AND REPORTING OF INVESTMENTS AVAILABLE-FOR-SALE SECURITIES**

1. Fair value of the securities
   - reported on the balance sheet
2. Unrealized gain or loss
   - reported as a separate component of stockholders' equity

**SHORT-TERM INVESTMENTS STUDY (OBJECTIVE 5)**

**Securities held by a company**

1. Readily marketable
   - Can be sold easily when the need for cash arises
2. Intended to be converted into cash within the next year or operating cycle, whichever is longer
   - Intent to sell the investment within the next year or operating cycle, whichever is

**PRESENTATION OF SHORT-TERM INVESTMENTS**

Short-Term Investments

- Listed immediately below cash in the current asset section of the balance sheet
- Reported at fair value

**PACE CORPORATION**
**Balance Sheet (partial)**

| | |
|---|---|
| **Current assets** | |
| **Cash** | **$ 21,000** |
| **Short-term Investments at fair value** | **147,000** |

**NONOPERATING ITEMS RELATED TO INVESTMENTS**

- Long-term investments are reported in a separate section of the balance sheet immediately below current assets
- The items below are reported in the nonoperating section of the income statement:

| Other Revenues and Gains | Other Expenses and Losses |
|---|---|
| **Interest Revenue** | **Loss on Sale of Investments** |
| **Dividend Revenue** | **Unrealized Loss – Income** |
| **Gain on Sale of Investments** | |
| **Unrealized Gain – Income** | |

## UNREALIZED LOSS IN STOCKHOLDERS' EQUITY SECTION

- An unrealized gain or loss on available-for-sale securities is reported as a separate component of stockholders' equity.
- 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.
- The statement presentation of the unrealized loss is shown below.

***DAWSON INC.***
**Partial Balance Sheet**

| | |
|---|---|
| Stockholders' equity | |
| Common stock | $ 3,000,000 |
| Retained earnings | 1,500,000 |
| Total paid-in capital and retained earnings | 4,500,000 |
| Less: Unrealized loss on available-for-sale securities | ( 100,000) |
| Total stockholders' equity | $ 4,400,000 |

## COMPREHENSIVE BALANCE SHEET

The comprehensive balance sheet for Pace Corporation includes the following assets:

1. Short-term Investments,
2. 2 Investments of less than 20%, and
3. Investments of 20% - 50%

**PACE CORPORATION**
Balance Sheet
December 31, 2005

| | | | |
|---|---|---|---|
| **Assets** | | | |
| Current assets | | | |
| Cash | | | $ 21,000 |
| **Short-term investments, at fair value** | | | **147,000** |
| 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 | | | |
| **Investments in stock of less than 20% owned companies, at fair value** | | **50,000** | |
| **Investment in stock of 20–50% owned company, at equity** | | **150,000** | |
| 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 | | | $1,710,000 |

**The comprehensive balance sheet for Pace Corporation includes the following element of stockholders' equity: Unrealized Gain on Available-for-Sale Securities.**

## Liabilities and Stockholders' Equity

| | | |
|---|---|---|
| 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 2016 | $ 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 | |
| Add: **Unrealized gain on available-for-sale securities** | **10,000** | |
| Total stockholders' equity | | 1,165,000 |
| Total liabilities and stockholders' equity | | $1,710,000 |

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

**REVIEW**

1. Debt investments are initially recorded at:

a. Cost.
b. Cost plus accrued interest.
c. Fair value.
d. None of the above

2. In the balance sheet, a debit balance in Unrealized Gain or Loss – Equity is reported as a:

a. Contra asset account.

b. Contra stockholders' equity account.
c. Loss in the income statement.
d. Loss in the retained earnings statement.

3. Ron Weasley Company acquired 25% of the outstanding common stock of Hagrid, Inc. on January 1, 2009, by paying Rp1.200.000.000 for 50.000.000 shares. Hagrid Inc. declared and paid an Rp800,00 per share cash dividend on June 30 and again on Dec. 31, 2009. Hagrid Inc. reported net income of Rp800.000.000,00 for the year. At December 31, 2009, the market price of Hagrid Inc. common stock was Rp30.000,00 per share.

   Instructions:
   a. Prepare a journal entries for Ron Weasley Company for 2009, assuming Ron Weasley Company cannot execise significant influense over Hagrid Inc. (use the cost method and assume Hagrid's common stock should be classified as available-for-sale.)
   b. Prepare a journal entries for Ron Weasley Company for 2009, assuming Ron Weasley Company can execise significant influense over Hagrid Inc. (use the equity method)
   c. In tabular form, indicate the investment and income account balances at 31 December, 2009 under each method of accounting.

**Reference**

Weigandt, Kieso, and Kimmel. (2005). Accounting Principles, 6th Ed. Canada: John Wiley and Sons.

Reeve, James M, Caarl S. Waren and Jonathan E. Duchac. Principles of Accounting. Singapore: Cengage Learning Asia Pte Ltd. (R)