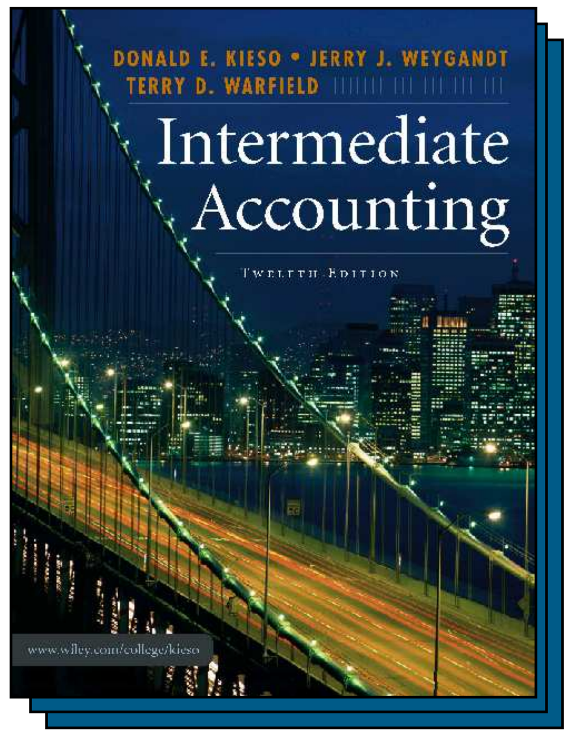
Debt and Equity Investments

Chapter 17

Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



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Learning Objectives

1. Identify the three categories of debt securities and describe the accounting and reporting treatment for each category.
2. Understand the procedures for discount and premium amortization on bond investments.
3. Identify the categories of equity securities and describe the accounting and reporting treatment for each category.
4. Explain the equity method of accounting and compare it to the fair value method for equity securities.
5. Describe the disclosure requirements for investments in debt and equity securities.
6. Discuss the accounting for impairments of debt and equity investments.
7. Describe the accounting for transfer of investment securities between categories.

Investments

Investments in Debt Securities

- Held-to-maturity securities
- Available-for-sale securities
- Trading securities

Investments in Equity Securities

- Holdings of less than 20%
- Holdings between 20% and 50%
- Holdings of more than 50%

Other Reporting Issues

- Financial statement presentation
- Impairment of value
- Transfers between categories
- Fair value controversy

Investments

Different motivations for investing:

- To earn a high rate of return.
- To secure certain operating or financing arrangements with another company.

Investments

Companies account for investments based on

- the type of security (debt or equity) and
- their intent with respect to the investment.

Illustration 17-1

Types of Security	Management Intent	Valuation Approach
Debt (Section 1)	No plans to sell	Amortized cost
	Plan to sell	Fair value
Equity (Section 2)	Plan to sell	Fair value
	Exercise some control	Equity method

Investments in Debt Securities

Debt securities (creditor relationship):

Type	Accounting Category
U.S. government securities	Held-to-maturity
Municipal securities	Trading
Corporate bonds	Available-for-sale
Convertible debt	
Commercial paper	

LO 1 Identify the three categories of debt securities and describe the accounting and reporting treatment for each category.

Investments in Debt Securities

Accounting for Debt Securities by Category

Illustration 17-2

Category	Valuation	Unrealized Holding Gains or Losses	Other Income Effects
Held-to-maturity	Amortized cost	Not recognized	Interest when earned; gains and losses from sale.
Trading securities	Fair value	Recognized in net income	Interest when earned; gains and losses from sale.
Available-for-sale	Fair value	Recognized as other comprehensive income and as separate component of stockholders' equity	Interest when earned; gains and losses from sale.

LO 1 Identify the three categories of debt securities and describe the accounting and reporting treatment for each category.

Held-to-Maturity Securities

Classify a debt security as **held-to-maturity** only if it has **both**

(1) the positive intent and

(2) the ability to hold securities to maturity.

Accounted for at **amortized cost**, not fair value.

Amortize premium or discount using the **effective-interest method** unless the straight-line method—yields a similar result.

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Held-to-Maturity Securities

E17-3 **(Held-to-Maturity Securities)** On January 1, 2006, Hi and Lois Company purchased 12% bonds, having a maturity value of $300,000, for $322,744. The bonds provide the bondholders with a 10% yield. They are dated January 1, 2006, and mature January 1, 2011, with interest receivable December 31 of each year. Hi and Lois Company uses the effective-interest method to allocate unamortized discount or premium. The bonds are classified in the held-to-maturity category.

Instructions **(a)** Prepare the journal entry at the date of the bond purchase.

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Held-to-Maturity Securities

E17-3 (a) Prepare the journal entry at the date of the bond purchase.

January 1, 2006:

Held-to-Maturity Securities	322,744	
Cash		322,744

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Held-to-Maturity Securities

E17-3 (b) Prepare a bond amortization schedule.

Date	Cash Received	10% Interest Revenue	Premium Amortized	Carrying Amount
1/1/06				$ 322,744
12/31/06	$ 36,000	$ 32,274	$ 3,726	319,018
12/31/07	36,000	31,902	4,098	314,920
12/31/08	36,000	31,492	4,508	310,412
12/31/09	36,000	31,041	4,959	305,453
12/31/10	36,000	30,547 *	5,453	300,000

* rounding

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Held-to-Maturity Securities

E17-3 (c) (d) Prepare the journal entry to record the interest received and the amortization for 2006 & 2007.

December 31, 2006:

Cash	36,000	
Held-to-Maturity Securities		3,726
Interest Revenue		32,274

December 31, 2007:

Cash	36,000	
Held-to-Maturity Securities		4,098
Interest Revenue		31,902

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Available-for-Sale Securities

Companies report available-for-sale securities at

- fair value, with
- unrealized holding gains and losses reported as part of comprehensive income (equity).

Any discount or premium is amortized.

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Available-for-Sale Securities

E17-4 (Available-for-Sale Securities) Assume the same information as in **E17-3** except that the securities are classified as available-for-sale. The fair value of the bonds at December 31 for 2006 and 2007 is $320,500 and $309,000, respectively.

Instructions

(a) Prepare the journal entry at date of bond purchase.

(b) Prepare the journal entries to record the interest received and recognition of fair value for 2006.

(c) Prepare the journal entry to record recognition of fair value for 2007.

Available-for-Sale Securities

E17-4 (a) Prepare the journal entry at date of bond purchase.

January 1, 2006:

Available-for-Sale Securities	322,744	
Cash		322,744

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Available-for-Sale Securities

E17-4 (b) Prepare the journal entries to record the interest received and recognition of fair value for 2006.

December 31, 2006:

Cash	36,000	
Available-for-Sale Securities		3,726
Interest Revenue		32,274
Securities Fair Value Adjustment-AFS	1,482	
Unrealized Holding Gain/Loss		1,482

($320,500 – $319,018 = $1,482)

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Available-for-Sale Securities

E17-4 (c) Prepare the journal entry to record recognition of fair value for 2007.

December 31, 2007:

Unrealized Holding Gain/Loss	7,402	
Securities Fair Value Adjustment-AFS		7,402

Available-for-sale bonds at cost	$	314,920
Available-for-sale bonds at fair value		309,000
Unrealized holding gain (loss)		(5,920)
Previous securities fair value adjustment—Dr.		1,482
Securities fair value adjustment—Cr.	$	(7,402)

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Available-for-Sale Securities

Sale of Available-for-Sale Securities

If company sells bonds before maturity date:

- Must make entry to remove the,
  - Cost in Available-for-Sale Securities and
  - Securities Fair Value Adjustment accounts.
- Any realized gain or loss on sale is reported in the "Other expenses and losses" section of the income statement.

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Trading Securities

Companies report trading securities at

- fair value, with
- unrealized holding gains and losses reported as part of net income.

Any discount or premium is amortized.

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Trading Securities

BE17-4 (Trading Securities) Pete Sampras Corporation purchased trading investment bonds for $40,000 at par. At December 31, Sampras received annual interest of $2,000, and the fair value of the bonds was $38,400.

Instructions

(a) Prepare the journal entry for the purchase of the investment.

(b) Prepare the journal entries for the interest received.

(c) Prepare the journal entry for the fair value adjustment.

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Trading Securities

BE17-4 Prepare the journal entries for (a) the purchase of the investment, (b) the interest received, and (c) the fair value adjustment.

(a)	Trading securities	40,000	
	Cash		40,000
(b)	Cash	2,000	
	Interest revenue		2,000
(c)	Unrealized Holding Loss - Income	1,600	
	Securities Fair Value Adj.- Trading		1,600

LO 2 Understand the procedures for discount and premium amortization on bond investments.

Investments in Equity Securities

Represent ownership of capital stock.

Cost includes:

- price of the security, plus
- broker's commissions and fees related to purchase.

The degree to which one corporation **(investor)** acquires an interest in the common stock of another corporation **(investee)** generally determines the accounting treatment for the investment subsequent to acquisition.

LO 3 Identify the categories of equity securities and describe the accounting and reporting treatment for each category.

Investments in Equity Securities

Ownership Percentages

0 -------------20% ------------ 50% -------------- 100%

0 – 20%	20% – 50%	50% – 100%
SFAS 115	APBO 18, SFAS 142	SFAS 141, SFAS 142
No significant influence usually exists	Significant influence usually exists	Control usually exists
Investment valued using **Fair Value Method**	Investment valued using **Equity Method**	Investment valued on parent's books using Cost Method or Equity Method (investment eliminated in **Consolidation**)

LO 3 Identify the categories of equity securities and describe the accounting and reporting treatment for each category.

Holdings of Less Than 20%

Accounting Subsequent to Acquisition

Market Price Available	Market Price Unavailable
Value and report the investment using the **fair value method**.	Value and report the investment using the **cost method**.*

* Securities are reported at cost. Dividends are recognized when received and gains or losses only recognized on sale of securities.

Holdings of Less Than 20%

Accounting and Reporting – Fair Value Method

Category	Valuation	Unrealized Holding Gains or Losses	Other Income Effects
Holdings less than 20%			
1. Available-for-sale	Fair value	Recognized in "Other comprehensive income" and as separate component of stockholders' equity	Dividends declared; gains and losses from sale.
2. Trading	Fair value	Recognized in net income	Dividends declared; gains and losses from sale.

Because equity securities have no maturity date, companies cannot classify them as held-to-maturity.

LO 3 Identify the categories of equity securities and describe the accounting and reporting treatment for each category.

Holdings of Less Than 20%

P17-6 Loxley Company has the following portfolio of securities at September 30, 2007, its last reporting date.

Trading Securities	Cost	Fair Value
Dan Fogelberg, Inc. common (5,000 shares)	$ 225,000	$ 200,000
Petra, Inc. preferred (3,500 shares)	133,000	140,000
Tim Weisberg Corp. common (1,000 shares)	180,000	179,000

On Oct. 10, 2007, the Fogelberg shares were sold at a price of $54 per share. In addition, 3,000 shares of Los Tigres common stock were acquired at $59.50 per share on Nov. 2, 2007. The Dec. 31, 2007, fair values were: Petra $96,000, Los Tigres $132,000, and the Weisberg common $193,000.

LO 3 Identify the categories of equity securities and describe the accounting and reporting treatment for each category.

Holdings of Less Than 20%

P17-6 Prepare the journal entries to record the sale, purchase, and adjusting entries related to the trading securities in the last quarter of 2007.

Portfolio at September 30, 2007

Trading Securities	Cost	Fair Value
Dan Fogelberg, Inc. common (5,000 shares)	$ 225,000	$ 200,000
Petra, Inc. preferred (3,500 shares)	133,000	140,000
Tim Weisberg Corp. common (1,000 shares)	180,000	179,000
	$ 538,000	$ 519,000

Securities Fair Value Adjustment - credit ($19,000)

LO 3 Identify the categories of equity securities and describe the accounting and reporting treatment for each category.

Holdings of Less Than 20%

P17-6 Prepare the journal entries to record the sale, purchase, and adjusting entries related to the trading securities in the last quarter of 2007.

October 10, 2007 (Fogelberg):

Cash (5,000 x $54)	270,000	
Trading securities		225,000
Gain on sale		45,000

November 2, 2007 (Los Tigres):

Trading securities (3,000 x $59.50)	178,500	
Cash		178,500

Holdings of Less Than 20%

P17-6 Portfolio at December 31, 2007

Trading Securities	Cost	Fair Value	Unrealized Gain (Loss)
Petra, Inc. preferred	$ 133,000	$ 96,000	$ (37,000)
Tim Weisberg Corp. common	180,000	193,000	13,000
Los Tigres common	178,500	132,000	(46,500)
	$ 491,500	$ 421,000	(70,500)
Prior securities fair value adjustment balance			(19,000)
Securities fair value adjustment			$ (51,500)

December 31, 2007:

Unrealized holding loss - income	51,500	
Securities fair value adj. - Trading		51,500

LO 3 Identify the categories of equity securities and describe the accounting and reporting treatment for each category.

Holdings of Less Than 20%

P17-6 How would the entries change if the securities were classified as available-for-sale?

The entries would be the same except that the

- Unrealized Holding Gain or Loss—Equity account is used instead of Unrealized Holding Gain or Loss—Income.
- The unrealized holding loss would be deducted from the stockholders' equity section rather than charged to the income statement.

Holdings Between 20% and 50%

An investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary, an investor has the ability to exercise **significant influence** over an investee.

In instances of "significant influence," the investor must account for the investment using the **equity method**.

LO 4 Explain the equity method of accounting and compare it to the fair value method for equity securities.

Holdings Between 20% and 50%

Equity Method

Record the investment at cost and subsequently adjust the amount each period for

- the investor's proportionate share of the earnings (losses) and
- dividends received by the investor.

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

LO 4 Explain the equity method of accounting and compare it to the fair value method for equity securities.

Holdings Between 20% and 50%

E17-17 (Equity Method) On January 1, 2007, Pennington Corporation purchased 30% of the common shares of Edwards Company for $180,000. During the year, Edwards earned net income of $80,000 and paid dividends of $20,000.

Instructions

Prepare the entries for Pennington to record the purchase and any additional entries related to this investment in Edwards Company in 2007.

LO 4 Explain the equity method of accounting and compare it to the fair value method for equity securities.

Holdings Between 20% and 50%

E17-17 Prepare the entries for Pennington to record the purchase and any additional entries related to this investment in Edwards Company in 2007.

Investment in Stock		180,000	
Cash			180,000
Investment in Stock		24,000	
Investment Revenue	($80,000 x 30%)		24,000
Cash		6,000	
Investment in Stock	($20,000 x 30%)		6,000

LO 4 Explain the equity method of accounting and compare it to the fair value method for equity securities.

Holdings of More Than 50%

Controlling Interest - When one corporation acquires a voting interest of more than 50 percent in another corporation

- Investor is referred to as the **parent.**
- Investee is referred to as the **subsidiary**.
- Investment in the subsidiary is reported on the parent's books as a long-term investment.
- Parent generally prepares **consolidated financial statements**.

LO 4 Explain the equity method of accounting and compare it to the fair value method for equity securities.

Financial Statement Presentation

Report **trading** securities at aggregate fair value as current assets.

Report **held-to-maturity** and **available-for-sale** securities as current or noncurrent.

- Aggregate fair value, gross unrealized holding gains, gross unrealized losses, amortized cost basis by type (debt and equity), and information about the maturity of debt securities.

Financial Statement Presentation

Disclosures Required under the Equity Method

1. Name of each investee and percentage ownership.
2. Accounting policies of the investor.
3. Difference between amount in the investment account and amount of underlying equity in the net assets of the investee.
4. The aggregate value of each identified investment based on quoted market price (if available).
5. When material, present information concerning assets, liabilities, and results of operations of the investees.

LO 5 Describe the disclosure requirements for investments in debt and equity securities.

Financial Statement Presentation

Reclassification Adjustments

Company needs a reclassification adjustment when it reports

- realized gains or losses as part of net income but also
- shows the amounts as part of other comprehensive income in the current or in previous periods.

Impairment of Value

Impairments of debt and equity securities are

- losses in value that are determined to be other than temporary,
- based on a fair value test, and
- are charged to income.

LO 6 Discuss the accounting for impairments of debt and equity investments.

Transfers Between Categories

Transfers between **Trading** and **Available-for-Sale**

- Security transferred at fair value.
- Unrealized gain or loss at date of transfer increases or decreases stockholders' equity.
- Unrealized gain or loss at date of transfer is recognized in income.

LO 7 Describe the accounting for transfer of investment securities between categories.

Transfers Between Categories

Transfer from **Held-to-Maturity** to **Available-for-Sale**

- Security transferred at fair value.
- Separate component of stockholders' equity is increased or decreased by the unrealized gain or loss at date of transfer .
- NO impact of transfer on net income.

LO 7 Describe the accounting for transfer of investment securities between categories.

Transfers Between Categories

Transfer from **Available-for-Sale** to **Held-to-Maturity**

- Security transferred at fair value.
- Unrealized gain or loss at date of transfer carried as a separate component of stockholders' equity is amortized over the remaining life of the security.
- NO impact of transfer on net income.

LO 7 Describe the accounting for transfer of investment securities between categories.

Fair Value Controversy

Major Unresolved Issues

- Measurement Based on Intent
- Gains Trading
- Liabilities Not Fairly Valued
- Subjectivity of Fair Values

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