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Chapter 12

In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?

Video Clip

[\(click to see video\)](#)

In this video, Professor Joe Hoyle introduces the essential points covered in [Chapter 12 "In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?"](#).

12.1 Accounting for Investments in Trading Securities

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Realize that the financial reporting of investments in the ownership shares of another company depends on the purpose of the acquisition.
2. Explain the characteristics of investments that are classified as trading securities.
3. Account for changes in the value of investments in trading securities and understand the rationale for this handling.
4. Record dividends received from investments that are classified as trading securities.
5. Determine the gain or loss to be recorded on the sale of a trading security.

The Reasons Why One Company Buys Ownership Shares of Another

Question: Businesses frequently acquire ownership shares (often referred to as equity or capital shares) of other companies. On September 30, 2011, Microsoft disclosed that it held “equity and other investments” reported at nearly \$8.6 billion. Many such investments are only made to acquire a small percentage of the ownership. However, that is not always the case. In April, 2011, Johnson & Johnson announced the \$21.3 billion purchase of Swiss medical device maker Synthes Inc. Whether a few shares are bought, or the entire company is bought, such investments offer many potential benefits. What are the most common reasons for one company to buy the ownership shares of another company?

Answer: Potentially, many benefits can accrue from obtaining shares of the capital stock issued by another business. Interestingly, the specific method of financial reporting depends on the owner’s purpose for holding such investments. Thus, the accounting process here is quite unique. The reporting of most assets (such as inventory and equipment) does not vary because of the rationale for making the purchase and then retaining the property. In contrast, the accounting process used

to report the ownership of stock in another company falls within one of several methods based solely on the reason for the investment.

Companies frequently find that they are holding excess cash not needed at the moment for operating purposes. Such money can be temporarily invested to increase net income. Traditional savings accounts or money market funds offer only very low returns. Company officials often seek greater profit by using surplus money to buy the ownership shares of other organizations. The hope is that the market price of these shares will appreciate in value and/or dividends will be received before the cash is needed for operations. Such investments can be held for a few days (or even hours) or many years. Although earnings can improve through this strategy, the buyer does face additional risk. Share prices do not always go up. They can also decline in value, resulting in losses for the investor.

When equity shares are bought solely as a way to store cash and increase profits, the investor has no desire to influence or control the decisions of the other company. That is not the reason for the purchase; the ownership interest is much too small.

Investors, though, may also embrace a strategy of acquiring enough shares to gain some degree of influence over the other organization. Often, profitable synergies can be developed by having two companies connected in this way. For example, as of October 3, 2010, **Starbucks Corporation** held 39.9 percent of the outstanding stock of **Starbucks Coffee Japan Ltd.** **Starbucks** does not own a sufficient number of shares to **control**¹ the operations of the Japanese company, but it certainly can apply significant influence if it so chooses.

Finally, as in the acquisition of **Synthes** by **Johnson & Johnson**, the investor may seek to obtain a controlling interest in the other company (in U.S. GAAP that is viewed as being over 50 percent of the outstanding capital stock). In many cases, the parent company chooses to buy 100 percent ownership of the other business to gain complete control. Such acquisitions are common as large companies attempt to (a) move into new industries or geographical areas, (b) become bigger players in their current markets, (c) gain access to valuable assets, or (d) eliminate competitors. Many smaller companies are started by entrepreneurs with the specific hope that success will attract acquisition interest from a larger organization. Often, significant fortunes are earned by the original owners as a result of the sale of their company to a bigger business.

1. According to U.S. GAAP, it exists when one company owns more than 50 percent of the outstanding common shares of another company so that the parent can direct all decision making; for external reporting purposes, the financial information of both companies must be consolidated to form a single set of financial statements.

Trading Securities

Question: As can be seen in the previous answer, several different reasons exist for buying capital stock. Applicable accounting rules can best be demonstrated by focusing on one of these types of investments at a time.

Assume that Valente Corporation is holding \$25,000 in cash that it will not need for several weeks. This money is currently in a money market fund earning only a 1 percent annual rate of return. In hopes of generating a higher profit, the president of Valente has studied the financial statements of Bayless Corporation, a company with capital stock trading on the New York Stock Exchange for \$25 per share. By November 30, Year One, the president has come to believe that Bayless stock will make a rather significant jump in market price in the near future. Consequently, Valente uses the \$25,000 to acquire one thousand shares of stock in Bayless that will be held for only a few weeks or months. How does a company report an equity investment that is bought with the expectation that the shares will be sold shortly after the purchase is made?

*Answer: If management intends to sell the equity shares of another company shortly after buying them, the purchase is classified on the balance sheet as an investment in **trading securities**². On the acquisition date, as shown in [Figure 12.1 "Purchase of Ownership Shares Classified as Trading Securities"](#), the asset is recorded by Valente at historical cost.*

Figure 12.1 Purchase of Ownership Shares Classified as Trading Securities

Investment in Trading Securities	25,000	
Cash		25,000

As an owner, even if the shares are only held for a short time, Valente might receive a cash dividend from Bayless. Many companies distribute dividends to their stockholders periodically as a way of sharing a portion of any income that has been earned.

Assume that Bayless has been profitable and, as a result, a \$0.20 per share cash dividend is declared by its board of directors and paid in December, Year One. Valente receives \$200 of this dividend ($\$0.20 \text{ per share} \times 1,000 \text{ shares}$), which is

2. Classification of investments in stocks and bonds when management's intentions are to sell them quickly in the near term; they are reported as assets on the balance sheet at fair value with all changes in value affecting net income.

reported as revenue on the owner's Year One income statement. The journal entry is presented in [Figure 12.2 "Receipt of Dividend from Investment in Stock"](#).

Figure 12.2 Receipt of Dividend from Investment in Stock

Cash	200	
Dividend Revenue		200

Because of the short-term nature of this investment, Valente might sell these shares prior to the end of Year One. The purchase of Bayless stock was made anticipating a quick sale. Consequently, a gain is reported if more than \$25,000 is received, whereas a loss results if the shares are sold for less than \$25,000. Such gains and losses appear on the owner's income statement when created by the sale of a trading security.

The Value of Trading Securities at Year's End

Question: The accounting process for trading securities becomes more complicated if Valente continues to own this investment in Bayless at year end. Should equity shares held as a trading security be reported on the owner's balance sheet at historical cost or current fair value? Which reporting provides the most helpful information to outside decision makers?

Answer: U.S. GAAP requires investments in trading securities to be reported on the owner's balance sheet at fair value. Therefore, if the shares of Bayless are worth \$28,000 at December 31, Year One, Valente must adjust the reported value from \$25,000 to \$28,000 by reporting a gain as shown in [Figure 12.3 "Shares of Bayless \(a Trading Security\) Adjusted to Fair Value at End of Year One"](#).

Figure 12.3 Shares of Bayless (a Trading Security) Adjusted to Fair Value at End of Year One

Investment in Trading Securities	3,000	
Unrealized Gain—Trading Securities		3,000

3. A gain or loss created by an increase or decrease in the value of an asset although not yet finalized by a sale.

The gain here is labeled as **unrealized**³ to indicate that the value of the asset has appreciated but no final sale has yet taken place. Therefore, the gain is not

guaranteed; the value might go back down before the shares are sold. However, the \$3,000 unrealized gain is reported on Valente's Year One income statement so that net income is affected.

TEST YOURSELF

Question:

James Attenborough is studying the financial statements published for the Hawthorne Roberts Corporation. This company owns shares in **Microsoft** and several other companies. Consequently, it reports an investment in trading securities account on its year-end balance sheet as an asset with a balance of \$18,765. What does that figure represent?

- a. It is impossible to tell without reading the notes to the financial statements.
- b. The \$18,765 was the historical cost of these shares.
- c. The \$18,765 is the fair value of the shares on the balance sheet date.
- d. The \$18,765 is the lower of the cost or market value of these shares at the end of the year.

Answer:

The correct answer is choice c: The \$18,765 is the fair value of the shares on the balance sheet date.

Explanation:

Investments in trading securities are held for a relatively quick sale. They are always reported at fair value regardless of whether that figure is above or below the cost of acquisition. Fair value is easy to determine and the company knows that it can get that amount on the balance sheet date.

Reporting Trading Securities at Fair Value

Question: The reporting demonstrated above for an investment in a trading security raises a theoretical question that has long been debated in financial accounting. Is recognizing a gain in the value of a trading security (or a loss if the stock price has declined) on the owner's income statement appropriate before an actual sale takes place? In this illustration, for example, a \$3,000 gain is reported, but the value of these shares might suddenly plummet and eliminate that gain prior to a sale. The gain might never be received. In previous

chapters, assets such as buildings and inventory were never adjusted to fair value unless impairment had taken place. Why is an investment in a trading security always reported at fair value regardless of whether that value is above or below historical cost?

Answer: Changes in the value of trading securities are recognized and the resulting gains or losses are included within current net income for several reasons:

- The Bayless shares sell on a stock exchange. Thus, the reported value of \$28,000 can be objectively determined. It is not an estimated amount subject to manipulation as is the fair value of assets such as buildings and inventory.
- The stock can be sold immediately; Valente does not even have to find a buyer. The stock exchange provides a workable mechanism to create a sale whenever the owner wants to liquidate the investment. No question exists that these shares can be sold at any time. Once again, the same assertion cannot be made for assets such as buildings and inventory.
- As a trading security, a sale is anticipated in the near term. The owner does not plan to hold the stock for a long period of time. Further changes in value can certainly take place but are less likely to be severe. The shortness of time limits the chance of radical fluctuations in value after the balance sheet date.

For these reasons, U.S. GAAP requires that investments in trading securities be reported on the owner's balance sheet at fair value (\$28,000 in this example). Therefore, Valente will report both the dividend revenue of \$200 and the unrealized gain of \$3,000 on its Year One income statement.

If, instead, the fair value at year-end had been only \$21,000, a \$4,000 unrealized loss appears on Valente's income statement to reflect the decline in value (\$25,000 historical cost dropping to \$21,000 fair value).

TEST YOURSELF

Question:

During Year One, Hancock Corporation buys 2,000 shares of Waltz Inc. for \$34 per share. Hancock appropriately records this acquisition as an investment in trading securities because it plans to make a sale in the near future. In December of Year One, Waltz pays a \$1 per share cash dividend to its owners. On the last day of December, the stock is selling on a stock exchange for \$39 per share. What is the impact of these events on the income reported by Hancock for Year One?

- a. No effect
- b. Increase of \$2,000
- c. Increase of \$10,000
- d. Increase of \$12,000

Answer:

The correct answer is choice d: Increase of \$12,000.

Explanation:

The dividend that is received (\$2,000 or \$1.00 per share \times 2,000 shares) is reported as revenue by the recipient (Hancock). In addition, because these shares are classified as trading securities, the change in value this year also impacts net income. The price of the stock went up \$5 per share (\$39 less \$34) so that Hancock reports a gain of \$10,000 (\$5 per share \times 2,000 shares). Total increase in income reported by Hancock is \$12,000 (\$2,000 plus \$10,000).

The Sale of a Trading Security

Question: In this ongoing illustration, Valente Corporation bought one thousand shares of Bayless Corporation which it planned to sell in a relatively short period of time. At the end of Year One, this trading security was adjusted from the historical cost of \$25,000 to its fair value of \$28,000. The \$3,000 unrealized gain was reported within net income on the Year One income statement.

Assume that these shares are sold by Valente on February 3, Year Two, for \$27,000 in cash. What financial reporting is appropriate when an investment in trading securities is sold in a subsequent period? What effect does this final transaction have on reported income?

Answer: Following the Year One adjustment, this investment is recorded in the general ledger at the fair value of \$28,000 rather than historical cost. When eventually sold, any difference between the sales price and this carrying amount is recorded as a gain or a loss on the Year Two income statement.

Because the sales price of these shares (\$27,000) is less than the balance now being reported (\$28,000), recognition of a \$1,000 loss is appropriate, as can be seen in Figure 12.4 "Sale of Shares of Bayless (a Trading Security) for \$27,000 in Year Two". This loss reflects the drop in value of the shares that took place during Year Two.

Figure 12.4 Sale of Shares of Bayless (a Trading Security) for \$27,000 in Year Two

Cash	27,000	
Loss on Sale of Trading Investment	1,000	
Investment in Trading Securities		28,000

This investment was originally bought for \$25,000 and later sold for \$27,000 so an overall gain of \$2,000 was earned. For reporting purposes, this income effect is spread between the two years of ownership. A gain of \$3,000 was recognized in Year One to reflect the appreciation in value during that period of time. Then, in Year Two, a loss of \$1,000 is reported because the stock price fell by that amount prior to being sold.

Investments in trading securities are always shown on the owner's balance sheet at fair value. The gains and losses reported in the income statement will parallel the movement in value that took place each period.

TEST YOURSELF

Question:

Late in Year One, a company buys one share of a publicly traded company for \$75. This investment is reported as a trading security because the owner plans to sell the stock in the near future. At the end of Year One, this share is only worth \$62. However, early in Year Two, the stock price soars to \$80 and the stock is sold. A \$2 cash dividend is also received by the owner in January of Year Two. What is the reported income effect of this ownership?

- a. No change in income in Year One but a \$5 increase in Year Two.
- b. No change in income in Year One but a \$7 increase in Year Two.
- c. Net income is reduced \$13 in Year One but an \$18 increase in Year Two.
- d. Net income is reduced \$13 in Year One but a \$20 increase in Year Two.

Answer:

The correct answer is choice d: Net income is reduced \$13 in Year One but a \$20 increase in Year Two.

Explanation:

As a trading security, the \$13 drop in value in Year One (\$75 less \$62) is reported as a loss on the owner's income statement. Then, the \$18 rise in value in Year Two (\$80 less \$62) increases net income. In addition, the \$2 dividend increases the Year Two income reported by the owner bringing it up to \$20.

KEY TAKEAWAY

Many companies acquire the equity shares of other companies as investments. The applicable accounting procedures depend on the purpose for the ownership. If the stock is only to be held for a short period of time, it is labeled a trading security. The investment is then adjusted to fair value whenever financial statements are to be produced. Any change in value creates a gain or loss that is reported within net income because fair value is objectively determined, the shares can be liquidated easily, and a quick sale is anticipated before a significant change in fair value is likely to occur. Dividends received by the owner are recorded as revenue. Whenever trading securities are sold, only the increase or decrease in value during the current year is reported within net income since earlier changes have already been reported in that manner.

12.2 Accounting for Investments in Securities That Are Classified as Available-for-Sale

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Identify the types of investments classified as available-for-sale.
2. Record the receipt of dividends from an investment that is viewed as available-for-sale.
3. Explain the financial reporting of changes in the fair value of investments in available-for-sale securities.
4. Calculate the gain or loss to be reported when available-for-sale securities are eventually sold.
5. Understand the need for reporting comprehensive income as well as net income.
6. Explain the adjustment made to net income in order to arrive at comprehensive income.

Reporting Available-For-Sale Investments

Question: Not all investments in stock are bought for quick sale. Assume that Valente Corporation bought one thousand shares of Bayless Corporation for \$25 each in Year One but does not anticipate selling this investment in the near term. Company officials intend to hold these shares for the foreseeable future until the money is clearly needed. Although the stock could be sold at any time, the president of Valente believes the investment might well be retained for years. During Year One, a \$200 cash dividend is received from the Bayless shares. At the end of that period, the stock is selling for \$28 per share. How does the decision to hold equity shares for an extended period of time impact the financial reporting process?

4. Accounting classification for investments in stocks and bonds when management's intentions are to retain them for an indefinite period; they are reported on the balance sheet at fair value although unrealized gains and losses are included in stockholders' equity and not within net income.

Answer: Valente does not anticipate a quick sale of its investment in Bayless. Because Valente's intention is to retain these shares for an indefinite period, they will be classified on the company's balance sheet as an investment in **available-for-sale securities**⁴ rather than as trading securities. Despite the difference in the plan for holding these shares, they are—once again—recorded at historical cost when

acquired, as shown in [Figure 12.5 "Purchase of Ownership Shares Classified as Available-for-Sale Securities"](#).

Figure 12.5 Purchase of Ownership Shares Classified as Available-for-Sale Securities

Investment in Available-for-Sale Securities	25,000	
Cash		25,000

The receipt of the dividend is also reported in the same manner as before with the dividend revenue increasing Valente's net income. No difference is created between the accounting for trading securities and accounting for available-for-sale securities as a result of a dividend.

Figure 12.6 Receipt of Dividend from Investment in Available-for-Sale Securities

Cash	200	
Dividend Revenue		200

The difference in reporting begins at the end of the year. U.S. GAAP requires available-for-sale investments to be included on the investor's balance sheet at fair value (in the same manner as trading securities). As before, this adjustment to fair value creates an unrealized gain of \$3,000, as is reflected in [Figure 12.7 "Shares of Bayless \(an Available-for-Sale Security\) Are Adjusted to Fair Value at End of Year One"](#). However, reported net income is not affected as it was with the investment in the trading security.

Figure 12.7 Shares of Bayless (an Available-for-Sale Security) Are Adjusted to Fair Value at End of Year One

Investment in Available-for-Sale Securities	3,000	
Unrealized Gain on Available-for-Sale Securities		3,000

Accumulated Other Comprehensive Income

Question: Based on the previous discussion, an immediate question is obvious: If the \$3,000 unrealized gain shown in [Figure 12.7 "Shares of Bayless \(an Available-for-Sale Security\) Are Adjusted to Fair Value at End of Year One"](#) is not presented on the income statement, where

is that amount reported by the owner? How are changes in the fair value of available-for-sale securities reported?

Answer: Because no sale is anticipated in the near term, the fair value of available-for-sale shares will possibly go up and down numerous times before being sold. Hence, the current gain is not viewed as “sure enough.” As a result of this uncertainty, a change in the owner’s reported net income is not considered appropriate.

Instead, any unrealized gain (or loss) in the value of an investment that is classified as available-for-sale is reported within the stockholders’ equity section of the balance sheet. The figure is listed either just above or below the retained earnings account. A few other unrealized gains and losses are handled in this manner and are combined and reported as **accumulated other comprehensive income**⁵ as shown in Figure 12.8 "Stockholders’ Equity Including Accumulated Other Comprehensive Income".

Figure 12.8 *Stockholders’ Equity Including Accumulated Other Comprehensive Income*

Contributed Capital (or Capital Stock)	XXX
Retained Earnings	XXX
Accumulated Other Comprehensive Income:	
Unrealized Gain on Available-for-Sale Securities	3,000

Consequently, the primary difference in the financial accounting for trading securities and available-for-sale securities is in the placement of unrealized gains and losses from changes in value:

- Changes in the value of trading securities are reported in the income statement.
- Changes in the value of available-for-sale securities are shown in stockholders’ equity and not net income.

5. A section of the stockholders’ equity of a balance sheet where unrealized gains and losses on available-for-sale securities (as well as a few other specified gains and losses) are shown rather than being presented on the reporting company’s income statement.

The described procedures were first created in 1993 and have been used since that time. Interestingly, in 2007, FASB passed a rule that allows companies to elect to report available-for-sale investments as trading securities. This option must be selected when the investment is purchased. Thus, if that election is made, the \$3,000 unrealized gain is reported on the income statement despite the intention to

hold the securities for an indefinite period. This is another example of accounting rules that are not as rigid as sometimes perceived.

TEST YOURSELF

Question:

Company A buys shares of a well-known company in Year One for \$130,000. Company officials plan to hold this investment for only a short period of time so that it is classified as a trading security. Coincidentally, Company B makes the same investment at the same time for the same cost. However, Company B officials expect to hold these shares indefinitely. Company B reports this investment as available-for-sale and does not elect to report it in the same manner as a trading security. Both companies continue to hold their investments at the end of the year when they are each worth \$144,000. Which of the following is not true?

- a. Both companies will report their investment at \$144,000.
- b. Net income will increase more for Company A than for Company B because of these investments.
- c. Company A reports other accumulated comprehensive income on the December 31, Year One, balance sheet of \$14,000.
- d. Company B reports other accumulated comprehensive income on the December 31, Year One, balance sheet of \$14,000.

Answer:

The correct answer is choice c: Company A reports other accumulated comprehensive income on the December 31, Year One, balance sheet of \$14,000.

Explanation:

Both companies report the asset as \$144,000, its fair value at the end of the year. Company A views these shares as trading securities so that the increase in value of \$14,000 is reported as an unrealized gain in net income. However, Company B has classified the investment as available-for-sale. Thus, the \$14,000 unrealized gain is not shown within net income but, rather, in stockholders' equity as "other accumulated comprehensive income."

The Sale of Available-For-Sale Securities

Question: Assume that Valente did not choose to report the available-for-sale investment as a trading security but rather by means of the traditional approach. Thus, the \$3,000 unrealized gain created by the appreciation of value is reported within stockholders' equity at the end of Year One. In Year Two, these shares are sold on the stock exchange for \$27,000. What reporting is made at that time? How is the eventual sale of investments that are classified as available-for-sale securities reported?

Answer: When available-for-sale securities are sold, the difference between the original cost (\$25,000) and the selling price (\$27,000) appears as a realized gain (or loss) on the owner's income statement. Because no change in net income was reported in the previous year, this entire amount has to be recognized at the date of sale. Having presented the unrealized gain within stockholders' equity in Year One, the change in value only touches net income when sold.

However, mechanical complexities now exist. The investment has been adjusted to a \$28,000 carrying amount, and a \$3,000 unrealized gain still remains within stockholders' equity. As a balance sheet account, this \$3,000 figure is not closed out at the end of Year One. Therefore, when the investment is sold, both the \$28,000 asset and the \$3,000 unrealized gain must be removed. The net amount mirrors the \$25,000 historical cost of these shares. By eliminating the previous gain in this manner, the asset is brought back to the original \$25,000. Thus, as shown in [Figure 12.9 "Sale of Available-for-Sale Security in Year Two"](#), the appropriate realized gain of \$2,000 is recognized. The shares were bought for \$25,000 and sold for \$27,000, and the previous unrealized gain is removed.

Figure 12.9 Sale of Available-for-Sale Security in Year Two

Cash	27,000	
Unrealized Gain on Available-for-Sale Securities	3,000	
Investment in Available-for-Sale Securities		28,000
Gain on Sale of Available-for-Sale Investment		2,000

TEST YOURSELF

Question:

Company A buys ownership shares of a well-known company for \$68,000 in Year One and classifies the asset as an investment in trading securities. Company B also buys shares of this company on the same date for \$68,000. However, the investment is reported by this owner as available-for-sale. Company B does not elect to report this investment in the same manner as a trading security. Both investments are worth \$70,000 at the end of Year One. Both investments are sold in Year Two for \$60,000. Which of the following is true?

- a. Company B reports a bigger gain on its income statement in Year One than does Company A.
- b. Company B reports a bigger loss on its income statement in Year Two than does Company A.
- c. Company A reports a bigger loss on its income statement in Year One than does Company B.
- d. Company A reports a bigger loss on its income statement in Year Two than does Company B.

Answer:

The correct answer is choice d: Company A reports a bigger loss on its income statement in Year Two than does Company B.

Explanation:

Company A reports a trading security; the \$2,000 increase in value is an income statement gain in Year One. The \$10,000 drop in value is an income statement loss in Year Two. Because Company B reports these shares as available-for-sale, no income effect is recognized in Year One. In Year Two, the \$8,000 difference between cost and amount received is a loss on the income statement. The gain reported by Company A is larger in Year One but the loss reported by Company A is larger in Year Two.

The Reporting of Comprehensive Income

Question: In Year One, Valente's investment in the shares of Bayless Corporation rose in value by \$3,000. As discussed earlier, if those securities are classified as available-for-sale,

the unrealized gain does not impact reported net income but, rather, stockholders' equity. This handling is justified because a number of additional changes in value (both increases and decreases) are likely to take place prior to the eventual sale of the investment.

As a result, the net income figure reported by Valente seems a bit misleading. It does not include the increase in the reported worth of this asset. Are decision makers well-served by an income figure that omits certain gains and losses? Assume, for example, that Valente reports total net income for Year One of \$80,000. This figure includes no part of the \$3,000 unrealized gain. What reporting is necessary to help investors and creditors understand the impact on income of a change in value when investments are labeled as available-for-sale?

Answer: As noted, changes in the value of available-for-sale securities create unrealized gains or losses that appear in the stockholders' equity section of the balance sheet but not in net income. The completeness of reported net income in such situations can be questioned.

To help decision makers better evaluate reporting companies with such unrealized items, a second income figure is presented that does include these gains or losses. The resulting balance, known as **comprehensive income**⁶, is shown within a company's financial statements. In [Figure 12.10 "Net Income Converted to Comprehensive Income"](#), by adding in the \$3,000 change in fair value, Valente's net income figure is adjusted to the more complete total.

Figure 12.10 Net Income Converted to Comprehensive Income

Net Income	\$80,000
Unrealized Gain in Available-for-Sale Securities	3,000
Comprehensive Income	<u>\$83,000</u>

Decision makers can choose to emphasize one figure (net income) or another (comprehensive income) in their analysis of a reporting company. More appropriately, they can view these two figures as simply different ways to portray the results of the current year and make use of both.

6. Net income plus any unrealized gains and less any unrealized losses that appear in stockholders' equity rather than within net income.

Comprehensive income includes all changes in stockholders' equity other than (a) amounts contributed by stockholders and (b) dividend distributions made to stockholders. Unrealized gains and losses on available-for-sale securities are

common but several other unrealized gains and losses are also included in moving from net income to comprehensive income.

Sometimes comprehensive income makes a company appear more successful, sometimes less so. For example, for the year ended December 31, 2010, **Yahoo! Inc.** reported its net income as \$1.245 billion. However, the financial picture seems improved by disclosure of comprehensive income for the period of \$1.367 billion. Conversely, **The Dow Chemical Company** reported net income for the same year of \$2.321 billion but comprehensive income of only \$1.803 billion.

TEST YOURSELF

Question:

The Jelanizada Company reports revenue of \$800,000 in Year One along with expenses of \$700,000. In addition, the company bought shares of a publicly held company for \$50,000 that was worth \$70,000 by year's end. This investment was reported as available-for-sale. Which of the following is true?

- a. Jelanizada should report net income for Year One of \$80,000.
- b. Jelanizada should report net income for Year One of \$120,000.
- c. Jelanizada should report comprehensive income for Year One of \$100,000.
- d. Jelanizada should report comprehensive income for Year One of \$120,000.

Answer:

The correct answer is choice d: Jelanizada should report comprehensive income for Year One of \$120,000.

Explanation:

As an investment in an available-for-sale security, the \$20,000 increase in value is reported as a gain in other accumulated comprehensive income in the stockholders' equity section of the balance sheet. Net income is revenue minus expenses or \$100,000 (\$800,000 less \$700,000). The gain, though, must then be included in arriving at a more inclusive comprehensive income figure of \$120,000 (net income of \$100,000 plus gain of \$20,000).

KEY TAKEAWAY

Investments in equity securities are often held by the owner for an indefinite period of time. As such, the asset is classified as available-for-sale and shown at fair value each period. Any change in the reported amount is not included in net income but is rather listed within accumulated other comprehensive income in the stockholders' equity section of the balance sheet. However, dividends that are received from the investment are reported as revenue and do impact the computation of net income. When eventually sold, the difference between the original cost of the securities and the proceeds received is reported as a gain or loss shown within net income. Because the periodic changes in value are not factored into the calculation of net income, they are included in the calculation of comprehensive income. Thus, both net income and comprehensive income are reported to decision makers to provide them with a better understanding of the impact of these unrealized gains and losses.

12.3 Accounting for Investments by Means of the Equity Method

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Describe the theoretical criterion for applying the equity method to an investment in stock and explain the practical standard that is often used.
2. Compute the amount of income to be recognized when using the equity method and make the journal entry for its recording.
3. Understand the handling of dividends that are received when the equity method is applied and make the journal entry.
4. Indicate the impact that a change in fair value has on the reporting of an equity method investment.
5. Prepare the journal entry to record the sale of an equity method security.

The Need to Apply the Equity Method

Question: Not all investments in capital stock are made solely for the possibility of gaining dividends and share price appreciation. As mentioned earlier, Starbucks holds 39.9 percent ownership of Starbucks Coffee Japan Ltd. The relationship between those two companies is different. The investor has real power; it can exert some amount of authority over the investee. Starbucks owns a large enough stake in Starbucks Coffee Japan Ltd. so that operating and financing decisions can be influenced. When one company holds a sizable portion of another company, is accounting for the investment as either an available-for-sale or trading security a reasonable approach?

7. A method of reporting an investment in stock that is applied when the owner has the ability to exert significant influence on the decisions of an investee; in practice, it is used to report investments where 20 percent or more and less than or equal to 50 percent of the shares are held, unless evidence exists that significant influence does not exist.

Answer: The answer to this question depends on the size of ownership. As the percentage of shares being held grows, the investor gradually moves from having little or no authority over the investee to a position where significant influence can be exerted. At that point, for financial reporting purposes, the investment no longer qualifies as a trading security or an available-for-sale security. Instead, the shares are reported by means of the **equity method**⁷. The owner's rationale for holding the investment has changed. The equity method views the connection between the

two companies in an entirely different fashion. The accounting process applied by the investor is altered to more closely mirror this relationship.

The equity method is applied when the investor has the ability to apply significant influence to the operating and financing decisions of the investee. Unfortunately, the precise point at which one company gains that ability is impossible to ascertain. A bright line distinction simply does not exist. Although certain clues such as membership on the board of directors and the comparative size of other ownership interests can be helpful, the degree of influence is a nebulous criterion. When a question arises as to whether the ability to apply significant influence exists, the percentage of ownership can be used to provide an arbitrary standard.

According to U.S. GAAP, unless signs of significant influence are present, an investor owning less than 20 percent of the outstanding shares of another company reports the investment as either a trading security or available-for-sale security. In contrast, an investor holding 20 percent or more but less than or equal to 50 percent of the shares of another company is assumed to possess the ability to exert significant influence. Consequently, unless evidence is present that significant influence does not exist, the equity method is applied by the investor to report all investments in this 20–50 percent range of ownership.

TEST YOURSELF

Question:

Howard Company acquires 26 percent of the outstanding stock of Birmingham Bottling Company. Unfortunately, the Larito Company holds the other 74 percent of Birmingham and pays no attention to the ideas and suggestions put forth by Howard. Which of the following is true about Howard's reporting of this investment?

- a. The equity method should be applied because Howard holds 20–50 percent of the shares of Birmingham Bottling.
- b. The equity method should not be applied because Howard only holds 26 percent of the shares of Birmingham Bottling.
- c. The equity method should be applied because Howard has significant influence over Birmingham Bottling.
- d. The equity method should not be applied because Howard does not have significant influence over Birmingham Bottling.

Answer:

The correct answer is choice d: The equity method should not be applied because Howard does not have significant influence over Birmingham Bottling.

Explanation:

Normally, if one company holds 20–50 percent of the outstanding stock of another company, significant influence is assumed and the equity method is applied. However, in this situation, Howard Company has virtually no influence because Larito Company holds a majority of the stock and does not pay any attention to Howard Company. Without the ability to apply significant influence, the equity method should not be adopted regardless of the amount of stock that is held.

The Reporting of Investments When Applying the Equity Method

Question: One company holds shares of another and has the ability to apply significant influence. Thus, the equity method of accounting is appropriate. What financial reporting is made of an investment when the equity method is used? What asset value is reported on the

owner's balance sheet and when is income recognized from the investment under this approach?

Answer: When applying the equity method, the investor does not wait until dividends are received to recognize profit from its investment. Because of the close relationship between the two companies, the investor reports income as it is earned by the investee. That is a key element of using the equity method. If, for example, a company reports net income of \$100,000 in the current year, an investor holding a 40 percent ownership interest immediately records an increase in its own income of \$40,000 ($\$100,000 \times 40$ percent). The appropriate percentage of the investee's income is recognized by the investor. The investor also increases its investment account by \$40,000 to reflect the growth in the size of the investee company.

Because income is recognized by the investor as earned by the investee, it cannot be reported again when a subsequent dividend is collected. That would double-count the impact. Income must be recognized either when earned by the investee or when later distributed to the investor in the form of a dividend, but not at both times. The equity method uses the earlier date rather than the latter.

Eventual payment of a dividend actually shrinks the size of the investee company because it has fewer assets. To reflect that change in size, the investor decreases the investment account when a dividend is received if the equity method is applied. No additional income is recorded because it was recorded by the investor when earned by the investee.

Because of the fair value option, companies are also allowed to report equity investments as if they were trading securities. However, few investors seem to have opted to make this election. If chosen, the investment is reported at fair value despite the degree of ownership with gains and losses in the change of fair value reported within net income.

Application of the Equity Method Illustrated

Question: In applying the equity method, income is recognized by the investor when earned by the investee. Subsequent dividend collections are not reported as revenue by the investor but rather as a reduction in the size of the investment account to avoid including the income twice.

To illustrate, assume that Big Company buys 40 percent of the outstanding stock of Little Company on January 1, Year One, for \$900,000. No evidence is present to indicate that Big lacks the ability to exert significant influence over the financing and operating decisions of Little. Thus, application of the equity method is appropriate. During Year One, Little reports net income of \$200,000 and distributes a total cash dividend to its stockholders of \$30,000. What journal entries are appropriate for an investor when the equity method is applied to an investment?

Answer: The purchase of 40 percent of Little Company for cash is merely the exchange of one asset for another. Thus, the investment is recorded initially by Big at its historical cost, as shown in [Figure 12.11 "Acquisition of Shares of Little to Be Reported Using the Equity Method"](#).

Figure 12.11 Acquisition of Shares of Little to Be Reported Using the Equity Method

Investment in Little Cash	900,000	900,000
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Ownership here is in the 20 to 50 percent range and no evidence is presented to indicate that the ability to apply significant influence is missing. Thus, according to U.S. GAAP, the equity method should be applied. That means Big recognizes its portion of Little's \$200,000 net income as soon as it is earned by the investee. As a 40 percent owner, Big accrues income of \$80,000 ($\$200,000 \times 40\%$). Because earning this income caused Little Company to grow, Big increases its investment account to reflect the change in the size of the investee. Big's journal entry is shown in [Figure 12.12 "Income of Investee Recognized by Investor Using the Equity Method"](#).

Figure 12.12 Income of Investee Recognized by Investor Using the Equity Method

Investment in Little Investment Income—Little	80,000	80,000
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Big recognized its share of the income from this investee as it was earned. Consequently, any eventual dividend received from Little is a reduction in the investment rather than a new revenue. The investee company is smaller as a result of the cash payout. The balance in this investment account rises when the investee

reports income but falls (by \$12,000 or 40 percent of the dividend distribution of \$30,000) when that income is later passed through to the stockholders.

Figure 12.13 *Dividend Received from Investment Accounted for by the Equity Method*

Cash	12,000	
Investment in Little		12,000

At the end of Year One, the investment account appearing on Big's balance sheet reports a total of \$968,000 ($\$900,000 + 80,000 - 12,000$). This balance does not reflect fair value as was appropriate with investments in trading securities and available-for-sale securities. Unless impaired, fair value is ignored in reporting an equity method investment.

The reported amount also does not disclose historical cost. Rather, the asset figure determined under the equity method is an unusual mixture. It is the original cost of the shares plus the investor's share of the investee's subsequent income less any dividends received since the date of acquisition. Under the equity method, the investment balance is a conglomerate of amounts.

TEST YOURSELF

Question:

Giant Company buys 30 percent of the outstanding stock of Tiny Company on January 1, Year One for \$300,000. This ownership provides Giant with the ability to significantly influence the operating and financing decisions of Tiny. Subsequently, Tiny reports net income of \$70,000 each year and pays an annual cash dividend of \$20,000. Giant does not elect to report this investment as a trading security. Which of the following statements is true?

- a. Giant will report this investment at \$342,000 on December 31, Year Two.
- b. Giant will report this investment at \$363,000 on December 31, Year Three.
- c. Giant will report income from this investment of \$27,000 in Year Two.
- d. Giant will report income from this investment of \$21,000 in Year Three.

Answer:

The correct answer is choice d: Giant will report income from this investment of \$21,000 in Year Three.

Explanation:

Because the ability to apply significant influence is held, Giant uses the equity method. Each year, income of \$21,000 is recognized ($\$70,000 \times 30$ percent) with an increase in the investment. Dividends are reported by Giant as a \$6,000 reduction in the investment and not as income. The investment balance grows at a rate of \$15,000 per year (\$21,000 increase less \$6,000 decrease) so that it is reported as \$315,000 at the end of Year One, \$330,000 (Year Two), and \$345,000 (Year Three).

Selling an Investment Reported by Means of the Equity Method

Question: Assume, at the end of Year One, after the above journal entries have been made, Big sells all of its shares in Little Company for \$950,000 in cash. When the equity method is applied to an investment, what is the appropriate recording of an eventual sale?

Answer: Any investment reported using the equity method quickly moves away from historical cost as income is earned and dividends received. After just one year in this illustration, the asset balance reported by Big has risen from \$900,000 to \$968,000 (income of \$80,000 was added and \$12,000 in dividends were subtracted). If these shares are then sold for \$950,000, a loss of \$18,000 is recognized, as shown in [Figure 12.14 "Sale of Investment Reported Using the Equity Method"](#).

Figure 12.14 *Sale of Investment Reported Using the Equity Method*

Cash	950,000	
Loss on Sale of Equity Method Securities	18,000	
Investment in Little		968,000

If the shares of Little had been sold for more than their \$968,000 carrying value, a gain on the sale is recorded.

Summary. All investments in the stock of another company—where ownership is no more than 50 percent—must be accounted for in one of three ways depending on the degree of ownership and the intention of the investor: as trading securities, as available-for-sale securities, or according to the equity method. [Figure 12.15 "Comparison of Three Methods to Account for Investments"](#) provides an overview of the essential differences in these three accounting approaches. Note here that the available-for-sale securities and the investment using the equity method will have the same accounting as the trading securities if the fair value option is chosen.

Chapter 12 In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?

Figure 12.15 Comparison of Three Methods to Account for Investments

	Investment in Trading Securities	Investment in Available for Sale Securities	Investment—Equity Method
Primary Characteristic	Expected to be sold in near term	Will be sold when cash is eventually needed	Investor has ability to apply significant influence (usually shown by 20% to 50% ownership)
Reported Investment Balance	Fair value	Fair value	Cost plus portion of income less portion of dividends
Changes in Fair Value	Included in net income	Included within stockholders' equity and then within comprehensive income	Ignored unless permanent drop in value occurs
Amounts Reported within Investor's Net Income	Dividends received plus change in fair value	Dividends received	Portion of income as earned by Investee
Dividends Received	Included in net income	Included in net income	Reduces investment balance

TEST YOURSELF

Question:

A company holds many investments in the stock of other companies. A dividend is received from one of these investments. Which of the following is true?

- a. If the equity method is applied, the investment balance is increased.
- b. If the investment is a trading security, the investment balance is reduced.
- c. If the investment is available-for-sale, net income is increased.
- d. If the equity method is applied, net income is increased.

Answer:

The correct answer is choice c: If the investment is available-for-sale, net income is increased.

Explanation:

For trading securities and available-for-sale securities, dividends are recorded as income and have no impact on the investment balance. For an equity method investment, dividends are recorded as a reduction in the investment account with no change reported in net income.

TEST YOURSELF

Question:

A company holds many investments in the stock of other companies. One of these investments goes up in value by \$10,000. Which of the following is true?

- a. Net income increases if the investment is available-for-sale.
- b. Net income increases if the investment is a trading security.
- c. Net income increases if the equity method is applied.
- d. Comprehensive income increases if the equity method is applied.

Answer:

The correct answer is choice b: Net income increases if the investment is a trading security.

Explanation:

Increases in value are not recorded when the equity method is in use. For trading securities, they increase net income. For available-for-sale securities, they do not increase net income but are recorded as other accumulated comprehensive income in the stockholders' equity section of the balance sheet. They are then used in adjusting net income to arrive at comprehensive income.

KEY TAKEAWAY

An investor can gain enough equity shares of another company to have the ability to apply significant influence to its operating and financing decisions. For accounting purposes, use of the equity method then becomes appropriate. The point where significant influence is achieved can be difficult to gauge, so ownership of 20–50 percent of the stock is the normal standard applied in practice. However, if specific evidence is found indicating that significant influence is either present or does not exist, that information takes precedence regardless of the degree of ownership. According to the equity method, income is recognized by the investor as soon as earned by the investee. The investment account also increases as a result of this income recognition. Conversely, dividends are not reported as income but rather as reductions in the investment balance. Unless an impairment occurs, fair value is not taken into consideration in accounting for an equity method investment. When sold, the book value of the asset is removed, and any difference with the amount received is recognized as a gain or loss.

12.4 Reporting Consolidated Financial Statements

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. List various reasons for one company to seek to gain control over another.
2. Recognize that consolidated financial statements must be prepared if one company has control over another which is normally assumed at the point when ownership is over 50 percent of the other company's outstanding stock.
3. Explain the reporting of a subsidiary's revenues and expenses when consolidated financial statements are prepared at the date of acquisition.
4. Explain the reporting of a subsidiary's assets and liabilities when consolidated financial statements are prepared at the date of acquisition.

Accounting for Mergers and Acquisitions

*Question: Companies frequently buy more than 50 percent of the stock of other companies in order to gain control. In a large number of these transactions, one company obtains all the outstanding shares of the other so that ownership is complete. If two companies are brought together to form a third, a merger has taken place. If one company simply buys another, the transaction is referred to as an acquisition. These corporate purchases can be monetarily huge and have a long-lasting impact on an industry or the economy as a whole. "Global dollar volume in announced mergers and acquisitions rose 23.1 percent in 2010, to \$2.4 trillion, according to Thomson Reuters data. In the United States, merger volume rose 14.2 percent, to \$822 billion." Michael J. de la Merced and Jeffrey Cane, "Confident Deal Makers Pulled Out Checkbooks in 2010," *DealBook* (January 3, 2011), <http://dealbook.nytimes.com/2011/01/03/confident-deal-makers-pulled-out-checkbooks-in-2010/>.*

- Such investments are often made to expand operations into new markets or new industries. Google, for example, acquired YouTube for \$1.65 billion to provide an entrance into online videos.
- As discussed earlier in the coverage of intangible assets, one company might buy another to obtain valuable assets such as patents, real estate, trademarks,

technology, and the like. The purchase by Walt Disney of Pixar and its digital animation expertise certainly falls into this category.

- *A takeover can also be made to eliminate competition or in hopes of gaining economies of scale. The \$35 billion merger of Sprint with Nextel was projected to increase profits for the combined companies by lowering operating expenses while also reducing the number of competitors in the wireless communication industry.*

To help demonstrate the appropriate method of accounting for such investments, assume that Giant Company acquires 100 percent of Tiny Company. Obviously, Giant has gained control of Tiny. How is the reporting by Giant affected? Because over 50 percent of the stock was purchased, none of the previously described accounting methods are applicable. How does a company report the acquisition of another company where control is established?

Answer: The stockholders of Giant now control both Giant and Tiny. As a result, a business combination has been formed from the two previously independent companies. For external reporting purposes, **consolidated financial statements**⁸ are required. Giant does not report an investment in Tiny on its balance sheet as with the other accounting methods described previously. Instead, the individual account balances from each organization are put together in a prescribed fashion to represent the single economic entity that has been created. In simple terms, the assets, liabilities, revenues, and expenses of Tiny (the subsidiary) are consolidated with those of Giant (the parent) to reflect the united business.

Because such acquisitions are common, the financial statements reported by most well-known corporations actually include consolidated financial data from dozens, if not hundreds, of different subsidiaries where control has been gained over a number of years. As just one example, **Cisco Systems** made over 40 acquisitions of other companies between 2006 and 2011. Consolidated financial statements published today by **Cisco Systems** will include the revenues, expenses, assets, and liabilities of each of those subsidiaries along with those same accounts for the parent.

8. Statements that are prepared when one company holds control over another company so that all assets, liabilities, revenues, and expenses must be combined in a method stipulated by U.S. GAAP; control is assumed to exist when more than 50 percent of the ownership shares are owned.

Consolidation of financial statements is one of the most complex topics in all of financial accounting. However, the basic process is quite straightforward.

Subsidiary revenues and expenses. The revenues and expenses reported by each subsidiary are included in consolidated figures but only for the period of time after control is obtained. Consequently, if Giant obtains Tiny by buying 100 percent of its

stock on April 1, Year One, a consolidated income statement will contain no revenues and expenses recognized by Tiny prior to that date. Income statement balances accrued under previous owners have no financial impact on the new owner (Giant). Only the revenues earned and expenses incurred by this subsidiary after April 1 are included in consolidated totals.

Subsidiary assets and liabilities. Consolidation of subsidiary assets and liabilities is a more complicated process. On the date of the takeover, a total acquisition price is determined based on the fair value surrendered by the parent to gain control. A search is then made to identify all of the individual assets and liabilities held by the subsidiary at that time. As discussed previously, the parent recognizes subsidiary assets (1) that provide contractual or legal rights or (2) that can be separated from the subsidiary and then sold. Fair value is established and recorded for each of these assets as if the parent were acquiring them individually. A transaction has taken place that brings all of the subsidiary properties under the control of the parent.

Also, as explained previously, if the acquisition price is more than the total fair value of these identifiable assets and liabilities, the intangible asset goodwill is reported for the excess. As a going concern, a total value is usually attributed to a company that exceeds the individual values of its assets and liabilities. Having loyal customers and trained employees, for example, helps a company generate more profits than its assets could otherwise earn. When a company is being bought, such anticipated profitability usually leads to an increase in the negotiated price. This excess amount necessitates the recognition of goodwill on the consolidated balance sheet.

TEST YOURSELF

Question:

Tall Company buys all the outstanding stock of Small Company on November 1, Year One for \$500,000 and is now preparing consolidated financial statements at the end of Year One. Small earned revenues of \$10,000 per month during Year One along with expenses of \$8,000 per month. On November 1, Year One, Small had one asset—a piece of land with a cost of \$300,000 and a fair value of \$450,000—and no liabilities. The land continues to appreciate in value and is worth \$470,000 at the end of Year One. Which of the following statements is true about the consolidated financial statements at the end of Year One?

- a. Consolidated net income will include \$4,000 earned by Small.
- b. Goodwill at the end of Year One is reported as \$30,000.
- c. The land owned by Small is reported at the end of Year One at \$470,000.
- d. On consolidated financial statements, a \$150,000 gain is reported on the land that was owned by Small.

Answer:

The correct answer is choice a: Consolidated net income will include \$4,000 earned by Small.

Explanation:

In consolidation, only revenues and expenses recognized by Small after the purchase are included. Revenues of \$20,000 ($\$10,000 \times 2$ months) for November and December are recorded this year as well as expenses of \$16,000 ($\$8,000 \times$ two months). The value of subsidiary assets and liabilities at the date of acquisition serves as the basis for reporting so the land will be shown in consolidation at \$450,000. Because \$500,000 was paid by the parent, goodwill is the excess \$50,000.

The Consolidation of Financial Information

Question: To illustrate the consolidation process, assume that Tiny has earned revenues of \$800,000 and incurred expenses of \$500,000 during the year to date. In addition, the company reports a single asset, land costing \$400,000 but with a \$720,000 fair value. The only liability is a \$300,000 note payable. Thus, the company's reported net book value is \$100,000 (\$400,000

land less \$300,000 note payable). Tiny also owns the rights to a well-known trademark that has no book value because it was developed many years ago at little or no cost. However, it is now estimated to be worth \$210,000.

The assets and liabilities held by Tiny have a net fair value of \$630,000 (\$720,000 land plus \$210,000 trademark less \$300,000 note payable). Over the years, the company has been extremely popular and developed a large customer base. Therefore, after extensive negotiations, Giant agrees to pay \$900,000 in cash to acquire all the outstanding stock of Tiny. If consolidated financial statements are created at the time of a corporate acquisition, what figures are reported by the business combination?

Answer: In consolidating Giant and its subsidiary Tiny at the date of this acquisition, neither the subsidiary revenues of \$800,000 nor its expenses of \$500,000 are included. Their financial impact occurred prior to the takeover by Giant. Those profits benefited the previous owners. Therefore, only revenues and expenses reported by Giant make up the consolidated income statement totals determined on the day the parent acquires this subsidiary.

At the same time, consolidated balance sheet totals will not show any “investment in Tiny Company” as in the other methods demonstrated earlier. Instead, Tiny’s land is added to Giant’s own totals at its \$720,000 fair value, and the trademark is consolidated at its \$210,000 fair value. These balances reflect the amounts paid by Giant to acquire ownership of the subsidiary. The note payable is included in the consolidated figures at \$300,000, which was its fair value as well as its book value. Subsidiary assets and liabilities are consolidated as if purchased by the parent on an open market.

The acquisition price of \$900,000 paid by Giant exceeds the net value of the subsidiary’s identifiable assets and liabilities (\$630,000 or $\$720,000 + \$210,000 - \$300,000$) by \$270,000. In consolidation of a parent and subsidiary, any excess acquisition payment is assumed to represent goodwill and is reported as an intangible asset.

Chapter 12 In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?

Figure 12.16 Consolidated Totals—Date of Acquisition

Revenues	Parent total only
Expenses	Parent total only
Net income	Parent total only
Reported Assets and Liabilities	Parent book value plus fair value of subsidiary accounts
Trademark (previously unreported)	Fair value of subsidiary account
Investment in Tiny	Not reported for consolidation—actual assets and liabilities are included instead
Goodwill	Excess payment made to acquire subsidiary
Liabilities	Parent book value plus fair value of subsidiary figures
Stockholders' Equity	Parent total only

TEST YOURSELF

Question:

Large Company produces a balance sheet that shows patents with a book value of \$200,000. The next day, Large Company buys all of Short Company for \$3 million. Consolidated financial statements are then produced that show patents with a book value of \$300,000. What does the reader of these financial statements know about the patents held by Large and its consolidated subsidiary?

- a. Acquiring Short made the patents held by Large more valuable.
- b. At the date of acquisition, Short held patents with a fair value of \$100,000.
- c. At the date of acquisition, Short held patents with a historical cost of \$100,000.
- d. At the date of acquisition, Short held patents with a net book value (cost minus accumulated amortization) of \$100,000.

Answer:

The correct answer is choice b: At the date of acquisition, Short held patents with a fair value of \$100,000.

Explanation:

On the date that a business combination is formed, the fair value of all identifiable assets and liabilities of the subsidiary are added to those same accounts of the parent. Because the patent account balance went up by \$100,000 as a result of the purchase, that figure was the apparent fair value of any patents held by Short Company at that time.

Analyzing a Company's Use of Its Assets

*Question: This chapter completes coverage of the assets reported by an organization on its balance sheet. In earlier chapters, vital signs were computed and explained in connection with receivables, inventory, and property and equipment. Figures and ratios were presented that are often used in evaluating a business—especially its financial health and future prospects. Do any similar vital signs exist for assets as a whole that decision makers will typically determine as part of an overall examination of an organization such as **PepsiCo** or **The Coca-Cola Company**?*

Answer: A company controls a specific amount of assets. Investors and other decision makers are interested in how effectively management is able to make use of these resources. Individuals who study specific companies search for signs that an appropriate level of income was generated from the assets on hand.

Total asset turnover. **Total asset turnover**⁹ is one such figure. It indicates management's efficiency at generating sales revenue. Sales must occur before profits can be earned from normal operations. If assets are not well used to create sales, profits are unlikely to arise.

$$\text{total asset turnover} = \text{sales revenue} / \text{average total assets}$$

To illustrate, here is information reported for 2010 by **PepsiCo Inc.** and **The Coca-Cola Company**. Based on these figures, the total asset turnover can be computed for each company for comparison purposes as shown in Figure 12.17 "2010 Comparison of ".

Figure 12.17 2010 Comparison of PepsiCo Inc. and The Coca-Cola Company

	PepsiCo	Coca-Cola
Total Assets		
Beginning of Year	\$39.8 billion	\$48.7 billion
End of Year	\$68.2 billion	\$72.9 billion
Average for Year	\$54.0 billion	\$60.8 billion
Net Sales Revenue	\$57.8 billion	\$35.1 billion
Total Asset Turnover	1.07 times	.58 times

9. A ratio used to measure the efficient use of assets; it is computed by dividing sales revenue by average total assets for the period.
10. A ratio used to measure the profitable use of assets by a company's management; it is computed by dividing net income by the average total assets for the period.

Return on assets. Probably one of the most commonly used vital signs employed in studying the financial health of a company is its **return on assets**¹⁰, often known as ROA. It is computed by taking net income and then dividing that figure by the average total assets for the period. It is viewed by many as an appropriate means of measuring management's efficiency in using company resources.

return on assets (ROA) = net income/average total assets

Variations of this formula do exist. For example, some analysts modify the income figure by removing interest expense to eliminate the impact of different financing strategies so that the computation focuses on operations.

For 2010, **PepsiCo** reported net income of \$6.3 billion so that its ROA for the year was 11.7 percent (\$6.3 billion net income/\$54.0 billion as the average total assets). For the same period, **The Coca-Cola Company** reported net income of \$11.8 billion for an ROA of 19.4 percent (\$11.8 billion net income/\$60.8 billion in average total assets).

KEY TAKEAWAY

Companies attempt to obtain control of other companies for many reasons including obtaining access to valuable assets, gaining entry into new industries, and eliminating competition. According to U.S. GAAP, control is established over another company by acquiring 50 percent or more of its ownership shares. At that point, consolidated financial statements must be prepared bringing together the financial accounts from both companies. For the subsidiary, only revenues and expenses since the takeover are included. In consolidating the assets and liabilities of the subsidiary, the fair value at the date of acquisition is assumed to represent the cost incurred by the parent. The intangible asset goodwill is reported for any unexplained excess payment made by the parent in acquiring control over the subsidiary. To evaluate the efficiency of management's use of company assets, many analysts compute total asset turnover and return on assets (ROA).

Talking with a Real Investing Pro (Continued)

Following is a continuation of our interview with Kevin G. Burns.

Question: For the year ended December 31, 2010, **The Dow Chemical Company** reported its net income as approximately \$2.321 billion. The company also disclosed comprehensive income for the same period of only \$1.803 billion. That's a 22 percent reduction. Are you disturbed that a company can report two separate income figures that are so significantly different? Or, do you find disclosing income in two distinct ways to be helpful when you analyze a business?

Kevin Burns: Actually I think the idea of disclosing income in two different ways makes sense. Having said that, if I were a shareholder of **Dow Chemical**, I would want to know why these numbers are so far apart? What exactly is included in (or excluded from) each of these income figures? Is the company's core business sound? This question is probably best answered by net income. The reduction in arriving at comprehensive income is likely to have come from losses in the value of available-for-sale investments and from holding foreign currency balances. That can provide interesting information. Perhaps the management is distracted by trying to manage a large stock investment portfolio. How much of the difference comes from currency rate changes, and is there a way to hedge this volatility to reduce the impact? If there is a way to hedge that risk, why did company officials choose not to do so?

In sum, the reason I like including both income numbers is that anything that increases disclosure is a positive, especially when investing money. The more transparency the better is my feeling. Then, investors can make up their own minds as to management's competence and the future success of the overall business operations.

Video Clip

[\(click to see video\)](#)

Chapter 12 In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?

Professor Joe Hoyle talks about the five most important points in [Chapter 12 "In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?"](#).

12.5 End-of-Chapter Exercises

QUESTIONS

1. On January 1, Year One, the Lawrence Company acquires 10,000 shares of the Memphis Company for \$39 per share. What are possible reasons why Lawrence chose to use its cash to make this acquisition?
2. Wilson Company buys 200 shares of Pepitone Corporation for \$17 per share, an asset that is classified as an investment in trading securities. Why is an investment classified in this manner?
3. An investor owns equity shares of a number of companies. Some of these investments are reported as trading securities while others are shown as available-for-sale securities. The investor receives a cash dividend of \$1,000. How is that receipt reported by the investor?
4. The Amos Corporation bought 1,000 shares of Jones Company during Year One for \$18 per share. The investment is labeled as a trading security. Amos plans to sell these shares on the stock market for \$27 each and is trying to decide whether to make the sell on December 30, Year One, or January 2, Year Two. How will reported net income differ in Year One and in Year Two based on the timing of this sale?
5. Unless value is impaired, equipment and inventory are reported based on historical cost. Why is the financial accounting of an investment in trading securities handled differently from these other assets?
6. StampCo Corporation bought 1,000 shares of Bates Corporation on December 1, Year One. Company officials are trying to decide whether to report this asset as an investment in trading securities or as an investment in available-for-sale securities. How is this decision made?
7. Company A bought 1,000 shares of Company Y for \$13 per share and 2,000 shares of Company Z for \$18 per share. At the end of the year, the stock of Company Y is worth \$15 per share and the stock of Company Z is worth \$14 per share. What is reported at year-end if these investments are both classified as investments in trading securities? What is reported at year-end if these investments are both classified as investments in available-for-sale securities?
8. An investment is bought during Year One for a total of \$9,000. At the end of Year One, these shares are worth \$10,000. However, they are sold on February 11, Year Two, for only \$6,000. What is the income effect for these two years if this stock is viewed by company officials as a trading security? What is the income effect for these two years if this stock is viewed by company officials as available-for-sale?
9. A company acquires an investment in available-for-sale securities during Year one for \$23,000. At the end of the year, this investment was worth \$19,000. Reported net income was \$200,000. What should the company report as its comprehensive income?

10. The Lincoln Corporation bought 1,000 shares of Illinois Company during Year One for \$21 per share. The investment is labeled as available-for-sale. Lincoln plans to sell these shares on the stock market for \$26 each and is trying to decide whether to make the sell on December 30, Year One, or January 2, Year Two. How will reported net income differ in Year One and in Year Two based on the timing of this sale?
11. Big Company acquired enough shares of Little Company so that it has gained the ability to exert significant influence over its operating and financing decisions. How should Big report this investment?
12. Mama Corporation acquired a rather large block of the capital shares of Child Corporation. Currently, company officials for Mama are trying to decide whether application of the equity method is appropriate. In theory, how is that decision made? In practice, how is that decision made?
13. Archibald Corporation owns 30 percent of Saratoga Corporation and will apply the equity method to this investment. During the current year, Saratoga reported net income of \$150,000 and paid a total cash dividend of \$60,000. What reporting is required of Archibald in connection with this investment?
14. Why are dividends that are received from an investment that is being accounted for by means of the equity method not reported as revenue?
15. The Walters Company acquired 40 percent of the Ameston Company on January 1, Year One, for \$388,000. Ameston reported net income of \$100,000 for Year One and paid a total cash dividend of \$40,000. At the end of Year One, this investment was worth \$460,000. What is reported on the owner's balance sheet for this investment, and what does that figure represent?
16. Giant Corporation buys 54 percent of the outstanding stock of Small Corporation. Under normal conditions, how will this investment be reported?
17. Lauderdale Corporation has two assets. The land cost \$100,000 and is worth \$220,000. A building has a net book value of \$650,000 and a fair value of \$730,000. Yarrow Corporation buys 100 percent of the outstanding stock of Lauderdale for cash of \$1 million. What journal entry does Yarrow make to consolidate Lauderdale's assets within its own financial records?
18. Donnelly Corporation generated revenues of \$900,000 during Year One while Nelson Company generated revenues of \$600,000 during the same period. On the last day of the year, Donnelly buys all of the ownership shares of Nelson. In consolidated financial statements for December 31, Year One, and the year then ended, what is the reported amount of revenues?

19. Financial analysts determine the total asset turnover for the Paquet Corporation as 2.3. How did these decision makers arrive at this figure?
20. Financial analysts study the financial statements reported by Williamston Corporation and calculate a return on assets of 11.3 percent. How did they arrive at that figure?

TRUE OR FALSE

1. ____ To keep the information relatively simple for financial statement users, all investments in the ownership shares of other companies are accounted for in the same way according to U.S. GAAP.
2. ____ If the owner of trading securities receives a cash dividend, it should be recorded as revenue at that time and shown on the income statement.
3. ____ All investments in other companies should be reported at the historical cost of the investment.
4. ____ A company buys trading securities in Year One for \$11,000. They increase in value by \$2,000 in Year One and are then sold in Year Two for \$14,000. A gain of \$3,000 is recognized on the company's income statement in Year Two.
5. ____ The Argentina Company buys shares of another company and is currently attempting to determine whether this ownership qualifies as an investment in trading securities or available-for-sale securities. The total amount of assets reported by Argentina will vary depending on which approach is selected.
6. ____ Changes in the value of available-for-sale securities do not affect the reported net income of the investor until the securities are sold.
7. ____ The Nile Company buys 100 shares of a company for \$7,000 in cash in Year One. The shares increase in value by \$1,000 in Year One and then by \$2,000 in Year Two and are then sold. In addition, a dividend is received from this investment of \$300. In Year Two, the Nile Company will increase its net income by \$3,300 if this investment is judged to be a trading security.
8. ____ At the beginning of Year One, the Barksdale Corporation buys shares of another company for \$7,000. The stock goes up in value during Year One by \$5,000. Dividends of \$1,000 are also collected. Company officials view this as an investment in available-for-sale securities. If net income is reported as \$40,000, then comprehensive income will be \$45,000.
9. ____ Accumulated other comprehensive income is included by a company on its income statement within the computation of net income.
10. ____ If one company owns 25 percent of another company, it must use the equity method to account for this investment.
11. ____ Equity method investments are reported at current fair value on the owner's balance sheet.
12. ____ On January 1, Year One, Ajax Company spends \$200,000 on an investment. In this purchase, the company gains 30 percent ownership of another company and the ability to apply significant influence.

During Year One, the other company reports net income of \$50,000 and distributes a cash dividend of \$10,000. Ajax should report dividend revenue of \$3,000.

13. ____ On January 1, Year One, Dylan Company spends \$300,000 on an investment. The company buys 30 percent of another company and gains the ability to apply significant influence. During Year One, the other company reports net income of \$70,000 and distributes a cash dividend of \$20,000. At the end of the year, these shares have a fair value of \$400,000. Ajax should report the investment on its balance sheet at \$315,000.
14. ____ Big Company has held 30 percent of Little Company's ownership for several years and uses the equity method for financial reporting. Little reports net income in the current year of \$40,000 while paying no dividends. Big reports its share of Little's net income in the current year.
15. ____ Consolidated financial statements are only created when one company acquires 100 percent ownership over another company.
16. ____ Bismarck Company buys control over another company late in Year One. One of the likely reasons for this acquisition is so that the revenues earned throughout the year can be added to those of Bismarck on consolidated statements to make that company's financial situation look better.
17. ____ Reinstein Company has net assets with a net book value of \$600,000 but a fair value of \$740,000. If a company buys control over Reinstein for \$740,000, no goodwill is recognized.
18. ____ The NYork Company has only one asset and no liabilities. It owns a building that it rents out. The building has a net book value of \$800,000 but is worth \$960,000. Another company paid exactly \$1 million to gain all of the outstanding stock of NYork. The building will be added to consolidated financial statements on that date at \$960,000.
19. ____ The higher a company's ROA, the more efficiently the company is using its assets.

MULTIPLE CHOICE

1. On November 5, Year One, Maxwell Corporation purchased seventy shares of Tyrone Company for \$30 per share, planning to hold the investment for a short time and then sell these shares. At the end of Year One, Tyrone is selling for \$32 per share on a stock exchange. What unrealized gain will Maxwell report for Year One, and where should that balance be reported?
 - a. \$140 unrealized gain, stockholders' equity section of balance sheet
 - b. \$140 unrealized gain, income statement
 - c. \$2,240 unrealized gain, income statement
 - d. \$2,240 unrealized gain, stockholders' equity section of balance sheet

2. Which of the following is **not** a reason investments in trading securities are shown at fair value on the balance sheet?
 - a. The fair values of publicly-traded securities are readily available.
 - b. Fair value is considered relevant information to financial statement users.
 - c. The fair value is an objective amount determined by the stock market.
 - d. Fair value is easier to determine than historical cost.

3. Hope Corporation buys shares of Lonesome Corporation for \$14,000 during Year One. By year-end, the stock has a total market value of \$18,000. Which of the following is **not** true?
 - a. If viewed as a trading security, the asset is reported on the balance sheet at \$18,000.
 - b. If viewed as a trading security, Hope's net income will increase in Year One by \$4,000.
 - c. If viewed as an available-for-sale security, the asset is reported on the balance sheet at \$18,000.
 - d. If viewed as an available-for-sale security, Hope's net income will increase in Year One by \$4,000.

4. An investor spends \$23,000 for shares of another company late in Year One. The shares are worth \$24,000 at the end of that year. Early in Year Two, a \$1,200 dividend is received from this investment. Shortly thereafter, the shares are sold for \$26,000. If this asset is an investment in trading securities, what is the impact on net income in Year Two?
 - a. Increase by \$1,200.
 - b. Increase by \$2,000.
 - c. Increase by \$3,200.
 - d. Increase by \$4,200.

5. The Andre Corporation spends \$35,000 for shares of another company late in Year One. The shares are worth \$34,000 at the end of that year. Early in Year Two, a \$900 dividend is received from this investment. Shortly thereafter, the shares are sold for \$38,000. If this asset is viewed as an investment in trading securities, what is the impact on net income in Year Two?
 - a. Increase by \$3,000
 - b. Increase by \$3,900
 - c. Increase by \$4,000
 - d. Increase by \$4,900

6. Early in Year One, Jackson Corporation purchased 150 shares of Riley Corporation for \$46 per share. The investment is classified as available-for-sale. At the end of Year One, Riley's stock is selling on a stock exchange for \$43 per share. Jackson's reported net income for the year was \$235,000. What should Jackson report as its comprehensive income for Year One?
 - a. \$228,100
 - b. \$228,550
 - c. \$234,550
 - d. \$235,000

7. In Year One, Jeremiah Corporation purchased shares of Lauren Corporation for \$9,000. The investment is classified as a trading security. At the end of Year One, Lauren's stock has a value on a stock exchange equal to \$13,000. Jeremiah's reported net income

for the year was \$180,000. What should Jeremiah report as its comprehensive income for Year One?

- a. \$180,000
 - b. \$184,000
 - c. \$189,000
 - d. \$193,000
8. The Monroe Corporation owns the capital stock of several corporations and receives a cash dividend of \$7,000 this year. Which of the following statements is true?
- a. For both trading securities and available-for-sale securities, the dividend is a reduction in the investment account.
 - b. For trading securities, the dividend is included in net income; for available-for-sale securities, the dividend is a reduction in the investment account.
 - c. For trading securities, the dividend is a reduction in the investment account; for available-for-sale securities, the dividend is included in net income.
 - d. For both trading securities and available-for-sale securities, the dividend is included in net income.
9. Wisconsin Corporation makes an investment in Badger Corporation for \$38,000 at the beginning of Year One. At the end of the year, the shares are selling at an amount equal to \$34,000. The drop in value is viewed as temporary. During the period, Badger earned \$30,000 in income and Wisconsin received a dividend of \$1,800. Which of the following is **not** true?
- a. If this investment is viewed as a trading security, it should be reported on a year-end balance sheet at \$34,000.
 - b. If this investment is viewed as available-for-sale, dividend revenue is recognized for \$1,800.
 - c. If this investment is viewed as a trading security, dividend revenue is recognized for \$1,800.
 - d. If this investment is accounted for by means of the equity method, it should be reported on a year-end balance sheet at \$34,000.

10. Anton Company owns shares of Charlotte Corporation. Which of the following is true about the reporting for this investment?
 - a. If Anton owns 15 percent of Charlotte and has significant influence, the investment must be reported by the equity method.
 - b. If Anton owns 25 percent of Charlotte and does not have significant influence, the investment must be reported by the equity method.
 - c. If Anton owns 4 percent of Charlotte and does not have significant influence, the investment must be reported as a trading security.
 - d. If Anton owns 56 percent of Charlotte and has control, the investment must be reported by the equity method.

11. Rocko Corporation acquires 40 percent of Hailey Corporation on January 1, Year One, for \$400,000. By this purchase, Rocko has gained the ability to exert significant influence over Hailey. Hailey reports net income of \$80,000 in Year One and \$100,000 in Year Two. Hailey pays a total dividend of \$30,000 each year. These shares have a value of \$460,000 at the end of Year One and \$500,000 at the end of Year Two. On a December 31, Year Two, balance sheet, what does Rocko report for this investment?
 - a. \$448,000
 - b. \$472,000
 - c. \$500,000
 - d. \$520,000

12. Lancaster Inc. purchases all the outstanding stock of Lucy Company for \$4,500,000. The net assets of Lucy have a total fair value of \$2,900,000. These assets include a patent with a net book value of \$4,700 and a fair value of \$159,000. At what amount should the patent and any goodwill from this purchase be shown on consolidated financial statements produced on the date of purchase?
 - a. Patent—\$4,700; Goodwill—\$0
 - b. Patent—\$159,000; Goodwill—\$0
 - c. Patent—\$159,000; Goodwill—\$1,600,000
 - d. Patent—\$4,700; Goodwill—\$1,600,000

13. On December 31, Year One, Brenda Corporation purchased 100 percent of Kyle Inc. for \$3,400,000. The net assets of Kyle had a net book value of \$3 million. Kyle had a trademark with a fair value (\$45,000) that exceeded its book value (\$15,000) by \$30,000. For all other assets and liabilities reported by Kyle, net book value was the same as fair value. At what amounts should the trademark and goodwill be shown on Brenda's consolidated balance sheet on December 31, Year One?
- Trademark—\$15,000; Goodwill—\$370,000
 - Trademark—\$15,000; Goodwill—\$400,000
 - Trademark—\$45,000; Goodwill—\$370,000
 - Trademark—\$45,000; Goodwill—\$400,000
14. On December 31, Year One, the Bolger Corporation purchases all of the capital stock of Osbourne Corporation for \$200,000 more than the fair value of the subsidiary's identifiable assets and liability. During Year One, Bolger reported revenues of \$900,000 and expenses of \$600,000. In the same period, Osbourne reported revenues of \$700,000 and expenses of \$500,000. On a consolidated income statement for Year One, what is reported for revenues and expenses?
- Revenues—\$900,000; Expenses—\$600,000
 - Revenues—\$1.6 million; Expenses—\$600,000
 - Revenues—\$900,000; Expenses—\$1.1 million
 - Revenues—\$1.6 million, Expenses—\$1.1 million
15. Hydro Company and Aqua Corporation are in the same industry. During Year One, Hydro had average total assets of \$35,000 and sales of \$47,800. Aqua had average total assets of \$49,000 and sales of \$56,900. Which of the following is true?
- Aqua Corporation has a total asset turnover of 0.86 times.
 - Hydro Company is not using its assets as efficiently as Aqua Corporation.
 - Aqua Corporation has a higher ROA than Hydro Company.
 - Hydro Corporation has a total asset turnover of 1.37 times.
16. Tried Company began the year with \$450,000 in total assets and ended the year with \$530,000 in total assets. Sales for the year

were \$560,000 while net income for the year was \$46,000. What was Tried Company's return on assets (ROA) for the year?

- a. 8.2%
- b. 9.4%
- c. 10.2%
- d. 14.0%

VIDEO PROBLEMS

Professor Joe Hoyle discusses the answers to these two problems at the links that are indicated. After formulating your answers, watch each video to see how Professor Hoyle answers these questions.

1. Your roommate is an English major. The roommate's parents own a chain of ice cream shops located throughout Florida. One day, while waiting for a bus to go across campus, your roommate poses this question: "As you can imagine, my parent's business is very seasonal. They do great during the summer but not nearly as well in the winter. So, the business has to save up enough cash by the end of summer to support operations over the colder months. This year the business bought shares of several well-known companies in September that will be sold in February when cash reserves begin to run low. Unfortunately, the stock market went down, and now my parents are telling me that they have to report a loss at the end of December. I don't understand. If they are not going to sell this stock until February, why do they have to report a loss in December? The stock market price may well go way up by the time they sell those shares in February. They have plenty of time to recoup the lost value." How would you respond?

[\(click to see video\)](#)

2. Your uncle and two friends started a small office supply store several years ago. The company has expanded and now has several large locations. Your uncle knows that you are taking a financial accounting class and asks you the following question: "We have some friends who own an office supply service in the next state. They had been having some trouble, so at the beginning of the current year, our company bought 35 percent of their company for a considerable amount of money. We have plans to help them get their operations turned around. We believe, in the long run, that this investment will be very profitable as they begin to make the changes we suggest. This year, that other company only made a profit of \$40,000 and paid a total cash dividend of \$10,000. However, in the future, we believe that they will do much better. We've never owned a portion of a business like this before. How do we go about

accounting for our ownership interest in this other company?”
How would you respond?
[\(click to see video\)](#)

PROBLEMS

1. The Kansas Company buys 1,000 shares of Topeka Inc. on August 1, Year One, for \$19 per share. Topeka paid a \$1 per share cash dividend on December 12, Year One. The shares are worth \$23 per share on December 31, Year One. Kansas sells this entire investment on April 7, Year Two, for \$25 per share.
 - a. If this asset is viewed as an investment in trading securities, what is reported in the Year One financial statements for Kansas?
 - b. If this asset is viewed as an investment in trading securities, what is reported in the Year Two financial statements for Kansas?
 - c. If this asset is viewed as an investment in available-for-sale securities, what is reported in the Year One financial statements for Kansas?
 - d. If this asset is viewed as an investment in available-for-sale securities, what is reported in the Year Two financial statements for Kansas?
2. Record Investor Corporation's journal entry for each of the following events.
 - a. Investor Corporation purchases 600 shares of stock in Company A for \$60 per share on December 6, Year One. This investment is considered a trading security.
 - b. At the end of Year One, Company A shares are selling for \$63 each.
 - c. On January 31, Year Two, Company A pays a cash dividend of \$2 per share.
 - d. At the end of Year Two, Company A shares are selling for \$59 each.
 - e. On January 22, Year Three, Investor sells all of the shares of Company A for \$62 each.
3. On September 9, Year One, Johnson Inc. purchased 500 shares of Thomas Company stock when this stock was selling for \$20 per share. Johnson plans to hold these shares for a short time and hopefully sell the investment for a gain. Shortly thereafter, Thomas paid a cash dividend of \$0.32 per share.

On December 31, Year One, Johnson prepares its financial statements. At that time, this stock is selling for \$18 per share.

- a. Determine all balances that Johnson will report on its Year One income statement in connection with this investment.
 - b. Determine all balances that Johnson will report on its December 31, Year One, balance sheet in connection with this investment.
 - c. If Johnson reports net income of \$79,000 for Year One, what should be disclosed as comprehensive income?
4. In Year One, Waterloo Corporation makes an investment in the equity securities of another company for \$53,000. The company then collects a cash dividend of \$2,000. At the end of Year One, this investment is valued at \$58,000. In March of Year Two, the entire investment is sold for cash of \$54,000.

Waterloo reported this investment as being in available-for-sale securities. How would Waterloo's reported net income have been different in each of these two years if the investment had been reported as a trading security?

5. Record Christopher Corporation's journal entry for each of the following events. After each entry, indicate the balances that will be reported on Christopher Corporation's balance sheet at that date.
- a. Christopher Corporation purchases 1,000 shares of stock in Alpha Company for \$30 per share on July 7, Year Two. This investment is considered an available-for-sale security.
 - b. At the end of Year Two, Alpha Company's stock is selling for \$25 per share.
 - c. At the end of Year Three, Alpha Company's stock is selling for \$28 per share.
 - d. On February 16, Year Four, Alpha Company pays a \$0.60 per share cash dividend to its stockholders.
 - e. On March 27, Year Four, Christopher sells all of these shares for \$36 per share in cash.
6. On April 16, Youngstown Inc. purchased 900 shares of Cool Company stock when Cool's stock was selling for \$15 per share.

Youngstown plans to hold this stock indefinitely until the company has a need for cash.

- a. On December 31, Cool's stock is selling for \$20 per share. What appears on the financial statements for Youngstown?
 - b. If Youngstown reports net income of \$190,000, what should the company report as its comprehensive income?
 - c. Assume that Youngstown sells this investment three months later when Cool's shares are selling for \$24 per share. Make the journal entry to record the sale.
7. Ordello Company buys 20 percent of the capital stock of Pottsboro Corporation on January 1, Year One, for \$370,000. Ordello plans to hold these shares for an indefinite period of time. Pottsboro reports net income of \$80,000 in Year One and \$100,000 in Year Two. The company pays a total cash dividend of \$30,000 in each year. Ordello's investment is worth \$420,000 at the end of Year One and \$470,000 at the end of Year Two. Ordello sells this investment on the first day of Year Three for \$470,000 in cash.
- a. Assume that the ownership of these shares does not give Ordello the ability to apply significant influence over Pottsboro. Make all journal entries for Ordello for Years One, Two, and Three.
 - b. Assume that the ownership of these shares does give Ordello the ability to apply significant influence over Pottsboro. Make all journal entries for Ordello for Years One, Two, and Three.
8. Oregon Company, a paper products manufacturer, wishes to enter the Canadian market. The company purchased 30 percent of the outstanding stock of Canadian Paper Inc. on January 1, Year One, for \$6,000,000. The CEO of Oregon will sit on the board of directors of Canadian, and other evidence of significant influence does exist.
- a. Canadian reported net income of \$760,000 for the year. Record the journal entry (if any) to be prepared by Oregon.
 - b. Canadian paid a cash dividend of \$80,000. Record the journal entry for Oregon.

- c. What amount would Oregon report on its balance sheet as its investment in Canadian as of the end of Year One?
9. At the beginning of Year One, Current Properties paid \$1,000,000 for 25 percent of the shares of Nealy Enterprises. Current immediately begins to exert significant influence over the operating decisions of Nealy.
 - a. Nealy reported earnings of \$400,000 during Year One. Record the appropriate journal entry for Current.
 - b. Nealy paid a total cash dividend of \$50,000 during October of Year One. Record the appropriate journal entry for Current when the company receives this dividend.
 - c. At the end of Year One, what amount does Current report on its balance sheet as its investment in Nealy? What does Current report on its income statement as its investment income from Nealy?
 - d. Nealy reported earnings of \$440,000 during Year Two. Nealy paid dividends of \$60,000 during Year Two. What is the balance of the Investment in Nealy at the end of Year Two?
 - e. At the end of Year Two, Current sells its entire investment in Nealy for \$1,200,000 in cash. Record the appropriate journal entry for Current.
10. Teckla Corporation purchases all the outstanding stock of Feather Company on January 1, 20X3 for \$5,000,000. Teckla's balance sheet on that date **before the purchase** is shown in the following:

Figure 12.18
Assets and Liabilities of Teckla

Teckla Corporation Balance Sheet January 1, 20X3			
Assets		Liabilities	
Cash	\$9,400,000	Accounts Payable	\$1,950,000
Inventory	700,000	Notes Payable	4,895,000
Land	5,000,000	Owners' Equity	
		Capital Stock	\$5,000,000
		Retained Earnings	3,255,000
Total Assets	\$15,100,000	Total Liabilities & Owners' Equity	\$15,100,000

On January 1, 20X3, Feather has assets and liabilities as shown in the following:

Figure 12.19
Assets and Liabilities of Feather

	Value on Feather's Books	Current Market Value
Cash	\$456,000	\$456,000
Inventory	873,000	873,000
Land	50,000	760,000
Patent	5,000	1,000,000
Accounts Payable	500,000	500,000

- a. Determine the amount of goodwill (if any) that Teckla will show on its consolidated balance sheet at January 1, 20X3.
 - b. Prepare a consolidated balance sheet for Teckla after it purchases Feather on January 1, 20X3.
11. In several past chapters, we have met Heather Miller, who started her own business, Sew Cool. The following are the financial statements for December. To calculate average total assets, assume that total assets on June 1, 20X8, when Sew Cool first started in business, were zero.

Figure 12.20
Sew Cool Financial Statements

Sew Cool Income Statement As of December 31, 20X8	
Revenue	\$4,000
Cost of Goods	(2,200)
Gross Profit	1,800
Other Expenses	(1,600)
Earnings before Tax	200
Tax Expense	(20)
Net Income	\$180

Figure 12.21

Sew Cool Stmt. of Retained Earnings As of December 31, 20X8	
Retained Earnings, December 1, 20X8	\$500
Net Income	198
Dividends	(158)
Retained Earnings, December 31, 20X8	\$540

Figure 12.22

Sew Cool Balance Sheet December 31, 20X8			
Assets		Liabilities	
Current		Current	
Cash	\$940	Accounts Payable	\$900
Accounts Receivable	500	Income Tax Payable	120
Less Allowance for Doubtful Accounts	(20)	Total Current Liabilities	\$1,020
Net Accounts Receivable	480		
Inventory	700	Noncurrent	
Total Current Assets	\$2,120	Notes Payable	\$1,060
		Owners' Equity	
Noncurrent		Capital Stock	\$500
Equipment	\$1,000	Retained Earnings	540
		Total Owners' Equity	\$1,040
Total Assets	\$3,120	Total Liabilities & Owners' Equity	\$3,120

Based on the financial statements determine the following:

- a. Total asset turnover
- b. Return on assets

COMPREHENSIVE PROBLEM

This problem will carry through several chapters, building in difficulty. It allows students to continually practice skills and knowledge learned in previous chapters.

In Chapter 11 "In a Set of Financial Statements, What Information Is Conveyed about Intangible Assets?", financial statements for November were prepared for Webworks. They are included here as a starting point for the required recording for December.

Figure 12.23

Webworks Financial Statements

Webworks Income Statement As of November 30	
Revenue	\$16,000
Cost of Goods Sold	(8,171)
Gross Profit	7,829
Deprec. and Amort. Expense	(363)
Other Expenses	(3,680)
Earnings before Tax	3,786
Tax Expense	(1,135)
Net Income	\$2,651

Figure 12.24

Webworks Stmt. of Retained Earnings As of November 30	
Retained Earnings, November 1	\$6,671
Net Income	2,651
Retained Earnings, November 30	\$9,322

Figure 12.25

Webworks Balance Sheet November 30			
Assets		Liabilities	
Current		Current	
Cash	\$ 2,097	Accounts Payable	\$ 2,585
Accounts Receivable	1,750	Salaries Payable	\$ 150
Less Allowance for Doubtful Accounts	(175)	Unearned Revenue	400
Net Accounts Receivable	1,575		
Merchandise Inventory	1,129		
Supplies Inventory	20		
Prepaid Rent	200		
Total Current Assets	\$ 5,021	Total Current Liabilities	\$ 3,135
Property, Plant, and Equipment			
Equipment	\$ 7,000		
Less Accumulated Depreciation	(730)		
Furniture	1,000		
Less Accumulated Depreciation	(34)		
Total P, P, and E	\$ 7,236		
Other Noncurrent Assets			
Licensing Agreement, Net	\$ 2,200		
		Owners' Equity	
		Capital Stock	\$ 2,000
		Retained Earnings	9,322
		Total Owners' Equity	\$11,322
		Total Liabilities & Owners' Equity	
Total Assets	\$14,457		\$14,457

The following events occur during December:

- a. Webworks starts and completes nine more Web sites and bills clients for \$5,000.
- b. Webworks purchases supplies worth \$130 on account.
- c. At the beginning of December, Webworks had nine keyboards costing \$111 each and ten flash drives costing \$13 each. Webworks uses periodic FIFO to cost its inventory.
- d. Webworks purchases seventy keyboards for \$113 each and one hundred flash drives for \$15 each, all on account.
- e. Webworks decides to invest a small amount of its excess cash in the stock market in the hopes of making a quick gain. Webworks purchases sixty shares of stock in XYZ Corporation for \$5 per share in cash.
- f. Webworks pays Nancy Po \$750 for her work during the first three weeks of December.
- g. Webworks sells sixty-five keyboards for \$9,750 and ninety flash drives for \$1,800 cash.
- h. The Web site for the realtor started in November is completed.
- i. Webworks collects \$4,500 in accounts receivable.
- j. Webworks pays off its salaries payable from November.

- k. Webworks pays off \$10,500 of its accounts payable.
- l. XYZ Corporation pays Webworks a dividend of \$40.
- m. Webworks pays Leon Jackson (the owner of the business) a salary of \$2,000.

- n. Webworks pays taxes of \$1,272 in cash.

Required:

- a. Prepare journal entries for the previous events.
- b. Post the journal entries to T-accounts.
- c. Prepare an unadjusted trial balance for Webworks for December.
- d. Prepare adjusting entries for the following and post them to your T-accounts.

- o. Webworks owes Nancy Po \$200 for her work during the last week of December.
- p. Leon's parents let him know that Webworks owes \$300 toward the electricity bill. Webworks will pay them in January.
- q. Webworks determines that it has \$60 worth of supplies remaining at the end of December.
- r. Prepaid rent should be adjusted for December's portion.
- s. Webworks is continuing to accrue bad debts at 10 percent of accounts receivable.
- t. Webworks continues to depreciate its equipment over four years and its furniture over five years, using the straight-line method.
- u. The license agreement should continue to be amortized over its one-year life.
- v. On December 31, XYZ stock is selling for \$6 per share.
- w. Record cost of goods sold.

- x. Near the end of December, a new flash drive appears on the market that makes the ones Webworks has been selling virtually obsolete. Leon believes that it might be able to sell the rest of its inventory (twenty flash drives) for \$5 each.

- e. Prepare an adjusted trial balance.
- f. Prepare financial statements for December.

RESEARCH ASSIGNMENT

Assume that you take a job as a summer employee for an investment advisory service. One of the partners for that firm is currently looking at the possibility of investing in **Google**. The partner is aware that **Google** holds an enormous amount of marketable securities. The partner is curious as to the actual size of that balance. The partner is also interested in knowing whether these marketable securities are reported as trading securities or as available-for-sale securities. The partner asks you to look at the 2010 financial statements for **Google** by following this path:

- Go to <http://www.google.com>.
 - At the very bottom of this screen, click on “About Google.”
 - Near the top of the next screen, click on “Investor Relations.”
 - On the next screen, scroll to the bottom and click on “View 2011 Proxy Materials.”
 - On the next screen, in the center, click on “December 31, 2010 Annual Report” to download.
 - Go to page 49 and find the balance sheet for December 31, 2010.
 - Go to page 56 and read the second paragraph under “Cash, Cash Equivalents, and Marketable Securities” shown within Note One.
- a. Using the balance sheet information located on **Google**’s website, what is the dollar amount reported by **Google** as of December 31, 2010, for its “marketable securities?” What percentage does this asset comprise of the company’s total assets?
- b. Using the information found in the section of Note One describing “Cash, Cash Equivalents, and Marketable Securities,” determine whether these marketable securities are reported as trading securities or available-for-sale securities.