

Investments in Equity Securities

Pratt, Financial Accounting 7e, Chapter 8

Motives:

- To earn a return through dividends and stock price increases
- To obtain control or influence

Equity Securities Classified as Current

- General motives:
 - To earn a return
 - To provide for liquidity needs
 - To hedge certain risks
- Short-term investments are classified as current assets if they are both:
 - Readily marketable
 - It's management's intent to sell them in the next year (or operating cycle whichever is longer)
- If a security does not meet both criteria it is classified as a long-term investment

Trading vs. Available-for-Sale Securities

- Trading Securities are purchase for the purpose of selling them in the near future with the objective being short-term profits. These are always classified as current assets.
- Available-for-Sale Securities are equity securities not classified as Trading Securities

Mark-to-Market

- Both Trading and Available-for-Sale Securities are marked-to-market each period
- How/where the changes in value are reported is not the same between the two classifications

Example:

The Herdez Corporation purchased the following marketable securities on January 1, 2008:

- 100 shares of BMI for \$20 per share
- 200 shares of XTC for \$40 per share

On June 1, 2008 BMI declared a \$1 per share dividend that was paid on June 30, 2008.

On December 20, 2008 the shares of BMI were sold for \$26 each.

At the end of December the XTC shares traded at \$36 per share.

On May 15, 2009 the shares of XTC were sold for \$38 each.

1) Record transactions assuming that the securities are properly classified as Trading Securities.

Date	Accounts	Debit	Credit
1/1/08	Trading Securities – BMI	2,000	
	Trading Securities – XTC	8,000	
	Cash		10,000
6/1/08	Dividends Receivable	100	
	Dividend Revenue		100
6/30/08	Cash	100	
	Dividends Receivable		100
12/20/08	Cash	2,600	
	Trading Securities – BMI		2,000
	Realized Gain on Sale of TS		600
12/31/08	Unrealized Loss on TS	800	
	Trading Securities - XTC		800
5/15/09	Cash (\$38X200)	7,600	
	Realized Gain on Sale of TS		400
	Trading Securities		7,200

2) Record transactions assuming that the securities are properly classified as Available-for-Sale Securities.

Date	Accounts	Debit	Credit
1/1/08	Available-for-Sale Securities – BMI	2,000	
	Available-for-Sale – XTC	8,000	
	Cash		10,000
6/1/08	Dividends Receivable	100	
	Dividend Revenue		100
6/30/08	Cash	100	
	Dividends Receivable		100
12/20/08	Cash	2,600	
	Available-for-Sale Securities – BMI		2,000
	Realized Gain on Sale of TS		600
12/31/08	Unrealized Price Decrease on AFSS	800	
	Available-for-Sale Securities – XTC		800
5/15/09	Cash (\$38X200)	7,600	
	Realized Loss on Sale of AFSS	400	
	Unrealized Price Decrease on AFSS		800
	Available-for-Sale Securities		7,200

Reclassifications Between Categories

- When securities are reclassified from Trading to Available-for-Sale any unrealized holding gains or losses between the most recent balance sheet date and the date of reclassification are recognized immediately in the income statement
- When securities are reclassified from Available-for-Sale to Trading all previously recognized gains and losses from price changes plus any gains or losses since the most recent balance sheet date are immediately recognized in the income statement

Permanent Declines in Value are Recognized Regardless of Category

Comprehensive Income

- All non-owner changes in the value of net assets are reported in Comprehensive Income
- Differences between Net Income and Comprehensive Income are called Other Comprehensive Income
- Accumulated Other Comprehensive Income is reported in the Stockholders' Equity section of the balance sheet
- Price increases and decreases on Available-for-Sale Securities are one source of Other Comprehensive Income

% of Equity Owned		
0%-20%	20%-50%	>50%
Nominal Influence	Significant Influence	Control
Mark-to-Market (or Cost Method)	Equity Method	Consolidation

Cost Method

- Used for Trading Securities and Available-for-Sale Securities that do not have an active market
- Record initially at cost with no adjustments for changes in value until sold
- Record realized gains and losses when sold

Equity Method

- Used when the level of influence is judged to be significant
- Record initially at cost
- No adjustments for changes in market value
- Record pro-rata share of investee net income
- Record dividends as a return of investment, not income

Example: On January 1, 2008 Penn Corporation purchased for \$300,000 a 25% interest in Teller Company. The investment enables Penn to exert significant influence over Teller. On December 1st Teller declared a dividend of \$60,000 which was paid on December 15th. For the full year Teller earned Net Income of \$180,000. Prepare journal entries on Penn's books to record these events.

Accounts	Debit	Credit
Long-Term Investment in Equity Securities	300,000	
Cash		300,000
Dividend Receivable	15,000	
Long-Term Investment in Equity Securities		15,000
Cash	15,000	
Dividend Receivable		15,000
Long-Term Investment in Equity Securities	45,000	
Income from Long-Term Equity Investments		45,000

Acquisitions, Mergers, Goodwill and Consolidations

Acquisitions

- When one company acquires a controlling interest in another company it is referred to as an acquisition
- The investor is called the parent
- The investee is called the subsidiary
- Both the parent and the subsidiary are separate legal entities and have separate accounting records
- Consolidated financial statements are prepared for the combined entities because the subsidiary is controlled by the parent (they are separate legal entities but are a single economic entity)

Merger

- In this type of acquisition the assets and liabilities of two or more companies are combined to form a single new legal entity

Goodwill

- When one business purchases another business often the purchase price is an amount greater than the fair value of the net assets of the acquired entity
- This excess is called Goodwill
- Goodwill is an intangible asset
- Goodwill is subject to impairment testing each year

Example: On January 1, 2008 Ortiz Corporation purchased Santiago Company by paying \$350,000 cash. On that day Santiago had the following balance sheet:

**Santiago Company
Balance Sheet
January 1, 2008**

Cash	\$50,000	Accounts Payable	\$200,000
Receivables	90,000	Stockholders' Equity	235,000
Inventory	100,000		
Land	40,000		
Buildings, net	75,000		
Equipment, net	70,000		
Trademarks	10,000		
Total Assets	<u>\$435,000</u>	Total Liab. & SHE	<u>\$435,000</u>

All amounts are at fair value except the following:

Account	Fair Value
Inventory	125,000
Land	60,000
Trademarks	15,000

Accounts	Debit	Credit
Cash	50,000	
Receivables	90,000	
Inventory	125,000	
Land	60,000	
Buildings	75,000	
Equipment	70,000	
Trademarks	15,000	
Goodwill	*65,000	
Accounts Payable		200,000
Cash		350,000

*350,000 – (50+90+125+60+75+70+15-200)

Special Purpose Entities (SPEs)

- Special Purpose Entities (SPEs) are carefully crafted entities create to carry out a very precise purpose
- In most cases SPEs are designed so that their assets and liabilities are required to be consolidated with the company that created them
- There are real benefits such as lower cost financing as SPE is bankruptcy remote
- There is also some evidence that SPEs are formed to conceal the economics of a transaction.

