APPENDIX D

Investments in Other Corporations

The Washington Post Company is best known for publishing the most important newspaper in our nation's capital. However, the company does much more than that. It owns television stations, Cable One (a TV cable company), and a variety of community newspapers.

The company has achieved its diversity in part by investing in the stock of other companies. For example, it spent $900 million over the last six years to purchase other companies, including the online magazine *Slate* and a variety of private education companies around the world. It jointly owns one of the major providers of the paper on which *The Washington Post* is printed. In addition, the company's investment portfolio consists of more than $350 million worth of stock of other companies.

In this appendix, you will see how to account for four different types of investments. To understand these investments and the reasons they are accounted for in certain ways, you first need to answer the following question: Why do companies invest in other companies?

An Overview

REASONS COMPANIES INVEST

Many factors motivate managers to invest in securities. Some do so **because the very nature of their business requires it.** For example, pension funds, insurance companies, and mutual funds receive large sums of cash from their clients. To generate earnings—an important source of revenue in these companies—they invest the cash in the securities of other companies. Investments are significant assets to these companies.

Other managers invest in securities **to even out seasonal fluctuations in cash.** A manager whose company has extra cash at the end of a busy season may want to earn a return on the idle funds until they are needed for other purposes, such as repaying loans, purchasing property and equipment, or paying dividends. Excess cash can be invested in the stocks and bonds of other companies, either long or short term. Managers may also invest excess cash to provide a cushion against future downturns in the economy or unanticipated emergencies. Such investments in securities are referred to as **passive investments** because the investors are not interested in influencing or controlling the companies that issued the securities. The Washington Post Company's 2011 balance sheet in Exhibit D.1 reflects both short-term and long-term Investments in Marketable Securities accounts—passive investments.

EXHIBIT D.1 The Washington Post Company's Balance Sheet

Control → Consolidated

THE WASHINGTON POST COMPANY
Consolidated Balance Sheet
December 31, 2011
(Dollars in millions)

ASSETS:		LIABILITIES & STOCKHOLDERS' EQUITY	
Current Assets:		**Current Liabilities:**	
Cash and Cash Equivalents	$ 406	Accounts Payable	$ 495
Investments in Marketable Securities (Passive)	339	Other Current Liabilities (*summarized*)	500
Other Current Assets (*summarized*)	501	Total Current Liabilities	995
Total Current Assets	1,246	Long-term Debt	452
Investments in Affiliates (Significant Influence)	17	Other Liabilities	968
Plant, Property, and Equipment, Net	1,152	**Stockholders' Equity:**	
Goodwill	1,415	Common Stock	20
Other Assets (*summarized*)	1,187	Additional Paid-in Capital	253
		Retained Earnings	4,562
		Accumulated Other Comprehensive Income:	
		Unrealized Gain on Investments (Related to passive investments)	80
		Other (*summarized*)	85
		Less: Treasury Stock	(2,398)
Total Assets	$5,017	**Total Liabilities and Stockholders' Equity**	$5,017

Sometimes managers want to expand their company's presence in a related industry or market. They do so by investing in another company **with the purpose of influencing, but not controlling, the company's policies and activities.** Washington Post's balance sheet reports these types of investments as Investments in Affiliates in Exhibit D.1—investments for significant influence.

Finally, managers may want **to control another company,** either by purchasing it directly or by becoming the majority shareholder. In this case, the two companies combine their financial reports into **consolidated** financial statements, as Washington Post has done (see the title to its "consolidated" balance sheet). As you saw in Chapter 9, when one company purchases another for more than the fair value of its assets and liabilities, the company records the difference as Goodwill (see Exhibit D.1).

IDENTIFYING INVESTMENT TYPES AND ACCOUNTING METHODS

The accounting methods used to record investments are directly related to the purpose of the investment.

Passive Investments in Debt and Equity Securities

Investors make **passive investments** to earn a high rate of return on funds that may be needed in the future for either short- or long-term purposes. This category includes investments in both debt securities (bonds and notes) and equity securities (stock):

- **Investments in equity securities** are presumed to be passive if the investing company owns less than 20 percent of the other company's outstanding voting shares or any amount of nonvoting shares. The fair value method is used to measure and report these investments.
- **Investments in debt securities** are always considered to be passive. If they are meant to be sold before maturity, they are accounted for in the same way as equity securities reported using the fair value method. If the company intends and has the ability to hold them until the maturity date, however, the company measures and reports them at amortized cost.

Investments in Stock for Significant Influence

Active investments are those in which a company owns enough stock in another business to influence or control that business. An investor or company that owns enough shares of voting stock of another company to have an important impact on its operating and financing policies is said to have **significant influence.** Significant influence is presumed to exist if the investing company owns from 20 to 50 percent of the outstanding voting shares. However, other factors may also indicate significant influence, including membership on the board of directors of the other company, participation in its policy-making processes, evidence of material transactions between the two companies, an interchange of managerial personnel, and technological dependency. The equity method is used to measure and report this type of investment.

Investments in Stock for Control

Control is the ability to determine the operating and financial policies of another company through ownership of its voting stock. For all practical purposes, control is presumed when the investing company owns more than 50 percent of the outstanding voting stock. These investments are accounted for by combining the two companies using the acquisition method and preparing consolidated financial statements.

The three investment types and the appropriate measuring and reporting methods for each may be summarized as follows:

	Investment in Debt Securities of Another Entity		Investment in the Voting Common Stock of Another Entity		
Investment Category	Passive		Passive	Significant Influence	Control
Level of ownership	Held to maturity	Not held to maturity	<20% of outstanding shares	20–50% of outstanding shares	>50% of outstanding shares
Measuring and reporting method	Amortized cost method	Fair value method		Equity method	Acquisition method and consolidation

Let's look more closely at the accounting and reporting rules for each of these investment types.

Accounting for Passive Investments

DEBT INVESTMENTS HELD TO MATURITY: AMORTIZED COST METHOD

When a company's management has the intent and ability to hold bonds or other similar debt investments until maturity (when the principal is due), they are reported in the account named **Held-to-Maturity Investments.** These bonds are reported at **amortized cost**—that is, at cost adjusted for the amortization of any bond discount or premium. We illustrate how to account for these investments from their purchase date through the maturity date.

Bond Purchases

On the date of purchase, a bond may be acquired at face value, for less than face value (at a discount), or for more than face value (at a premium). Following the cost principle, the bond's total cost is debited to Held-to-Maturity Investments.

To illustrate, assume that on October 1, 2013, The Washington Post Company paid the face value of $100 million for 8 percent bonds due to mature on October 1, 2018. The 8 percent interest is paid each September 30. Management plans and has the ability to hold the bonds for five years until their maturity date. The purchase of the bonds on October 1, 2013, would be accounted for as follows (amounts in millions):

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity
Held-to-Maturity Investments	+100				
Cash	−100				

2 Record

dr Held-to-Maturity Investments (+A)	100	
cr Cash (−A)		100

Interest Earned

In this illustration, the company purchased the bonds at par, or face value. Because there is no premium or discount to amortize, the book value remains constant over the life of the investment. In such situations, the revenue earned on the investment each period is measured as the amount of interest collected in cash or accrued at year-end. The following accrual of $2 million in interest would be required on December 31 [$100 million face value × 0.08 (or 8%) × 3/12 of a year (since the October 1 purchase)]:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Interest Receivable	+2				Interest Revenue (+R)	+2

2 Record

dr Interest Receivable (+A)	2	
cr Interest Revenue (+R, +SE)		2

On September 30, 2014, when the investor receives a full year of interest ($2 million each quarter × 4 quarters = $8 million), the following effects are recorded:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+8				Interest Revenue (+R)	+6
Interest Receivable	−2					

2 Record

dr Cash (+A)	8	
cr Interest Receivable (−A)		2
cr Interest Revenue (+R, +SE)		6

Succeeding interest payments would be accounted for in the same way. On the income statement, Interest Revenue is reported in the Other Items section.

Principal at Maturity

When the bonds mature on October 1, 2018, the journal entry to record receipt of the $100 million face value payment is:

1 Analyze

Assets		= Liabilities	+ Stockholders' Equity
Cash	+100		
Held-to-Maturity Investments	−100		

2 Record

dr Cash (+A)	100	
cr Held-to-Maturity Investments (−A)		100

If the bond investment is sold before maturity, any difference between the fair value (the proceeds from the sale) and the net book value (the unamortized cost) is reported in the income statement as a gain or loss on the sale. If management intends to sell the bonds before the maturity date, they are treated in the same way as available-for-sale securities, which we discuss in the next section.

AVAILABLE-FOR-SALE SECURITIES: FAIR VALUE METHOD

When the investing company owns less than 20 percent of the outstanding voting stock in another company, the investment is considered passive. Among the assets and liabilities shown on the balance sheet, only passive investments in marketable securities (other than debt held to maturity) are **required** to be reported using the **fair value method.**

Classifying Passive Investments

Depending on management's intent, passive investments may be classified as either trading securities or available-for-sale securities:

Trading Securities **Trading Securities** are traded actively with the objective of generating short-term profits on changes in the price of securities. This approach is similar to the one taken by many mutual funds. The portfolio manager actively seeks opportunities to buy and sell securities. Trading Securities are classified as current assets on the balance sheet.

Available-for-Sale Securities Most companies do not actively trade the securities of other companies. Instead they invest to earn a return on funds they may need for future operating purposes. These investments are called **Available-for-Sale Securities**. On the balance sheet, they are classified as either current or noncurrent assets, depending on whether management intends to sell them within the next year.

Because available-for-sale securities are the most common type of passive investment, we focus on this category in the next section by analyzing Washington Post's investing activities.

YOU SHOULD KNOW

Trading securities: Securities purchased with the intent of selling them in the near future at a profit.

Available-for-sale securities: Securities purchased with excess funds, with the intent of earning a return until the funds are needed for the company's operating or financing activities.

Recording and Reporting Available-for-Sale Securities

Washington Post's Investments in Marketable Securities accounts were reported for the year 2011 at $339 million (see Exhibit D.1). The notes to Washington Post's financial statements reported the following about its investments:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investments in Marketable Equity Securities. The Company's investments in marketable equity securities are classified as **available-for-sale** and therefore are recorded at fair value in the consolidated financial statements, with the change in fair value during the period excluded from earnings and recorded net of income taxes as a separate component of other comprehensive income.

Here is how the fair value method is applied:

- Washington Post initially records the cost of its passive investment as an asset called Available-for-Sale Securities (part of Investments in Marketable Securities on Washington Post's balance sheet in Exhibit D.1).
- At period-end, these investments are adjusted to their fair value. This adjustment involves increasing or decreasing the asset, Available-for-Sale Securities,[1] and recording this change in investment value as Net Unrealized Losses/Gains. The **net unrealized losses/gains** is reported in the Stockholders' Equity section of the balance sheet under Accumulated Other Comprehensive Income. This is the source of the $80 million that Washington Post reported in Exhibit D.1.
- Dividends received while holding the investment are reported on the income statement as Dividend Revenue.

COACH'S TIP

A realized gain or loss occurs when a company actually sells its investments. Gains or losses from simply holding the available-for-sale investments are not realized because no sale has occurred.

This process may sound complicated so let's simplify it a little. Let's assume that Washington Post had no passive investments at the beginning of 2012. In the following example, we apply the fair value method to a sample securities purchase.

Purchase of Stock Assume that on January 2, 2013, Washington Post purchased 1,000,000 shares of Internet Financial News (IFN) common stock for $60 per share, paying $60,000,000. On that date, 10,000,000 shares were outstanding, so Washington Post owned 10 percent of IFN (1,000,000 ÷ 10,000,000). This investment would be treated as a passive investment that is recorded initially (on January 2, 2013) at cost:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity
Available-for-Sale Securities	+60				
Cash	−60				

2 Record

dr Available-for-Sale Securities (+A)	60	
cr Cash (−A)		60

Dividends Earned Dividends are reported as Dividend Revenue and included in the computation of net income for the period. Let's assume that on December 15, 2013, Washington Post received a $1 per share cash dividend from IFN totaling $1,000,000 ($1 × 1,000,000 shares). The dividend received is accounted for as follows:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+1				Dividend Revenue (+R)	+1

2 Record

dr Cash (+A)	1	
cr Dividend Revenue (+R, +SE)		1

Year-End Valuation At the end of the accounting period, Washington Post reports passive investments on the balance sheet **at fair value.** Assume that IFN had a $58 per share fair value at the end of the year. That is, the investment had lost value ($60 − $58 = $2 per share). Because the shares were not sold, however, the loss is an unrealized loss, not a realized loss.

[1] Companies often keep the asset value at cost and record the change in fair value in a related valuation allowance account, which is added or subtracted from the asset. This does not change the financial statement presentation.

This $2 million unrealized loss would be recorded as a reduction in the asset, Available-for-Sale Securities, and in a stockholders' equity account, Net Unrealized Losses/Gains, as follows:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Available-for-Sale Securities	−2				Net Unrealized Losses/Gains	−2

2 Record

dr Net Unrealized Losses/Gains (−SE)	2	
cr Available-for-Sale Securities (−A)		2

On the 2013 balance sheet under Investments in Marketable Securities, Washington Post would report Available-for-Sale Securities of $58 million ($60 million cost minus $2 million decrease in fair value). The company also would report, under a subsection of Stockholders' Equity called Accumulated Other Comprehensive Income, its net unrealized losses/gains of $2 million. The only item that would be reported on the income statement for 2013 would be dividend revenue of $1 million, classified under Other Items.

Now let's assume that Washington Post held the IFN securities through the year 2014. At the end of 2014, the stock had a fair value of $61 per share. This $3 increase per share, from $58 to $61, equates to a $3 million unrealized gain in 2014. This unrealized gain would be netted against the unrealized loss from the prior year, using the following journal entry on December 31, 2014:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Available-for-Sale Securities	+3				Net Unrealized Losses/Gains	+3

2 Record

dr Available-for-Sale Securities (+A)	3	
cr Net Unrealized Losses/Gains (+SE)		3

Exhibit D.2 shows the T-accounts containing the journal entries to record the initial cost of the investment and the fair value adjustments for 2013 and 2014. Notice that the balance in Available-for-Sale Securities is equal to its fair value at each year-end. Also, the net loss/gain in the Net Unrealized Losses/Gains account at each year-end is equal to the amount by which the investment lost or gained in value since it was first acquired. For example, the ending 2014 balance is equal to the $1 gain per share between its purchase date and the 2014 year-end ($61 − $60 per share times 1 million shares).

EXHIBIT D.2 T-Accounts for the Illustrated Transactions (in millions)

dr + Available-for-Sale Securities (A) *cr* −

1/1/13 Bal.	0		
1/2/13 Purchase	60	2	AJE 12/31/13
12/31/13 Bal.	58		
12/31/14 AJE	3		
12/31/14 Bal.	61		

dr − Net Unrealized Losses/Gains (SE) *cr* +

		0	Bal. 1/1/13
12/31/13 AJE	2		
12/31/13 Bal.	2		
		3	AJE 12/31/14
		1	Bal. 12/31/14

Disposal of Securities When available-for-sale securities are sold, Cash is increased and **two** accounts on the balance sheet are eliminated: (1) Available-for-Sale Securities, and (2) Net Unrealized Lossses/Gains.

Let's assume that on March 17, 2015, Washington Post sold all of its investment in IFN for $64 per share. The company receives $64 million in cash ($64 × 1,000,000 shares) for stock purchased at $60 million in 2013 ($60 × 1,000,000 shares). On that date, accountants record a $4 million **realized gain** on the sale ($64 million − $60 million) and then eliminate the Available-for-Sale Securities and Net Unrealized Losses/Gains accounts, as follows:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+64				Net Unrealized Losses/Gains	−1
Available-for-Sale Securities	−61				Gain on Sale of Investments (+R)	+4

2 Record

dr Cash (+A)	64	
dr Net Unrealized Losses/Gains (−SE)	1	
cr Available-for-Sale Securities (−A)		61
cr Gain on Sale of Investments (+R, +SE)		4

COMPARISON OF AVAILABLE-FOR-SALE AND TRADING SECURITIES

The reporting impact of unrealized gains or losses depends on whether the investment is classified as an available-for-sale security or a trading security.

Available-for-Sale Securities

As you learned in the last section, the balance in the Unrealized Gain (Loss) on Investments account is reported as a separate component of stockholders' equity under **Accumulated Other Comprehensive Income.** It is not reported on the income statement and it does not affect net income. Later, at the time of sale, the difference between the proceeds from the sale and the original cost of the investment is recorded as a gain or loss on the sale of available-for-sale securities. It is reported on the income statement then because the gain has been realized. At the same time, the Available-for-Sale Securities and the Net Unrealized Losses/Gains accounts are eliminated.

Trading Securities

For trading securities, the amount of the adjustment to record unrealized holding losses/gains is included **in each period's income statement** (that is, it is treated as if it were realized). The amount recorded as Net Unrealized Losses/Gains on trading securities is closed to Retained Earnings at the end of the period. When selling a trading security, Cash and only one other balance sheet account are affected: Trading Securities.

See Exhibit D.3 for a comparison of the treatment of trading securities and available-for-sale securities using the previous transactions from 2013 to 2015. **Note that the total investment income reported on the income statement for the three years is the same for both trading securities and available-for-sale securities ($5 million). Only the allocation across periods differs.**

	REPORTED ON INCOME STATEMENT (in millions)	
	Trading Securities	Available-for-Sale Securities
Dividend Revenue in 2013	$1	$1
Unrealized Loss in 2013	(2)	—
Unrealized Gain in 2014	3	—
Gain on Sale in 2015	3	4
Total Income from Investments	$5	$5

SPOTLIGHT ON **Financial Reporting**

Reporting the Fair Value of Investments

Accounting standards require that companies explain how they determine the fair values of assets on the balance sheet. The fair value of an asset is the amount that would be received in an orderly sale. The standards recognize three approaches in order of decreasing reliability:

- Level 1: Quoted prices in active markets for identical assets.
- Level 2: Estimates based on other observable inputs (e.g., prices for similar assets).
- Level 3: Estimates based on unobservable estimates (the company's own estimates of factors that market participants would consider).

Fair value should be determined using the **most** reliable method available (Level 1 if possible).

Companies also have the option of accounting for other financial assets (such as notes receivable) and financial liabilities (such as bonds payable) at fair value. Thus far, application of this **fair value option** has been limited mostly to banks and other financial institutions.

EXHIBIT D.3 Comparison of Accounting for Trading and Available-for-Sale Securities

Part A: Journal Entries	Trading Securities (in millions)			Available-for-Sale Securities (in millions)		
2013						
• Purchase (for $60 million cash)	*dr* Trading Securities (+A)	60		*dr* Available-for-Sale Securities (+A)	60	
	cr Cash (−A)		60	*cr* Cash (−A)		60
• Receive dividends ($1 million cash)	*dr* Cash (+A)	1		*dr* Cash (+A)	1	
	cr Dividend Revenue (+R, +SE)		1	*cr* Dividend Revenue (+R, +SE)		1
• Year-end adjustment to fair value of $58 million	*dr* Net Unrealized Losses/Gains (+E, −SE)	2		*dr* Net Unrealized Losses/Gains (−SE)	2	
	cr Trading Securities (−A)		2	*cr* Available-for-Sale Securities (−A)		2
2014						
• Year-end adjustment to fair value of $61 million	*dr* Trading Securities (+A)	3		*dr* Available-for-Sale Securities (+A)	3	
	cr Net Unrealized Losses/Gains (+R, +SE)		3	*cr* Net Unrealized Losses/Gains (+SE)		3
2015	**One** balance sheet account is eliminated:			**Two** balance sheet accounts are eliminated:		
• Sale (for $64 million)	*dr* Cash (+A)	64		*dr* Cash (+A)	64	
				dr Net Unrealized Losses/Gains (−SE)	1	
	cr Trading Securities (−A)		61	*cr* Available-for-Sale Securities (−A)		61
	cr Gain on Sale of Investments (+R, +SE)		3	*cr* Gain on Sale of Investments (+R, +SE)		4

EXHIBIT D.3 Comparison of Accounting for Trading and Available-for-Sale Securities (*Continued*)

Part B: Financial Statements	Trading Securities				Available-for-Sale Securities			
Balance Sheet	*Assets*	*2015*	*2014*	*2013*	*Assets*	*2015*	*2014*	*2013*
	Trading Securities	—	$61	$58	Available-for-Sale Securities	—	$61	$58
					Stockholders' Equity			
					Accumulated Other Comprehensive Income			
					Net Unrealized Losses/Gains	—	$ 1	$(2)
Income Statement		*2015*	*2014*	*2013*		*2015*	*2014*	*2013*
	Dividend Revenue	—	—	$ 1	Dividend Revenue	—	—	$1
	Net Unrealized Losses/Gains	—	$3	(2)	Gain on Sale of Investments	$4	—	—
	Gain on Sale of Investments	$3	—	—				

Accounting for Influential Investments

INVESTMENTS FOR SIGNIFICANT INFLUENCE: EQUITY METHOD

For a variety of reasons, an investor may want to exert significant influence (by owning 20 to 50 percent of a company's outstanding voting stock) without becoming the controlling shareholder (by acquiring over 50 percent of the voting stock). For example:

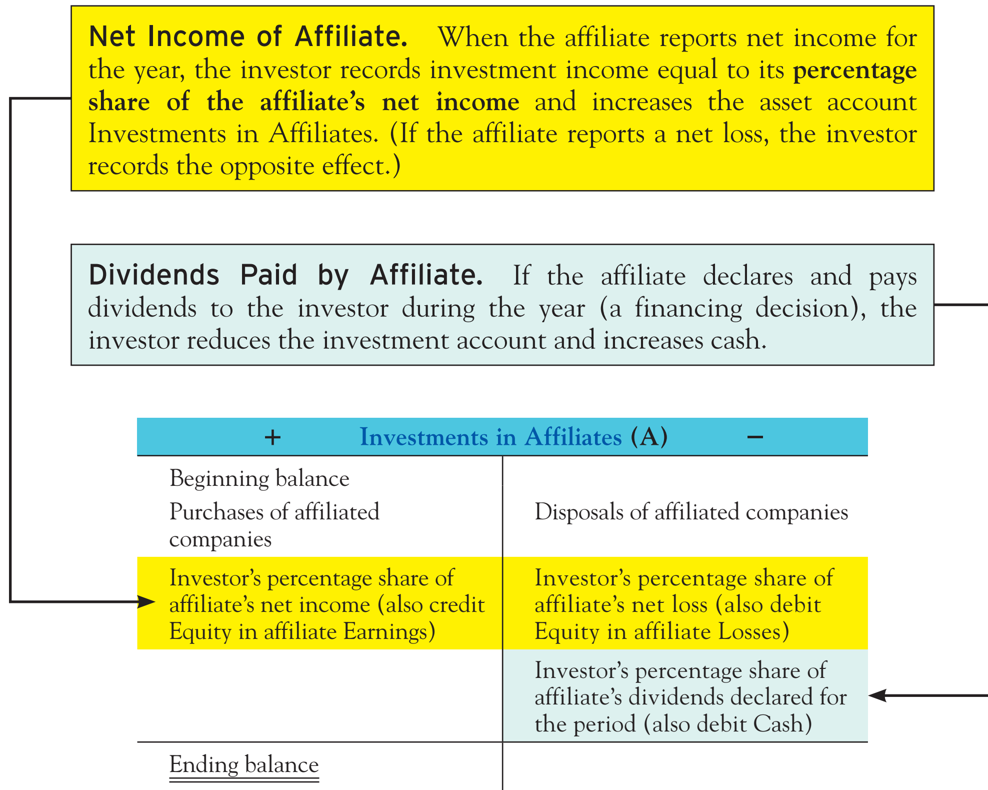
- A retailer may want to influence a manufacturer to ensure obtaining certain products designed to its specifications.
- A manufacturer may want to influence a computer consulting firm to incorporate the firm's cutting-edge technology in its manufacturing processes.
- A manufacturer may recognize that a parts supplier lacks experienced management and could prosper with additional managerial support.

When an investor can exert **significant influence** over an **afffiliate** (the company it partially owns), accountants must use the **equity method** to value the investment. As you have seen, when Washington Post invests in securities as a passive investor, the company reports those investments on the balance sheet as Investments in Marketable Securities. However, when Washington Post owns 20 to 50 percent of the outstanding voting stock, the company is presumed to be taking a more active role as an investor. On the balance sheet, Washington Post reports these long-term **investments for significant influence** as Investments in Affiliates (see Exhibit D.1).

Recording Investments under the Equity Method

Under the equity method, the investor's 20 to 50 percent ownership in a company presumes significant influence over the affiliate's operating and financing policies. Often the affiliate's board of directors may include a representative of the investor who influences the affiliate's board to declare dividends among other decisions. Because of this influence, the investment is accounted for as if the two companies were one. That is, the net income the affiliate earned increases the affiliate's net assets (assets − liabilities). Likewise, the investor should report a portion of the affiliate's net income as its income

and an increase in the investment account. Dividends paid by the affiliate decrease the affiliate's net assets. Similarly, the receipt of dividends by the investor is treated as a reduction of the investment account, not revenue. A summary follows:



Purchase of Stock For simplification, let's assume that at the beginning of 2012, Washington Post had no long-term investments in companies over which it exerted significant influence. On January 2, 2013, Washington Post purchased 4 million shares of the outstanding voting stock of IFN for $240 million cash. Because IFN had 10 million shares of common stock outstanding, Washington Post acquired a 40 percent interest (4 million ÷ 10 million shares) and was presumed to have significant influence over the affiliate. Therefore, Washington Post must use the equity method to account for the investment. The purchase of the asset would be recorded on January 2, 2013, at cost in Investments in Affiliates.

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity
Investments in Affiliates	+240				
Cash	−240				

2 Record

dr Investments in Affiliates (+A)	240	
cr Cash (−A)		240

Affiliate Earnings Because the investor can influence the affiliate's income-earning process, the investor bases its investment income on the affiliate's earnings rather than on the dividends paid. In 2013, IFN reported net income of $50 million.

Washington Post's percentage share of that income, $20 million (40% × $50 million), would be recorded on December 31, 2013, as follows:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Investments in Affiliates	+20				Equity in Affiliate Earnings (+R)	+20

2 Record

dr Investments in Affiliates (+A)	20	
cr Equity in Affiliate Earnings (+R, +SE)		20

If reporting a net loss, the investor records its share of the loss by decreasing the investment account and recording the loss under Equity in Affiliate Losses. Equity in Affiliate Earnings (or Losses) is reported in the Other Items section of the income statement along with interest revenue and interest expense.

Dividends Received Because Washington Post can influence the dividend policies of its affiliates, any dividends it receives should **not** be recorded as income. Instead, dividends reduce its investment account. On December 1, 2013, IFN declared and paid a cash dividend of $2 per share to stockholders. Washington Post received $8 million in cash ($2 per share × 4 million shares) from IFN, and recorded this on December 1, 2013, as follows:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity
Investments in Affiliates	−8				
Cash	+8				

2 Record

dr Cash (+A)	8	
cr Investments in Affiliates (−A)		8

The cumulative effects of the IFN purchase, earnings, and dividends for 2013 are reflected in the following T-accounts (in millions of dollars):

3 Summarize

Investments in Affiliates (A)

	Debit	Credit	
1/1/13	0		
Purchases	240		
Share of affiliate net earnings	20	8	Share of affiliate dividends
12/31/13	252		

Equity in Affiliate Earnings (R)

	Debit	Credit	
		0	1/1/13
		20	Share of affiliate net earnings
		20	12/31/13

COACH'S TIP

Because Washington Post owned 40 percent of IFN prior to the sale (4 million of the 10 million shares outstanding), it will then own 30 percent (3 million of 10 million shares) after the sale. Thus, it must still apply the equity method.

Disposal of Stock Companies record any sale of stock in affiliated companies in the same way as sales of other assets. Investment in Affiliates is reduced by the percentage of stock sold, Cash is debited, and the difference is recorded as either a Gain (or Loss) on Sale of Investments.

Let's assume that on January 2, 2014, Washington Post decided to sell 1,000,000 of the 4,000,000 shares of stock it owned in IFN for $70 million. That represents 25 percent of Washington Post's Investment in Affiliates. One-fourth of the balance in the account is equal to $63 million ($252 million × ¼), so the accounting effects on January 2, 2014, are:

1 Analyze

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+70				Gain on Sale of Investments (+R)	+7
Investments in Affiliates	−63					

2 Record

dr Cash (+A)	70	
cr Investments in Affiliates (−A)		63
cr Gain on Sale of Investments (+R, +SE)		7

Reporting Investments under the Equity Method

On the balance sheet, Investments in Affiliates is reported as a long-term asset. However, as the year-end entries show, the investment account does not reflect either cost or fair value. Instead, the following occurs:

- The investment account increases with the cost of the purchased shares and the proportional share of the affiliate's income.
- The investment account decreases with the dividends received from the affiliate, the proportional share of any affiliate losses, and any sale of shares in the affiliate.

At the end of the accounting period, accountants **do not adjust the investment account to reflect changes in the fair value** of securities accounted for under the equity method. When the securities are sold, accountants record the difference between the cash received and the book value of the investment as a Gain (Loss) on Sale of Investments and report the amount on the income statement in the Other Items section.

SPOTLIGHT ON Ethics

Improper Influence

A key assumption in accounting is that all transactions occur at "arm's length." That is, each party to the transaction is acting in his or her own self-interest. But when one company exerts significant influence over another (that is, when it owns 20 to 50 percent of the voting common stock), it is unreasonable to assume that transactions between the two companies are made at arm's length.

Consider what might happen if an investor company could affect the affiliate's dividend policy. If the investor reported dividends paid by the affiliate as dividend revenue, the investor could manipulate its own income by influencing the other company's dividend policy. In a bad year, the investor might request large dividend payments to bolster its income. In a good year, it might try to cut dividend payments to build up the affiliate's retained earnings, which would support large dividends in the future.

The equity method prevents this type of manipulation. Instead of recognizing dividends as revenue, this method bases income from the investment on a percentage of the affiliated company's reported net income.

INVESTMENTS WITH CONTROLLING INTERESTS: CONSOLIDATED STATEMENTS

Why Control Other Companies?

Before we discuss financial reporting of investments that involve ownership of more than 50 percent of another company's outstanding voting stock, we should consider the

The Washington Post
MARYLAND EDITION
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Obama Taps CIA Veteran As Adviser On Terror
Brennan Has Drawn Fire on Interrogations

Geithner Preparing Overhaul Of Bailout
Obama Team Broadens Scope to Secure Final $350 Billion for Rescue

100 Survivors Rescued in Gaza From Ruins Blocked by Israelis
Relief Agencies Fear More Are Trapped, Days After Neighborhood Was Shelled

reasons for acquiring this level of ownership. Following are some of these reasons:

1. **Vertical integration.** In this type of acquisition, one company acquires another company that operates on a different level in the distribution channel. For example, Washington Post owns a newsprint company that provides raw materials.
2. **Horizontal growth.** Horizontal acquisitions involve companies that operate on the same level of the distribution channel. For example, Washington Post has expanded internationally by creating or acquiring newspaper companies in major international markets.
3. **Synergy.** Two companies operating together may be more profitable than two companies operating separately. Washington Post has created or purchased a number of broadcast and Internet services. Merging these companies and sharing news content may create more profits than operating separate entities could.

Understanding why one company has acquired control over other companies is a key factor in understanding that company's business strategy.

What Are Consolidated Statements?

YOU SHOULD KNOW

Parent company: The entity that controls another company.
Subsidiary company: The entity that is controlled by the parent.

Any corporate acquisition involves two companies. A **merger** occurs when one company purchases all assets and liabilities of another company and the **acquired company goes out of existence.** When the acquired company remains in business, the company that gains control over it by acquiring all or a majority of the voting stock is the **parent company**. The **subsidiary company** is the company that the parent acquired.[2] Following is a list of three corporations and some of the well-known companies they own:

Gap, Inc.	YUM! Brands, Inc.	The Walt Disney Company
Gap	Pizza Hut	ABC television network
Old Navy	KFC	ESPN
Banana Republic	Taco Bell	Disneyland
Athleta		Pixar Animation Studios
		Touchstone Pictures

YOU SHOULD KNOW

Consolidated financial statements: Combine the financial statements of parent and subsidiary companies into a single set of financial statements.

When one company acquires another, the results of their operations must be reported together in consolidated statements. **Consolidated financial statements combine the operations of two or more companies into a single set of statements,** usually identified by the word consolidated in the statement titles. For example, the title of the statement in Exhibit D.1 is *Consolidated* Balance Sheet. Consolidated statements may be thought of as adding together the financial statements for two or more companies so that they appear to be a single company. Thus, the cash accounts for the companies are summed, along with the inventory accounts, the land accounts, and all other accounts. Combining all financial information into one set of consolidated statements gives users better information on the size and scope of operations in companies controlled by the parent corporation.

The notes to Washington Post's 2011 annual report provide the following information:

NOTES TO FINANCIAL STATEMENTS

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation. The accompanying consolidated financial statements include the assets, liabilities, results of operations, and cash flows of the Company and its majority-owned and controlled subsidiaries. All significant intercompany accounts and transactions have been eliminated.

[2]The discussion assumes acquisition of 100 percent of another company. Any acquisition of 51 to 99 percent of another company creates a minority interest that is discussed in advanced accounting courses.

As the note indicates, when consolidated statements are prepared, intercompany items such as loans from the parent company to the subsidiaries must be eliminated. Remember that consolidated statements imply that a single company exists when in fact there are two or more separate legal entities. Intercompany items do not exist in a single corporation. For example, a debt Washington Post (the parent) owes to its newsprint subsidiary is not reported on a consolidated statement because a company cannot owe money to itself. Accounting for business acquisitions and preparing consolidated financial statements are discussed in detail in advanced accounting courses.

A summary of all four methods of accounting for investments in the stock of other corporations is presented in Exhibit D.4.

EXHIBIT D.4 Accounting for Investments in Other Corporations' Stock

Level of Involvement in Decision Making (Percent of Ownership)	Reason for the Investment	Method of Accounting	How It Works
Control (more than 50%)	Take over the company →	Acquisition	Combine the financial statements of parent and subsidiaries
Significant Influence (20–50%)	Influence the company →	Equity Method	Record investment at cost, add % share of net income, deduct % share of dividends
Passive (less than 20%)	Invest excess cash to earn greater return →	Available for Sale Securities at Fair Value	Record investment at cost but adjust to fair value at period-end; report dividends and realized gains/losses on the income statement; report net unrealized gains/losses in stockholders' equity
Passive (less than 20%)	Securities trading →	Trading Securities at Fair Value	Record investment at cost but adjust to fair value at period-end; report dividends and all gains/losses (either realized or unrealized) on the income statement

DEMONSTRATION CASE A: TRADING SECURITIES

Howell Equipment Corporation sells and services a major line of farm equipment. Both sales and service operations have been profitable. The following transactions affected the company during 2013:

a. Jan. 1 Purchased 2,000 shares of common stock in Dear Company at $40 per share. Purchase represented 1 percent of the shares outstanding. Management intends to trade these shares actively.

b. Dec. 28 Received $4,000 cash dividend on Dear Company stock.

c. Dec. 31 Determined that the current market price of Dear stock was $39.

Required:

1. Prepare the journal entry for each of these transactions.
2. What accounts and amounts will be reported on the balance sheet at the end of 2013 and on the income statement for 2013?

Suggested Solution for Case A

1. a. *dr* **Trading Securities** (+A) 80,000
   cr **Cash** (−A) (2,000 shares × $40) 80,000

   b. *dr* **Cash** (+A) 4,000
   cr **Dividend Revenue** (+R, +SE) 4,000

   c. *dr* **Net Unrealized Losses/Gains** (+E, −SE) 2,000
   cr **Trading Securities** (−A) 2,000

Year: 2013		
Fair value	$78,000	($39 per share × 2,000 shares)
− Cost	− 80,000	($40 per share × 2,000 shares)
Amount for adjusting entry in c.	$ (2,000)	An unrealized loss **to income**

2. On the balance sheet / On the income statement

Current Assets	
Trading Securities	$78,000

Other Items	
Dividend Revenue	$ 4,000
Net Unrealized (Losses)/Gains	(2,000)

DEMONSTRATION CASE B: AVAILABLE-FOR-SALE SECURITIES

Assume the same facts as in Case A except that the shares were purchased as available-for-sale securities rather than as trading securities.

Required:

1. Prepare the journal entry for each of these transactions.
2. What accounts and amounts will be reported on the balance sheet at the end of 2013 and on the income statement for 2013?

Suggested Solution for Case B

1. a. *dr* **Available-for-Sale Securities** (+A) 80,000
   cr **Cash** (−A) (2,000 shares × $40) 80,000

   b. *dr* **Cash** (+A) 4,000
   cr **Dividend Revenue** (+R, +SE) 4,000

   c. *dr* **Net Unrealized Losses/Gains** (−SE) 2,000
   cr **Available-for-Sale Securities** (−A) 2,000

Year: 2013		
Fair value	$78,000	($39 per share × 2,000 shares)
− Cost	− 80,000	($40 per share × 2,000 shares)
Amount for adjusting entry	$ (2,000)	An unrealized loss **in stockholders' equity**

2. On the balance sheet / On the income statement

Current (or noncurrent) Assets	
Available-for-Sale Securities	$78,000
Stockholders' Equity	
Accumulated Other Comprehensive Income:	
Net Unrealized Gain (Loss)	(2,000)

Other Items	
Dividend Revenue	$4,000

DEMONSTRATION CASE C: EQUITY METHOD

On January 1, 2013, Connaught Company purchased 40 percent of the outstanding voting shares of London Company on the open market for $85,000 cash. London paid $10,000 in total cash dividends on December 1, 2013, and reported net income of $60,000 for the year on December 31, 2013.

Required:

1. Prepare the journal entries for 2013.
2. What accounts and amounts were reported on Connaught's balance sheet at the end of 2013 and on Connaught's income statement for 2013?

Suggested Solution for Case C

1.

Date	Account	Debit	Credit
Jan. 1	*dr* **Investments in Affiliates** (+A)	85,000	
	cr **Cash** (−A)		85,000
Dec. 1	*dr* **Cash** (+A) (40% × $10,000)	4,000	
	cr **Investments in Affiliates** (−A)		4,000
Dec. 31	*dr* **Investments in Affiliates** (+A) (40% × $60,000)	24,000	
	cr **Equity in Affiliate Earnings** (+R, +SE)		24,000

2. On the balance sheet

Noncurrent Assets

Investments in Affiliates	$105,000

On the income statement

Other Items

Equity in Affiliate Earnings	$24,000

$ 85,000 cost
− 4,000 dividends
+ 24,000 percentage of affiliate's net income
$105,000 balance in Investments account

KEY TERMS

Available-for-Sale Securities p. D5
Consolidated Financial Statements p. D14
Parent Company p. D14
Subsidiary Company p. D14
Trading Securities p. D5

See complete definitions in the glossary in the back of the text.

PRACTICE MATERIAL

QUESTIONS

1. When is it appropriate to use acquisition/consolidation, equity, or fair value methods for an investment in another corporation?
2. How do the accounting methods used for available-for-sale securities and trading securities differ?
3. How do the accounting methods used for passive investments and investments involving a significant influence differ?
4. How do the accounting methods used for investments involving a significant influence and investments involving control differ?
5. What are consolidated financial statements and what do they attempt to accomplish?
6. Under the equity method, dividends received from the affiliated company are not recorded as revenue. Recording dividends as revenue would involve double counting. Explain.
7. What are the two sources of return for passive investments?
8. Where are unrealized gains and losses reported for available-for-sale securities? Where are unrealized gains and losses reported for trading securities? What's the reason for this reporting difference?

MULTIPLE CHOICE

1. Company A owns 40 percent of Company B and exercises significant influence over the management of Company B. Therefore, Company A uses what accounting method for reporting its ownership of stock in Company B?
   a. The consolidation method.
   b. The fair value method for available-for-sale securities.
   c. The equity method.
   d. The fair value method for trading securities.
2. Company A purchases 10 percent of Company X and intends to hold the stock for at least five years. At the end of the current year, how would Company A's investment in Company X be reported on Company A's December 31 (year-end) balance sheet?
   a. At original cost, in the current assets section.
   b. At the December 31 fair value, in the current assets section.
   c. At original cost, in the noncurrent assets section.
   d. At the December 31 fair value, in the noncurrent assets section.
3. Consolidated financial statements are required in which of the following situations?
   a. Only when a company can exert significant influence over another company.
   b. Only when a company has a passive investment in another company.
   c. Only when a parent company can exercise control over its subsidiary.
   d. None of the above.
4. When recording dividends received from a stock investment accounted for using the equity method, which of the following statements is true?
   a. Total assets are increased and net income is increased.
   b. Total assets are increased and total stockholders' equity is increased.
   c. Total assets are decreased and total stockholders' equity is decreased.
   d. Total assets and total stockholders' equity do not change.
5. When using the equity method of accounting, when is revenue recorded on the books of the investor company?
   a. When the fair value of the affiliate stock increases.
   b. When a dividend is received from the affiliate.
   c. When the affiliate company reports net income.
   d. Both *b* and *c* above.
6. Dividends received from stock that is reported as *available-for-sale securities* in the balance sheet are reported as which of the following?
   a. An increase to cash and a decrease to the available-for-sale securities account.
   b. An increase to cash and an unrealized gain on the balance sheet.
   c. An increase to cash and an increase to dividend revenue.
   d. An increase to cash and an unrealized gain on the income statement.
7. Realized gains and losses are recorded on the income statement for which of the following transactions in *trading securities* and *available-for-sale securities?*
   a. When adjusting *trading securities* to fair value.
   b. When adjusting *available-for-sale securities* to fair value.
   c. Only when recording the sale of *trading securities*.
   d. When recording the sale of either *trading securities* or *available-for-sale securities*.
8. Schlumber Corp. paid $200,000 to purchase 30 percent of the stock of Schleep, Inc., this year. At the end of the year, Schleep reported net income of $50,000 and declared and paid dividends of $20,000. If Schlumber uses the equity method to account for its investment in Schleep, at what amount would the investment be reported at the end of the year?
   a. $200,000
   b. $209,000
   c. $215,000
   d. $221,000
9. During the current year, Winterpeg Enterprises purchased common shares of Lakeview Development Corp. (LDC) for $200,000, received a $2,000 dividend from LDC, and saw the fair value of its investment in LDC increase by $4,000 by year-end. If Winterpeg considers its investment in LDC to be available-for-sale securities, what amount will Winterpeg report on its income statement this year?
   a. $2,000
   b. $4,000
   c. $6,000
   d. None of the above.
10. Assume the same facts as described in 9, except that Winterpeg considers its investment in LDC to be trading securities. What amount will Winterpeg report on its income statement this year?
    a. $2,000
    b. $4,000
    c. $6,000
    d. None of the above.

Answers to Multiple Choice Questions
1. *c* 2. *d* 3. *c* 4. *d* 5. *c* 6. *c* 7. *d* 8. *b* 9. *a* 10. *c*

MINI-EXERCISES

McGraw Hill connect® ACCOUNTING

MD-1 Recording Equity Method Securities Transactions

On January 2, 2013, Ubuy.com paid $100,000 to acquire 25 percent (10,000 shares) of the common stock of E-Net Corporation. The accounting period for both companies ends December 31. Give the journal entries for the purchase on January 2, and for each of the following transactions that occurred during 2013:

July 2	E-Net declared and paid a cash dividend of $3 per share.
Dec. 31	E-Net reported net income of $200,000.

MD-2 Determining Financial Statement Effects of Equity Method Securities

Using the following categories, indicate the effects (direction and amount) of the transactions listed in MD-1. Use + for increase and − for decrease.

	Balance Sheet			Income Statement		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income

MD-3 Recording Trading Securities Transactions

During 2013, Princeton Company acquired some of the 50,000 outstanding shares of the common stock of Cox Corporation as trading securities. The accounting period for both companies ends December 31. Give the journal entries for each of the following transactions that occurred during 2013:

July 2	Purchased 8,000 shares of Cox common stock at $28 per share.
Dec. 15	Cox Corporation declared and paid a cash dividend of $2 per share.
31	Determined the fair value of Cox stock to be $29 per share.

MD-4 Determining Financial Statement Effects of Trading Securities Transactions

Using the following categories, indicate the effects (direction and amount) of the transactions listed in MD-3. Use + for increase and − for decrease.

	Balance Sheet			Income Statement		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income

MD-5 Recording Available for Sale Securities Transactions

Using the data in MD-3, assume that Princeton Company purchased the voting stock of Cox Corporation for its portfolio of available-for-sale securities instead of its trading securities portfolio. Give the journal entries for each of the transactions listed.

MD-6 Determining Financial Statement Effects of Available-for-Sale Securities Transactions

Using the following categories, indicate the effects (direction and amount) of the transactions referenced in MD-5. Use + for increase and − for decrease.

	Balance Sheet			Income Statement		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income

MD-7 Recording the Purchase and Sale of a Passive Investment

Rocktown Corporation bought 600 shares of General Eccentric stock on March 20, 2013, for its trading securities portfolio at $29 per share. Rocktown sold the stock at $33 per share on June 23, 2013. Prepare the journal entries to record the transactions on each of these dates, assuming that the investment had not yet been adjusted to fair value (that is, the investment was still recorded at cost at the time of sale).

EXERCISES

ED-1 Recording and Reporting an Equity Method Security

Felicia Company acquired 21,000 of the 60,000 shares of outstanding common stock of Nueces Corporation during 2013 as a long-term investment. The annual accounting period for both companies ends December 31. The following transactions occurred during 2013:

Jan. 10	Purchased 21,000 shares of Nueces common stock at $12 per share.
Dec. 31	Nueces Corporation reported net income of $90,000.
Dec. 31	Nueces Corporation declared and paid a cash dividend of $0.60 per share.
Dec. 31	Determined the fair value of Nueces stock to be $11 per share.

Required:

1. What accounting method should the company use? Why?
2. Give the journal entries for each of these transactions. If no entry is required, explain why.
3. Show how the long-term investment and the related revenue should be reported on the 2013 financial statements of Felicia Company.

ED-2 Recording Unrealized Losses/Gains for Available-for-Sale Securities

On June 30, 2012, MetroMedia, Inc., purchased 10,000 shares of Mitek stock for $20 per share. The following information pertains to the fair value of Mitek stock:

	Per Share
12/31/2012	$24
12/31/2013	31

Required:

Assume that management considers the stock to be available-for-sale securities. Prepare the journal entries required on each date given.

ED-3 Recording Unrealized Losses/Gains for Trading Securities

Refer to the data in ED-2.

Required:

Assume that MetroMedia management purchased the Mitek stock as trading securities. Prepare the journal entries required on each date given.

ED-4 Reporting Unrealized Losses/Gains for Available-for-Sale Securities and Trading Securities

Refer to the data in ED-2.

Required:

1. Assume that management intends to hold the stock as available-for-sale securities for three years or more. Show how the stock investment and its net unrealized losses/gains would be reported at the end of 2013 and 2012 on the classified balance sheet and income statement.
2. Assume that management purchased the stock as trading securities. Show how the investment and net unrealized losses/gains would be reported at the end of 2013 and 2012 on the classified balance sheet and income statement.

ED-5 Recording Unrealized Losses/Gains for Available-for-Sale Securities

On March 10, 2012, Global Solutions, Inc., purchased 5,000 shares of Superior Technologies stock for $50 per share. The following information pertains to the fair value of Superior Technologies stock:

	Per Share
12/31/2012	$45
12/31/2013	42

Required:

Assume that management considers the stock to be available-for-sale securities. Prepare the journal entries required on each date given.

ED-6 Recording Unrealized Losses/Gains for Trading Securities

Refer to the data in ED-5.

Required:

Assume that Global Solutions purchased the Superior Technologies stock as trading securities. Prepare the journal entries required on each date given.

ED-7 Reporting Unrealized Losses/Gains for Available-for-Sale Securities and Trading Securities

Refer to the data in ED-5.

Required:

1. Assume that management intends to hold the stock as available-for-sale securities for three years or more. Show how the stock investment and its net unrealized losses/gains would be reported at each year-end on the classified balance sheet and income statement.
2. Assume that management purchased the stock as trading securities. Show how the investment and net unrealized losses/gains would be reported at each year-end on the classified balance sheet and income statement.

COACHED PROBLEMS

CPD-1 Recording Passive Investments and Investments for Significant Influence

On August 4, 2011, Cappio Corporation purchased 1,000 shares of Maxwell Company for $45,000. The following information applies to the fair value of Maxwell Company:

	Per Share
12/31/2011	$52
12/31/2012	47
12/31/2013	38

Maxwell Company declares and pays cash dividends of $2 per share on June 1 of each year.

Required:

1. Prepare journal entries to record the facts in the case, assuming that Cappio considers the shares to be available-for-sale securities.
   TIP: Net unrealized losses/gains on available-for-sale securities are reported in stockholders' equity.
2. Prepare journal entries to record the facts in the case, assuming that Cappio considers the shares to be trading securities.
   TIP: Net unrealized losses/gains on trading securities are reported in the income statement.
3. Prepare journal entries to record the facts in the case, assuming that Cappio uses the equity method to account for the investment. Cappio owns 30 percent of Maxwell, and Maxwell reported $50,000 of net income each year.

CPD-2 Comparing Methods to Account for Various Levels of Ownership of Voting Stock

Bart Company had outstanding 30,000 shares of common stock, par value $10 per share. On January 1, 2013, Homer Company purchased some of these shares at $25 per share, with the intent of holding them for a long time. At the end of 2013, Bart Company reported the following: net income, $50,000, and cash dividends declared and paid during the year, $25,500. The fair value of Bart Company stock at the end of 2013 was $22 per share.

Required:

1. This problem involves two separate cases. For each case (shown in the table), identify the method of accounting that Homer Company should use. Explain why.
   TIP: Divide the number of shares purchased by the number outstanding to determine the percent of ownership.
2. Give the journal entries for Homer Company at the dates indicated for each of the two independent cases. If no entry is required, explain why. Use the following format:

	Case A: 3,600 Shares Purchased	Case B: 10,500 Shares Purchased
1. Accounting method?		
2. Journal entries made by Homer Company:		
a. To record the acquisition of Bart Company at January 1, 2013.		
b. To recognize the income reported by Bart Company for 2013.		
c. To recognize the dividends declared and paid by Bart Company.		
d. Entry to recognize the fair value adjustment at end of 2013.		

3. Complete the following schedule to show the separate amounts that should be reported on the 2013 financial statements of Homer Company:

	Dollar Amounts	
	Case A	Case B
Balance sheet		
Investments		
Stockholders' Equity		
Income statement		
Dividend Revenue		
Equity in Affliate Earnings		

4. Explain why the assets, stockholders' equity, and income statements for the two cases differ.

GROUP A PROBLEMS

PAD-1 Recording Passive Investments and Investments for Significant Influence

On July 12, 2011, Rossow Corporation purchased 1,000 shares of Reimer Company for $30,000. The following information applies to the fair value of Reimer Company:

	Per Share
12/31/2011	$33
12/31/2012	28
12/31/2013	20

Reimer Company declares and pays cash dividends of $2 per share on May 1 of each year.

Required:

1. Prepare journal entries to record the facts in the case, assuming that Rossow considers the shares to be available-for-sale securities.
2. Prepare journal entries to record the facts in the case, assuming that Rossow considers the shares to be trading securities.

3. Prepare journal entries to record the facts in the case, assuming that Rossow uses the equity method to account for the investment. Rossow owns 30 percent of Reimer, and Reimer reported $50,000 of net income each year.

PAD-2 Comparing the Fair Value and Equity Methods

Lisa Company had outstanding 100,000 shares of common stock. On January 10, 2013, Marg Company purchased a block of these shares in the open market at $20 per share, with the intent of holding the shares for a long time. At the end of 2013, Lisa reported net income of $300,000 and cash dividends of $0.60 per share. At December 31, 2013, Lisa Company stock was selling at $18 per share.

Required:

1. This problem involves two separate cases. For each case (shown in the table), identify the method of accounting that Marg Company should use. Explain why.
2. Give the journal entries for Marg Company at the dates indicated for each of the two independent cases. If no entry is required, explain why. Use the following format:

	Case A: 10,000 Shares Purchased	Case B: 40,000 Shares Purchased
1. Accounting method?		
2. Journal entries made by Marg Company:		
a. To record the acquisition of Lisa Company on January 10, 2013.		
b. To recognize the income reported by Lisa Company for 2013.		
c. To recognize the dividends declared and paid by Lisa Company.		
d. Entry to recognize the fair value adjustment at end of 2013.		

3. Complete the following schedule to show the separate amounts that should be reported on the 2013 financial statements of Marg Company:

	Dollar Amounts	
	Case A	Case B
Balance sheet		
Investments		
Stockholders' Equity		
Income statement		
Dividend Revenue		
Equity in Affiliate Earnings		

4. Explain why the assets, stockholders' equity, and income statements for the two cases differ.