APPENDIX A

reporting and interpreting
investments in other corporAtions

# Learning Objectives and Related Assignment Materials

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| **Learning Objectives** | **Mini-Exercises** | **Exercises** | **Problems** | **Alternate Problems** | **Cases and Projects** |
| A-1 Analyze and report investments in debt securities held to maturity. | 1, 2 | 1, 11 | 1 | 1 | 1, 2 |
| A-2 Analyze and report passive investments in securities using the fair value method. | 1, 3, 4, 5, 6, 10 | 2, 3, 4, 5, 6, 10 | 2, 3, 4, 5, 6, 7, 11 | 2, 3, 4, 5 | 1, 2, 3, 7 |
| A-3 Analyze and report investments involving significant influence using the equity method. | 1, 7, 8 | 2, 7, 8 | 5, 6, 7, 8, 9 | 4, 5 | 3, 7 |
| A-4 Analyze and report investments in controlling interests. | 1, 9, 11 | 9 | 10 | 6 | 1, 4, 5, 6, 7 |
| Chapter Supplement – Held-to-Maturity Bonds Purchased at Other than Par Value: Amortized Cost Method |  | 11 |  |  |  |

# Synopsis of Chapter Revisions

Focus Company: Graham Holdings Company

* + *New* focus company, Graham Holdings Company, a company that expands primarily through investing in other companies, including Kaplan, Inc. (top admissions test preparation organization). Accounting and reporting are discussed and illustrated for: (1) debt securities held to maturity, (2) passive investments using the fair value method, (3) investments involving significant influence using the equity method, and (4) investments in controlling interests.
	+ Focus and contrast company data updated.
	+ GUIDED HELP feature provides free access to step-by-step video instruction on accounting for and reporting available-for-sale securities as investments at fair value.
	+ *New* CONTINUING PROBLEM added to the end-of-chapter problems. Using the activities of Pool Corporation, students are asked to record passive investments as trading securities and as available-for-sale securities over a three-year period.
	+ *New and updated real companies,* as well as additional exercises on key con­cepts, in end-of-chapter exercises, prob­lems, and cases.
	+ *New* Annual Report Case that can be graded through Connect®.

# PowerPoint Slides

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| **Learning Objectives** | **PowerPoint® Slides** |
| A-1 Analyze and report investments in debt securities held to maturity. | A-3 through A-10 |
| A-2 Analyze and report passive investments in securities using the fair value method. | A-11 through A-23 |
| A-3 Analyze and report investments involving significant influence using the equity method. | A-24 through A-33 |
| A-4 Analyze and report investments in controlling interests. | A-33 through A-39 |
| Chapter Supplement – Held-to-Maturity Bonds Purchased at Other than Par Value: Amortized Cost Method | A-40 |

# Chapter Take-Aways

**A-1 Analyze and report investments in debt securities held to maturity.**

When management intends to an investment in a debt security (such as a bond or note) until it matures, the held-to-maturity security is recorded at cost when acquired and reported at amortized cost on the balance sheet. Any interest earned during the period is reported on the income statement.

**A-2 Analyze and report passive investments in securities using the fair value method.**

Acquiring debt securities not held to maturity or less than 20 percent of the outstanding voting shares of another company’s common stock is presumed to be a passive stock investment. Passive investments may be classified as:

* Trading securities (actively traded to maximize return) or
* Available-for-sale securities (which earn a return but are not as actively traded) depending on management’s intent.

The investments are recorded at cost and adjusted to fair value at year-end. The resulting unrealized gain or loss is recorded.

* For trading securities, the net unrealized gains and losses are reported in net income.
* For available-for-sale securities, the net unrealized gains and losses are reported as a component of stockholders’ equity in other comprehensive income.

Any dividends earned are reported as revenue, and any gains or losses on sales of passive investments are reported on the income statement.

**A-3 Analyze and report investments involving significant influence using the equity method.**

If between 20 and 50 percent of the outstanding voting shares are owned, significant influence over the affiliate firm’s operating and financing policies is presumed, and the equity method is applied. Under the equity method, the investor records the investment at cost on the acquisition date. Each period thereafter, the investment amount is increased (or decreased) by the proportionate interest in the income (or loss) reported by the affiliate corporation and decreased by the proportionate share of the dividends declared by the affiliate corporation.

# Chapter Take-Aways, continued

**A-4 Analyze and report investments in controlling interests.**

Mergers occur when one company purchases all of the net assets of another and the target company ceases to exist as a separate legal entity. Mergers and ownership of a controlling interest of another corporation (more than 50 percent of the outstanding voting shares) must be accounted for using the acquisition method. The acquired company’s assets and liabilities are measured at their fair values on the date of the transaction. Any amount paid above the fair value of the assets less liabilities is reported as goodwill by the buyer.

# Key Ratio

**Economic Return from Investing** measures the performance of a company’s securities portfolios. Investment returns include both dividends received and any change in the fair value. A high or rising ratio suggests that a firm’s securities portfolio is improving. It is computed as follows

Economic Return from Investing = (Dividends and Interest Received + Change in Fair Value) ÷ Fair Value of Investments (beginning of period)

Change in Fair Value = Ending Balance of Investments – Beginning Balance of Investments

# Finding Financial Information

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| **Balance Sheet** ***Current Assets*** Investment in trading securities Investment in available-for-sale securities***Noncurrent Assets***  Investment in available-for-sale securities Investment in affiliates (or associated companies) Investments held to maturity***Stockholders’ Equity***Other comprehensive income: Net unrealized gains and losses (on  available-for-sale securities) |  | **Income Statement** ***Under “Other Items”***Dividend (and interest) revenueLoss or gain on sale of investmentsNet unrealized gains/losses (on trading securities)Equity in affiliate earnings/losses |
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| **Statement of Cash Flows** ***Operating Activities***Net income adjusted for: Gains/losses on sale of investments Equity in earnings/losses of affiliates Dividends received from affiliates Net unrealized gains/losses on trading securities***Investing Activities*** Purchase/sale of investments |  | **Notes*****In Various Notes***Accounting policies for investmentsDetails on securities held as trading and available-for-sale securities and investments in affiliates |

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| Chapter Outline | Teaching Notes |
| ***LO A-1 – Analyze and report investments in debt securities held to maturity.*** |
| I. Types of Investments and Accounting Methods  | *Illustrated in Exhibit A.1* |
| A. Passive Investments in Debt and Equity Securities |  |
| 1. Passive investments are made to earn a return on funds that may be needed for future  |  |
| 2. Category includes: |  |
| a. Investments in debt (bonds and notes); always considered passive investments |  |
| i. If the company intends to hold the securities until they reach maturity, the investments are measured and reported at amortized cost |  |
| ii. If they are to be sold before maturity, they are reported using the fair value method |  |
| b. Investments in equity securities (stock) |  |
| i. Presumed passive if the investing company owns less than 20% of the outstanding voting shares of the other company |  |
| ii. The fair value method is used to measure and report the investments |  |
| B. Investments in Stock for Significant Influence |  |
| 1. Significant influence is the ability to have an important impact on the operating, investing, and financing policies of another company |  |
| a. Presumed if the investing company owns from 20% to 50% of the outstanding voting shares of the other company |  |
| b. Other factors may also indicate that significant influence exists  |  |
| i. Membership on the board of directors of the other company |  |
| ii. Participation in the policy-making processes |  |
| iii. Evidence of material transactions between the two companies |  |
| iv. An interchange of management personnel |  |
| v. Technological dependency |  |
| 2. Equity method is used to measure and report investments in stock for significant influence |  |
| C. Investments in Stock for Control |  |
| 1. Control is the ability to determine the operating and financing policies of another company through ownership of voting stock |  |
| 2. Presumed when the investing company owns more than 50% of the outstanding voting stock of the other company |  |
| 3. Purchase accounting and consolidation are applied to combine the companies |  |

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| II. Debt Held to Maturity: Amortized Cost Method  |  |
| A. Terminology |  |
| 1. Held-to-maturity investments––investments in debt securities that management has the intent and ability to hold until maturity |  |
| 2. Amortized cost method––reports investments in debt securities held to maturity at cost minus any premium or plus any discount |  |
| B. Bond Purchases |  |
| 1. On the date of purchase, a bond may be acquired at the maturity amount (at par), for less than the maturity amount (at a discount), or for more than the maturity amount (at a premium) |  |
| 2. The total cost of the bond, including all incidental acquisition costs such as transfer fees and broker commissions, is debited to the Held-to-Maturity Investments account |  |
| 3. On July 1, 2016, Graham Holdings paid the par value of $100,000 for 8% bonds that mature on June 30, 2021; interest at 8% is paid each June 30 and December 31, and management plans to hold the bonds for five years, until maturity |  |
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| dr Held-to-Maturity Investments  (+A) | 100,000 |  |
|  cr Cash (–A) |  | 100,000 |

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|  Assets = Liabilities + Stockholders’ EquityHeld-to-Maturity Investments (A) +100,000 + Cash (A) –100,000 = No change |  |
| B. Interest Earned |  |
| 1. Since no premium or discount needs to be amortized, the book value remains constant over the life of the investment; revenue earned from the investment each period is measured as the amount of interest collected in cash or accrued at year-end | *Only purchases at par are covered here; purchases of bonds at amounts at other than par are covered in the chapter supplement* |
| 2. Interest is received on December 31 |  |
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| dr Cash (+A) ($100,000 x .08 x 6/12) | 4,000 |  |
|  cr Interest Revenue (+R, +SE) |  | 4,000 |

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|  Assets = Liabilities + Stockholders’ EquityCash (A) +4,000 = Interest Revenue (R) +4,000 |  |
| C. Principal at Maturity |  |
| 1. Principal payment is received when the bonds mature on June 30, 2021 |  |
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| dr Cash (+A) | 100,000 |  |
|  cr Held-to-Maturity Investments  (–A) |  | 100,000 |

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|  Assets = Liabilities + Stockholders’ EquityCash (A) +100,000 + Held-to-Maturity Investments (A) –100,000 = No change |  |

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| 2. If sold before maturity, any difference between market value (the proceeds from the sale) and net book value would be reported as a gain or loss on sale  |  |
| 3. If management intends to sell the bonds before the maturity date, they are treated in the same manner as investments in stock classified as available-for-sale securities (discussed in next section) |  |
| ***LO A-2 – Analyze and report passive investments in securities using the fair value method.*** |
| III. Passive Investments: The Fair Value Method |  |
| A. Reporting Method for Passive Investments |  |
| 1. Among all assets and liabilities, only passive investments in marketable securities (other than debt held to maturity) are required to be reported using the fair value method |  |
| 2. Fair value method––reports securities at their current market value (the amount that would be received in an orderly sale) |  |
| 3. Reasons that passive investments are reported at fair value: |  |
| a. Relevance – best estimate of cash that could be generated by the sale of these securities is their current fair value |  |
| b. Measurability – only items that can be measured in dollar terms with a high degree of reliability (an unbiased and verifiable measurement) are recorded |  |
| 4. Whenever the fair value of investments changes: |  |
| a. The investment account is adjusted |  |
| b. The other account affected is for unrealized holding gains (losses)  |  |
| i. Unrealized holding gains (losses)––amounts associated with price changes of securities that are currently held |  |
| ii. Unrealized because no actual sale has taken place; value has changed simply by holding the security |  |
| iii. Financial statement treatment depends on the classification of the passive investments |  |
| B. Classifying Passive Investments at Fair Value |  |
| 1. Depending on management's intent, passive investments at fair value may be classified as: |  |
| a. Trading securities––all investments in stocks or bonds held primarily for the purpose of active trading (buying and selling) in the near future; classified as short-term |  |
| b. Available-for-sale securities––all passive investments other than trading securities and debt held to maturity; classified as short-term or long-term |  |

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| C. Available-for-Sale Securities |  |
| 1. Purchase of Securities  |  |
| a. Recorded initially at cost |  |
| b. Graham Holdings had no passive investments at the end of 2014. At the beginning of 2015, Graham Holdings purchases for cash 15,000 shares of INews common stock for $10 per share; Graham Holdings owns 15% of INews, which is treated as a passive investment |  |
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| dr Investments in AFS Securities (+A) | 150,000 |  |
|  cr Cash (–A) |  | 150,000 |

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|  Assets = Liabilities + Stockholders’ EquityInvestments in AFS Securities (A) +150,000 + Cash (A) –150,000 = No change |  |
| 2. Dividends Earned |  |
| a. Dividends earned are reported as investment income on the income statement and are included in the computation of net income for the period |  |
| b. Graham Holdings received a $1 per share cash dividend from INews totaling $15,000 |  |
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| dr Cash (+A) | 15,000 |  |
|  cr Dividend Revenue (+R, +SE) |  | 15,000 |

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|  Assets = Liabilities + Stockholders’ EquityCash (A) +15,000 = Dividend Revenue (R) +15,000 |  |
| 3. Year-End Valuation |  |
| a. At end of accounting period, passive investments are reported on the balance sheet at fair value**,** the amount that would be received in an orderly sale |  |
| b. Reporting the AFS investment at fair value requires adjusting the Investments in AFS Securities up or down to fair value at the end of the period |
| c. The gain is credited or the loss is debited to the Net Unrealized Gains (Losses) account to complete the entry |  |
| i. For available-for-sale securities, the Net Unrealized Gains (Losses) account is reported in the stockholders’ equity section of the balance sheet under Other Comprehensive Income (denoted as OCI). |  |
| ii. Thus, the balance sheet remains in balance.  |  |
| iii. Only when the security is sold are any realized gains or losses included in net income. |  |

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| d. INews had an $8 per share fair value at the end of 2015; the investment had lost value ($10 − $8 = $2 per share) for the year  |  |
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| dr Net Unrealized Gains (Losses) (–OCI, –SE) (15,000 x $2) | 30,000 |  |
|  cr Investments in AFS Securities (–A) |  | 30,000 |

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|  Assets = Liabilities + Stockholders’ EquityInvestments in AFS Securities (A) –30,000 = Net Unrealized Gains (Losses) (OCI, SE) –30,000 |  |
| e. INews had an $11 per share fair value at the end of 2016; the investment had gained value ($11 − $8 = $2 per share) for the year  |  |
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| dr Investments in AFS Securities (+A) (15,000 x $3) | 45,000 |  |
|  cr Net Unrealized Gains (Losses) (+OCI, +SE)  |  | 45,000 |

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|  Assets = Liabilities + Stockholders’ EquityInvestments in AFS Securities (A) +45,000 = Net Unrealized Gains (Losses) (OCI, SE) +45,000 |  |
| f. On its 2016 balance sheet, Graham Holdings would report: |  |
| i. Under Assets: A investment in available-for-sale securities of $165,000  |  |
| ii. Under Other Comprehensive Income (in the stockholders’ equity section): The net unrealized gain on available-for-sale securities of $15,000 ($30,000 debit at end of 2015 offset by $45,000 credit at end of 2016 = account balance of $15,000) |  |
| 4. Sale of Securities |  |
| a. When available-for-sale securities are sold, Cash is increased and two accounts on the balance sheet are eliminated: Investments in AFS Securities (A) and Net Unrealized Gains (Losses) (OCI, SE) |  |
| b. Proceeds from sale − Investment cost = Gain if positive (Loss if negative) |  |

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| c. At the end of 2017, Graham Holdings sold all of its AFS investment in INews for $13 per share for $195,000 in cash ($13 × 15,000 shares) for stock it paid $150,000 for in 2012 ($10 × 15,000 shares) |  |
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| dr Cash (+A) | 195,000 |  |
| dr Net Unrealized Gains (Losses) (− OCI, − SE) | 15,000 |  |
|  cr Investments in AFS  Securities (−A) |  | 165,000 |
|  cr Gain on Sale of Investments (+Gain, +SE) |  | 45,000 |

 | *Use Supplemental Enrichment Activity #1*  |
|  Assets = Liabilities + Stockholders’ EquityCash (A) +195,000 + Investments in AFS Securities (A) −165,000 +Net Unrealized Gains (Losses) (OCI, SE) −15,000 = Gain on Sale of Investments (Gain, SE) +45,000 | *See Financial Analysis feature “Reporting the Fair Value of Investments”* |
| D. Comparing Trading and Available-for- Sale Securities | *Exhibit A.2 compares the accounting for trading securities and available-for-sale portfolios* |
| 1. Available-for-Sale Portfolio |
| a. Balance in net unrealized holding gains and losses is reported as a separate component of stockholders’ equity (under Accumulated Other Comprehensive Income) |
| i. Not reported on the income statement  |  |
| ii. Does not affect net income |  |
| b. At the time of sale: |  |
| i. Difference between the proceeds from the sale and the original cost of the investment is recorded as a gain or loss on sale of available-for-sale securities |  |
| ii. At the same time, the Investments in AFS Securities and Net Unrealized Gains (Losses) accounts are eliminated |  |
| 2. Trading Securities Portfolio |  |
| a. Amount of the adjustment to record net unrealized holding gains and losses is included on each period’s income statement |  |
| i. Net holding gains increase and net holding losses decrease net income |  |
| ii. This also means that the amount recorded as net unrealized gains and losses on trading securities is closed to Retained Earnings at the end of the period |  |
| b. At time of sale , only the Cash and Investments in TS account are affected |  |
| c. Only the difference between the cash from the sale and the book value (not cost) of the Investment in TS is recorded as a gain or loss on sale | *Use Supplemental Enrichment Activity #2* |
| 3. Over time, the total income reported is the same for both trading securities and available-for-sale securities; only the allocation across the three periods differs |  |

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| E. Financial Analysis: Reporting the Fair Value of Investments |  |
| 1. GAAP requires that companies disclose the measurements used to determine the fair values of assets  | *See Financial Analysis feature “Proposed Changes”* |
| 2. The fair value of an asset is the amount that would be received in an orderly sale | *to Measuring Certain Investments* |
| 3. To measure fair value, the standard recognizes three approaches in order of decreasing reliability: |  |
| a. Level 1: Quoted prices in active markets for identical assets |  |
| b. Level 2: Estimates based on other observable inputs (e.g., prices for similar assets) |  |
| c. Level 3: Estimates based on unobservable estimates (the company’s own estimates of factors that market participants would consider) |  |
| 4. Fair value should be determined using the most reliable method available (Level 1 if possible) |  |
| 5. Reporting company must disclose the amounts determined under each approach in a note to the financial statements | *Refer students to Pause for Feedback – Self-Study Quiz* |
| a. 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 |  |
| b. Thus far, application of this fair value option has been limited mostly to banks and other financial institutions |  |
| F. Key Ratio Analysis: Economic Return from Investing |  |
| 1. Economic Return from Investing = Dividends and Interest Received + Change in Fair Value ÷ Fair Value of Investments (beginning of period) |  |
| 2. Change in Fair Value = Beginning balance of Investments − Ending balance of Investments |  |
| 3. Ratio provides a percentage of what was earned plus any realized and/or unrealized gains or losses on the portfolio |  |
| ***LO A-3 – Analyze and report investments involving significant influence using the equity method.*** |
| IV. Investments for Significant Influence: Equity Method  |  |
| A. Recording Investments Under the Equity Method |  |
| 1. An investor may want to exert influence (presumed by owning 20% to 50% of the outstanding voting stock) without becoming the controlling shareholder (presumed when owning more than 50% of the voting stock) for the following reasons: |  |
| a. A retailer may want to influence a manufacturer to be sure that it can obtain certain products designed to its specifications |  |
| b. A manufacturer may want to influence a computer consulting firm to ensure that it can incorporate the consulting firm’s cutting-edge technology in its manufacturing processes |  |

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| c. A manufacturer may recognize that a parts supplier lacks experienced management and could prosper with additional managerial support |  |
| 2. Equity method––used when an investor can exert significant influence over an affiliate; the method permits recording the investor’s share of the affiliate’s income |  |
| 3. Investments in affiliates or associated companies––investments in stock held for the purpose of influencing the operating and financing strategies of the entity for the long term |  |
| 4. Under the equity method, the investor’s 20% to 50% ownership of a company presumes significant influence over the affiliate’s process of earning income |  |
| a. As a consequence, the investor reports its portion of the affiliate’s net income as its income and increases the investment account by the same amount |  |
| i. If affiliates report positive results of operations for the year, the investor then records investment income equal to its percentage share of the affiliates’ net income and increases its asset account Investments in Affiliates (or Associated Companies) |  |
| ii. If the affiliates report net losses, the investor records the opposite effect. |  |
| b. The receipt of dividends by the investor is treated as a reduction of the investment account (not revenue) |  |
| i. If affiliates declare and pay dividends during the year (a financing decision), the investor reduces its investment account and increases cash when it receives its share of the dividends |  |
| 5. Summary: |  |
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|  | Investments in Affiliates (A) |
|  | Beginning balance |  |
|  | Purchases | Sales |
|  | Company’s % share of affiliates’ net income (credit Equity in Affiliate Earnings [increase income]) | Company’s % share of affiliates’ net losses (debit Equity in Affiliate Losses [decrease income] |
|  |  | Company’s % share of affiliates’ dividends declared for the period (debit Cash) |
|  | Ending balance |  |
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| 6. Purchase of Stock |  |
| At the beginning of 2015, Graham Holdings had no long-term investments in companies over which it exerted significant influence. In 2015,, Graham Holdings purchased 40,000 shares of the outstanding voting common stock of INews for $400,000; Graham Holdings acquired 40% and was presumed to have significant influence  |  |
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| dr Investments in Affiliates (+A) | 400,000 |  |
|  cr Cash (–A) |  | 400,000 |

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|  Assets = Liabilities + Stockholders’ EquityInvestments in Affiliates (A) +400,000 + Cash (A)–400,000 = No change |  |
| 7. Earnings of Affiliates |  |
| During 2015, INews reported a net income of $500,000 for the year; Graham Holdings’s percentage share of INews’s income was $200,000 (40% × $500,000) |  |
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| dr Investments in Affiliates (+A) | 200,000 |  |
|  cr Equity in Affiliate Earnings  (+R, +SE) |  | 200,000 |

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|  Assets = Liabilities + Stockholders’ EquityInvestments in Affiliates (A) +200,000 = Equity in Affiliate Earnings (R) +200,000 |  |
| a. If the affiliates report a net loss for the period, the investor records its percentage share of the loss by decreasing the investment account and recording Equity in Affiliate Loss. |  |
| b. The Equity in Affiliate Earnings (or Loss) is reported in the Other Items section of the income statement, with interest revenue, dividend revenue, and interest expense |  |
| 8. Dividends Received |  |
| During 2015, INews declared and paid a cash dividend of $1 per share to stockholders; Graham Holdings received $40,000 ($1 × 40,000 shares) |  |
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| dr Cash (+A) | 40,000 |  |
|  cr Investments in Affiliates (–A) |  | 40,000 |

 | *Use Supplemental Enrichment Activity #3* |
|  Assets = Liabilities + Stockholders’ EquityCash (A) +40,000 + Investments in Affiliates (A) –40,000 = No change |  |

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| B. Reporting Investments Under the Equity Method |  |
| 1. The Investments in Affiliates account is reported on the balance sheet as a long-term asset |  |
| a. The investment account does not reflect either cost or fair value; instead, the following occurs: |  |
| i. The investment account is increased by the cost of shares that were purchased and the proportional share of the affiliates’ net income |  |
| ii. The account is reduced by the amount of dividends received from the affiliate companies and the proportional share of any affiliates’ net losses and the cost of shares that were sold |  |
| b. At the end of the accounting period, accountants do not adjust the investment account to reflect changes in the fair value of the securities that are held | *Refer students to Pause for Feedback – Self-Study Quiz* |
| c. When sold, the difference between the cash received and the book value of the investment is:  | *See A Question of Ethics feature “Transaction Structuring: Selecting Accounting Methods for Minority Investments”* |
| i. Recorded as a gain or loss on the sale of the investment  |
| ii. Reported on the income statement in the Other Items section |
| C. Focus on Cash Flows: Investments |  |
| 1. The cash resulting from the sale or purchase is reflected in the Investing Activities section |  |
| 2. In the Operating Activities section, there are a number of adjustments to net income: |  |
| a. Any gain (loss) on the sale is subtracted from (added to) net income |  |
| b. Any unrealized holding gain (loss) on trading securities is subtracted from (added to) net income |  |
| c. Equity in affiliate earnings (losses) is subtracted from (added to) net income because no cash was involved in the recording of the revenue under the equity method |  |
| d. Any dividends received from an affiliate are added to net income because, when cash was received, no revenue was recorded under the equity method. |  |
| ***LO A-4 – Analyze and report investments in controlling interests.*** |
| V. Controlling Interests: Mergers and Acquisitions |  |
| A. Reasons for Acquiring Control of Another Corporation |  |
| 1. Vertical integration: In this type of acquisition, a company acquires another at a different level in the channels of distribution |  |
| 2. Horizontal growth: These acquisitions involve companies at the same level in the channels of distribution |  |
| 3. Synergy: The operations of two companies together may be more profitable than the combined profitability of the companies as separate entities |  |

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| B. Recording a Merger |  |
| 1. Merger––occurs when one company purchases all of the assets and liabilities of another and the acquired company goes out of existence |  |
| 2. Acquisition method––records assets and liabilities acquired in a merger or acquisition at their fair value on the transaction date |  |
| a. Only method allowed by U.S. GAAP and IFRS for recording a merger or acquisition. |  |
| b. Requires that the assets and liabilities of the company acquired be recorded by the acquiring company on its books at their fair value on the date of the merger  |  |
| c. Acquiring company must go through a two-step process, often called the purchase price allocation, to determine how to record the acquisition: |  |
| i. Step 1: Estimate the fair value of the acquired company’s tangible assets, identifiable intangible assets, and liabilities  |  |
| ii. Step 2: Compute goodwill (cost in excess of net assets acquired) ––for accounting purposes, the excess of the purchase price of a business over the fair value of the acquired company’s assets and liabilities | *Illustrated in this section of the text* |
| d. Assume that INews owned two assets (equipment and a patent) and had one liability (a note payable). Graham Holdings followed the two steps and produced the following: |  |
| i. Step 1: The fair values were as follows: equipment $350,000; patents $600,000; and notes payable $100,000  |  |
| ii. Step 2: Purchase price for INews $1,000,000 – Fair value of assets of $950,000 (= $350,000 + $600,000) – Fair value of liabilities ($100,000) = Goodwill of $150,000 |  |
|

|  |  |  |
| --- | --- | --- |
| dr Equipment (+A) | 350,000 |  |
| dr Patents (+A) | 600,000 |  |
| dr Goodwill (+A) | 150,000 |  |
|  cr Notes Payable (+L) |  | 100,000 |
|  cr Cash (–A) |  | 1,000,000 |

 |  |
|  Assets = Liabilities + Stockholders’ EquityCash (A) –1,000,000 + Equipment (A) +350,000 + Patents (A) +600,000 + Goodwill (A) 150,000 = Notes Payable (L) +100,000 |  |
| e. In summary, when performing a purchase price allocation, it is important to remember two points: |  |
| i. The book values on the acquired company’s balance sheet are irrelevant unless they repre­sent fair value |  |
| ii. Goodwill is reported only if it is acquired in a merger or acquisition transaction |  |

|  |  |
| --- | --- |
| C. Reporting for the Combined Companies |  |
| 1. After the merger, the acquiring company will treat the acquired assets and liabilities in the same manner as if they were acquired individually |  |
| a. For example, the company will depreciate amounts added to equipment over its remaining useful life |  |
| b. Goodwill is considered to have an indefinite life  | *As discussed in Chapter 8* |
| i. As a consequence, it is not amortized, but, like all long-lived assets, goodwill is reviewed for possible impairment of value |  |
| ii. Recording an impairment loss would increase expenses for the period and reduce the amount of goodwill on the balance sheet |  |
| 2. When a company acquires another, and both companies continue their separate legal existence, consolidated financial statements must be presented |  |
| a. The parent company is the company that gains control over the other company |
| b. The subsidiary company is the company that the parent acquires |  |
| c. When the parent buys 100% of the subsidiary, the resulting consolidated financial statements look the same as they would if the companies were combined into one in a simple merger (as discussed above) | *Refer students to Pause for Feedback – Self-Study Quiz* |
| IV. Chapter Supplement A: Held-to-Maturity Bonds Purchased at Other than Par Value: Amortized Cost Method |
| A. Bond Purchases |  |
| 1. On the date of purchase, a bond may be acquired at the maturity amount (at par), for less than the maturity amount (at a discount), or for more than the maturity amount (at a premium) |  |
| 2. The total cost of the bond, including all incidental acquisition costs such as transfer fees and broker commissions, is debited to the Held-to-Maturity Investments account |  |
| 3. On July 1, 2016, Graham Holdings paid $92,277 cash for an 8%, 5-year $100,000 bond that paid interest semiannually (on 6/30 and 12/31); bond’s yield was 10%Present value of the bond investment = Present value of the face + Present value of the interest annuity$92,277 = ($100,000 x .6139) + ($4,000 x 7.7217)[n = 10 periods; interest rate = 5%] |  |
|

|  |  |  |
| --- | --- | --- |
| dr Held-to-Maturity Investments  (+A) | 92,277 |  |
| cr Cash (−A) |  | 92,277 |

 |  |
|  Assets = Liabilities + Stockholders’ EquityHeld-to-Maturity Investments (A) +92,277 + Cash (A) − 92,277 = No change |  |

|  |  |
| --- | --- |
| B. Interest Earned |  |
| 1. The discount that needs to be amortized over the life of the investment; using the effective interest amortization method: |  |
| a. Cash received is based on the face amount of the bond multiplied by the stated rate of interest for half of a year (4%) |  |
| b. Revenue earned is computed by multiplying the present value of the bond times the market rate for half of a year (5%) |  |
| 2. Receipt of interest on December 31, 2016 |  |
|

|  |  |  |
| --- | --- | --- |
| dr Cash (+A) | 4,000 |  |
| dr Held-to-Maturity Investments  (+A) | 614 |  |
|  cr Interest Revenue (+R, +SE) |  | 4,614 |

 |  |
|  Assets = Liabilities + Stockholders’ EquityCash (A) +4,000 + Held-to-Maturity Investments (A) +614 = Interest Revenue (R) +4,614 |  |
| 3. The amount reported on the balance sheet at December 31, 2016 is $92,891 ($92,277 + $614), which will be the present value of the bond used in determining interest revenue on the next payment date of June 30, 2017 |  |
| 4. If the bond investment must be sold before maturity, any difference between market value on the date of sale and net book value would be reported as a gain or loss on sale |  |

# Supplemental Enrichment Activities

Note: These activities would be suitable for individual or group activities.

1. Handout A-1

Use Handout A-1 for an in-class activity to review the accounting for available-for-sale securities. The solution follows the handout master.

1. Handout A-2

Use Handout A-2 for an in-class activity to review the accounting for trading securities. The solution follows the handout master.

1. Handout A-3

Use Handout A-3 for an in-class activity to review the equity method. The solution follows the handout master.

# HANDOUT A – 1

# BELLOWS CORP.

1. Bellows Corp. had $100,000 in its Cash account on January 1, Year 1. On June 15, Year 1, Bellows Corp. acquired 100 shares of Sonny, Inc. for $75 per share. Assume that Bellows considers the stock as an available-for-sale security. Prepare the journal entry required to record this transaction and, after entering the beginning Cash account balance, post it to the appropriate T-accounts:

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1. On September 15, Year 1, Bellows Corp. received dividends from Sonny of $2 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

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1. At December 31, Year 1, the value of the stock was $120 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

Computation of amount:

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# HANDOUT A – 1, continued

1. On February 17, Year 2, Bellows sold the stock for $115 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

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# HANDOUT A – 1 Solution

# BELLOWS CORP.

1. Bellows Corp. had $100,000 in its Cash account on January 1, Year 1. On June 15, Year 1, Bellows Corp. acquired 100 shares of Sonny, Inc. for $75 per share. Assuming that Bellows considers the stock as an available-for-sale security, prepare the journal entry required to record this transaction and post it to the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

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| --- | --- | --- | --- |
| June 15 | Investments in AFS Securities (+A) | 7,500 |  |
|  |  Cash (–A) |  | 7,500 |

 |
|  |  |
| + Investments in AFS Securities (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| June 15 | 7,500 |  |  |
|  |  |  |  |
|  | 7,500 |  |  |

 | + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 100,000 |  |  |
|  |  | 7,500 | June 15 |
|  | 92,500 |  |  |

 |

1. On September 15, Year 1, Bellows Corp. received dividends from Sonny of $2 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| --- | --- | --- | --- |
| Sept. 15 | Cash (+A) (100 shares x $2 per share) | 200 |  |
|  |  Dividend Revenue (+R, +SE) |  | 200 |

 |
|  |  |
| – Dividend Revenue (R, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | 200 | Sep. 15 |
|  |  |  |  |
|  |  | 200 |  |

 | + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 100,000 |  |  |
| Sept. 15 | 200 | 7,500 | June 15 |
|  | 92,700 |  |  |

 |

1. At December 31, Year 1, the value of the stock was $120 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year | Fair Value | - | Book Value before Adjustment | = | Amount for Adjusting Entry |
| 1 | $12,000 ($120 x 100) | - | 7,500 | = | 4,500 |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| --- | --- | --- | --- |
| Dec. 31 | Investments in AFS Securities (+A) | 4,500 |  |
|  |  Net Unrealized Gains (Losses) (+OCI, +SE) |  | 4,500 |

 |
|  |  |
| + Investments in AFS Securities (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Dec. 31 | 7,500 |  |  |
| Dec. 31 | 4,500 |  |  |
|  | 12,000 |  |  |

 | – Net Unrealized Gains (Losses) (OCI, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | 4,500 | Dec. 31 |
|  |  |  |  |
|  |  | 4.500 |  |

 |

# HANDOUT A – 1 Solution, continued

1. On February 17, Year 2, Bellows sold the stock for $115 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
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| --- | --- | --- | --- |
| Feb. 17 | Cash (+A) ($115 x 100) | 11,500 |  |
|  | Net Unrealized Gains (Losses) (–OCI, –SE) | 4,500 |  |
|  |  Investments in AFS Securities (–A) |  | 12,000 |
|  |  Gain on Sale of Investments (+Gain, +SE) |  | 4,000 |

 |
|  |  |
| + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 92,700 |  |  |
| Feb. 17  | 11,500 |  |  |
|  | 104,200 |  |  |

 | + Investments in AFS Securities (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| June 15 | 7,500 |  |  |
| Dec 31 | 4,500 | 12,000 | Feb. 17 |
|  | 0 |  |  |

 |
| – Net Unrealized Gains (Losses) (OCI, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | 4,500 | Dec. 31 |
| Feb. 17 | 4,500 |  |  |
|  |  | 0 |  |

 | – Gain on Sale of Investments (Gain, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | 4,000 | Feb. 17 |
|  |  |  |  |
|  |  | 4,000 |  |

 |

# HANDOUT A – 2

# BAWL CORP.

1. Bellows Corp. had $100,000 in its Cash account on January 1, Year 1. On June 15, Year 1, Bellows Corp. acquired 100 shares of Sonny, Inc. for $75 per share. Assuming that Bellows considers the stock as a trading security, prepare the journal entry required to record this transaction and post it to the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| June 15 |  |  |  |
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 |

1. On September 15, Year 1, Bawl Corp. received dividends from Darkness of $2 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| Sept. 15 |  |  |  |
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1. At December 31, Year 1, the value of the stock was $120 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

Computation of amount:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| Dec. 31 |  |  |  |
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# HANDOUT A – 2, continued

1. On February 17, Year 2, Bawl sold the stock for $115 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| Feb. 17 |  |  |  |
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# HANDOUT A – 2 Solution

# BAWL CORP.

1. Bellows Corp. had $100,000 in its Cash account on January 1, Year 1. On June 15, Year 1, Bellows Corp. acquired 100 shares of Sonny, Inc. for $75 per share. Assuming that Bellows considers the stock as a trading security, prepare the journal entry required to record this transaction and post it to the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| June 15 | Investments in TS (+A) | 7,500 |  |
|  |  Cash (–A) |  | 7,500 |

 |
|  |  |
| + Investments in TS (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| June 15 | 7,500 |  |  |
|  |  |  |  |
|  | 7,500 |  |  |

 | + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 100,000 |  |  |
|  |  | 7,500 | June 15 |
|  | 92,500 |  |  |

 |

1. On September 15, Bawl Corp. received dividends from Darkness of $2 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| Sept. 15 | Cash (+A) (100 shares x $2) | 200 |  |
|  |  Dividend Revenue (+R, +SE) |  | 200 |

 |
|  |  |
| + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 100,000 |  |  |
| Sept. 15 | 200 | 7,500 | June 15 |
|  | 92,700 |  |  |

 | – Dividend Revenue (R, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | 200 | Sep. 15 |
|  |  |  |  |
|  |  | 200 |  |

 |

1. At December 31, Year 1, the value of the stock was $120 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year | Fair Value | - | Book Value before Adjustment | = | Amount for Adjusting Entry |
| 1 | $12,000 ($120 x 100) | - | 7,500 | = | 4,500 |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| Dec. 31 | Investments in TS (+A) | 4,500 |  |
|  |  Net Unrealized Gains (Losses) (+Gain, +SE) |  | 4,500 |

 |
|  |  |
| + Investments in TS (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| June 15 | 7,500 |  |  |
| Dec. 31 | 4,500 |  |  |
|  | 12,000 |  |  |

 | – Net Unrealized Gains (Losses) (Gain, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | 4,500 | Dec. 31 |
|  |  |  |  |
|  |  | 4,500 |  |

 |

# HANDOUT A – 2 Solution, continued

1. On February 17, Year 2, Bawl sold the stock for $115 per share. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| Feb. 17 | Cash (+A) (100 shares x $115) | 11,500 |  |
|  | Loss on Sale of Investments (+Loss, –SE)($11,500 – $12,000) | 500 |  |
|  |  Investments in TS (–A) |  | 12,000 |

 |
|  |  |
| + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 92,700 |  |  |
| Feb. 17  | 11,500 |  |  |
|  | 104,200 |  |  |

 | + Investments in TS (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| June 15 | 7,500 |  |  |
| Dec. 31 | 4,500 | 12,000 | Feb. 17 |
|  | 0 |  |  |

 |
| + Loss on Sale of Investments (+Loss, –SE)

|  |  |  |  |
| --- | --- | --- | --- |
| Feb. 17 | 500 |  |  |
|  |  |  |  |
|  | 500 |  |  |

 |  |

# HANDOUT A – 3

#  PARADE CORP.

1. Parade Corp. had $10,000,000 in its Cash account on January 1, Year 1. On January 2, Year 1, Parade Corp. paid $5,000,000 cash to acquire 400,000 shares of stock in Band Corp. These shares represent 40% of Band Corp.’s total outstanding stock. Parade accounted for this acquisition using the equity method. Prepare the journal entry required to record this transaction and, after entering the beginning Cash account balance, post it to the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| Jan. 2 |  |  |  |
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1. For the year ended December 31, Year 1, Band Corp. earned $800,000 in net income. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

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| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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| --- | --- | --- | --- |
| Dec. 31 |  |  |  |
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 |

1. On December 31, Year 1, Band Corp. declared and paid $500,000 in dividends. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
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|  |  |  |  |
| --- | --- | --- | --- |
| Dec. 31 |  |  |  |
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 |

# HANDOUT A – 3 Solution

# PARADE CORP.

1. Parade Corp. had $10,000,000 in its Cash account on January 1, Year 1. On January 2, Year 1, Parade Corp. paid $5,000,000 cash to acquire 400,000 shares of stock in Band Corp. These shares represent 40% of Band Corp.’s total outstanding stock. Parade accounted for this acquisition using the equity method. Prepare the journal entry required to record this transaction and, after entering the beginning Cash account balance, post it to the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 2 | Investments in Affiliates (+A) | 5,000,000 |  |
|  |  Cash (-A) |  | 5,000,000 |

 |
|  |  |
| + Investments in Affiliates (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 0 |  |  |
| Jan. 2 | 5,000,000 |  |  |
|  | 5,000,000 |  |  |

 | + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 10,000,000 |  |  |
|  |  | 5,000,000 | Jan. 2 |
|  | 5,000,000 |  |  |

 |

1. For the year ended December 31, Year 1, Band Corp. earned $800,000 in net income. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| Dec. 31 | Investments in Affiliates (+A) | 320,000 |  |
|  |  Equity in Affiliate Earnings (+R, +SE) |  | 320,000 |

 |
| $800,000 x 40% = $320,000 |  |
| + Investments in Affiliates (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 0 |  |  |
| Jan. 2 | 5,000,000 |  |  |
| Dec. 31 | 320,000 |  |  |
|  | 5,320,000 |  |  |

 | – Equity in Affiliate Earnings (R, SE) +

|  |  |  |  |
| --- | --- | --- | --- |
|  |  |  |  |
|  |  | 320,000 | Dec. 31 |
|  |  | 320,000 |  |

 |

1. On December 31, Year 1, Band Corp. declared and paid $500,000 in dividends. Prepare the journal entry required to record this transaction and update the appropriate T-accounts:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
| Dec. 31 | Cash (+A) | 200,000 |  |
|  |  Investments in Affiliates (-A) |  | 200,000 |

 |
| $500,000 x 40% = $200,000 |  |
| + Investments in Affiliates (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 0 |  |  |
| Jan. 2 | 5,000,000 |  |  |
| Dec. 31 | 320,000 | 200,000 | Dec. 31 |
| End Bal | 5,120,000 |  |  |

 | + Cash (A) –

|  |  |  |  |
| --- | --- | --- | --- |
| Jan. 1 | 10,000,000 |  |  |
| Dec. 31 | 200,000 | 5,000,000 | Jan. 2 |
| End Bal | 5,200,000 |  |  |

 |