CHAPTER 17

Investments

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Debt investments.	1, 2, 3, 13		1		4, 7
(a) Held-for-collection.	4, 5, 6, 8, 11, 13	1, 3, 10	2, 3, 4	1, 2, 7	1, 4
(b) Trading.	2, 4, 7, 8, 9, 22	2, 4	5	1, 3, 4, 7	1, 4
2. Bond amortization.	6, 7	1, 2, 3	3, 4, 5	1, 2	
3. Equity investments.	1, 12, 17		1		4, 7
(a) Non-trading.	16, 22	7, 8	8, 10, 11	5, 6, 8, 9, 10, 12	3
(b) Trading.	8, 9, 14, 15, 16, 22	6	8, 9, 11, 12, 13, 15, 16, 17	3, 5, 6, 8, 9, 10, 11	1, 2, 3
(c) Equity method.	17, 18, 19, 20, 21	9	13, 14, 17, 18	8	5, 6
4. Disclosures of investments.	22		10, 11	5, 8, 9, 10, 11, 12	
5. Fair value option.	10, 11, 25	5	6, 7	2, 7	
6. Impairments.	23, 27	10	19, 20		1, 3
7. Transfers between categories.	24	11			1, 3, 7
8. Comprehensive income.	29	12	21	12	
*9. Derivatives.	30, 31, 32, 33, 34, 35, 36, 37		22, 23, 24, 25, 26, 27	13, 14, 15, 16, 17, 18	

*This material is dealt with in an Appendix to the chapter.

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives		Brief Exercises	Exercises	Problems
1.	Describe the accounting framework for financial assets.		1	
2.	Understand the accounting for debt investments at amortized cost.	1, 2, 3	2, 3, 4	1, 2, 7
3.	Understand the accounting for debt investments at fair value.	2, 4	1, 5,	1, 3, 4, 7
4.	Describe the accounting for the fair value option.	5	6, 7	2, 7, 10,
5.	Understand the accounting for equity investments at fair value.	6, 7, 8, 12	8, 9, 10, 11, 12, 13, 15, 16, 17,	3, 5, 8, 9, 10, 11, 12
6.	Explain the equity method of accounting and compare it to the fair value method for equity securities.	9	13, 14, 17, 18	6, 8
7.	Discuss the accounting for impairments of debt investments.	10	19, 20	
8.	Describe the accounting for transfer of investments between categories.	11		
*9.	Explain why companies report reclassification adjustments.		21	12
*10.	Explain who uses derivatives and why.			
*11.	Understand the basic guidelines for accounting for derivatives.			
*12.	Describe the accounting for derivative financial instruments.		22, 26	13, 14, 15
*13.	Explain how to account for a fair value hedge.		23, 25	16, 18
*14.	Explain how to account for a cash flow hedge.		24, 27	17

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E17-1	Investment classifications.	Simple	5–10
E17-2	Debt investments.	Simple	10–15
E17-3	Debt investments.	Simple	15–20
E17-4	Debt investments.	Simple	10–15
E17-5	Debt investments.	Simple	10–15
E17-6	Fair value option.	Simple	5–10
E17-7	Fair value option.	Moderate	15–20
E17-8	Entries for equity investments.	Simple	10–15
E17-9	Equity investments.	Simple	10–15
E17-10	Equity investment entries and reporting.	Simple	5–10
E17-11	Equity investment entries and financial statement presentation.	Simple	10–15
E17-12	Equity investment entries.	Simple	20–25
E17-13	Journal entries for fair value and equity methods.	Simple	15–20
E17-14	Equity method.	Moderate	10–15
E17-15	Equity investments—trading.	Moderate	10–15
E17-16	Equity investments—trading.	Moderate	15–20
E17-17	Fair value and equity method compared.	Simple	15–20
E17-18	Equity method.	Simple	10–15
E17-19	Impairment.	Moderate	15–20
E17-20	Impairment.	Moderate	10–15
E17-21	Comprehensive income disclosure.	Moderate	20–25
*E17-22	Derivative transaction.	Moderate	15–20
*E17-23	Fair value hedge.	Moderate	20–25
*E17-24	Cash flow hedge.	Moderate	20–25
*E17-25	Fair value hedge.	Moderate	15–20
*E17-26	Call option.	Moderate	20–25
*E17-27	Cash flow hedge.	Moderate	25–30
P17-1	Debt investments.	Moderate	20–30
P17-2	Debt investments, fair value option.	Moderate	30–40
P17-3	Debt and equity investments.	Moderate	25–30
P17-4	Debt investments.	Moderate	25–35
P17-5	Equity investment entries and disclosures.	Moderate	25–35
P17-6	Equity investments.	Simple	25–35
P17-7	Debt investment entries.	Moderate	25–35
P17-8	Fair value and equity methods.	Moderate	20–30
P17-9	Financial statement presentation of equity investments.	Moderate	20–30

ASSIGNMENT CHARACTERISTICS TABLE (Continued)

Item	Description	Level of Difficulty	Time (minutes)
P17-10	Equity investments.	Complex	30–40
P17-11	Investments—statement presentation.	Moderate	20–30
P17-12	Gain on sale of investments and comprehensive income.	Moderate	20–30
*P17-13	Derivative financial instrument.	Moderate	20–25
*P17-14	Derivative financial instrument.	Moderate	20–25
*P17-15	Free-standing derivative.	Moderate	20–25
*P17-16	Fair value hedge interest rate swap.	Moderate	30–40
*P17-17	Cash flow hedge.	Moderate	25–35
*P17-18	Fair value hedge.	Moderate	25–35
CA17-1	Issues raised about investments.	Moderate	25–30
CA17-2	Equity investments.	Moderate	25–30
CA17-3	Financial statement effect of investments.	Simple	20–30
CA17-4	Equity investments.	Moderate	20–25
CA17-5	Investment accounted for under the equity method.	Simple	15–25
CA17-6	Equity investments.	Moderate	25–35
CA17-7	Fair value—ethics.	Moderate	25–35

ANSWERS TO QUESTIONS

1. The two criteria for determining the valuation of financial assets are the (1) company's business model for managing their financial assets and (2) contractual cash flow characteristics of the financial asset.

2. Only debt investments such as loans and bond investments are valued at amortized cost. A company should use amortized cost if it has a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset gives specified dates to cash flows.

3. Amortized cost is the initial recognition amount of the investment minus repayments, plus or minus cumulative amortization and net of any reduction for uncollectibility.

Fair value is the amount for which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction.

4. Lady Gaga should classify this investment as a trading investment because companies frequently buy and sell this type of investment to generate profits in short term differences in price.

5. If Lady Gaga plans to hold the investment to collect interest and receive the principal at maturity, it should account for this investment at amortized cost.

6. \$3,500,000 X 10% = \$350,000; \$350,000 ÷ 2 = \$175,000. Wheeler would make the following entry:

Cash (\$4,000,000 X 8% X $^{1}/_{2}$)	160,000	
Debt Investments	15,000	
Interest Revenue (\$3,500,000 X 10% X $^{1}/_{2}$)		175,000

7.

Securities Fair Value Adjustment	89,000	
Unrealized Holding Gain or Loss—Income [\$3,604,000 – (\$3,500,000 + \$15,000)*]		89,000

*See number 6.

8. Unrealized holding gains and losses for trading investments should be included in net income for the current period. Unrealized holding gains and losses are not recognized for held-for-collection investments.

9. (a)

Unrealized Holding Gain or Loss—Income	60,000	
Securities Fair Value Adjustment		60,000

(b)

Unrealized Holding Gain or Loss—Income	70,000	
Securities Fair Value Adjustment		70,000

10. The fair value option allows companies the choice of reporting debt investments at fair value. If this option is chosen, the company records in net income unrealized gains and losses with corresponding increases/decreases to the debt investment. The unrealized gain (loss) is the difference between the investment's amortized cost and its fair value.

11. No, Franklin cannot use the fair value option for this investment. This option is generally available only at the time a company first purchases the investment.

12. Investments in equity securities can be classified as follows:
(a) Holdings of less than 20% (fair value method)—investor has passive interest.
(b) Holdings between 20% and 50% (equity method)—investor has significant influence.
(c) Holdings of more than 50% (consolidated statements)—investor has controlling interest.

Holdings of less than 20% are then classified into trading and non-trading, assuming determinable fair values.

13. Investments in shares do not have a maturity date and therefore cannot be classified as held-for-collection.

14.

Equity Investments	260,000	
Brokerage Expense	1,500	
Cash [(10,000 X $26) + $1,500]		261,500

15.

Gross selling price of 10,000 shares at $27.50		$275,000
Less: Brokerage commissions		(1,770)
Proceeds from sale		273,230
Cost of 10,000 shares		(260,000)
Gain on sale of shares		$ 13,230

Cash	273,230	
Equity Investments		260,000
Gain on Sale of Equity Investment		13,230

16. Both trading and non-trading equity investments are reported at fair value. However, any unrealized holding gain or loss is reported in net income for trading investments but as other comprehensive income and as a separate component of equity for non-trading investments.

17. Significant influence over an investee may result from representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. An investment (direct or indirect) of 20% or more of the voting shares of an investee constitutes significant influence unless there exists evidence to the contrary.

18. Under the equity method, the investment is originally recorded at cost, but is adjusted for changes in the investee's net assets. The investment account is increased (decreased) by the investor's proportionate share of the earnings (losses) of the investee and decreased by all dividends received by the investor from the investee.

19. The following information is reported under the equity method:

1. Investments originally recorded at cost with adjustment for the investor's share of the investee's income or loss, and decreased by dividends received from the investee (reported under investments.)

2. Investment revenue is recognized equal to the investor's ownership percentage times the investee's income or loss reported subsequent to the date of acquisition (reported under other income and expense).

20. Dividends subsequent to acquisition should be accounted for as a reduction in the equity investment account.

21. Ordinarily, Raleigh Corp. should discontinue applying the equity method and not provide for additional losses beyond the carrying value of £170,000. However, if Raleigh Corp.'s loss is not limited to its investment (due to a guarantee of Borg's obligations or other commitment to provide further financial support or if imminent return to profitable operations by Borg appears to be assured), it is appropriate for Raleigh Corp. to provide for its entire £186,000 share of the £620,000 loss.

22. Trading equity investments are reported as a current asset while non-trading investments are reported as a long-term investment. Trading investments are expected to be disposed of within the coming year and therefore qualify as current assets. This is not the case for non-trading investments which are presented under investments.

23. A debt investment is impaired when "it is probable that the investor will be unable to collect all amounts due according to the contractual terms." When an impairment has occurred, the investment is written down to its fair value, which is also the security's new cost basis. The amount of the writedown is accounted for as a realized loss.

24. When an investment is transferred from one category to another, the transfer should be recorded at fair value, which in this case becomes the new basis for the security.

25. Major unresolved issues related to fair value accounting include measurement based on business model, gains trading, and liabilities not fairly valued.

26. **Similarities include:** (1) The accounting for trading investments is the same between U.S. GAAP and IFRS. Held-to-maturity (U.S. GAAP) and held-for-collection investments are accounted for at amortized cost. Gains and losses related to available-for-sale securities (U.S. GAAP) and non-trading equity investments (IFRS) are reported in other comprehensive income; (2) U.S. GAAP and IFRS are similar in the accounting for the fair value option. That is, the selection to use the fair value method must be made at initial recognition, the selection is irrevocable, and gains and losses related to fair value changes are reported as part of income; (3) Measurement of impairments is similar under U.S. GAAP and IFRS; (4) Both U.S. GAAP and IFRS use the same tests to determine whether the equity method of accounting should be used—that is, significant influence with a general guide of over 20 percent ownership.

Differences include: (1) U.S. GAAP and IFRS have different classifications for investments. U.S. GAAP classifies investments as trading, available-for-sale (both debt and equity investments), and held-to-maturity (only for debt investments). IFRS uses held-for-collection (debt investments), trading (both debt and equity investments), and non-trading equity investments classifications. U.S. GAAP classifications are based on management's intent with respect to the investment. IFRS classifications are based on the business model used to manage the investments and the type of security; (2) Reclassifications in and out of trading securities are allowed under U.S. GAAP if management changes its intent, but this type of reclassification should be rare. Reclassifications of held-to-maturity investments are tightly constrained under U.S. GAAP. IFRS allows reclassifications if the business model for managing the investments changes. Similar to U.S. GAAP, such changes in business model should be rare; (3) The basis for consolidation under IFRS is control. Under U.S. GAAP, a bipolar approach is used, which is a risk-and-reward model (often referred to as a variable-entity approach) and a voting-interest approach. However, under both systems, for consolidation to occur, the investor company must generally own 50 percent of another company (4) U.S. GAAP allows the fair value option for equity method investments; IFRS does not; and (5) U.S. GAAP does not permit the reversal of an important charge related to available-for-sale debt and equity investments. IFRS allows reversals of impairments of held-for-collection investments.

27. (a) Under U.S. GAAP, Ramirez makes no entry, because impaired investments may not be written up if they recover in value. Under IFRS, Ramirez makes the following entry:

(b) Debt Investments	300,000	
Recovery of Loss on Investment		300,000

28. IFRS 9, introduced new investment classifications and increased the situations when investments are accounted for at fair value with gains and losses recorded in income. The IASB's decision to issue new rules on investments before the FASB has completed its deliberations on financial instrument accounting could affect convergence with U.S. GAAP.

*__29.__ Reclassification adjustments are necessary to insure that double counting does not result when realized gains or losses are reported as part of net income but also are shown as part of other comprehensive income in the current period or in previous periods.

*__30.__ An underlying is a special interest rate, security price, commodity price, index of prices or rates, or other market-related variable. Changes in the underlying determine changes in the value of the derivative. Payment is determined by the interaction of the underlying with the face amount and the number of shares, or other units specified in the derivative contract (these elements are referred to as notional amounts).

*__31.__ See illustration below:

Feature	**Traditional Financial Instrument (e.g., Trading Security)**	**Derivative Financial Instrument (e.g., Call Option)**
Payment Provision	Share price times the number of shares.	Change in share price (underlying) times number of shares (notional amount).
Initial Investment	Investor pays full cost.	Initial investment is less than full cost.
Settlement	Deliver shares to receive cash.	Receive cash equivalent, based on changes in share price times the number of shares.

For a traditional financial instrument, an investor generally must pay the full cost, while derivatives require little initial investment. In addition, the holder of a traditional security is exposed to all risks of ownership, while most derivatives are not exposed to all risks associated with ownership in the underlying. For example, the intrinsic value of a call option only can increase in value. Finally, unlike a traditional financial instrument, the holder of a derivative could realize a profit without ever having to take possession of the underlying. This feature is referred to as net settlement and serves to reduce the transaction costs associated with derivatives.

*__32.__ The purpose of a fair value hedge is to offset the exposure to changes in the fair value of a recognized asset or liability or of an unrecognized firm commitment.

*__33.__ The unrealized holding gain or loss on non-trading equity investments should be reported as income when this security is designated as a hedged item in a qualifying fair value hedge. If the hedge meets the special hedge accounting criteria (designation, documentation, and effectiveness), the unrealized holding gain or losses is reported as income.

*__34.__ This is likely a setting where the company is hedging the fair value of a fixed-rate debt obligation. The fixed payments received on the swap will offset fixed payments on the debt obligation. As a result, if interest rates decline, the value of the swap contract increases (a gain), while at the same time the fixed-rate debt obligation increases (a loss). The swap is an effective risk management tool in this setting because its value is related to the same underlying (interest rates) that will affect the value of the fixed-rate bond payable. Thus, if the value of the swap goes up, it offsets the loss in the value of the debt obligation.

*__35.__ A cash flow hedge is used to hedge exposures to cash flow risk, which is exposure to the variability in cash flows. The cash flows received on the hedging instrument (derivative) will offset the cash flows received on the hedged item. Generally, the hedged item is a transaction that is planned some time in the future (an anticipated transaction).

*__36.__ Derivatives used in cash flow hedges are accounted for at fair value on the statement of financial position but gains or losses are recorded in equity as part of other comprehensive income.

*__37.__ A hybrid security is a security that has characteristics of both debt and equity and often is a combination of traditional and derivative financial instruments. A convertible bond is a hybrid security because it is comprised of a debt security, referred to as the host security, combined with an option to convert the bond to ordinary shares, the embedded derivative.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 17-1

(a)	Debt Investments	74,086	
	Cash		74,086
(b)	Cash (€80,000 X .09)	7,200	
	Debt Investments	949	
	Interest Revenue (€74,086 X .11)		8,149

BRIEF EXERCISE 17-2

(a)	Debt Investments	74,086	
	Cash		74,086
(b)	Cash (€80,000 X .09)	7,200	
	Debt Investments	949	
	Interest Revenue (€74,086 X .11)		8,149
(c)	Securities Fair Value Adjustment	465	
	Unrealized Holding Gain or Loss—Income [(€74,086 + €949) – €75,500]		465

BRIEF EXERCISE 17-3

(a)	Debt Investments	65,118	
	Cash		65,118
(b)	Cash (€60,000 X .08 x $^6/_{12}$)	2,400	
	Debt Investments		446
	Interest Revenue (€65,118 X .06 x $^6/_{12}$)		1,954

BRIEF EXERCISE 17-4

(a)	Debt Investments	50,000	
	Cash		50,000
(b)	Cash	2,000	
	Interest Revenue		2,000
(c)	Unrealized Holding Gain or Loss—Income	2,600	
	Securities Fair Value Adjustment ($50,000 – $47,400)		2,600

BRIEF EXERCISE 17-5

Unrealized Holding Gain or Loss—Income	672	
Debt Investments [(€65,118 – €446) – €64,000]		672

BRIEF EXERCISE 17-6

(a)	Equity Investments	13,200	
	Cash		13,200
(b)	Cash	1,300	
	Dividend Revenue (400 X £3.25)		1,300
(c)	Securities Fair Value Adjustment	600	
	Unrealized Holding Gain or Loss—Income [(400 X £34.50) – £13,200]		600

BRIEF EXERCISE 17-7

(a)	Equity Investments	13,200	
	Cash		13,200
(b)	Cash	1,300	
	Dividend Revenue (400 X £3.25)		1,300
(c)	Securities Fair Value Adjustment	600	
	Unrealized Holding Gain or Loss—Equity [(400 X £34.50) – £13,200]		600

BRIEF EXERCISE 17-8

Securities Fair Value Adjustment

Bal.	200	
	500	
Bal.	700	

Securities Fair Value Adjustment	500	
Unrealized Holding Gain or Loss—Equity		500

BRIEF EXERCISE 17-9

Equity Investments	300,000	
Cash		300,000
Equity Investments	54,000	
Revenue from Investment (30% X $180,000)		54,000
Cash	18,000	
Equity Investments (30% X $60,000)		18,000

BRIEF EXERCISE 17-10

Loss on Impairment	10,000	
Debt Investments		10,000

In this case, an impairment has occurred and the individual security should be written down.

BRIEF EXERCISE 17-11

Debt Investments	10,325	
Securities Fair Value Adjustment		10,325

BRIEF EXERCISE 17-12

(a) Other comprehensive income (loss) for 2011: (€20.380 million)

(b) Comprehensive income for 2011: €652.258 million or (€672.638 – €20.380)

(c) Accumulated other comprehensive income: €16.893 million or (€37.273 – €20.380)

SOLUTIONS TO EXERCISES

EXERCISE 17-1 (5–10 minutes)

(a) 2. (b) 4. (c) 2. (d) 1. (e) 1. (f) 4.

EXERCISE 17-2 (10–15 minutes)

(a) January 1, 2010

Debt Investments	300,000	
Cash		300,000

(b) December 31, 2010

Cash	30,000	
Interest Revenue		30,000

(c) December 31, 2011

Cash	30,000	
Interest Revenue		30,000

EXERCISE 17-3 (15–20 minutes)

(a) January 1, 2010

Debt Investments	537,907.40	
Cash		537,907.40

(b) Schedule of Interest Revenue and Bond Premium Amortization
12% Bonds Sold to Yield 10%

Date	Cash Received	Interest Revenue	Premium Amortized	Carrying Amount of Bonds
1/1/10	—	—	—	$537,907.40
12/31/10	$60,000	$53,790.74	$6,209.26	531,698.14
12/31/11	60,000	53,169.81	6,830.19	524,867.95
12/31/12	60,000	52,486.80	7,513.20	517,354.75
12/31/13	60,000	51,735.48	8,264.52	509,090.23
12/31/14	60,000	50,909.77*	9,090.23	500,000.00

*Rounded by 75¢.

EXERCISE 17-3 (Continued)

(c) December 31, 2010

Cash	60,000.00	
Debt Investments		6,209.26
Interest Revenue		53,790.74

(d) December 31, 2011

Cash	60,000.00	
Debt Investments		6,830.19
Interest Revenue		53,169.81

EXERCISE 17-4 (10–15 minutes)

(a) Schedule of Interest Revenue and Bond Discount Amortization
9% Bond Purchased to Yield 12%

Date	Cash Received	Interest Revenue	Bond Discount Amortization	Carrying Amount of Bonds
1/1/10	—	—	—	$278,384.00
12/31/10	$27,000	$33,406.08*	$6,406.08	284,790.08
12/31/11	27,000	34,174.81	7,174.81	291,964.89
12/31/12	27,000	35,035.11**	8,035.11	300,000.00

*$278,384 X .12 = $33,406.08
**Rounded by $.68.

(b) December 31, 2011

Cash	27,000.00	
Debt Investments	7,174.81	
Interest Revenue		34,174.81

EXERCISE 17-5 (10–15 minutes)

(a) January 1, 2010

Debt Investments	537,907.40	
Cash		537,907.40

EXERCISE 17-5 (Continued)

(b) December 31, 2010

Cash	60,000.00	
Debt Investments		6,209.26
Interest Revenue ($537,907.40 X .10)		53,790.74
Securities Fair Value Adjustment	2,501.86	
Unrealized Holding Gain or Loss—Income ($534,200.00 – $531,698.14)		2,501.86

(c) December 31, 2011

Unrealized Holding Gain or Loss—Income	12,369.81	
Securities Fair Value Adjustment		12,369.81

	Amortized Cost	Fair Value	Unrealized Holding Gain (Loss)
Debt investments	$524,867.95	$515,000.00	$ (9,867.95)
Previous securities fair value adjustment—Dr.			2,501.86
Securities fair value adjustment—Cr.			$(12,369.81)

EXERCISE 17-6 (5–10 minutes)

(a) December 31, 2010

Debt Investments	8,301.86	
Unrealized Holding Gain or Loss—Income ($540,000 – $531,698.14)		8,301.86

EXERCISE 17-6 (Continued)

(b) December 31, 2011

Unrealized Holding Gain or Loss-Income	8,169.81	
Debt Investments ($533,169.81 – $525,000)		8,169.81

Carrying Value at 12/31/10	$540,000.00	
Amortization	(6,830.19)	(See Exercise 17-3)
Carrying Value at 12/31/11	$533,169.81	

EXERCISE 17-7 (15-20 minutes)

(a)

Net income before gains and losses	$100,000
Investments Debt ($41,000 – $40,000)	1,000
Bonds payable ($220,000 – $195,000)	25,000
Net income	$126,000

(b)

Bonds Payable	25,000	
Unrealized Holding Gain or Loss-Income ($220,000 – $195,000)		25,000

EXERCISE 17-8 (10–15 minutes)

(a)

Securities Fair Value Adjustment	3,000	
Unrealized Holding Gain or Loss—Income		3,000

(b)

Securities Fair Value Adjustment	3,000	
Unrealized Holding Gain or Loss—Equity.........		3,000

(c) The Unrealized Holding Gain or Loss—Income account is reported in the income statement under Other income and expense. The Unrealized Holding Gain or Loss—Equity account is reported as a part of other comprehensive income and as a component of equity until realized. The Securities Fair Value Adjustment account is added to the cost of the Equity Investments account to arrive at fair value.

EXERCISE 17-9 (10–15 minutes)

(a) December 31, 2010

Unrealized Holding Gain or Loss—Income	1,400	
Securities Fair Value Adjustment		1,400

(b) During 2011

Cash	9,500	
Loss on Sale of Equity Investment	500	
Equity Investments		10,000

(c) December 31, 2011

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Stargate Corp. shares	€20,000	€19,300	€ (700)
Vectorman Co. shares	20,000	20,500	500
Total of portfolio	€40,000	€39,800	(200)
Previous securities fair value adjustment balance—Cr.			(1,400)
Securities fair value adjustment—Dr.			€1,200

Securities Fair Value Adjustment	1,200	
Unrealized Holding Gain or Loss—Income		1,200

EXERCISE 17-10 (5–10 minutes)

The unrealized gains and losses resulting from changes in the fair value of equity investments [classified as non-trading] are recorded in an unrealized holding gain or loss account that is reported as other comprehensive income and as a separate component of equity until realized. Therefore, the following adjusting entry should be made at the year-end:

Unrealized Holding Gain or Loss—Equity	6,000	
Securities Fair Value Adjustment		6,000

Unrealized Holding Gain or Loss—Equity is reported as other comprehensive income and as a separate component in equity and not included in net income. The Securities Fair Value Adjustment account is a valuation account to the related investment account.

EXERCISE 17-11 (10–15 minutes)

(a) The portfolio should be reported at the fair value of $54,500. Since the cost of the portfolio is $53,000, the unrealized holding gain is $1,500, of which $200 is already recognized. Therefore, the December 31, 2010 adjusting entry should be:

Securities Fair Value Adjustment	1,300	
Unrealized Holding Gain or Loss—Income		1,300

(b) The unrealized holding gain of $1,300 should be reported as other income and expense on the income statement and the Securities Fair Value Adjustment account balance of $1,500 should be added to the cost of the investment account.

WENGER, INC.
Statement of Financial Position
As of December 31, 2010

Current assets:	
Equity investment..	$54,500

(c) Computation of realized gain or loss on sale of investment:

Net proceeds from sale of investment	$15,300
Cost of investment A..	(17,500)
Loss on sale of shares......................................	($ 2,200)

January 20, 2011

Cash	15,300	
Loss on Sale of Equity Investment...........................	2,200	
Equity Investments...		17,500

(d)

Securities Fair Value Adjustment	1,300	
Unrealized Holding Gain or Loss—Equity........		1,300

EXERCISE 17-12 (20–25 minutes)

(a) The total purchase price of these investments is:

Gonzalez:	(9,000 X $33.50) = $301,500
Belmont:	(5,000 X $52.00) = $260,000
Thep:	(7,000 X $26.50) = $185,500

The purchase entries will be:

January 15, 2011

Commission Expense	1,980	
Equity Investments	301,500	
Cash		303,480

April 1, 2011

Commission Expense	3,370	
Equity Investments	260,000	
Cash		263,370

September 10, 2011

Commission Expense	4,910	
Equity Investments	185,500	
Cash		190,410

(b)

Gross selling price of 3,000 shares at $35	$105,000
Less: Commissions, taxes, and fees	(2,850)
Net proceeds from sale	102,150
Cost of 3,000 shares ($301,500 X 3/9)	(100,500)
Gain on sale of shares	$ 1,650

May 20, 2010

Cash	102,150	
Equity Investment		100,500
Gain on Sale of Equity Investment		1,650

EXERCISE 17-12 (Continued)

(c)

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Gonzalez Co.	$201,000*	$180,000[(1)]	$(21,000)
Belmont Co.	260,000	275,000[(2)]	15,000
Thep Co.	185,500	196,000[(3)]	10,500
Total portfolio value	$646,500	$651,000	4,500
Previous securities fair value adjustment balance			0
Securities fair value adjustment—Dr.			$ 4,500

*$301,500 X 6/9 = $201,000.
(1)(6,000 X $30) (2)(5,000 X $55) (3)(7,000 X $28)

December 31, 2010

Securities Fair Value Adjustment	4,500	
Unrealized Holding Gain or Loss—Income		4,500

EXERCISE 17-13 (15–20 minutes)

Situation 1: Journal entries by Hatcher Cosmetics:

To record purchase of 20,000 shares of Ramirez Fashion at a cost of $14 per share:

March 18, 2010

Equity Investments	280,000	
Cash		280,000

To record the dividend revenue from Ramirez Fashion:

June 30, 2010

Cash	7,500	
Dividend Revenue ($75,000 X 10%)		7,500

EXERCISE 17-13 (Continued)

To record the investment at fair value:

December 31, 2010

Securities Fair Value Adjustment	20,000	
Unrealized Holding Gain or Loss—Income		20,000*

*($15 – $14) X 20,000 shares = $20,000

Situation 2: Journal entries by Holmes, Inc.:

To record the purchase of 25% of Nadal Corporation's ordinary shares:

January 1, 2010

Equity Investments...	67,500	
Cash [(30,000 X 25%) X $9]		67,500

Since Holmes, Inc. obtained significant influence over Nadal Corp., Holmes, Inc. now employs the equity method of accounting.

To record the receipt of cash dividends from Nadal Corporation:

June 15, 2010

Cash ($36,000 X 25%)...	9,000	
Equity Investments..		9,000

To record Holmes's share (25%) of Nadal Corporation's net income of $85,000:

December 31, 2010

Equity Investments (25% X $85,000)...............................	21,250	
Revenue from Investment..		21,250

EXERCISE 17-14 (10–15 minutes)

(a) $130,000, the increase to the Investment account.

(b) If the dividend payout ratio is 40%, then 40% of the net income is their share of dividends = $52,000. The answer is also given in the T-account information.

(c) Their share is 25%, so, Total Net Income X 25% = $130,000
Total Net Income = $130,000 ÷ 25% = $520,000

(d) $52,000 ÷ 25% = $208,000 or $520,000 X 40% = $208,000

EXERCISE 17-15 (10–15 minutes)

1.	Equity Investments (300 shares X $40)	12,000	
	Cash		12,000
2.	Cash (100 shares X $43)..	4,300	
	Gain on Sale of Equity Investment............		300
	Equity Investments (100 X $40)		4,000
3.	Unrealized Holding Gain or Loss—Income	1,000	
	Securities Fair Value Adjustment ($40 – $35) X 200		1,000

EXERCISE 17-16 (15–20 minutes)

(a)	Unrealized Holding Gain or Loss—Income............	5,900	
	Securities Fair Value Adjustment		5,900
(b)	Cash [(1,500 X £45) – £1,200]	66,300	
	Loss on Sale of Equity Investment..........................	5,200	
	Equity Investments...		71,500
(c)	Brokerage Expense...	1,300	
	Equity Investments (700 X £75)................................	52,500	
	Cash...		53,800

EXERCISE 17-16 (Continued)

(d)

Investments	Cost	Fair Value	Unrealized Holding Gain (Loss)
Beilman Corp., Ordinary	£180,000	£175,000	£(5,000)
McDowell Corp., Ordinary	52,500	50,400	(2,100)
Duncan, Inc., Preference	60,000	58,000	(2,000)
Total portfolio	£292,500	£283,400	(9,100)
Previous securities fair value adjustment—Cr.			(5,900)
Securities fair value adjustment—Cr.			£(3,200)

	Debit	Credit
Unrealized Holding Gain or Loss—Income	3,200	
Securities Fair Value Adjustment		3,200

EXERCISE 17-17 (15–20 minutes)

(a)

December 31, 2010

	Debit	Credit
Equity Investments	125,000,000	
Cash		125,000,000

June 30, 2011

	Debit	Credit
Cash	4,000,000	
Dividend Revenue (50,000 X ¥80)		4,000,000

December 31, 2011

	Debit	Credit
Cash	4,000,000	
Dividend Revenue (50,000 X ¥80)		4,000,000
Securities Fair Value Adjustment	10,000,000	
Unrealized Holding Gain or Loss—Income		10,000,000

¥2,700 X 50,000 = ¥135,000,000
¥135,000,000 – ¥125,000,000 = ¥10,000,000

EXERCISE 17-17 (Continued)

(b)

December 31, 2010

Equity Investments	125,000,000	
Cash...		125,000,000

June 30, 2011

Cash	4,000,000	
Equity Investments....................................		4,000,000

December 31, 2011

Cash	4,000,000	
Equity Investments....................................		4,000,000
Equity Investments	14,600,000	
Revenue from Investment		
(20% X ¥73,000,000)................................		14,600,000

(c)

	Fair Value Method	Equity Method
Investment amount (statement of financial position)	¥135,000,000	¥131,600,000*
Dividend revenue (income statement)	8,000,000	0
Unrealized holding gain (income statement)	10,000,000	
Revenue from investment (income statement)		14,600,000

*¥125,000,000 + ¥14,600,000 – ¥4,000,000 – ¥4,000,000

EXERCISE 17-18 (10–15 minutes)

Equity Investments	200,000	
Cash..		200,000
Cash (£20,000 X .25)...	5,000	
Equity Investments..		5,000
Equity Investments	20,000	

Revenue from Investment (.25 X £80,000)	**20,000**

EXERCISE 17-19 (15–20 minutes)

(a) The entry to record the impairment is as follows:

Loss on Impairment ($800,000 – $740,000)	60,000	
Debt Investments		60,000

(b) The new cost basis is $740,000. If the bonds are impaired, it is inappropriate to increase (amortize) the asset back up to its original maturity value.

(c)

Debt Investments	20,000	
Recovery of Impairment Loss ($760,000 – $740,000)		20,000

EXERCISE 17-20 (10–15 minutes)

(a)

Contractual cash flow [(€400,000 X .10 X 3) + €400,000]		€520,000
Expected cash flow		(455,000)
Cash flow loss		€ 65,000
Recorded investment		€400,000
Less: Present value of €350,000 due in 3 years at 10% (€350,000 X .75131)	€262,959	
Present value of €35,000 annual interest for 3 years at 10% (€35,000 X 2.48685)	87,040	349,999
Impairment loss		€ 50,001

(b)

Loss on Impairment	50,001	
Debt Investment		50,001

EXERCISE 17-20 (Continued)

(c) Since Komissarov will now receive the contractual cash flow (€520,000) there is no cash flow loss. Therefore Komissarov must reverse the impairment loss by debiting Debt Investments and crediting Recovery of impairment loss.

***EXERCISE 17-21 (20–25 minutes)**

(a)

WENGER, INC.
Statement of Comprehensive Income
For the Year Ended December 31, 2010

Net income	$120,000
Other comprehensive income	
Unrealized holding gain arising during year	1,300
Comprehensive income	$121,300

(b)

WENGER, INC.
Statement of Comprehensive Income
For the Year Ended December 31, 2011

Net income		$140,000
Other comprehensive income		
Holding gains arising during year	$30,000	
Add: Reclassification adjustment for loss included in net income......................	2,200	32,200
Comprehensive income		$172,200

***EXERCISE 17-22 (15–20 minutes)**

(a)	Call Option..	300	
	Cash		300
(b)	Unrealized Holding Gain or Loss—Income	100	
	Call Option ($300 – $200)..................................		100
	Call Option..	3,000	
	Unrealized Holding Gain or Loss—Income (1,000 X $3)..		3,000

(c) Unrealized Holding Gain: $2,900 ($3,000 – $100)

***EXERCISE 17-23 (20–25 minutes)**

	(a) 6/30/10	(b) 12/31/10
Fixed-rate debt	€100,000	€100,000
Fixed rate (6% ÷ 2)	X3%	X3%
Semiannual debt payment	€ 3,000	€ 3,000
Swap fixed receipt	(3,000)	(3,000)
Net income effect	€ 0	€ 0
Swap variable rate		
5.7% X 1/2 X €100,000	€ 2,850	
6.7% X 1/2 X €100,000	0	€ 3,350
Net interest expense	€ 2,850	€ 3,350

Note to instructor: An interest rate swap in which a company changes its interest payments from fixed to variable is a fair value hedge because the changes in fair value of both the derivative and the hedged liability offset one another.

***EXERCISE 17-24 (20–25 minutes)**

	(a) 12/31/10	(b) 12/31/11
Variable-rate debt	$10,000,000	$10,000,000
Variable rate	X5.8%	X6.6%
Debt payment	$ 580,000	$ 660,000
Debt payment	580,000	660,000
Swap variable received	(580,000)	(660,000)
Net income effect	$ 0	$ 0
Swap payable—fixed ($10,000 X 6%)	600,000	600,000
Net interest expense	$ 600,000	$ 600,000

Note to instructor: An interest rate swap in which a company changes its interest payments from variable to fixed is a cash flow hedge because interest costs are always the same.

*EXERCISE 17-25 (15–20 minutes)

(a)	Interest Expense	75,000	
	Cash (7.5% X £1,000,000)		75,000
(b)	Cash	13,000	
	Interest Expense		13,000
(c)	Swap Contract	48,000	
	Unrealized Holding Gain or Loss—Income		48,000
(d)	Unrealized Holding Gain or Loss—Income	48,000	
	Note Payable		48,000

*EXERCISE 17-26 (20–25 minutes)

(a)	August 15, 2010		
	Call Option	360	
	Cash		360
(b)	September 30, 2010		
	Call Option	3,200	
	Unrealized Holding Gain or Loss—Income ($8 X 400)		3,200
	Unrealized Holding Gain or Loss—Income	180	
	Call Option ($360 – $180)		180
(c)	December 31, 2010		
	Unrealized Holding Gain or Loss—Income	800	
	Call Option ($2 X 400)		800
	Unrealized Holding Gain or Loss—Income	115	
	Call Option ($180 – $65)		115

***EXERCISE 17-26 (Continued)**

(d) January 15, 2011

Call Option ($1 X 400)	400	
Unrealized Holding Gain or Loss—Income		400
Unrealized Holding Gain or Loss—Income	35	
Call Option ($65 – $30)		35
Cash (400 X $7)	2,800	
Loss on Settlement of Call Option	30	
Call Option*		2,830

*Value of Call Option at settlement:

Call Option

360	180
3,200	800
400	115
	35
2,830	

***EXERCISE 17-27 (25–30 minutes)**

(a) May 1, 2010

Memorandum entry to indicate entering into the futures contract.

(b) June 30, 2010

Futures Contract	400,000	
Unrealized Holding Gain or Loss—Equity [(¥52,000 – ¥50,000) X 200 ounces]		400,000

(c) September 30, 2010

Futures Contract	100,000	
Unrealized Holding Gain or Loss—Equity [(¥52,500 – ¥52,000) X 200 ounces]		100,000

*EXERCISE 17-27 (Continued)

(d) October 5, 2010

Titanium Inventory	10,500,000	
Cash (¥52,500 X 200 ounces)		10,500,000
Cash	500,000	
Futures Contract [(¥52,500 – ¥50,000) X 200 ounces]		500,000

Note to instructor: In practice, futures contracts are settled on a daily basis; for our purposes, we show only one settlement for the entire amount.

(e) December 15, 2010

Cash	25,000,000	
Sales Revenue		25,000,000
Cost of Goods Sold	14,000,000	
Inventory (Drivers)		14,000,000
Unrealized Holding Gain or Loss—Equity	500,000	
Cost of Goods Sold (¥400,000 + ¥100,000)		500,000

(f)

CHOI GOLF CO.
Partial Income Statement
For the Quarter Ended December 31, 2010

Sales revenue	¥25,000,000
Cost of goods sold	13,500,000*
Gross profit	¥11,500,000
*Cost of inventory	¥14,000,000
Less: Futures contract adjustment	500,000
Cost of goods sold	¥13,500,000

TIME AND PURPOSE OF PROBLEMS

Problem 17-1 (Time 20–30 minutes)
Purpose—the student is required to prepare journal entries and adjusting entries covering a three-year period for debt investments first classified as held-for-collection and then classified as trading. Bond premium amortization is also involved.

Problem 17-2 (Time 30–40 minutes)
Purpose—The student is required to prepare journal entries and adjusting entries for debt investments, along with an amortization schedule and a discussion of financial statement presentation.

Problem 17-3 (Time 25–30 minutes)
Purpose—to provide the student with an understanding of the differentiation in accounting treatments for debt and equity investments. The student is required to prepare the necessary journal entries to properly reflect transactions relating to debt and equity investments.

Problem 17-4 (Time 25–35 minutes)
Purpose—the student is required to distinguish between the existence of a bond premium or discount. The student is also required to prepare the adjusting entries at two year-ends for debt investments.

Problem 17-5 (Time 25–35 minutes)
Purpose—the student is required to prepare journal entries for the sale and purchase of equity investments along with the year-end adjusting entry for unrealized holding gains or losses and to discuss the financial statement presentation.

Problem 17-6 (Time 25–35 minutes)
Purpose—the student is required to prepare during-the-year and year-end entries for trading equity investments and to explain how the entries would differ if the investments were classified as non-trading.

Problem 17-7 (Time 25–35 minutes)
Purpose—the student is required to prepare during-the-year and year-end entries for debt investments and to explain how the entries would differ if the investments were classified as held-for-collection.

Problem 17-8 (Time 20–30 minutes)
Purpose—to provide the student with an understanding of the accounting for trading and equity investments. The student is required to apply the fair value method to both classes of investments and describe how they would be reflected in the body and notes to the financial statements.

Problem 17-9 (Time 20–30 minutes)
Purpose—to provide the student with an understanding of the proper accounting treatment with respect to trading equity investments and the resulting effect of a reclassification from trading to non-trading status. The student is required to discuss the descriptions and amounts which would be reported on the face of the statement of financial position with regard to these investments, plus prepare any necessary note disclosures.

Problem 17-10 (Time 30–40 minutes)
Purpose—to provide the student with an understanding of the reporting problems associated with trading equity investments. Description and amounts that should be reported on a company's comparative financial statements are then required.

Problem 17-11 (Time 20–30 minutes)
Purpose—to provide the student with an understanding of the reporting problems associated with trading equity investments. Description and amounts that should be reported on a company's comparative financial statements are then required.

Time and Purpose of Problems (Continued)

Problem 17-12 (Time 20–30 minutes)
Purpose—to provide the student with an opportunity to prepare entries for non-trading investment transactions and to report the results in a comprehensive income statement and a statement of financial position.

***Problem 17-13** (Time 20–25 minutes)
Purpose—the student is required to prepare the entries at purchase, throughout the life, and at expiration for a stand alone derivative (call option).

***Problem 17-14** (Time 20–25 minutes)
Purpose—the student is required to prepare the entries at purchase, throughout the life, and at expiration for a stand alone derivative (put option).

***Problem 17-15** (Time 20–25 minutes)
Purpose—the student is required to prepare the entries at purchase, throughout the life, and at expiration for a stand alone derivative (put option).

***Problem 17-16** (Time 30–40 minutes)
Purpose—the student is provided with an opportunity to prepare the entries for a fair value hedge in the context of an interest rate swap, including how the effects of the swap will be reported in the financial statements.

***Problem 17-17** (Time 25–35 minutes)
Purpose—the student is provided with an opportunity to prepare the entries for a cash flow hedge in the context of an option contract on the purchase of inventory, including how the effects of the hedge will be reported in the financial statements.

***Problem 17-18** (Time 25–35 minutes)
Purpose—the student is provided with an opportunity to prepare the entries for a fair value hedge in the context of the use of a put option to hedge a non-trading equity investment, including how the effects for the hedging instrument and hedged item will be reported in the financial statements.

SOLUTIONS TO PROBLEMS

PROBLEM 17-1

(a)	**December 31, 2008**		
	Debt Investments	108,660	
	Cash		108,660
(b)	**December 31, 2009**		
	Cash	7,000	
	Debt Investments		1,567
	Interest Revenue		5,433
(c)	**December 31, 2011**		
	Cash	7,000	
	Debt Investments		1,728
	Interest Revenue		5,272
(d)	**December 31, 2008**		
	Debt Investments	108,660	
	Cash		108,660
(e)	**December 31, 2009**		
	Cash	7,000	
	Debt Investments		1,567
	Interest Revenue		5,433
	Unrealized Holding Gain or Loss—Income ($107,093 – $106,500)	593	
	Securities Fair Value Adjustment		593
(f)	**December 31, 2011**		
	Cash	7,000	
	Debt Investments		1,728
	Interest Revenue		5,272

PROBLEM 17-1 (Continued)

	Amortized Cost	Fair Value	Unrealized Gain (Loss)
Spangler Company, 7% bonds	$103,719	$105,650	$1,931
Previous securities fair value adjustment—Dr.			2,053*
Securities fair value adjustment—Cr.			$ (122)

*($107,500 – $105,447)

Unrealized Holding Gain or Loss—Income................	122	
Securities Fair Value Adjustment		122

PROBLEM 17-2

(a) January 1, 2010 purchase entry:

Debt Investments	369,114	
Cash..		369,114

(b) The amortization schedule is as follows:

Schedule of Interest Revenue and Bond Discount Amortization
8% Bonds Purchased to Yield 10%

Date	Interest Receivable Or Cash Received	Interest Revenue	Bond Discount Amortization	Carrying Amount of Bonds
1/1/10	—	—	—	€369,114
7/1/10	€ 16,000	€ 18,456	€ 2,456	371,570
12/31/10	16,000	18,579	2,579	374,149
7/1/11	16,000	18,707	2,707	376,856
12/31/11	16,000	18,843	2,843	379,699
7/1/12	16,000	18,985	2,985	382,684
12/31/12	16,000	19,134	3,134	385,818
7/1/13	16,000	19,291	3,291	389,109
12/31/13	16,000	19,455	3,455	392,564
7/1/14	16,000	19,628	3,628	396,192
12/31/14	16,000	19,808*	3,808	400,000
Total	€160,000	€190,886	€30,886	

*€2 difference due to rounding.

(c) Interest entries:

July 1, 2010

Cash	16,000	
Debt Investments	2,456	
Interest Revenue..		18,456

December 31, 2010

Interest Receivable	16,000	
Debt Investments	2,579	

Interest Revenue	**18,579**

(d) January 1, 2012 sale entry:

Selling price of bonds	€370,726
Less: Amortized cost (see schedule from (b))	379,699
Realized loss on sale of investment	€ (8,973)

January 1, 2012

Cash	370,726	
Loss on Sale of Debt Investment	8,973	
Debt Investments		379,699

(e) December 31, 2010 adjusting entry:

Securities	Amortized Cost	Fair Value	Unrealized Gain (Loss)
Aguirre (total portfolio value)	€374,149*	€368,000	€(6,149)

*This is the amortized cost of the bonds on December 31, 2010. See (b) schedule.

December 31, 2010

Unrealized Holding Gain or Loss—Income	6,149	
Securities Fair Value Adjustment		6,149

PROBLEM 17-3

(a)

Equity Investments	37,400	
Debt Investments	162,000*	
Interest Revenue ($50,000 X .12 X 4/12)	2,000	
Investments		201,400

*[$110,000 + $52,000]

(b) December 31, 2010

Interest Receivable	8,025	
Interest Revenue		8,025

[Accrued interest
$50,000 X .12 X 10/12 = $5,000
Accrued interest
$110,000 X .11 X 3/12 = 3,025
$8,025]

(c) December 31, 2010
Investment Portfolio

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Sharapova Company shares	$ 37,400	$ 31,800	$(5,600)
Government bonds	110,000	124,700	14,700
McGrath Company bonds	52,000*	58,600	6,600
Total	$197,400	$215,100	15,700
Previous securities fair value adjustment balance			0
Securities fair value adjustment—Dr.			$15,700

PROBLEM 17-3 (Continued)

Securities Fair Value Adjustment	15,700	
Unrealized Holding Gain or Loss— Income		15,700

(d) July 1, 2011

Cash ($119,200 + $3,025)	122,225	
Debt Investments..		110,000
Interest Revenue ($110,000 X .11 X 3/12) ...		3,025
Gain on Sale of Debt Investment		9,200

PROBLEM 17-4

(a) The bonds were purchased at a discount. That is, they were purchased at less than their face value because the bonds' amortized cost increased from $491,150 to $550,000.

(b) **December 31, 2010**

Securities Fair Value Adjustment	4,850	
Unrealized Holding Gain or Loss—Income		4,850

Debt Investment Portfolio

	Amortized Cost	Fair Value	Unrealized Gain (Loss)
Bond Investment	$491,150	$497,000	$5,850
Previous securities fair value adjustment—Dr.			1,000
Securities fair value adjustment—Dr.			$4,850

(c) **December 31, 2011**

Unrealized Holding Gain or Loss—Income	16,292	
Securities Fair Value Adjustment		16,292

Debt Investment Portfolio

	Amortized Cost	Fair Value	Unrealized Gain (Loss)
Bond Investment	$519,442	$509,000	$(10,442)
Previous securities fair value adjustment—Dr.			5,850
Securities fair value adjustment—Cr.			($16,292)

PROBLEM 17-5

(a)

Gross selling price of 3,000 shares at $22	$66,000
Less: Commissions, taxes, and fees	2,150
Net proceeds from sale	63,850
Cost of 3,000 shares	(58,500)
Gain on sale of shares	$ 5,350

January 15, 2011

Cash	63,850	
Equity Investments		58,500
Gain on Sale of Equity Investment		5,350

(b) The total purchase price is:
(1,000 X $33.50) = $33,500.

The purchase entry will be:

April 17, 2011

Brokerage Expense	1,980	
Equity Investments	33,500	
Cash		35,480

(c) **Equity Investment Portfolio—December 31, 2011**

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Munter Ltd.	$580,000	$610,000	$30,000
King Co.	255,000	240,000	(15,000)
Castle Co.	33,500	29,000	(4,500)
Total of portfolio	$868,500	$879,000	10,500
Previous securities fair value adjustment balance—Cr.			(10,100)
Securities fair value adjustment—Dr.			$20,600

December 31, 2011

Securities Fair Value Adjustment	20,600	
Unrealized Holding Gain or Loss—Income		20,600

PROBLEM 17-5 (Continued)

(d) The unrealized holding gains or losses should be reported on the income statement under other income and expense. This investment would be reported as a current asset on the statement of financial position.

(e) If the King Company preference shares are classified as non-trading, the unrealized holding loss would be recorded in other comprehensive income and reported on the statement of financial position under the title "Accumulated other comprehensive income" as a separate component of equity.

PROBLEM 17-6

(a) (1) October 10, 2010

Cash (5,000 X £54)	270,000	
Gain on Sale of Stock		55,000
Equity Investments		215,000

(2) November 2, 2010

Equity Investments (3,000 X £54.50)	163,500	
Cash		163,500

(3) At September 30, 2010, McElroy had the following fair value adjustment:

Equity Investment Portfolio—September 30, 2010

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Horton, Inc. ordinary	£215,000	£200,000	£ (15,000)
Monty, Inc. preference	133,000	140,000	7,000
Oakwood Corp. ordinary	180,000	179,000	(1,000)
Total of portfolio	£528,000	£519,000	(9,000)
Previous securities fair value adjustment balance			0
Securities fair value adjustment—Cr.			£ (9,000)

At December 31, 2010, McElroy had the following fair value adjustment:

Equity Investment Portfolio—December 31, 2010

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Monty, Inc. preference	£133,000	£106,000	£ (27,000)
Oakwood Corp. ordinary	180,000	193,000	13,000
Patriot ordinary	163,500	132,000	(31,500)
Total of portfolio	£476,500	£431,000	(45,500)
Previous securities fair value adjustment balance—Cr.			(9,000)
Securities fair value adjustment—Cr.			£ (36,500)

The entry on December 31, 2010 is therefore as follows:

Unrealized Holding Gain or Loss—Income	36,500	
Securities Fair Value Adjustment		36,500

(b) The entries would be the same except that instead of debiting and crediting accounts associated with trading investments, the accounts used would be associated with non-trading investments. In addition, the Unrealized Holding Gain or Loss—Equity account is used instead of Unrealized Holding Gain or Loss—Income. The unrealized holding loss in this case would be deducted from the equity section rather than charged to the income statement.

PROBLEM 17-7

(a)

February 1

Debt Investments	300,000	
Interest Revenue (4/12 X .10 X $300,000)	10,000	
Cash		310,000

April 1

Cash	15,000	
Interest Revenue ($300,000 X .10 X 6/12)		15,000

July 1

Debt Investments	200,000	
Interest Revenue (1/12 X .09 X $200,000)	1,500	
Cash		201,500

September 1

Cash [($60,000 X 99%) + ($60,000 X .10 X 5/12)]	61,900	
Loss on Sale of Debt Investment	600	
Debt Investments		60,000
Interest Revenue (5/12 X .10 X $60,000 = $2,500)		2,500

October 1

Cash [($300,000 – $60,000) X .10 X 6/12]	12,000	
Interest Revenue		12,000

December 1

Cash ($200,000 X 9% X 6/12)	9,000	
Interest Revenue		9,000

PROBLEM 17-7 (Continued)

December 31

Interest Receivable	7,500	
Interest Revenue		7,500
(3/12 X $240,000 X .10 = $6,000)		
(1/12 X $200,000 X .09 = $1,500)		
($6,000 + $1,500 = $7,500)		

December 31

Unrealized Holding Gain or Loss—Income	26,000	
Securities Fair Value Adjustment		26,000

Debt Investment Portfolio

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Gibbons Co.	$240,000	$228,000*	$(12,000)
Sampson, Inc.	200,000	186,000**	(14,000)
Total	$440,000	$414,000	$(26,000)

*$240,000 X 95%
**$200,000 X 93%

(Note to instructor: Some students may debit Interest Receivable at date of purchase instead of Interest Revenue. This procedure is correct, assuming that when the cash is received for the interest, an appropriate credit to Interest Receivable is recorded.)

(b) All the entries would be the same except the last entry would not be made. In addition, held-for-collection investments would be carried at amortized cost and not valued at fair value at year-end.

(c) If Wildcat elects the fair value option for these investments, they would need to record an unrealized gain or loss each year. The unrealized gain (loss) would be the difference between the investments amortized cost and their year-end fair value.

PROBLEM 17-8

(a) 1. Trading investments:

Unrealized Holding Gain or Loss— Income	80,000	
Securities Fair Value Adjustment		80,000

2. Non-trading investments:

Securities Fair Value Adjustment	725,000	
Unrealized Holding Gain or Loss— Equity		725,000

Computations:

1.

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Delaney Motors	$1,400,000	$1,600,000	$ 200,000
Patrick Electric	1,000,000	720,000	(280,000)
Total of portfolio	$2,400,000	$2,320,000	$ (80,000)

2. Computation of Unrealized Gain or Loss in 2009

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Norton Ind.	$22,500,000	$21,500,000	($1,000,000)

Computation of Unrealized Gain or Loss in 2010

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Norton Ind.	$22,500,000	$22,225,000	$ (275,000)
Previous Securities Fair Value Adjustment (Cr)			($1,000,000)
Securities Fair Value Adjustment (Dr)			$ 725,000

PROBLEM 17-8 (Continued)

(b) The unrealized holding loss on the valuation of Brooks' trading investments is reported on the income statement. The loss would appear in the "Other income and expense" section of the income statement. The Securities Fair Value Adjustment is a valuation account and it will be used to show the reduction in the fair value of the trading investments. The trading investments portfolio is disclosed in the statement of financial position as a current asset and reported at its fair value.

The unrealized holding gain on the valuation of Brooks' non-trading investments is reported as other comprehensive income and as a separate component of equity. The Securities Fair Value Adjustment account is used to report the change in fair value of the non-trading investments. The fair value of the investments is reported in the Investments section of the statement of financial position. It should be noted that a combined statement of income and comprehensive income or a statement of comprehensive income would report the components of comprehensive income.

(c)

Equity Investments ($500,000 X 25%)	125,000	
Investment Revenue		125,000
Cash ($100,000 X 25%)	25,000	
Equity Investments		25,000

With 25%, Brooks has significant influence and should apply the equity method. No fair value adjustments are recorded under the equity method.

PROBLEM 17-9

(a) Equity Investment Portfolio

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Frank, Inc.	$ 22,000	$ 32,000	$ 10,000
Ellis Corp.	115,000	95,000	(20,000)
Mendota Company	124,000	96,000	(28,000)
Total of portfolio	$261,000	$223,000	$(38,000)

Statement of Financial Position—December 31, 2010

Investments:		
Equity investments, at cost	$261,000	
Less: Securities fair value adjustment	38,000	
Equity investments, at fair value		$223,000

Income Statement

Other income and expense	
Unrealized holding loss	$38,000

(b) Equity Investment Portfolio

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Ellis Corp.	$115,000	$140,000	$ 25,000
Mendota Company	174,000*	138,000**	(36,000)
Total of portfolio	$289,000	$278,000	(11,000)
Previous securities fair value adjustment balance—Cr.			(38,000)
Securities Fair Value Adjustment—Dr.			$ 27,000

*(4,000 X $31) + (2,000 X $25)
**[(4,000 + 2,000) X $23]

PROBLEM 17-9 (Continued)

Statement of Financial Position—December 31, 2011

Investments:		
Equity Investments, at cost	$289,000	
Less: Securities fair value adjustment	11,000	
Equity Investments, at fair value		$278,000

Income Statement

Other income and expense	
Unrealized holding gain	$27,000

The Frank investment is transferred to the non-trading investment category at fair value, which is the new cost basis of the investment.

PROBLEM 17-10

(a)

1.	3/1/10	Cash	1,800	
		Dividend Revenue (900 X £2)		1,800
2.	4/30/10	Cash	3,300	
		Gain on Sale of Equity Investment		600*
		Equity Investments		2,700
		*(300 X (£11 – £9))		
3.	5/15/10	Equity Investments	1,600	
		Cash (100 X £16)		1,600
4.	12/31/10	Securities Fair Value Adjustment	8,500	
		Unrealized Holding Gain or Loss—Equity		8,500

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Evers Comp. (£15,000 + £1,600)	£ 16,600	£ 18,700[(1)]	£2,100
Rogers Comp.	18,000	17,100[(2)]	(900)
Chance Comp. (£4,500 – £2,700)	1,800	1,600[(3)]	(200)
Total of Portfolio	£ 36,400	£ 37,400	£1,000
Previous securities fair value adjustment bal.—Cr.			(7,500)
Securities fair value adjustment—Dr.			£8,500

[(1)][(1,000 + 100) X £17]   [(2)](900 X £19)   [(3)][(500 – 300) X £8]

5.	2/1/11	Cash	1,600	
		Loss on Sale of Equity Investment [200 X (£8 – £9)]	200	
		Equity Investments		1,800
6.	3/1/11	Cash	1,800	
		Dividend Revenue		1,800

PROBLEM 17-10 (Continued)

7.	12/21/11	Dividend Receivable	3,300	
		Dividend Revenue (1,100 X £3)		3,300
8.	12/31/11	Securities Fair Value Adjustment	4,200	
		Unrealized Holding Gain or Loss—Income		4,200

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Evers Comp.	£16,600	£20,900[1]	£4,300
Rogers Comp.	18,000	18,900[2]	900
Total of Portfolio	£34,600	£39,800	£5,200
Previous securities fair value adjustment bal.—Dr.			1,000
Securities fair value adjustment—Dr.			£4,200

[1](1,100 X £19) [2](900 X £21)

(b)

Partial Statement of Financial Position as of	December 31, 2010	December 31, 2011
Investments		
Equity Investments, at fair value	£37,400	£39,800
Current Assets		
Dividend Receivable	0	3,300

(c) If the Evers investment was classified as trading, the unrealized holding gain would not be reported as equity. Instead the unrealized gain would be reported in net income.

PROBLEM 17-11

(a) **Statement of Financial Position**

Equity Investments, at fair value	€123,000

Income Statement

Unrealized Holding Loss (£127,000 – £123,000)	€ 4,000

(b) **Statement of Financial Position**

Equity Investments, at fair value	€ 94,000

Income Statement

Other income and expense	
Loss on Sale of Equity Investment	€ 1,800*
Unrealized Holding Loss [(€136,000 – €94,000) + €4,000*]	€ 38,000

*Prior security fair value adjustment balance.

*The entry made to recognize the loss on sale is as follows:

Cash	38,200	
Loss on Sale of Equity Investment	1,800	
Equity Investments		40,000

(c) **Statement of Financial Position**

Equity Investments, at fair value	€ 88,000

PROBLEM 17-11 (Continued)

Income Statement

Other income and expense	
Loss on Sale of Equity Investment	
(€8,100 + €2,700)	**€10,800**
Unrealized Holding Gain	
[€42,000* – (€88,000 – €80,000)]	**€34,000**

The entry made to record the sale of Lindsay Jones' shaves was:

Cash	**39,900**	
Loss on Sale of Equity Investment	**8,100**	
Equity Investments		
(€15,000 + €33,000)		**48,000**

***Prior securities fair value adjustment balance.**

PROBLEM 17-12

(a)

January 1, 2010

Fair value of equity investments		€240,000
Accumulated other comprehensive income		(30,000)
Cost basis		€210,000

December 31, 2010

Fair value of equity investments		€190,000
Cost basis		(140,000)
Accumulated other comprehensive income		€ 50,000

Cash (€70,000 + €30,000)	100,000	
Gain on Sale of Equity Investment		30,000
Equity Investments		70,000*

*(€210,000 – €140,000)

(b)

ACKER INC.
Statement of Comprehensive Income
For the Year Ended December 31, 2010

Net income		€35,000
Other comprehensive income		
Total holding gains arising during the year	€50,000*	
Less: Reclassification adjustment for gains included in income	30,000	20,000
Comprehensive income		€55,000

*Accumulated other comprehensive income 12/31/10	€50,000
Accumulated other comprehensive income 1/1/10	(30,000)
Increase in unrealized holding gain	20,000
Realized holding gain	30,000
Total holding gains arising during period	€50,000

PROBLEM 17-12 (Continued)

(c)

ACKER INC.
Statement of Financial Position
As of December 31, 2010

Assets		Equity	
Equity investments	€190,000	Share capital	€260,000
Cash	155,000*	Retained earnings	
		Accumulated other	35,000
		comprehensive income	50,000
Total assets	€345,000	Total equity	€345,000

*Beginning balance	€ 50,000
Dividend revenue	5,000
Cash proceeds on sale	100,000
	€155,000

***PROBLEM 17-13**

(a)	**July 7, 2010**		
	Call Option	240	
	Cash		240
(b)	**September 30, 2010**		
	Call Option	1,400	
	Unrealized Holding Gain or Loss—Income ($7 X 200)		1,400
	Unrealized Holding Gain or Loss—Income	60	
	Call Option ($240–$180)		60
(c)	**December 31, 2010**		
	Unrealized Holding Gain or Loss—Income	400	
	Call Option ($2 X 200)		400
	Unrealized Holding Gain or Loss—Income	115	
	Call Option ($180 – $65)		115
(d)	**January 4, 2011**		
	Call Option ($1 X 200)	200	
	Unrealized Holding Gain or Loss—Income		200
	Unrealized Holding Gain or Loss—Income	35	
	Call Option ($65 –$30)		35
	Cash (200 X $6)	1,200	
	Loss on Settlement of Call Option	30	
	Call Option*		1,230

*Value of Call Option at Settlement:

Call Option	
240	
1,400	60
200	400
	115
	35
1,230	

*PROBLEM 17-14

(a)	**July 7, 2010**		
	Put Option	240	
	Cash		240
(b)	**September 30, 2010**		
	Unrealized Holding Gain or Loss—Income	115	
	Put Option ($240 – $125)		115
(c)	**December 31, 2010**		
	Unrealized Holding Gain or Loss—Income	75	
	Put Option ($125 – $50)		75
(d)	**January 31, 2011**		
	Unrealized Holding Gain or Loss—Income	50	
	Put Option ($50 – $0)		50

***PROBLEM 17-15**

		Debit	Credit
(a)	**January 7, 2010**		
	Put Option	360	
	Cash		360
(b)	**March 31, 2010**		
	Put Option	2,000	
	Unrealized Holding Gain or Loss—Income ($5 X 400)		2,000
	Unrealized Holding Gain or Loss—Income	160	
	Put Option ($360 – $200)		160
(c)	**June 30, 2010**		
	Unrealized Holding Gain or Loss—Income	800	
	Put Option ($2 X 400)		800
	Unrealized Holding Gain or Loss—Income	110	
	Put Option ($200 – $90)		110
(d)	**July 6, 2010**		
	Put Option ($5 X 400)	2,000	
	Unrealized Holding Gain or Loss—Income		2,000
	Unrealized Holding Gain or Loss—Income	65	
	Put Option ($90 – $25)		65
	Cash (400 X $8)	3,200	
	Loss on Settlement of Put Option	25	
	Put Option*		3,225

*Value of Put Option at settlement:

Put Option	
360	
2,000	160
2,000	800
	110
	65
3,225	

***PROBLEM 17-16**

(a) (1) No entry necessary at the date of the swap because the fair value of the swap at inception is zero.

(2) June 30, 2011

Interest Expense	400,000	
Cash (8% X $10,000,000 X 1/2)		400,000

(3) June 30, 2011

Cash	50,000	
Interest Expense		50,000

	Interest Received (Paid)
Swap receivable (8% X $10,000,000 X 1/2)	$ 400,000
Payable at LIBOR (7% X 10,000,000 X 1/2)	(350,000)
Cash settlement	50,000

(4) June 30, 2011

Notes Payable	200,000	
Unrealized Holding Gain or Loss—Income		200,000

(5) June 30, 2011

Unrealized Holding Gain or Loss—Income	200,000	
Swap Contract		200,000

(b) Financial statement presentation as of December 31, 2010

Statement of Financial Position

Liabilities

Notes Payable $10,000,000

Income Statement

No effect

(c) **Financial statement presentation as of June 30, 2011**

Statement of Financial Position

Liabilities		
Notes Payable	$9,800,000	
Swap Contract	200,000	

Income Statement

Interest expense	$ 350,000	($400,000 – $50,000)
Unrealized Holding Gain—Note Payable	$ 200,000	
Unrealized Holding Loss—Swap	(200,000)	
Total	$ 0	

(d) **Financial statement presentation as of December 31, 2011**

Statement of Financial Position

Assets		
Swap Contract	$ 60,000	
Liabilities		
Notes Payable	10,060,000	

Income Statement

Interest expense		
First six months	$ 350,000	[as shown in (c)]
Next six months	375,000*	(see below)
Total	$ 725,000	
Unrealized Holding Gain—Swap	$ 60,000	
Unrealized Holding Loss—Note Payable	(60,000)	
Total	$ 0	

*Swap receivable (8% X 10,000,000 X 1/2)	$ 400,000
Payable at LIBOR (7.5% X 10,000,000 X 1/2)	(375,000)
Cash settlement	$ 25,000

Interest expense unadjusted June 30–December 31, 2011	$ 400,000
Interest expense-adjusted	(375,000)
Cash settlement	$ 25,000

*PROBLEM 17-17

(a) **April 1, 2010**

Memorandum entry to indicate entering into the futures contract.

(b) **June 30, 2010**

Futures Contract	500,000	
Unrealized Holding Gain or Loss—Equity [(¥31,000 – ¥30,000) X 500 ounces]		500,000

(c) **September 30, 2010**

Futures Contract	250,000	
Unrealized Holding Gain or Loss—Equity [(¥31,500 – ¥31,000) X 500 ounces]		250,000

(d) **October 10, 2010**

Gold Inventory	15,750,000	
Cash (¥31,500 X 500 ounces)		15,750,000
Cash	750,000	
Futures Contract [(¥31,500 – ¥30,000) X 500 ounces]		750,000

(e) **December 20, 2010**

Cash	35,000,000	
Sales Revenue		35,000,000
Cost of Goods Sold	20,000,000	
Inventory (Jewelry)		20,000,000
Unrealized Holding Gain or Loss—Equity	750,000	
Cost of Goods Sold (¥500,000 + ¥250,000)		750,000

*PROBLEM 17-17 (Continued)

(f)

SUZUKI JEWELRY COMPANY
Partial Statement of Financial Position
At June 30, 2010

Current Assets	
Futures contract	¥500,000
Equity	
Accumulated other comprehensive income	¥500,000

There are no income effects associated with this anticipated transaction in the quarter ended June 30, 2010.

(g)

SUZUKI JEWELRY COMPANY
Income Statement
For the Quarter Ended December 31, 2010

Sales revenue	¥35,000,000
Cost of goods sold	19,250,000*
Gross profit	¥15,750,000
*Cost of inventory	¥20,000,000
Less: Futures contract adjustment	(750,000)
Cost of goods sold	¥19,250,000

***PROBLEM 17-18**

(a) (1) **November 3, 2010**

Equity Investments	200,000	
Cash (4,000 X €50)		200,000
Put Option	600	
Cash		600

(2) **December 31, 2010**

Unrealized Holding Gain or Loss—Income	225	
Put Option (€600 – €375)		225

(3) **March 31, 2011**

Unrealized Holding Gain or Loss—Income	20,000	
Securities Fair Value Adjustment [(€50 – €45) X 4,000]		20,000
Put Option	20,000	
Unrealized Holding Gain or Loss—Income [(€50 – €45) X 4,000]		20,000
Unrealized Holding Gain or Loss—Income	200	
Put Option (€375 – €175)		200

(4) **June 30, 2011**

Unrealized Holding Gain or Loss—Income	8,000	
Securities Fair Value Adjustment [(€45 – €43) X 4,000]		8,000
Put Option	8,000	
Unrealized Holding Gain or Loss—Income [(€45 – €43) X 4,000]		8,000
Unrealized Holding Gain or Loss—Income	135	
Put Option (€175 – €40)		135

(5) July 1, 2011

Cash (€7 X 4,000)	28,000	
Loss on Settlement of Put Option	40	
Put Option		28,040
Cash (€43 X 4,000)	172,000	
Loss on Sale of Equity Investment	28,000	
Equity Investments		200,000
Securities Fair Value Adjustment	28,000	
Unrealized Holding Gain or Loss— Income		28,000

(b)

SPRINKLE COMPANY
Partial Statement of Financial Position
At December 31, 2010

Assets	
Equity Investments	€200,000
Put Option	375

SPRINKLE COMPANY
Income Statement
For the Year Ended December 31, 2010

Other income and expense	
Unrealized holding loss (Put option)	€(225)

*PROBLEM 17-18 (Continued)

(c)

SPRINKLE COMPANY
Partial Statement of Financial Position
At June 30, 2011

Assets	
Equity Investments	€172,000
Put Option	28,040

SPRINKLE COMPANY
Partial Income Statement
For Six Months Ended June 30, 2011

Other income and expense	
Unrealized holding loss (pratt investment)	€(28,000)
Unrealized holding gain (put option)	€ 27,665
	€ (335)

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 17-1 (Time 25–30 minutes)
Purpose—To provide the student with an opportunity to discuss issues related to debt and equity investments**.** For example, the proper accounting for the reclassification of an investment from trading to held-for-collection must be discussed. Four other situations involving debt and equity investments must be addressed.

CA 17-2 (Time 25–30 minutes)
Purpose—To provide the student with an opportunity to discuss the justification for using fair value as a basis for reporting equity investments. In addition, a number of computations are necessary to determine whether the company properly applied IFRS reporting provisions.

CA 17-3 (Time 20–30 minutes)
Purpose—To provide the student with an understanding of the accounting applications dealing with equity investments. This case involves three independent situations for which the student is required to discuss the effects upon classification, carrying value, and earnings.

CA 17-4 (Time 20–25 minutes)
Purpose—To provide the student with an understanding of the conceptual basis for the distinction between classifications of debt and equity investments. The student is required to discuss the factors to be considered in classifying debt and equity investments and how these factors affect the accounting treatment for unrealized losses.

CA 17-5 (Time 15–25 minutes)
Purpose—To allow the student to discuss the equity method of accounting for investments and to provide rationale for this method of accounting.

CA 17-6 (Time 25–35 minutes)
Purpose—To provide the student with an opportunity to discuss the equity method of accounting and provide rationale in a memorandum.

CA 17-7 (Time 25–35 minutes)
Purpose—To provide the student an opportunity to examine the ethical issues related to fair value accounting.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 17-1

Situation 1 IFRS requires that investments that are actively traded be reported on the statement of financial position at their fair value amount. Any changes in the fair value of trading investments from one period to another are included in earnings. Therefore, the $4,200 decrease will be reported on the income statement as an unrealized holding loss.

Situation 2 The investment should be reported in the held-for-collection category at the current fair value. The transfer of the investment does not affect earnings.

Situation 3 The reclassification does not affect earnings and the debt investment will continue to be reported at its fair value.

Situation 4 When a reduction in the fair value of an investment is considered to be an impairment, the new cost basis of the investment is its fair value. The investment is written down to the fair value amount and the loss is included in earnings. In this case, the fair value of the investment at the end of the prior year is the new cost basis. The increase in fair value in the current year will affect earnings and is reported under Other income and expense on the income statement.

Situation 5 The debentures would be classified as trading investments since management's intention is to sell the investment if the price increases. Trading investments are reported on the statement of financial position at their fair value. The unrealized holding loss of $7,700 is included in earnings as other income and expense on the income statement.

CA 17-2

(a) The reporting of these investments at fair value provides the financial statement user with more relevant financial, information. The fair value of the investments is essentially the present value of the investments future cash flows and so this helps investors and creditors assess the entity's liquidity. Also, the fair value of the investments helps the financial statement user to assess the entity's investment strategies. The financial statements of the entity will reflect which investments have increased in fair value and which investments have decreased in fair value. Since these investments have been purchased with the intention of selling them in the near future, the changes in the fair value of the investments are included in earnings. The rationale for this treatment is that trading investments are actively managed and any price changes should be reflected in earnings.

CA 17-2 (Continued)

(b) Lexington Company should record the following journal entry and then report the following amounts on its statement of financial position.

December 31, 2010

Unrealized Holding Gain or Loss—Income	1,100	
Securities Fair Value Adjustment		1,100

Statement of Financial Position—December 31, 2010

Investments:		
Equity Investments, at cost	$49,500	
Less: Securities fair value adjustment	1,100	
Equity Investments, at fair value		$48,400

Investments classified as trading investments should initially be recorded at their acquisition price. The valuation of these investments is subsequently reported at their fair value. Any changes in the fair value of the investments are recorded in an unrealized holding gain or loss account, which is reported in the other income and expense section of the income statement.

(c) No, Lexington Company did not properly account for the sale of the Summerset Company shares. The cost basis of the Summerset shares is still $9,500. Therefore, Lexington should have recorded a $300 ($9,200 – $9,500) loss from the sale of the investment as follows:

Cash	9,200	
Loss on Sale of Equity Investment	300	
Equity Investments		9,500

(d) December 31, 2011

Securities Fair Value Adjustment	1,500	
Unrealized Holding Gain or Loss—Income		1,500

Equity investments are reported at their fair value. Therefore, an adjusting entry must be made to show the $400 excess of fair value over cost in the portfolio. The unrealized holding loss from the previous period must be reversed. As a result, a $1,500 adjustment is needed to correctly state the equity investment portfolio.

Investments	Cost	Fair Value	Unrealized Gain (Loss)
Greenspan Corp. shares	$20,000	$19,900	$ (100)
Tinkers Company shares	20,000	20,500	500
Total of portfolio	$40,000	$40,400	400
Previous fair value adjustment balance—Cr.			(1,100)
Securities fair value adjustment—Dr.			$1,500

CA 17-3

Situation 1 The carrying value of the held-for-collection investment will be the fair value on the date of the transfer.

Situation 2 When a decrease in the fair value of an investment is considered to be permanent, an impairment in the value of the investment has occurred. As a result, the investment is written down to the fair value and this becomes the new cost basis of the investment. The investment is reported on the statement of financial position at its current fair value. The amount of the write-down is included in earnings as a realized loss.

Situation 3 Both the portfolio of trading investments and the portfolio of non-trading investments are reported at their fair value. The $13,500 decrease in fair value of the trading portfolio is recorded in the unrealized holding loss account and **is included** in earnings for the period. The $28,600 increase in fair value of the non-trading portfolio is recorded in the unrealized holding gain account and **is not included** in earnings for the period. Instead, the unrealized holding gain is shown as other comprehensive income and as a separate component of equity.

CA 17-4

(a) A company maintains the different investment portfolios because each portfolio serves a different investment objective. Since each portfolio serves a different objective, the possible risks and returns associated with that objective should be disclosed in the financial statements. This disclosure allows the financial statement user to assess the investment strategies for the company's investments, which when classified as trading investments are designed to return a profit to the entity on the basis of short-term price changes. On the other hand, investments which are classified as held-for-collection are designed to provide a steady stream of interest revenue. Investments which are classified as non-trading include the investments which are not classified in either of the first two categories. The combination of these three categories helps management to disclose in greater detail how it is investing its funds.

(b) The criteria which should be considered when determining how to properly classify investments are: (1) the company's business model for managing their financial assets, and (2) the contractual cash flow characteristics of the financial asset. If management is planning to sell the investment in the near future and to earn its profit on the basis of any price change, then the investment should be classified as a **trading investment**. On the other hand, if a company's business model is to hold assets in order to collect contractual cash flows and the contractual terms give specified dates to cash flows that are solely payments of principal and interest, then the investment should be classified as a **held-for-collection investment.** If the company's business model does not match either of the above categories, then the investment should be classified as a **non-trading investment.**

If a company does not plan to hold trading or non-trading investments until maturity, the investments are reported on the statement of financial position at fair value. Therefore, if the price of the investments decreases while the company is holding the investments, the company may incur an unrealized holding loss. The treatment of the unrealized loss is determined by the classification of the investments. If they are trading investments, the unrealized loss is included in earnings. If they are non-trading investments, the unrealized loss is recorded as other comprehensive income and as a separate component of equity. The rationale for this difference is that trading investments are actively managed and, therefore, any price changes should be included in earnings. Unrealized gains and losses are not recognized on held-for-collection investments (unless the fair value option is selected).

CA 17-5

Since Fontaine Company purchased 40% of Knoblett Company's outstanding ordinary shares, Fontaine is considered to have **significant influence** over Knoblett Company. Therefore, Fontaine will account for this investment using the equity method. The investment is reported on the December 31 statement of financial position as a long-term investment. The account balance includes the initial purchase price plus 40% of Knoblett's net income since the acquisition date of July 1, 2011. The investment account balance will be reduced by 40% of the cash dividends paid by Knoblett. The cash dividends represent a return of Fontaine's investment and, therefore, the investment account is reduced. The income statement will report 40% of Knoblett's net income received by Fontaine as investment income.

Investment in Knoblett Co.

Cost of investment 40% of Knoblett's income since 7/1/11	40% of cash dividends received from Knoblett

CA 17-6

<u>Memo on accounting treatment to be accorded Investment in Spoor Corporation</u>:

Selig Company should follow the equity method of accounting for its investment in Spoor Corporation because Selig Company is presumed to be able to exercise significant influence over the operating and financial policies of Spoor Corporation due to the size of its investment (40%).

In 2010, Selig Company should report its interest in Spoor Corporation's outstanding ordinary shares as a long-term investment. Following the equity method of accounting, Selig Company should record the cash purchase of 40 percent of Spoor Corporation at acquisition cost.

Forty percent of Spoor Corporation's total net income from July 1, 2010, to December 31, 2010, should be added to the carrying amount of the investment in Selig Company's statement of financial position and shown as revenue in its income statement to recognize Selig Company's share of the net income of Spoor Corporation after the date of acquisition. This amount should reflect adjustments similar to those made in preparing consolidated statements, including adjustments to eliminate intercompany gains and losses.

The cash dividends paid by Spoor Corporation to Selig Company should reduce the carrying amount of the investment in Selig Company's statement of financial position and have no effect on Selig Company's income statement.

CA 17-7

(a) Classifying the investments as they propose will indeed have the effect on net income that they say it will. Classifying all the gains as trading investments will cause all the gains to flow through the income statement this year and classifying the losses as non-trading and held-for-collection will defer the losses from this year's income statement. Classifying the gains and losses just the opposite will have the opposite effect.

(b) What each proposes is unethical since it is knowingly not in accordance with IFRS. The financial statements are fraudulently, not fairly, stated. The affected stakeholders are other members of the company's officers and directors, company employees, the independent auditors (who may detect these misstatements), the shareholders, and prospective investors.

CA 17-7 (Continued)

(c) The act of selling certain investments (those with gains or those with losses) is management's choice and is not per se unethical. IFRS allow the sale of selected investments so long as the inventory method of assigning cost adopted by the company is consistently applied. If the officers act in the best interest of the company and its stakeholders, and in accordance with IFRS, and not in their self-interest, their behavior is probably ethical. Knowingly engaging in unsound and poor business and accounting practices that waste assets or that misstate financial statements is unethical behavior.

FINANCIAL REPORTING PROBLEM

(a) M&S reports both current and non-current "other financial assets," along with both current and non-current derivative financial instruments. These investments are reported on the statement of financial position and in the notes to the financial statements.

(b) M&S's investments are valued at fair value for trading and non-trading, while held-for-collection investments are valued at amortized cost. If there is no quoted price in an active market for a security, and the fair value can't be reliably measured, then the security is held at cost. Derivatives are reported at fair value.

(c) M&S uses derivatives to manage its exposure to fluctuations in interest rates and exchange rates.

COMPARATIVE ANALYSIS CASE

CADBURY and NESTLE (in millions)

(a)

		Cadbury	Nestle
(1)	Cash used in (for) investing activities	£(831)	CHF (4,699)
(2)	Cash used for acquisitions (and disposals)	£ (60)	CHF(10,062)
(3)	Total investment in unconsolidated affiliates at 12-31-08	£ 28	CHF 7,796

(b) (1) Cadbury reported £28 million of equity method investments on its December 31, 2008 statement of financial position. Nestlé reported equity method investments of CHF7,796 million at 12-31-2008.

(2) Cadbury reported available-for-sale investments of 2 million pounds in its December 31, 2008 statement of financial position. It did not report any trading or held-to-maturity securities.

Nestlé did not report any information related to classifications of securities.

Note to instructors: Cadbury & Nestle have not yet adopted IFRS No. 9.

FINANCIAL STATEMENT ANALYSIS CASE

UNION PLANTERS

(a) While banks are primarily in the business of lending money, they also need to balance their asset portfolio by investing in other assets. For example, a bank may have excess cash that it has not yet loaned, which it wants to invest in very short-term liquid assets. Or it may believe that it can earn a higher rate of interest by buying long-term bonds than it can currently earn by making new loans. Or it may purchase investments for short-term speculation because it believes these investments will appreciate in value.

(b) Fair value is the amount for which an asset could be exchanged between knowledge of willing parties in an arm's length transaction. It is used for trading debt investments, equity investments, and when the fair value option is chosen. Amortized cost is the initial amount of the investment minus repayments plus (minus) cumulative amortization and net of any reduction for uncollectibility. It is used when the investments are held-for-collection.

(c) Investments are reported in different categories because these different categories reflect the likelihood that any unrealized gains and losses will eventually be realized by the company. That is, trading investments are held for a short period; thus, if the bank has an unrealized gain on its trading investment portfolio, it is likely that these investments will be sold soon and the gain will be realized. On the other hand, non-trading investments are not going to be sold for a longer period of time; thus, unrealized gains on these investments may not be realized for several years. If investments were all grouped into a single category, the investor would not be aware of these differences in the probability of realization.

(d) The answer to this involves selling your "winner" investments in your non-trading portfolio at year-end. Union Planters could have increased reported net income by $108 million (clearly, a material amount when total reported income was $224 million). Management chose not to sell these investments because at the time it must have felt that either the investments had additional room for price appreciation, or it didn't want to pay the additional taxes that would be associated with a sale at a gain, or it wanted to hold the investments because they were needed to provide the proper asset balance in its management of its total asset portfolio, or it would prefer to report the gain in the following year.

ACCOUNTING, ANALYSIS, AND PRINCIPLES

ACCOUNTING

(a) Instar's investment in Dorsel Corp. bonds should be classified as held-for-collection because they plan to hold the bonds to collect contractual cash flows until maturity.

Instar's investment of idle cash in equity investments should be classified as trading.

Instar's investment in its supplier should be classified as a non-trading investment. Instar does not intend to sell it in the short term and thus the investment does not qualify for classification as trading. Instar's ownership stake is far less than 20%, and there is no evidence that Instar can exert significant influence over the supplier, so the investment does not qualify for classification as an equity method investment.

For similar reasons, Instar's investment in Forter Corp. shares should be classified as non-trading.

Instar's investment in Slobbaer Co. shares should be classified as an equity method investment because its holdings are greater than 25% and Instar exerts significant influence over Slobbaer.

(b) To record the increase in the value of trading securities:

Securities Fair Value Adjustment	$120,000	
Unrealized Holding Gain or Loss—Income ($920,000 – $800,000)		120,000

To record the decline in value of the investment in Forter Co.:

Unrealized Holding Gain or Loss—Equity	13,000	
Securities Fair Value Adjustment ($200,000 – $187,000)		13,000

Cash	32,000	
Interest Revenue ($320,000 X 10%)		32,000

To record the increase in the value of the investment in the supplier:

Securities Fair Value Adjustment	350,000	
Unrealized Holding Gain—Income ($1,550,000 – $1,200,000)		350,000

To record the income of the equity-method investee:		
Investment in Slobbaer Co.	75,000	
Investment Revenue ($300,000 X 25%).............		75,000
To record the dividends received from the equity-method investee:		
Cash ($100,000 X 25%)...	25,000	
Investment in Slobbaer Co.		25,000

ANALYSIS

The total effect on net income is $120,000 + $350,000 + 32,000 + $75,000 = $577,000. Note that the gains/losses on the non-trading investment is a component of other comprehensive income, not net income reported on Instar's income statement. Note also that the equity method dividends received reduce the carrying value of the investment and are not recorded as revenue or income.

PRINCIPLES

The rationale for reporting held-for-collection securities at amortized cost is that if management intends to hold the investments to maturity, fair values are not relevant for evaluating the cash flows associated with these investments.

On the other hand, if the investments are trading or non-trading, they may be sold before maturity or have such short maturities that information on their fair value is relevant for determining future cash flows.

When a company exercises significant influence over the operations of another company, it is argued that the investor company should use the equity method of accounting. The rationale for this measurement basis is that the investor company should report the net income at the time the investee company earns it. Under the fair value method for non-trading investments, the company does not report income until it receives a dividend or sells the security (although it can increase or decrease other comprehensive income).

PROFESSIONAL RESEARCH

(a) According to IAS 39, paragraph AG71, "A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis."

(b) According to IAS 39, paragraph IN22, "The Standard requires that impairment losses on available-for-sale equity instruments cannot be reversed through profit or loss, i.e. any subsequent increase in fair value is recognised in other comprehensive income." Also, according to paragraph 58, "An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss."

(c) According to IFRS 9, paragraph B4.3,

Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur. For example, the entity may sell a financial asset if:

1. the financial asset no longer meets the entity's investment policy (e.g., the credit rating of the asset declines below that required by the entity's investment policy);

2. an insurer adjusts its investments portfolio to reflect a change in expected duration (i.e., the expected timing of payouts); or

3. an entity needs to fund capital expenditures.

However, if more than an infrequent number of sales are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

PROFESSIONAL SIMULATION

Journal Entries

(a) Equity Investments 37,400
Debt Investments 150,000*
Interest Revenue ($50,000 X .12 X 4/12) 2,000
Investments 189,400

*($100,000 + $50,000)

(b) December 31, 2010

Interest Receivable 7,750
Interest Revenue 7,750**

**Accrued interest: $50,000 X .12 X 10/12 = $5,000
Accrued interest: $100,000 X .11 X 3/12 = 2,750
$7,750

Measurement

	A	B	C	D	E	F	G	H	I	J
1	Investment Portfolio									
2	December 31, 2010									
3										
4	Investments		Cost		Fair Value		Unrealized Gain (Loss)			
5	Blossom Company shares		$37,400		$33,800		($3,600)			
6	Government bonds		100,000		124,700		24,700			
7	Buttercup Company bonds		50,000		58,600		8,600			
8	Total		$187,400		$217,100		29,700			
9										
10	Previous securities fair adjustment balance						0			
11	Securities fair value adjustment---Dr.						$29,700			
12										
13	Securities Fair Value Adjustment							29,700		
14		Unrealized Holding Gain or Loss---Income							29,700	
15										
16										

The following function is inserted in the cells in this column:-E2-C2

The following function is inserted into this cell:-E9-C9 or =sum (G6:G8)

PROFESSIONAL SIMULATION (Continued)

Explanation

If Powerpuff owns 30%, it will use the equity method to account for the investment. As a result, this investment would not be reported at fair value and there would be no unrealized holding gains or losses. Under the equity method, the investment carrying amount is periodically increased (decreased) by the investor's proportionate share of the earnings (losses) of the investor and decreased by all dividends received by the investor from the investee.