Chapter 16—Investments and International Operations

CHAPTER OVERVIEW

In Chapters 13 and 14, you learned about share capital from the perspective of the issuing corporation. In Chapter 15 we examined long-term liabilities and how corporations account for bonds payable and other obligations. Now we expand these topics but change the perspective. Corporations frequently purchase shares and bonds as investments. In addition, we learn about parent and subsidiary relationships and foreign currency transactions. The learning objectives for this chapter are to

1. Account for held-for-trading investments.
2. Account for long-term share investments.
3. Use the equity method to account for investments.
4. Understand consolidated financial statements.
5. Account for investments in bonds.
6. Understand how foreign-currency exchange rates are determined.

CHAPTER REVIEW

Shares are traded in markets. Prices are quoted in dollars and cents. The owner of a share is the investor. The corporation that issues the shares is the investee.

Share investments are assets to the investor. Short-term Investments are 1) liquid (readily convertible to cash) and 2) expected to be converted to cash within one year. Short-term Investments can be further classified as Held-for-trading investments, intended to be sold within one year, or available-for-sale investments, which are also classified as short-term if they are intended to be sold within one year. Long-term investments are 1) expected to be held for longer than one year or 2) not readily marketable. Short-term investments are always classified as current assets because the investor’s intent is to hold them for only a short time in the hope of earning profits on price changes. When a share investment is acquired but the intent is not to capture profits from price changes immediately, the investment is classified as a long-term investment.

Objective 1 - Account for held-for-trading investments.

Because short-term investments will be sold in the near future at their current market value and the investor owns less than 20% of the investee, the market-value method is used to account for all short-term investments. When acquired, the held-for-trading investments account is debited for their cost (price per share × number of shares acquired; commissions and other associated costs are expensed immediately), as follows:

\[
\text{Held-for-Trading Investments} \quad XX \\
\text{Cash} \quad XX
\]

As dividends are received, the transaction is

\[
\text{Cash} \quad XX \\
\text{Dividend Revenue} \quad XX
\]
On the balance sheet date, held-for-trading investments are reported at their fair, or market, value. Any gain or loss resulting from the change in fair value is recognized in net income for the period in which it arises, in the “Other gains and losses” section. The gain or loss is also recorded in the Fair-Value Valuation Allowance account, a companion account to the Held-for-Trading Investments account that is used to reflect the changes in fair value.

If the fair value is lower than the current carrying amount, the adjustment is:

- Unrealized Loss on Fair-Value Adjustment \( XX \)
- Fair-Value Valuation Allowance \( XX \)

If the fair value is higher than the current carrying amount, the adjustment is:

- Fair-Value Valuation Allowance \( XX \)
- Unrealized Gain on Fair-Value Adjustment \( XX \)

Available-for-sale investments can also be classified as short-term investments depending on the length of time management intends to hold the investment. Available-for-sale investments are also reported at fair value on the year-end balance sheet, but the accounting differs from held-for-trading investments. Accounting for available-for-sale investments is discussed more fully under Objective 2.

For held-for-trading and short-term available-for-sale investments, the fair value is determined on a security-by-security basis. The effect of the adjustment is to report short-term investments on the balance sheet at their current market value, which becomes their carrying value.

When a short-term investment is sold, the proceeds are compared with the current carrying value (NOT THE ORIGINAL COST) to determine whether a gain or loss results. Gains and losses on the sale of short-term investments are also reported in the “Other gains and losses” section of the income statement.

**Objective 2 - Account for long-term share investments.**

As with all assets, long-term investments are recorded at cost. Thereafter, however, the accounting treatment is dependent upon the purpose of the investment and the percentage of voting interest acquired.

An investor may make a **Long-term Available-for-Sale Investment** where the purpose is similar to that of short-term investing. The investor has no long-term interest in the investee, and typically holds less than 20% of the voting interest. Such an investment would normally be accounted for using the **market-value method**.

The beginning accounting value is the cost (debit Available-for-Sale Investments) at the date of purchase. Any cash dividends received are credited to **Dividend Revenue**. Gains and losses are reported on sales. The market-value method of accounting for long-term investments follows essentially the same procedures outlined for short-term investments except that an **Fair-Value Valuation Allowance** (reported as a companion account to the asset similar to the Allowance for Uncollectible Accounts and Accounts Receivable) account and an **Accumulated Other Comprehensive Income** account (reported within the Shareholder’s Equity section of the Balance Sheet) are used to reflect changes in market values.

**Objective 3 - Use the equity method to account for investments.**
An investor with a larger shareholding of from 20% to 50% of the investee’s voting shares may significantly influence how the investee operates the business. Consequently, the accounting treatment should reflect the investee’s success or failure. The *equity method* provides this treatment.

Investments are recorded initially at cost. The investor applies its percentage of ownership in recording its share of the investee’s net income and dividends. The investor increases the investment account and records Investment Revenue when the investee reports income. As the investee’s shareholders’ equity increases, so does the investor’s Long-Term Investment account.

Cash dividends are recorded as a reduction (credit) in the Long-Term Investment account. Dividends decrease the investee’s shareholders’ equity and so it also reduces the investor’s investment.

Gain or loss on the sale of an equity method investment is measured as the difference between the sale proceeds and the carrying value of the long-term investment.

**Objective 4 - Understand consolidated financial statements.**

An investor who owns more than 50% of an investee’s voting shares has a controlling (majority) interest. The investor is called the *parent company*, and the investee is called the *subsidiary*. Parent-subsidiary relationships are very common. See Exhibits 16-3 and 16-4 in your text.

*Consolidation accounting* combines the financial statements of two or more companies that are controlled by the same owners. The assets, liabilities, revenues, and expenses of the subsidiary are added to the parent’s accounts.

A separate set of books for the consolidated entity does not exist. The consolidation is accomplished by the use of a work sheet. *Goodwill* is recorded during the consolidation process if the parent buys the subsidiary for a price over the market value of the subsidiary’s tangible assets and identifiable intangible assets, net of liabilities.

A *minority interest* will appear on the consolidated balance sheet when the parent company owns more than 50% but less than 100% of the subsidiary’s shares. Minority interest usually is recorded as a liability on the consolidated balance sheet.

*Consolidated income* is equal to the net income of the parent plus the parent’s proportionate interest in the subsidiary’s net income.

**Objective 5 - Account for long-term investment in bonds.**

Investors purchase bonds issued by corporations. The investor can purchase short-term (current asset) or long-term (long-term investment) bonds.

Short-term investments in bonds are rare. More commonly, companies purchase bonds as long-term investments. If management intends to hold the bonds until maturity, they are *held-to-maturity*
investments. When acquired, these bonds are recorded at cost. Thereafter, they are reported on the balance sheet at their amortized cost. This means the balance in the Long-Term Investment account reflects both the initial cost of the bond plus or minus a portion of the discount (an addition to the account) or premium (a reduction in the account) on the bond. No Discount or Premium account is used. If the bonds were initially purchased at a discount, the balance in the Investment in Held-to-Maturity Bonds account increases as the bonds approach maturity. If the bonds were initially purchased at a premium, the balance in the Investment in Held-to-Maturity Bonds account decreases as the bonds approach maturity. The amortization of the bond discount would appear as follows:

\[
\begin{align*}
\text{Investment in Held-to-Maturity Bonds} & \quad \text{XX} \\
\text{Interest Revenue} & \quad \text{XX}
\end{align*}
\]

The amortization of a bond premium would be recorded as follows:

\[
\begin{align*}
\text{Interest Revenue} & \quad \text{XX} \\
\text{Investment in Held-to-Maturity Bonds} & \quad \text{XX}
\end{align*}
\]

**Study Tip:** From the buyer’s perspective, a discount means additional interest revenue while a premium means less interest revenue. This effect is exactly the opposite from the perspective of the issuer.

Carefully review the Decision Guidelines exhibit in your text. It presents an excellent summary of the rules governing share and bond investments.

**Objective 6 – Understand how foreign-currency exchange rates are determined.**

International accounting deals with business activities that cross national boundaries. Each country uses its own national currency; therefore, a step has been added to the transaction—one currency must be converted into another.

The price of one nation’s currency stated in terms of another country’s currency is called the foreign currency exchange rate. The conversion of one currency into another currency is called translation. Exchange rates are determined by supply and demand.

A strong currency is rising relative to other nations’ currencies, and a weak currency is falling relative to other currencies.

When Company A in Country A purchases goods from Company B in Country B, the transaction price may be stated in the currency of either country. Suppose the transaction is stated in Country A’s currency. The transaction requires two steps:

1. The transaction price must be translated for recording in the accounting records of Company B.
2. When payment is made, Company B may experience a foreign-currency translation gain or loss. This gain or loss results when there is a change in the exchange rate between the date of the purchase on account and the date of the subsequent payment of cash.

Note that there will be no foreign-currency gain or loss for Company A because the transaction price was stated in the currency of Country A.
The net amount of Foreign Currency Gains and Losses are combined for each accounting period and reported on the income statement as Other revenue and expense.

**Hedging** is a means of protecting the company from foreign currency transaction losses by purchasing a **futures contract**, the right to receive a certain amount of foreign currency on a particular date.
TEST YOURSELF

All the self-testing materials in this chapter focus on information and procedures that your instructor is likely to test in quizzes and examinations. Items with an A refer to information in the chapter appendix.

I. Matching  
*Match each numbered term with its lettered definition.*

_____ 1. consolidated statements  
_____ 10. non-controlling interest  
_____ 2. joint venture  
_____ 11. parent company  
_____ 3. controlling interest  
_____ 12. available-for-sale investments  
_____ 4. held-to-maturity investments in bonds  
_____ 13. strong currency  
_____ 5. equity method for investments  
_____ 14. subsidiary company  
_____ 6. foreign currency exchange rate  
_____ 15. majority interest  
_____ 7. held-for-trading investments  
_____ 16. weak currency  
_____ 8. hedging  
_____ 17. market-value method  
_____ 9. long-term investment

A. a separate entity or project owned and operated by a small group of businesses  
B. another term for controlling interest  
C. shares and bonds held for the short term with the intent of realizing profits from increases in prices  
D. combine the balance sheets, income statements, and other financial statements of the parent with those of the majority-owned subsidiaries into an overall set, as if the separate entities were one  
E. currency whose exchange rate is rising relative to other nations’ currencies  
F. investee company in which a parent owns more than 50% of the voting shares  
G. investor company that owns more than 50% of the voting shares of a subsidiary company  
H. short-term or long-term shares not classified as held-for-trading  
I. method used to account for investments in which the investor can significantly influence the decisions of the investee  
J. bonds and notes that investors intend to hold to maturity  
K. ownership of more than 50% of an investee company’s voting shares  
L. separate asset category reported on the balance sheet between current assets and plant assets  
M. strategy to avoid foreign currency transaction losses  
N. subsidiary company’s equity that is held by shareholders other than the parent company  
O. the price of one country’s currency stated in terms of another country’s monetary unit  
P. currency whose exchange rate is decreasing relative to other nations’ currencies  
Q. used to account for all short-term investments

II. Multiple Choice  
*Circle the best answer.*

1. A share is listed in the *National Post* as having a High of 90.28, a Low of 86.10, a Close of 86.75, and a Net Change of +1.33. What was the previous day’s closing price?

   A. $88.95  
   B. $84.27  
   C. $88.08  
   D. $85.42
2. Assets listed as held-for-trading on the balance sheet are

   A. only liquid
   B. listed on a national stock exchange
   C. only intended to be converted to cash within one year
   D. liquid and intended to be converted to cash within one year

3. Held-for-trading and short-term available-for-sale investments are reported on the balance sheet at

   A. current cost
   B. historical cost
   C. lower of cost or market
   D. fair value

4. Intercompany payables and receivables are eliminated in the consolidated entries so that

   A. assets will not be overstated
   B. liabilities will not be understated
   C. shareholders’ equity will not be understated
   D. net income will not be overstated

5. All of the following accounts are eliminated in the consolidated work sheet entries except

   A. investment in subsidiary
   B. subsidiary’s cash
   C. subsidiary’s common shares
   D. subsidiary’s retained earnings

6. The Non-Controlling Interest account is usually classified as a(n):

   A. revenue
   B. expense
   C. liability
   D. asset

7. The rate at which one unit of a currency can be converted into another currency is called the foreign currency:

   A. market rate
   B. interest rate
   C. exchange rate
   D. conversion rate

8. A strong currency has an exchange rate that is:

   A. inelastic with respect to other nations’ currencies
   B. inelastic with respect to its balance of trade
   C. increasing relative to other nations’ currencies
   D. decreasing relative to other nations’ currencies

9. Amortization of a discount on a long-term investment in a bond is normally accounted for as a

   A. credit to Investments in Held-to Maturity Bonds
   B. debit to Bond Discount
   C. debit to Cash
   D. debit to Investments in Held-to Maturity Bonds

10. A loss occurred by applying the market-value method normally results from:

    A. long-term share investments
    C. long-term investments in bonds
B. short-term investments  
D. all of the above
III. Completion  Complete each of the following statements.

1. The price at which shares change hands is determined by the __________________________.
2. Fair-value method gains and losses on held-for-trading investments are reported on the _______________ in the _______________________________.
3. Investments in shares are initially recorded at ____________________________.
4. The ______________________ method is used to account for investments when the investor can significantly influence the actions of the investee.
5. A(n) _____________________________ is ownership of at least 50% of the voting shares of a company.
6. Goodwill is a(n) ____________________________ asset.
7. A change in the currency exchange rates between the date of purchase and the date of payment will result in a(n) _____________________________.
8. Held-to-maturity investments in bonds are reported on the balance sheet at their ________________.
9. When a parent owns less than 100% of a subsidiary, the other owners are called the ________________.
10. A way for a company to protect itself from the effects of fluctuating foreign-currency exchange rates is by ______________________________.

IV. Daily Exercises

1. Parent, Inc., owns 100% of Subsidiary Corp. Parent’s Investment in Subsidiary account shows a balance of $2,200,000, while Subsidiary’s Common Shares account has a balance of $300,000 and Subsidiary’s Retained Earnings account has a balance of $1,900,000. In the space below, make the journal entry to eliminate the appropriate accounts.

2. On May 20 of the current year, Elder Corporation purchases 5,000 shares of Young Company for $32.60 a share, plus a broker’s commission of $95, as a held-for-trading investment. On December 15, Elder receives a cash dividend of $0.50 a share. Assuming Elder’s investment is not significant, what is the balance in Elder’s Held-for-Trading Investment account immediately after receipt of the cash dividend?

3. Review the information in Daily Exercise #2 and assume the Young’s shares are trading at $30.25 on December 31, the end of Elder’s fiscal year. Assuming this investment is classified as a held-for-trading investment, prepare the necessary adjusting entry.
4. Review the same facts in Daily Exercises #2 and #3, but assume the shares are classified as a long-term available-for-sale investment. Prepare the necessary adjusting entry on December 31.

5. When a company purchases equity securities as an investment, what determines whether the investment is classified as a short-term or a long-term investment?

6. On October 1 of the current year, Longo Company purchased a $100,000, 8%, 10-year bond at 98. Interest is payable on October 1 and April 1 each year. Longo’s intent is to hold the bond to maturity. Prepare the entry to record the purchase of the bond.

7. Review the information in Daily Exercise #6 and prepare the necessary adjusting entry on December 31, the end of Longo’s fiscal period, using straight-line amortization.

V. Exercises

1. Clear Company purchased 170,000 shares of Vue Corporation on January 1, 2008, for $850,000, as a short-term investment. Vue Corporation has 3,400,000 shares outstanding. Vue earned income of $480,000 and paid dividends of $160,000 during 2008. Vue Corporation shares were trading at $7.30 on December 31, 2008.

   A. What method should be used to account for the investment in Vue?

   B. How much revenue will be recorded by Clear in 2008 from the investment in Vue?
C. What is the balance in Clear’s Investment account at the end of 2008?

2. Steele Company purchased 30% of Beam Corporation on January 1, 2008, for $13,500,000, as a long-term investment. Steele Corporation earned income of $3,600,000 and paid dividends of $1,400,000 during 2008.

A. What method should be used to account for the investment in Beam Corporation?

B. How much revenue will be recorded by Steele Co. in 2008 from the investment in Beam Corporation?

C. What is the balance in the Investment account at the end of 2008?

3. Site Inc. invested in Sound Corporation on January 1, 2009, by purchasing 70% of the total shares of Sound Corporation for $1,575,000. Sound Corporation had common shares of $800,000 and retained earnings of $1,450,000.

A. What amount of Minority Interest will appear on a consolidated balance sheet prepared on January 1, 2009?

B. If Site Company owes Sound Corporation $85,000 on a note payable, prepare the two elimination entries in general journal form.

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<tr>
<th>Date</th>
<th>Account and Explanation</th>
<th>Debit</th>
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</table>
4. Prepare journal entries for the following long-term share investment:

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<tr>
<th>Date</th>
<th>Account and Explanation</th>
<th>Debit</th>
<th>Credit</th>
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<tbody>
<tr>
<td>Mar. 10</td>
<td>Purchased 1,000 Macro-Tech Corporation common shares at $35.25, plus a broker’s commission of $205.</td>
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<tr>
<td>Jul. 2</td>
<td>Received a $1.50 per share cash dividend.</td>
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<tr>
<td>Sept. 15</td>
<td>Sold 400 shares at $40.25 per share, less a commission of $80.</td>
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<tr>
<td>Dec. 31</td>
<td>Macro-Tech Corporation shares closed at $39.10.</td>
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5. Prepare journal entries for the following foreign currency transactions.

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<th>Date</th>
<th>Account and Explanation</th>
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<th>Credit</th>
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<tr>
<td>Mar. 5</td>
<td>Purchased 5,000 cases of dry cider from a German wholesaler for 4.55 Euros per case.</td>
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<tr>
<td>Mar. 20</td>
<td>Purchased 2,000 cases of red wine from a cooperative in Coustouge, France. The price was 64 francs per case. Today’s exchange rate is $1.00 = 4.45 French francs.</td>
<td></td>
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<tr>
<td>Apr. 10</td>
<td>Paid the British wholesaler. Today’s exchange rate is $2.37 = 1 pound sterling.</td>
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<tr>
<td>May 20</td>
<td>Paid for the French wine. Today’s exchange rate is $1.00 = 4.30 French francs.</td>
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</table>
VI. Beyond the Numbers

Review the information in Exercise #4 and change the Jul. 2 entry to the following:

Jul. 2 Received a 15% stock dividend. The shares were trading at $38 per share.

Prepare journal entries for Jul. 2, Sept. 15 and Dec. 31

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VII. Demonstration Problems

Demonstration Problem #1

Aunt Company paid $750,000 for 90% of the common shares of Niece Company. Niece owes Aunt $120,000 on an inter-company note payable. Complete the following work sheet, assuming that all of the excess that the Sister paid over the book value of Neice’s net assets is due to goodwill.

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Aunt Company</th>
<th>Niece Company</th>
<th>Eliminations Debit</th>
<th>Eliminations Credit</th>
<th>Consolidated Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>116,000</td>
<td>52,000</td>
<td></td>
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<tr>
<td>Note receivable from Niece</td>
<td>120,000</td>
<td>-</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Niece</td>
<td>750,000</td>
<td>-</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Property, plant, and equipment, net</td>
<td>436,000</td>
<td>656,000</td>
<td></td>
<td></td>
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<tr>
<td>Other assets</td>
<td>74,000</td>
<td>184,000</td>
<td></td>
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<tr>
<td>Total</td>
<td>1,496,000</td>
<td>892,000</td>
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</tbody>
</table>

Liabilities and Shareholders’ Equity:

| Accounts payable                | 76,000       | 82,000        |                    |                     |                      |
| Notes payable                   | 340,000      | 250,000       |                    |                     |                      |
| Minority interest               |              |               |                    |                     |                      |
| Common shares                   | 1,000,000    | 220,000       |                    |                     |                      |
| Retained earnings               | 80,000       | 340,000       |                    |                     |                      |
| Total                            | 1,496,000    | 892,000       |                    |                     |                      |

Demonstration Problem #2

At Dec. 31, 2010, Lovell Corporation had the following long-term investments in its portfolio:

<table>
<thead>
<tr>
<th>Long-term available-for-sale investments</th>
<th>Cost</th>
<th>Fair Value</th>
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</thead>
<tbody>
<tr>
<td>1,250 shares Newage.com, Inc.</td>
<td>$25.25</td>
<td>$28</td>
</tr>
<tr>
<td>3,000 shares SipLit, Inc.</td>
<td>10.38</td>
<td>18.50</td>
</tr>
<tr>
<td>1,900 shares Viron Corp</td>
<td>48</td>
<td>37.75</td>
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<tr>
<td>700 shares Diteck</td>
<td>63.50</td>
<td>66.88</td>
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<table>
<thead>
<tr>
<th>Long-term investments in bonds</th>
<th>Cost</th>
<th>Fair Value</th>
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<tbody>
<tr>
<td>$100,000, 9% Sonmil, Inc., due Oct.1,2020</td>
<td>$100,000</td>
<td>$100,000</td>
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</tbody>
</table>
The holdings did not amount to more than 20% of any investee shares.

**Requirement 1**

In the space below, present the long-term investments as they would appear on Lovell Corporation’s Dec. 31, 2010 balance sheet. None of the share investments is influential. The bonds pay interest semiannually on Apr.1 and Oct. 1.

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**Requirement 2**

Record the following 2011 events related to Lovell Corporation’s long-term investments:

Newage.com, Inc.—these shares paid quarterly dividends of $0.15/share on Feb. 10 and May 10. The shares were sold on Jul. 2 for $32/share less a broker’s commission of $185.

SipLit Inc.—these shares pay no cash dividends; however, a 10% stock dividend was received on Aug. 10. The investment remained in the portfolio at the end of the year, at which time its market value was $24.25 per share.

Viron Corp—these shares continued to decline in value throughout January and management decided to sell them on Feb. 8 for $31/share, less a commission of $205.

Diteck—these shares remained in the portfolio throughout the year. On Sep.15 the stock split 3 for 2. At year end, the shares were trading for $55/share.

Sonmil Inc.—Cheques for interest were received Apr. 1 and Oct. 1. The bonds remained in the portfolio at year end.

On Nov. 1, 2011 Lovell Corporation purchased $250,000, 10-year, 6% bonds from Sand Inc., for 97. The bonds pay semiannual interest on May 1 and Nov. 1.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account and Explanation</th>
<th>Debit</th>
<th>Credit</th>
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</tbody>
</table>
### Requirement 3

Record the necessary adjusting entries.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account and Explanation</th>
<th>Debit</th>
<th>Credit</th>
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<tbody>
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</tbody>
</table>

### Requirement 4
Present the long-term investments as they would appear on Lovell Corporation’s Dec. 31, 2011 balance sheet, taking into consideration the events described in Requirement 2 above.

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>
SOLUTIONS

I. Matching


II. Multiple Choice

1. D The High is the previous day’s highest price, the Low is the lowest price of the previous day. The Close is the last price at which the shares traded yesterday. Net Change is the increase (+) or decrease (-) in the Close compared to the previous day. The previous day’s close is $86.75 – $1.33 = $85.42.
2. D Note that besides the determinable liquidity of the investment, the intent of management determines an investment’s classification.
3. D GAAP requires held-for-trading investments to be reported on the balance sheet at their fair, or market, value.
4. A Failure to eliminate inter-company payables and receivables would result in the overstatement of both assets and liabilities of the consolidated entity. Accordingly, of the items listed, only A is correct.
5. B Elimination is not intended to remove the assets and liabilities of the subsidiary. The intent of elimination is to remove only those things that would double up or be counted twice if not eliminated, such as inter-company payables and receivables and the investment in subsidiary and subsidiary shareholders’ equity.
6. C The Minority Interest account represents the ownership interest of parties outside of the Parent-Subsidiary relationship. In actual practice it is most often reported as part of the liability section on the balance sheet.
7. C The exchange rate is used to convert one currency into another.
8. C Strong currencies are those that increase relative to other currencies.
9. D Amortization of a discount is recorded by directly debiting the Long-Term Investment in Bonds account.
10. A Unrealized gains (or losses) are a result of the market value method applied to long-term investments.
III. Completion

1. market (The market allows buyers and sellers with opposing interests to arrive at a price acceptable to both.)
2. income statement, other gains and losses
3. cost
4. equity
5. controlling interest
6. intangible
7. foreign-currency transaction gain or loss
8. amortized cost
9. minority interest
10. balance sheet; shareholders’ equity

IV. Daily Exercises

1. 

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Shares</td>
<td>300,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>1,900,000</td>
</tr>
<tr>
<td>Investment in Subsidiary</td>
<td>2,200,000</td>
</tr>
</tbody>
</table>

2. $163,000 (5,000 × $32.60 = $163,000) The $95 broker’s commission is expensed immediately. The dividends would be credited to a Dividend Revenue account.

3. 

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Loss on Fair-Value Adjustment</td>
<td>11,750</td>
</tr>
<tr>
<td>Fair-Value Valuation Allowance</td>
<td>11,750</td>
</tr>
</tbody>
</table>

The market value method requires short-term investments to be listed on the balance sheet at their fair value. The shares are currently worth $151,250 (5,000 × $30.25) but listed in the account at $163,000. The difference, $11,750 is an Unrealized Loss on Fair-Value Adjustment.

**Study Tip** Unrealized gains or losses on fair-value adjustment are reported on the income statement under “Other gains and losses.”

4. The same entry as Daily Exercise 3.

5. Long-term investments are defined by exception. In other words, if the investment is not a short-term investment, then it is classified as a long-term investment.

6. 

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Held-to-Maturity Bonds</td>
<td>98,000</td>
</tr>
<tr>
<td>Cash</td>
<td>98,000</td>
</tr>
</tbody>
</table>

The discount is not recorded on the books of the purchaser, only on the books of the selling corporation.
7. Interest Receivable 2,000
   Interest Revenue 2,000
   $(100,000 \times 8\% \times 3/12)$

   Long-Term Investment 50
   Interest Revenue 50
   $(2,000 \div 10 \text{ years} \times 3/12)$

V. Exercises

1. A. fair-value method
   B. 5% (170,000/3,400,000) of $160,000 = $8,000 dividend revenue
   C. $850,000

2. A. equity method
   B. 0.30 × $3,600,000 = $1,080,000
   C. $13,500,000 + $1,080,000 − (0.30 × $1,400,000) = $14,160,000

3. A. .30 × ($800,000 + $1,450,000) = $675,000
   B. (1) Note Payable to Works 85,000
      Note Receivable from Water 85,000
   (2) Common shares (Works) 800,000
      Retained earnings (Works) 1,450,000
      Investment in Works 1,575,000
      Minority Interest 675,000

   Brokerage Commissions Expense 205
   Cash 35,455
   ((1,000 shares × $35.25) plus $205)

   Jul. 2 Cash 1,500
   Dividend Revenue 1,500

   Sept. 15 Cash 16,020
   Available-for-Sale Investment—Macro-Tech 14,100
   Gain on Sale of Investment 1,920
   The gain is the difference between the proceeds and our cost. Our cost is 400 shares × $35.25/share (see Mar.2).

   Dec. 31 Fair-Value Valuation Allowance 2,310
   Unrealized Gain on Fair-Value Adjustment 2,310
   Market value = 600 × $39.10 = $23,460
   Cost = $35,250–$14,100 = 21,150
   Adjustment 2,310
5.

Mar. 5  Inventory  
  Accounts Payable  
(5,000 cases × 4.55 pounds sterling × $2.40)  

Mar. 20  Inventory  
  Accounts Payable  
(2,000 cases × 64 francs / 4.45)  

Apr. 10  Accounts Payable  
  Foreign-Currency Transaction Gain  
  Cash  
(5,000 cases × 4.55 pounds sterling × $2.37)  

May 20  Accounts Payable  
  Foreign-Currency Transaction Loss  
  Cash  
(2,000 cases × 64 francs / 4.30)  

Because the dollar strengthened relative to the British pound (on Jan. 5 it took $2.40 to purchase 1 pound sterling - a month later the same pound would only cost $2.37) a foreign currency gain was realized when we paid the bill. Conversely, the dollar weakened relative to the French franc, so we realized a foreign currency loss. Foreign currency gains and losses are reported on the income statement as “Other revenues and expenses.”

VI.  Beyond the Numbers

Mar.10  Available-for-Sale Investment—Macro-Tech  35,250  
  Brokerage Commissions Expense  205  
  Cash  35,455  
(1,000 shares × $35.25 plus $205)  

Jul. 2  No entry - however we need to note the receipt of the additional 150 shares. We now own 1,150 shares that cost us $35,250, or $30.65 (rounded) per share.

Study Tip: the current fair value of the shares is irrelevant from our perspective. It is only relevant to Macro-Tech. Macro-Tech used it to record the charge against Retained Earnings when the dividend was declared.

Sept.15  Cash  16,020  
  Available-for-Sale Investment—Macro-Tech  12,260  
  Gain on Sale of Investment  3,760  

Our cost per share was $30.65 (rounded)—see Jul. 2 details. We sold 400 shares at $40.25/share, less the $80 commission. The gain is the difference between our proceeds (400 shares × $40.25 less $80) and the cost basis of those shares, $30.65 × 400.
VII. Demonstration Problems

Demonstration Problem #1 Solved and Explained

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Aunt Company</th>
<th>Neice Company</th>
<th>Eliminations</th>
<th>Consolidated Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>116,000</td>
<td>52,000</td>
<td></td>
<td>168,000</td>
</tr>
<tr>
<td>Note receivable from Neice</td>
<td>120,000</td>
<td>-</td>
<td>(a) 120,000</td>
<td></td>
</tr>
<tr>
<td>Investment in Neice</td>
<td>750,000</td>
<td>-</td>
<td>(b) 750,000</td>
<td>246,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td>-</td>
<td></td>
<td>1,092,000</td>
</tr>
<tr>
<td>Property, plant, and</td>
<td>436,000</td>
<td>656,000</td>
<td></td>
<td>258,000</td>
</tr>
<tr>
<td>equipment, net</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>74,000</td>
<td>184,000</td>
<td></td>
<td>1,764,000</td>
</tr>
<tr>
<td>Total</td>
<td>1,496,000</td>
<td>892,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Shareholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
</tr>
<tr>
<td>Notes payable</td>
</tr>
<tr>
<td>Minority interest</td>
</tr>
<tr>
<td>Common shares</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Entry (a) eliminated Aunt’s $120,000 inter-company note receivable against the note payable owed by Neice. Note that the consolidated total represents the amount owed to outside creditors ($340,000 owed by Sister + $250,000 owed by Neice less $120,000 inter-company debt = $470,000).

Entry (b) eliminates Sister’s $750,000 investment balance against the $560,000 in Neice’s equity. Aunt acquired a 90% interest, so the minority interest is $56,000 (10% × $560,000). Goodwill is the difference
between the investment ($750,000) and 90% of Neice’s Common Shares and Retained Earnings, or $246,000 ($750,000 – (90% × $560,000)).

Demonstration Problem #2 Solved and Explained

Requirement 1

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,250 shares of Newage.com Inc.</td>
<td>$31,562.50</td>
<td>$35,000.00</td>
</tr>
<tr>
<td>3,000 shares of SipLit Inc.</td>
<td>31,140.00</td>
<td>55,500.00</td>
</tr>
<tr>
<td>1,900 shares of Viron Corp.</td>
<td>91,200.00</td>
<td>71,725.00</td>
</tr>
<tr>
<td>700 shares of Diteck</td>
<td>44,450.00</td>
<td>46,816.00</td>
</tr>
<tr>
<td>Sonmil Inc. bonds</td>
<td>100,000.00</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Totals</td>
<td>$298,352.50</td>
<td>$309,041.00</td>
</tr>
</tbody>
</table>

The cost of the combined long-term investments (both equity and debt) is $298,352.50, while the Dec. 31, 2010 fair value of the portfolio is $309,041. Recall that long-term available-for-sale investments and bond investments are reported on the balance sheet at fair value.

Requirement 2

Newage.com Inc.

Feb. 10 Cash

Dividend Revenue 187.50

May 10 Cash

Dividend Revenue 187.50

Jul. 2 Cash

Shareholders’ Equity—

Accumulated Other Comprehensive Income 3,437.50

Available-for-Sale Investments 31,562.50

Fair-Value Valuation Allowance 3,437.50

Gain on Available-for-Sale Investment 8,252.50
SipLit Inc.

Aug. 10 no entry—memo only reflecting 3,300 shares now in the portfolio

Dec 31 Fair-Value Valuation Allowance 24,525.00
Unrealized Gain on Fair-Value Adjustment 31,562.50

($80,025 - $55,500 carrying value = $24,525 increase in fair value)

Viron Corp.

Feb. 8 Cash 58,695.00
Fair-Value Valuation Allowance 19,475.00
Loss on Available-for-Sale Investment 32,505.00
Available-for-Sale Investments 91,200.00
Shareholders’ Equity—
Accumulated Other Comprehensive Income 19,475.00

The loss is the difference between the cost (1,900 × $48) and the proceeds (1,900 × $31 less the $205 commission).

Diteck

Sep. 15 No entry—memo only reflecting 1,050 shares now in the portfolio

Dec 31 Fair-Value Valuation Allowance 10,934.00
Unrealized Gain on Fair-Value Adjustment 10,934.00
($57,750.00 - $46,816.00 carrying value = $10,934.00)

Sunmil

Apr. 1 Cash 4,500
Interest Receivable 2,250
Interest Revenue 2,250

Oct. 1 Cash 4,500
Interest Revenue 4,500

Sand Inc.

Nov. 1 Investment in Held-to-Maturity Bonds 242,500
Cash 242,500

As the purchaser of the bonds, we do not record the $7,500 discount in a contra account.

Requirement 3 (adjusting entries)

Dec 31 Interest Receivable 2,250
Interest Revenue 2,250
To adjust accrued interest ($100,000 \times 0.09 \times \frac{3}{12}) on Sonmil Inc. bonds.

Dec.31Interest Receivable 2,500
Investment in Held-to-Maturity Bonds 125
Interest Revenue 2,625

To adjust for accrued interest ($250,000 \times .06 \times \frac{2}{12}) and amortize the discount ($7,500 /10 years \times \frac{2}{12})

Recall that long-term investments in bonds must be reported on the balance sheet at their fully amortized cost. When bonds are purchased at a discount, the amortized cost will increase over the life of the bonds. At maturity, the amortized cost will equal the bond’s face value.

**Requirement 4**

Long-Term available-for-sale Investments (at fair value) $137,775
Long-term Investments – Bonds (at cost) 342,625

The balance in the Long-Term Investments account consists of the following:

<table>
<thead>
<tr>
<th>Shares-</th>
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</thead>
<tbody>
<tr>
<td>Sip Lit, Inc.</td>
<td>$ 80,025</td>
<td></td>
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</tr>
<tr>
<td>Diteck</td>
<td>57,750</td>
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</tr>
<tr>
<td>Bonds- Sonmil Inc.</td>
<td>100,000</td>
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</tr>
<tr>
<td>- Sand Inc. ($242,500 + $125)</td>
<td>242,625</td>
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</tr>
<tr>
<td>Total</td>
<td>$418,215</td>
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</table>

Interest Receivable will be listed among the current assets and Interest Revenue under “Other revenues” on the income statement.