

## Chapter 18 - Investments

I. Introduction - In 1993, the FASB issued SFAS no. 115, "Accounting for Certain Investments in Debt and Equity Securities". The primary purpose of this standard was to provide guidelines [and requirements] for accounting for investments in securities at FMV. Prior to this time, we had generally accounted for Investments at historical or amortized cost. All that changed with SFAS 115.

### II. Investment in Debt Securities

Debt securities are defined as securities that represent a creditor relationship. A security is defined as a financial instrument that is commonly dealt on the open market.

A. In order to determine how to account for a Debt Security, we must first classify the security into one of these three categories:

Category	Valuation Method [Reported on Balance Sheet]	Treatment of Unrealized Gains and Losses	Other Effects on the Income Statement
Held-to-maturity	Reported at Amortized Cost	Not Recognized	Interest Revenue when earned; Gains and Losses when sold
Trading Securities	FMV	Recognized as a components of Income in Other Gains and Losses	Interest Revenue when earned; Gains and Losses when sold
Available-for-Sale	FMV	Recognized; but not on Inc. Stmt. Reported as a separate component in Equity	Interest Revenue when earned; Gains and Losses when sold

### III. Held-to-maturity Securities

In order to classify a security as held to maturity, the firm must demonstrate both:

- a. An intent to hold to maturity
- b. The ability to hold to maturity

#### A. Entries to consider.

1. Purchase - The investment is generally recorded at the purchase price, which may differ from the face value. Usually, when recorded the purchase of an investment at other than Par, we do NOT record a premium or discount.
2. Amortization of difference between Face Value and Cost -

Generally amortized directly into the ***Investment - Held to Maturity Securities*** account.

If the security was purchased at a ***discount***, the amortization entry is:

Investment  
Interest revenue.

If the security was purchased at a premium, the amortization entry:

Interest revenue.  
Investment

3. Recognition of Interest payments

Cash [or Interest Receivable]  
Interest Revenue

NOTE - 2. and 3. above may be combined into one entry!!

4. Entry to adjust to FMV

**None!!**

5. Entry to record Sale

Recognized gain of loss = Sales Price - Carrying Value

#### IV. Trading Securities

Trading securities are purchased with the intention of selling them within a relatively short period of time. [generally less than 3 months]

- A. The entries for debt securities classified as trading are the same as those for held-maturity with regard to the purchase, interest payments and sale. **However, there are no entries to amortize a discount or premium!!**
- B. The primary entry for us to consider associated with trading debt securities is the entry used to adjust cost to FMV:

Security FV Adjustment - Trading  
Unrealized holding gain or loss - **Income**

The KEY is the **INCOME suffix** attached to the gain or loss account. All adjustments to FMV for TRADING debt securities flow through income.

#### V. Available-For-Sale Debt Securities - A hybrid

The definition Available-for-Sale includes all other securities that do not fall into the other two security categories.

- A. Entries are similar to Held-to-Maturity securities with regard to purchase, interest payments, amortization and sale.
- B. However, we also make an entry to adjust the cost of the securities to FMV

Security FV Adjustment - Available-for Sale  
Unrealized holding gain or loss - **Equity**

The KEY is the **EQUITY suffix** attached to the gain or loss account. All adjustments to FMV for AVAILABLE - FOR - SALE debt securities flow directly to equity. The adjustment does not effect income. See discussion at the top of page 886.

## SECTION 2 - Investment in Equity securities

I. Equity securities represent ownership in the invested corporation [Investee]. Usually represented by common or preferred stock. [Redeemable preferred stock does not fall into this category.]

### II. **Investment in Held-To-Maturity equity securities.**

No such category. Equity securities do not mature.

### III. **Available-For-Sale and Trading equity securities**

If the investor owns less than 20% of the stock of a corporation, the accounting and valuation techniques for equity securities are essentially the same as debt securities. The differences are:

1. There is no Stated Value or Face Value of equity securities, so there is no amortization entry.
2. Equity securities earn dividends instead of interest. Thus, the income earned is Dividend income.

***The adjustments to FMV are the same as debt securities.***

1. FMV adjustments for Trading equity securities flow through income.
2. FMV adjustments for Available-for-sale equity securities flow directly to equity.

- IV. If the investor owns at least 20% of the stock of a corporation but less than 50%, the accounting and valuation techniques for equity securities use the **EQUITY METHOD**. The FASB has determined that, generally, 20% ownership indicates an ability to exercise "significant influence" over an Investee. Your text points out exceptions to this rule.
- A. Under the **equity method** the investment's carrying amount is periodically
1. Increased (decreased) by the investor's proportionate share of the earnings (losses) of the Investee, and
  2. Decreased by all dividends received by the investor from the Investee.
  3. In addition, the investor must record as separate components the amount of ordinary and extraordinary income as reported by the Investee.
  4. If an investor's share of the Investee's losses exceeds the carrying amount of the investment, the investor should discontinue applying the equity method and not recognize additional losses (unless the investor's loss is not limited).
- V. When one corporation (the parent) acquires a voting interest of more than 50% in another corporation (the subsidiary), we prepare **consolidated financial statements**. This is the focus of Advanced Accounting.
- VI. If an investment is deemed impaired (a loss that is not temporary), the cost basis of the individual security is written down to a new cost basis. The amount of the writedown is accounted for as a realized loss and, therefore, included in net income.
- VII. Transfers between any of the investment categories are accounted for at fair value. Stockholders' equity and net income are not affected. When transferring from **available-for-sale** investments to **trading** investments, unrealized gains or losses reported in stockholders' equity are reversed and the gain or loss is recognized in income.