Accounting for Investments

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Course Description

Companies have different motivations for investing in securities issued by other companies. One motivation is to earn a high rate of return. Another motivation for investing (in equity securities) is to secure certain operating or financing arrangements with another company. This course addresses the accounting for debt and equity investments and disclosure requirements. To provide useful information, companies account for investments based on the type of security (debt or equity) and their intent with respect to the investment. The course organizes the study of investments by type of security. Within each section, it explains how the accounting for investments in debt and equity securities varies according to management intent.

Field of Study	Accounting
Level of Knowledge	Basic
Prerequisite	Basic Accounting
Advanced Preparation	None

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Accounting for Investments

Learning Objectives:

After completing this section, you should be able to:

- Recognize the differences between trading securities, available-for-sale securities, and held-to-maturity securities.
- Identify the categories of equity securities and the accounting and reporting treatment for each category.
- Identify the three categories of debt securities and the accounting and reporting treatment for each category.
- Properly identify how purchases, sales, and changes in fair value of securities affect accounts.
- Recognize the proper classification and disclosure of investments in securities.
- Determine when it is appropriate to use the equity method to account for investments in other companies.

Companies invest in the debt and equity securities of other businesses for a variety of reasons. The most common reason is to earn a return on idle cash. Other reasons for investing in other companies include establishing a business relationship through ownership, diversifying seasonal or industry risk, and gaining access to a company's research or technology. The intended outcome of investing in other companies is to enhance the overall return to shareholders. One significant motivation for investing (in equity securities) is to secure certain operating or financing arrangements with another company.

This course addresses the accounting for debt and equity investments and disclosure requirements. To provide useful information, companies account for investments based on the type of security (debt or equity) and their intent with respect to the investment. The course organizes the study of investments by type of security. Within each section, it explains how the accounting for investments in debt and equity securities varies according to management intent.

Accounting for these investments involves several activities. These activities are summarized in Exhibit 1. Each of the issues presented in Exhibit 1 will be addressed in turn.

Exhibit 1: TIME LINE of BUSINESS ISSUES
INVOLVED with INVESTMENT SECURITIES

DETERMINE	CLASSIFY	PURCHASE	EARN AND RECOGNIZE	MONITOR	SELL	TRANSFER	DISCLOSE
Purpose of investment	Investments	Securities	A return	Change in value	Securities	Securities between categories	Status of portfolio at the end of period

Exhibit 2 illustrates the major classifications of debt and equity securities, while Exhibit 3 the criteria for those classifications. Note, however, that the classification is reassessed at each reporting date.

EXHIBIT 2: CLASSIFICATIONS OF DEBT AND EQUITY SECURITIES

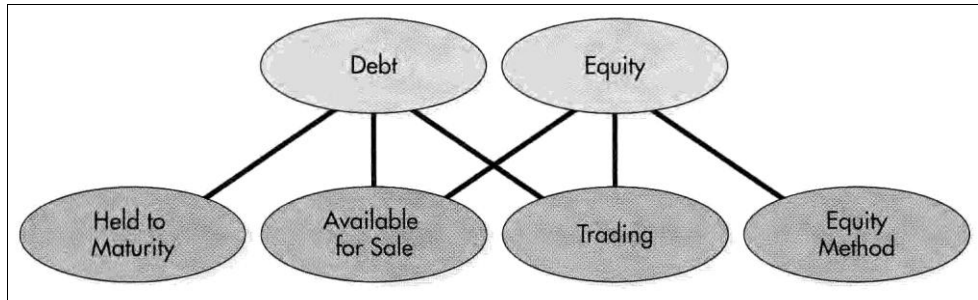


EXHIBIT 3: THE CRITERIA FOR THE CLASSIFICATION

	Trading	*Available-for-sale*	*Held-to-maturity*
Criteria	A *debt* or *equity* security that is purchased mainly with the intent of reselling the securities in the short term	Not classified as trading or held to maturity; a *debt* or *equity* security that is purchased with the intent of reselling before it reaches maturity but is not actively traded.	A *debt* security that the reporting entity has the positive intent and ability to hold to maturity

Background

Beginning in 1975, the FASB only required securities held as investments to be classified as debt or equity. However, there was dissatisfaction among regulators that reporting debt securities at amortized cost did not provide investors with optimum decision-making information. As a result, in 1993 the FASB established the current three-way classification system, which takes cognizance of the entity's intent regarding its investment securities. Current GAAP is found in ASC 320.

ASC 320-10-05-1 and 05-2, *Investments—Debt and Equity Securities: Overall*, set forth the accounting and financial reporting requirements for **investments in equity securities with determinable fair market value and for all investments in debt securities.** ASC 320-10-05-1 and 05-2 applies to preferred stock and common stock (if ownership is less than 20%, or if ownership exceeds 20% but effective control [significant influence] is lacking). As per ASC 323-10-15-10, *Investments— Equity Method and Joint Ventures Overall*, the following circumstances may imply that the investor is *not* able to exercise effective control:

- The investor is not included on the investee's board of directors.
- The investor is unable to gather the financial data required to account under the equity method.
- The investee is opposed to the investment, such as by instituting a lawsuit against it or filing a complaint with the SEC.
- A written agreement between the parties specifies that there is no effective control.
- Significant influence exists by a small group of stockholders, excluding the investor constituting majority ownership of the investee.

ASC 320-10-05-1 and 05-2 are not applicable to investments under the equity method, consolidated subsidiaries, such specialized industries as brokers and dealers, or not-for-profits. Nonprofit entities are governed by ASC 958-320-05-2, *Not-for-Profit Entities: Investments—Debt and Equity Securities*, which requires fair value reporting for all investment categories, including held-to-maturity. ASC 323-10-15-8, *Investments—Equity Method and Joint Ventures: Overall*, provides the accounting, reporting, and disclosure requirements under the equity method. The equity method generally applies if the investor owns between 20% and 50% of the voting common stock of the investee. The equity method may also apply if ownership is less than 20% but effective control exists.

Exhibit 4 lists levels of interest or influence and the corresponding valuation and reporting method that companies must apply to the investment.

EXHIBIT 4:
LEVELS OF INFLUENCE AND THE CORRESPONDING VALUATION AND REPORTING METHOD

Percentage of Ownership	*0% <———————> 20%*	*20% <——————> 50%*	*50<———————>100%*
Level of Influence	Little or None	Significant	Control
Valuation Method	Fair Value Method	Equity Method	Consolidation

Excerpt from Accounting Standards Codification

Investments — Debt and Equity Securities — Overall

Classification of Investment Securities

320-10-25-1

At acquisition, an entity shall classify debt securities and equity securities into one of the following three categories:

a) Trading securities. If a security is acquired with the intent of selling it within hours or days, the security shall be classified as trading. However, at acquisition an entity is not precluded from classifying as trading a security it plans to hold for a longer period. Classification of a security as trading shall not be precluded simply because the entity does not intend to sell it in the near term.
b) Available-for-sale securities. Investments in debt securities and equity securities that have readily determinable fair values not classified as trading securities or as held-to-maturity securities shall be classified as available-for-sale securities.
c) Held-to-maturity securities. Investments in debt securities shall be classified as held-to-maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity.

Subsequent Measurement

320-10-35-1

Investments in debt securities and equity securities shall be measured subsequently as follows:

a) Trading securities. Investments in debt securities that are classified as trading and equity securities that have readily determinable fair values that are classified as trading shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for trading securities shall be included in earnings.
b) Available-for-sale securities. Investments in debt securities that are classified as available for sale and equity securities that have readily determinable fair values that are classified as available for sale shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraphs 815-25-35-1 through 35-4.
c) Held-to-maturity securities. Investments in debt securities classified as held to maturity shall be measured subsequently at amortized cost in the statement of financial position. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to Subtopic 830-20.

Market Value Method and Amortized Cost Method per ASC 320

Equity securities represent an ownership interest either in common stock or preferred stock, or in rights to buy or sell interests, such as warrants, rights, or calls and put options. Redeemable preferred stock, however, is not treated as equity securities.

Debt securities are financial instruments evidencing a creditor relationship with a company or government. Examples are redeemable preferred stock, corporate bonds, municipal bonds, U.S. government obligations, convertible debt, collateralized mortgage obligations, strips, and commercial paper. Debt securities do not include futures contracts and option contracts.

Equity and debt securities are broken down into the following categories:

- Trading securities.
- Available-for-sale securities.
- Held-to-maturity securities.

Classification of the securities will be based on such factors as management intent considering past history of investments, subsequent events after the balance sheet date, and the nature and objective of the investment.

Trading Securities

Trading securities are debt securities (not classified as held-to-maturity) and equity securities with readily determinable fair values that are bought and held primarily for sale in the near term (usually three months or less). Hence, the bonds and the equity securities are trading securities. They are initially recorded at cost but are subsequently measured at fair value at each balance sheet date. There is active buying and selling of the securities to earn short-term profits from price appreciation. Thus, quoted market prices in active markets are the best evidence of fair value. Mortgage-backed securities held for sale related to mortgage banking activities are included in trading securities.

Trading securities are recorded in the balance sheet under *current assets at **fair value**.* Fair market value is based on stock or bond quotations on listed exchanges or in the over-the-counter market. However, restricted stock (stock restricted by governmental or contractual provisions) does not have a readily available fair value because it is not traded. Foreign securities are based on the market price of the foreign exchange if comparable to U.S. markets. Fair value of investments in a mutual fund is based on the published fair value per share. To determine the fair value of debt securities in which market price is unavailable, other valuation methods may be used, including present value of future cash flows, fundamental analysis, matrix pricing, and option-adjusted spread models. Market value is compared to cost on a total portfolio basis.

The **valuation allowance** (**market adjustment** or **securities fair value adjustmen**t) account is a **contra (offset) account** to trading securities in the balance sheet to present market value.

Balance sheet presentation follows:

Trading securities (cost)
Add (Less): Valuation allowance
Net (market value)

Unrealized (holding) gains and losses on trading securities are presented separately in the income statement.

Disclosure should be made of the method on which cost was determined in computing realized gain or loss on sale (e.g., specific identification, first- in, first-out [FIFO], and average cost).

EXAMPLE

On December 31, 2X12, a company had a portfolio of trading securities having a total cost of $200,000 and a total market value of $225,000. The entry is:

Valuation allowance	25,000	
Unrealized gain		25,000

The unrealized gain on trading securities is shown as a separate item in the income statement. Also, the valuation allowance account is a contra account to trading securities in the balance sheet. Therefore, the following is presented in the financial statements:

Income Statement For the year Ended December 31, 2X12	
Unrealized gain on trading securities	$25,000
Balance Sheet December 31, 2X12	
Current assets	
Trading securities (cost)	$200,000
Add: valuation allowance	25,000
Net (market value)	$225,000

On February 5, 2X13, trading securities costing $60,000 were bought. The entry is:

Trading securities	60,000	
Cash		60,000

On July 1, 2X13, a cash dividend of $15,000 is received. The entry is:

Cash	15,000	
Dividend revenue		15,000

On October 8, 2X13, trading securities costing $50,000 were sold for $49,000. The entry is:

Cash	49,000	
Realized loss on scale	1,000	
Trading securities		50,000

On December 31, 2X13, the total cost of trading securities remaining equaled $210,000 ($200,000 + $60,000 - $50,000). The total market value of the portfolio is assumed to be $206,000. Before showing the journal entry at year-end, it is easier to understand by presenting the current asset section of the balance sheet on 12/31/2X13:

CURRENT ASSETS

Trading securities cost	$210,000
Less: valuation allowance	4,000
Net (market value)	$206,000

The valuation allowance account appears as follows:

Valuation Allowance

12/31/2X12	25,000	Entry	29,000
		12/31/2X13	4,000

This requires a credit for the year to the valuation allowance of $29,000 to balance. Therefore, the journal entry to do this follows:

12/31/2X13	Unrealized loss	29,000	
	Valuation allowance		29,000

The following is presented in the income statement for the year ended December 31, 2X13:

Dividend revenue	$15,000

Realized loss on sale of trading securities	1,000
Unrealized loss on trading securities	29,000

In the case of trading securities, a change in market value of a forward contract or option contract is recognized in the income statement in the year it accrues. Trading securities bought under a forward contract or by exercising an option are recognized at fair value on the settlement date.

Review Questions

1. Investments in equity securities that have readily determinable fair values may be classified as I) Available-for-sale securities; II) Held-to-maturity securities; or III) Trading securities

A. I only.
B. I and II only.
C. I and III only.
D. I, II, and Ill.

2. On December 31, Ott Co. had investments in trading securities as follows: Man Co. with cost = $10,000 and fair value = $8,000; Kemo Inc with cost = $9,000 and fair value = $11,000; and Fenn Corp with cost = $11,000 and fair value = $ 9,000. Total cost = $30,000 and total Fair Value = $28,000. Ott's December 31 balance sheet should report the trading securities as

A. $26,000
B. $28,000
C. $29,000
D. $30,000

3. At year end, Slim Co. held several investments with the intent of selling them in the near term. The investments consisted of $100,000, 8%, five-year bonds, purchased for $92,000, and equity securities purchased for $35,000. At year-end, the bonds were selling on the open market for $105,000, and the equity securities had a market value of $50,000. What amount should Slim report as trading securities in its year-end balance sheet?

A. $50,000
B. $127,000
C. $142,000
D. $155,000

4. A company should report the marketable equity securities that it has classified as trading at

A. Lower of cost or market, with holding gains and losses included in earnings.
B. Lower of cost or market, with holding gains included in earnings only to the extent of previously recognized holding losses.
C. Fair value, with holding gains included in earnings only to the extent of previously recognized holding losses.
D. Fair value, with holding gains and losses included in earnings.

Available-for-Sale Securities

Available-for-sale securities may include equity and debt securities. Available-for-sale securities are not held for short-term profits, nor are they to be held to maturity. Therefore, they are in between trading and held-to-maturity classifications. Available-for-sale securities are presented in the balance sheet as either current assets or noncurrent assets at ***fair value***. They are *often* listed as *noncurrent assets.* However, if the intent is to hold for less than one year, they are current assets. Further, available-for-sale securities available for use in current operations should be listed as current assets. For example, if cash is used to buy equity securities for a contingency fund to be used as needed, the securities are classified as current.

Available-for-sale securities bought when exercising an option are recorded at the option strike price plus the fair value of the option at the exercise date. If the option is worthless and the same security is bought in the market, the security is recorded at the market value plus the remaining carrying amount of the option premium.

Market value is compared to cost on a total portfolio basis. Cumulative unrealized (holding) gains and losses are presented as a separate item in the stockholders' equity section and identified as "accumulated other comprehensive loss or gain." In addition, the holding loss or gain arising during the period is presented in the Statement of Comprehensive Income as Other Comprehensive Income, per ASC 220-10-15, *Comprehensive Income: Overall*.

The **valuation allowance** (**market adjustment** or **securities fair value adjustmen**t) account is a **contra (offset) account** to available-for-sale securities in the balance sheet to present market value. Balance sheet presentation follows:

Available-for-sale securities (cost)
Add (Less): valuation allowance
Net (market value)

EXAMPLE

On April 1, 2X12, the following three available-for-sale securities were bought:

Stock	*Shares*	*Cost per Share*	*Total Cost*
A	1,000	$60	$ 60,000
B	2,000	40	80,000
C	500	90	45,000
			$185,000

The entry is:

4/1/2X12	Available-for-sale securities	185,000	
	Cash		185,000

On September 1, 2X12, a cash dividend of $20,000 is received.

The entry is:

9/1/2X12	Cash	20,000	
	Dividend revenue		20,000

On December 31, 2X12, the market prices per share of the securities are stock A $55, stock B $42, and stock C $83.

An analysis of the year-end portfolio is now possible.

Portfolio of Available-for-Sale Securities 12/31/2X12

Stock	*Cost*	*Market Value*	
A	$ 60,000	$ 55,000	(1,000 × $55)
B	80,000	84,000	(2,000 × $42)
C	45,000	41,500	(500 × $83)
Total	$185,000	$180,500	
Unrealized Loss	$ 4,500		

The entry is:

12/31/2X12	Unrealized loss	4,500	
	Valuation allowance		4,500

The unrealized loss on available-for-sale securities for the period is disclosed in the **statement of comprehensive income** and transferred to the “accumulated other comprehensive loss or gain” section of stockholders' equity on the balance sheet. In addition, the valuation allowance account is a contra account to available-for-sale securities in the balance sheet. As such, the following is presented in the financial statements:

Combined Statement of Comprehensive Income (Select Items)
For the year ended 12/31/2X12

Dividend revenue	$20,000
Unrealized holding loss (other comprehensive income)	(4,500)

Balance Sheet 12/31/2X12

Noncurrent assets	
Available-for-sale securities (cost)	$185,000
Less: valuation allowance	4,500
Net (market value)	$180,500
Stockholders' equity:	
Accumulated other comprehensive loss	$ 4,500

On July 8, 2X13, the company sells all of stock A for $62 per share. The journal entry is:

7/8/2X13	Cash	62,000	
	Available-for-sale securities		60,000
	Realized gain on sale		2,000

The computation of the gain follows:

Net proceeds from sale	$62,000
Cost basis	60,000
Gain on sale of stock	$ 2,000

The realized gain on sale is presented separately in the income statement.

On September 5, 2X13, 4,000 shares of stock D are bought at $10 per share. The entry is:

9/5/2X13	Available-for-sale securities	40,000	
	Cash		40,000

On December 31, 2X13, the market prices per share of the securities remaining in the portfolio are stock B $36, stock C $78, and stock D $11.

An analysis of the year-end portfolio is now possible.

Portfolio of Available-for-Sale Securities 12/31/2X13

Stock	*Cost*	*Market Value*	
B	$ 80,000	$ 72,000	(2,000 × $36)
C	45,000	39,000	(500 × $78)
D	40,000	44,000	(4,000 × $11)
Total	$165,000	$155,000	

Before showing the journal entry needed at year-end, it is easier to understand by presenting the asset section of the balance sheet on December 31, 2X13:

NONCURRENT ASSETS

Available-for-sale securities (cost)	$165,000
Less: valuation allowance	10,000
Net (market value)	$155,000

The valuation allowance account appears as follows:

Valuation Allowance

	12/31/2X12	4,500
	Entry	5,500
	12/31/2X13	10,000

This requires an additional credit for the year to the valuation allowance of $5,500 to balance. Therefore, the journal entry to do this follows:

12/31/2X13	Unrealized loss	5,500	
	Valuation allowance		5,500

The unrealized loss to be presented in the December 31, 2X13 stockholders' equity section of the balance sheet is a cumulative $10,000. This is because as a balance sheet account the unrealized loss is cumulatively carried forward. In the statement of comprehensive income for the year ended December 31, 2X13, the holding loss arising during the year of $5,500 would be reported as part of comprehensive income as another comprehensive loss item.

EXAMPLE

The same information as in the preceding example is assumed, except that the December 31, 2X13 total market value of the portfolio is $163,000 instead of $155,000. In that case, the asset section of the December 31, 2X13, balance sheet would be:

Available-for-sale securities (cost)	$165,000
Less: valuation allowance	2,000
Net (market value)	$163,000

The valuation allowance account appears as follows:

Valuation Allowance

Entry	2,500	12/31/2X12	4,500

		12/31/2X13	2,000

This requires a debit of $2,500 to the valuation allowance account to balance. Therefore, the journal entry to do this follows:

12/31/2X13	Valuation allowance	2,500	
	Unrealized gain		2,500

The net unrealized cumulative loss to be presented in the December 31, 2X13 stockholders' equity section (as accumulated other comprehensive income) of the balance sheet is a net $2,000 ($4,500 - $2,500). However, the unrealized gain of $2,500 would be reported as part of comprehensive income as a $2,500 gain item of other comprehensive income.

EXAMPLE

The same information is again assumed, except that the December 31, 2X13 total market value of the portfolio is $170,000. In that case, the asset section of the December 31, 2X13 balance sheet would be:

Available-for-sale securities (cost)	$165,000
Add: valuation allowance	5,000
Net (market value)	$170,000

The valuation allowance account would appear as follows:

Valuation Allowance

Entry	9,500	12/31/2X12	4,500
12/31/2X13	5,000		

This requires a debit of $9,500 to the valuation allowance account to balance. Therefore, the journal entry to do this follows:

12/31/2X13	Valuation allowance	9,500	
	Unrealized gain		9,500

The net unrealized cumulative gain to be presented in the December 31, 2X13 stockholders' equity section of the balance sheet is a net $5,000 ($9,500 - $4,500). In addition, the unrealized gain is disclosed as other comprehensive income in the comprehensive income statement.

As a result of a permanent decline in fair value, the security should be written down to fair value, and the loss should be treated as a realized loss. Accordingly, the loss will flow through the income statement, and the new cost basis will not be adjusted for increases in the fair value of the security (assuming it is not designated as being hedged in a fair value hedge).

Held-to-Maturity Securities

Held-to-maturity securities can only be debt securities (principally bonds) because they have maturity dates and the intent is to hold to maturity. (Because equity securities do not have a maturity date, they are not in this category.) It is presumed that the company can, and does, hold the securities to maturity. If the company is not financially able to do so, then held-to-maturity classification is not possible. Held-to-maturity securities still may be classified as such even if they are pledged as collateral for a loan.

Debt securities should not be classified as held to maturity if they may be sold to respond to changing market conditions (e.g., prepayment risk, interest rate risk, foreign currency risk, liquidity requirements), changing fund sources and terms, changing availability and yield on alternative investments, or other asset-liability management reasons. If contractual provisions allow a debt security to be paid off in advance or settled in some other manner before maturity, held-to-maturity classification may not be appropriate. However, certain circumstances of an unusual and nonrecurring nature, which were not expected initially, may force a company to alter its intent to hold the security to the maturity date. In such case, no intent to deceive was present. For example, selling a security classified as held to maturity would not indicate initial incorrect classification if the sale decision was due to such reasons as change in tax law (e.g., interest on the security is no longer tax free) or governmental rules (e.g., SEC requirements), deteriorating financial condition of the issuer, change in credit risk policy resulting from a business combination, change in regulatory policy concerning the issuer's capital balances, or change in statutory requirements amending what qualifies as an allowable or dollar amount of investment in certain types of securities.

The sale of a debt security classified as held to maturity is deemed to be at maturity if the sale takes place just prior to the maturity date (usually within three months) and as such the security's fair value is not affected (or minimally affected) by changing market interest rates. The sale of a debt security classified as held to maturity is also considered at maturity if the company has already received 85% or more of the principal from the investment.

Held-to-maturity securities in the balance sheet are presented under *noncurrent assets at* ***amortized cost****.* However, those held-to-maturity securities maturing within one year are presented under current assets. An example is a 30-year bond that is maturing next year (its thirtieth year). **Note:** If a held-to-maturity security is sold before its maturity date, this may raise questions as to management's “real intent” and may result in reporting problems, such as reclassification.

Note: Under ASC 825-10-35-4, *Financial Instruments: Overall*, a company has the option to measure held-to-maturity securities at fair market value. If this fair value option is selected, unrealized (holding) gains and losses will be presented separately in the income statement.

According to ASC 320, an investment is impaired if the fair value is less than the amortized cost. This accounting standard applies to debt securities classified as available-for-sale and held-to-maturity that are subject to other-than-temporary impairment guidance.

If the fair value of a debt security is less than amortized cost at year-end, the company shall assess if impairment is other than temporary. If a company intends to sell the debt security, an other-than-temporary impairment has taken place. If a company is more likely than not to be required to sell the security before there is a recovery in its amortized cost, an other-than-temporary impairment has occurred.

If the company does not anticipate to recover the full amortized cost of the security, the company would be unable to assert it will recover its amortized cost. In this case, an other-than-temporary impairment has occurred. If the present value of cash flows expected to be collected is less than amortized cost, credit loss still exists, and an other-than-temporary impairment has occurred. To determine whether a credit loss exists consider such factors as the time period and degree to which fair value has been less than amortized cost.

If a company intends to sell the debt security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the difference between the investment's amortized cost basis and its fair value on the balance sheet date. If the entity does not intend to sell the security, the other-than-temporary impairment shall be separated into (l) the credit loss and (2) amount related to other factors. The amount of impairment related to the credit loss is recognized in earnings while the impairment related to other factors is recognized in other comprehensive income.

Held-to-maturity securities pledged as collateral may still be classified as such if the company intends and expects to be able to repay the borrowing and recover access to its collateral.

Review Questions

5. On July 2, Year 4, Wynn, Inc. purchased as a short-term investment a $1 million face value Kean Co. 8% bond for $910,000 plus accrued interest to yield 10%. The bonds mature on January 1, Year 11, and pay interest annually on January 1. On December 31, Year 4, the bonds had a fair value of $945,000. On February 13, Year 5, Wynn sold the bonds for $920,000. In its December 31, Year 4, balance sheet, what amount should Wynn report for the bond if it is classified as an available-for-sale security?

A. $910,000

B. $920,000

C. $945,000

D. $950,000

6. The following information pertains to Lark Corp.'s available-for-sale securities on Dec 31 of each year: Year 2 Cost = $100,000 and Fair Value = $90,000; Year 3 Cost = $100,000 and Fair Value = $120,000. Differences between cost and fair values are considered to be temporary. The decline in fair value was properly accounted for at December 31, Year 2. Ignoring tax effects, by what amount should other comprehensive income (OCI) be credited at December 31, Year 3?

A. $0

B. $10,000

C. $20,000

D. $30,000

7. Kale Co. purchased bonds at a discount on the open market as an investment and has the intent and ability to hold these bonds to maturity. Absent an election of the fair value option (FVO), Kale should account for these bonds at

A. Cost.

B. Amortized cost.

C. Fair value.

D. Lower of cost or market.

8. Investments classified as held-to-maturity securities should be measured at

A. Acquisition cost.

B. Amortized cost.

C. Lower of cost or market.

D. Fair value.

9. When the fair value of an investment in debt securities exceeds its amortized cost, how should each of the following debt securities be reported at the end of the year, given no election of the fair value option?

A. Held-to-Maturity securities should be reported at Amortized cost, and Available-for-Sale securities should be reported at Amortized cost

B. Held-to-Maturity securities should be reported at Amortized cost, and Available-for-Sale securities should be reported at Fair value

C. Held-to-Maturity securities should be reported at Fair value, and Available-for-Sale securities should be reported at Fair value

D. Held-to-Maturity securities should be reported at Fair value, and Available-for-Sale securities should be reported at Amortized cost

10. An available-for-sale debt security was purchased on September 1, 2X12 between interest dates. The next interest payment date was February 1, 2X13. Because of a permanent decline in fair value, the cost of the debt security substantially exceeded its fair value at December 31, 2X12. On the balance sheet at December 31, 2X12, the debt security should be carried at

A. Fair value plus the accrued interest paid.

B. Fair value.

C. Cost plus the accrued interest paid.

D. Cost.

Amortization of Bond Discount or Premium

To adjust the yield on a bond investment to equal the market rate, the price of the bond must fluctuate inversely with the market rate because the nominal interest rate is fixed. Bonds selling at a premium (discount) have a nominal rate greater than (less than) the market rate. If the market rate subsequently increases (decreases), the price of the bonds must decrease (increase) to provide a yield equal to the new market rate.

Amortization of bond discount or premium is either based on the **effective interest method** (preferred) or the **straight-line method**. The effective interest method of amortization results in the following journal entry:

Interest receivable (nominal interest rate × face value of bond)
Held-to-maturity securities (for discount amortization) - for difference
    Interest revenue (yield × carrying value of bond)
    Held-to-maturity securities (for premium amortization) - for difference

Under the effective interest method, yield is based on the yield to maturity formula (not the simple yield formula). Yield to maturity equals:

$$\frac{\text{Nominal interest + Discount/Years or (- Premium/Years)}}{\text{(Purchase price + Maturity value)/2}}$$

EXAMPLE

A $10,000, 8% bond is bought at $9,500 having a 10-year life. The yield equals:

$$\frac{\$800 + \$500/10}{(\$9{,}500 + \$10{,}000)/2} = \frac{\$850}{\$9{,}750} = 8.7\%$$

The effective interest method results in a **constant rate** but **different dollar amount** of amortization each period. The straight-line method of amortization for discount or premium per period equals:

Discount or (- Premium)/Number of periods

EXAMPLE

A $10,000, 10% bond bought at $9,000 and having a 10-year life would have an annual amortization of:

$1,000/10 years = $100

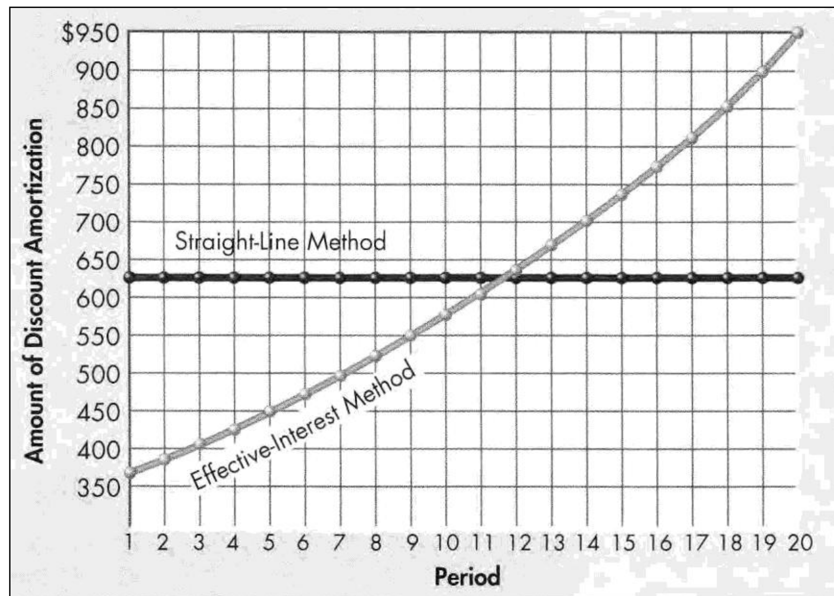
The straight-line method results in the following journal entry:

Interest receivable (nominal interest × face value of bond)
Held-to-maturity securities (for discount amortization)
    Held-to-maturity securities (for premium amortization)
    Interest revenue (for difference)

The straight-line method results in a **constant** dollar amount of amortization each period but at a different rate.

Exhibit 5 compares effective-interest and straight-line amortization methods.

EXHIBIT 5: COMPARISON OF EFFECTIVE-INTEREST AND STRAIGHT-LINE AMORTIZATION METHODS



EXAMPLE

On January 1, 2X12, ABC Company buys $100,000, 10%, five-year bonds of XYZ Company at 98%. Interest is payable annually on January 1. The effective interest method of amortization is used. The yield to maturity (effective interest rate) equals:

Nominal (coupon) interest = $100,000 × 10% = $10,000
Purchase price = $100,000 × 98% = $98,000
Discount = $100,000 - 98,000 = $2,000

Yield to maturity equals:

$$\frac{\text{Nominal Interest + Discount/Years}}{\text{(Purchasing price + Maturity value)/2}} = \frac{\$10,000 + \$2,000/5}{(\$98,000 + \$100,000)/2} = \frac{\$10,400}{\$99,000} = 10.505\%$$

The yield (10.505%) exceeds the nominal interest rate (10%) because the bond was bought at a discount (below face value). The investor earns the $2,000 discount between the purchase date and maturity date so as to increase the effective rate of return.

The entry for the purchase of the bond is:

1/1/2X12	Held-to-maturity securities	98,000	
	Cash		98,000

The following table is used to compute the cash interest received, interest revenue, amortization of bond discount, and carrying value of the bond:

10% Bond Bought to Yield 10.505%

Date	*Cash Interest Received 10% × $100,000*	*Interest Revenue 10.505% × Carrying Value*	*Amortization of Bond Discount*	*Carrying Value of Bond*
1/1/2X12				$98,000
1/1/2X13	$10,000	$10,295	$295	98,295
1/1/2X14	10,000	10,326	326	98,621
1/1/2X15	10,000	10,360	360	98,981
1/1/2X16	10,000	10,398	398	99,379
1/1/2X17	10,000	10,440	440	99,819*
Total	$50,000	$51,819	1,819	

* Difference between $99,819 and $100,000 maturity value is due to the inaccuracy of the approximation technique above. Actual interest rate = 10.535%

Note: The carrying value of the bond increases from $98,000 to $100,000 because it was bought at a discount (below face value). At maturity, the bond is worth its face value. Interest revenue increases because the carrying value of the bond increases. Amortization of bond discount increases because of the increasing interest revenue.

Based on this table, journal entries are prepared for 2X12 and 2X13.

12/31/2X12	Interest receivable	10,000	
	Held-to-maturity securities	295	
	Interest revenue		10,295
1/1/2X13	Cash	10,000	
	Interest receivable		10,000
12/31/2X13	Interest receivable	10,000	
	Held-to-maturity securities	326	
	Interest revenue		10,326

At the end of 2X12 and 2X13, respectively, the following are presented in the balance sheet and income statement:

Balance Sheet

	2X12	*2X13*
Current assets		
Interest receivable	$10,000	$10,000
Noncurrent assets		
Held-to-maturity securities (amortized cost)	98,295	98,621

Income Statement

	2X12	*2X13*
Other revenue		
Interest revenue	$10,295	$10,326

EXAMPLE

The facts from the previous example are again assumed, except that instead of using the effective interest method of amortization (the preferred method), the straight-line amortization method is used (less preferable under GAAP but accepted). The straight-line amortization per year equals:

Discount/Years = $2,000/5 = $400

The entry on January 1, 2X12, for the purchase of the bond is still the same. However, the other journal entries would be different because the amount of amortization per year is different. The entries would be:

12/31/2X12	Interest receivable	10,000	
	Held-to-maturity securities	400	
	Interest revenue		10,400
1/1/2X13	Cash	10,000	
	Interest receivable		10,000
12/31/2X13	Interest receivable	10,000	
	Held-to-maturity securities	400	
	Interest revenue		10,400

At the end of 2X12 and 2X13, respectively, the following are presented in the balance sheet and income statement:

Balance Sheet

	2X12	*2X13*
Current assets		
Interest receivable	$10,000	$10,000
Noncurrent assets		
Held-to-maturity securities		
(amortized cost)	$98,400	$98,800

Income Statement

	2X12	*2X13*
Other revenue		
Interest revenue	$10,400	$10,400

With regard to held-to-maturity securities, a change in market price of a forward contract or purchased option should be recognized if there has been a *permanent decline* in value. The permanent loss is presented in the current year's income statement.

Note: When a bond is purchased at a premium (discount), its initial carrying amount is greater (less) than the maturity amount. The carrying amount of a bond acquired at a premium will decrease over time as the premium is amortized. Under the *effective interest method,* interest revenue is equal to the carrying amount of the bond at the beginning of the interest period multiplied by the yield rate of interest. The amount of periodic amortization is the excess of the nominal interest received over the interest revenue. Because the carrying amount of the bond will decrease over time, the amount of interest revenue will also diminish. Subtracting the decreasing interest revenue from the constant periodic cash flow results in increasing amounts of premium amortization over the term of the bond. Under the *straight-line method* of amortization, equal amounts are amortized over the life of the bond. Accordingly, the least amount of premium will be amortized in the first year under the interest method, and the result will be the highest carrying amount of the bond at the end of this year.

Exhibit 6 presents the accounting and reporting for trading, available-for-sale, and held-to-maturity securities.

Exhibit 6: Accounting and Reporting for Investments in Equity and Debt Securities

	Trading	*Available-for-sale*	*Held-to-maturity*
Valuation	Fair value	Fair value	Amortized cost
Unrealized (holding) gain or loss	Income statement	Comprehensive income statement (other comprehensive income) stockholders' equity	Not reported
Realized gain or loss	Income statement	Income statement	Income statement

Classification in balance sheet	Current assets	Current or noncurrent assets	Noncurrent assets
Type of security	Equity or debt	Equity or debt	Debt only
Periodic income	Dividend or interest revenue	Dividend or interest revenue	Interest revenue

Fair Value Alternative for Available-for-Sale and Held-to-Maturity Securities

ASC 825-10-10-1, *Financial Instruments: Overall*, provides an entity with an option to improve its financial reporting by disclosing more relevant and understandable information relating to its financial assets and liabilities in the form of fair value. According to the FASB, fair value would improve users' assessment of an entity's current financial position because fair value better reflects the current cash equivalent of both the entity's financial assets and liabilities. In addition, this would be preferable to the use of historical prices, which would become irrelevant with the passage of time.

ASC 825-10-35-4, *Financial Instruments: Overall*, provides an entity with an irrevocable fair value reporting option for its available-for-sale and held-to-maturity securities held at the effective date currently accounted for under ASC 320-10-05, *Investments—Debt and Equity Securities: Overall*. Under this option, the entity may choose to report all unrealized holding gains and losses in earnings for which this election has been chosen. Essentially, this accounting is the same as that which currently exists for trading securities under ASC 320-10-05.

Impairment Guidance

Excerpt from Accounting Standards Codification

Investments — Debt and Equity Securities — Overall

Subsequent Measurement

Steps for Identifying and Accounting for Impairment
320-10-35-18

For individual securities classified as either available for sale or held to maturity, an entity shall determine whether a decline in fair value below the amortized cost basis is other than temporary. Providing a general allowance for unidentified impairment in a portfolio of securities is not appropriate.

Step 1: Determine Whether an Investment Is Impaired
320-10-35-21
An investment is impaired if the fair value of the investment is less than its cost.

Step 2: Evaluate Whether an Impairment Is Other Than Temporary
320-10-35-30
If the fair value of an investment is less than its amortized cost basis at the balance sheet date of the reporting period for which impairment is assessed, the impairment is either temporary or other than temporary. In addition to the guidance in this Section, an entity shall apply other guidance that is pertinent to the determination of whether an impairment is other than temporary, such as the guidance in Sections 323-10-35 and 325-40-35, as applicable. Other than temporary does not mean permanent.

Impairments are evaluated at each reporting date for every investment. ASC 325-40-65-1 deals with whether a company's investments should be considered “other-than-temporarily” impaired. This applies when a company holds corporate debt, equities, or structural investment securities (CDOs, mortgage-backed and other asset-backed securities). Companies must make a subjective evaluation in ascertaining when impairment is “other than temporary,” and if such is the case, to write down the impaired asset to its fair value recognizing a loss. After the realized loss is recognized, a new cost basis is established for the security. A later recovery in fair value cannot be recognized unless the security is later sold.

The Emerging Issues Task Force (EITF) provides disclosure requirements for securities with fair values below recorded cost. Companies must disclose in tabular form the amount of unrealized losses and the total fair value of investments with unrealized losses in investment securities having a fair value below book value and for which an other-than-temporary impairment charge has not been taken. The rationale for considering impairment as temporary should be presented. Disclosure should be made of the amounts of unrealized losses and the aggregated fair value of investments with unrealized losses. Companies must disclose in narrative form their rationale for considering existing impairment temporary including the following:

- Reasons for the impairment.
- Length and severity of the impairment.
- Nature of the investments.
- Number of investment positions that are considered unrealized.
- Other evidence in concluding the investment is not other-than-temporarily impaired.

Factors indicating an other-than-temporary impairment of a security's value has taken place include:

- Issuer's financial health.
- Investee's cash position.
- Credit rating of the security and any credit downgrading.

- How long and degree to which the market value has been below cost.
- Issuer's short-term prospects.
- Failure to make required interest payments.
- If the decline in fair value is applicable to negative conditions specifically related to, for example, the security, geographic locality, industry, overall economy, politics.
- Dividend reduction or elimination.
- Information about collectibility of the security such as present conditions, reasonable forecasts, prior events, and estimates of future cash flows.

If there is default by the issuer on principal and/or interest payments on debt, it is very probable that there is an other-then-temporary impairment. If the investor does not plan or is unable to hold the security long enough to realize the recorded amount, an impairment charge should be made.

The following is suggested:

- Document the factors for each security evaluated.
- Examine the inability to hold a security to maturity.
- Quarterly appraise impairment.
- Look at credit-related issues.
- Apply methodology consistently.
- Look at the nature of collateral including kind of assets and date of origination.
- Consider illiquidity.

Structured Notes

Structured notes are debt instruments whose cash flows are tied to the change in some index (e.g., Consumer Price Index, or CPI), foreign exchange rate, interest rate (e.g., prime interest rate), or price of some item (e.g., commodity). The notes usually include a nondetachable forward or option component (e.g., calls, caps). The cash flow associated with the payment of interest and/or principal will change in timing and amount over time, depending on the linked index, interest rate, or other market factor.

Income on structured notes classified as held to maturity or available for sale should be accounted for under the retrospective interest method, as long as at least one or more of the following criteria exist:

- The maturity date of the note depends on a particular index or happening of a given event not within the control of the participants to the transaction. An example is the maturity date tied to the prime interest rate or price of wheat.

- The interest on the note varies over its life such as an inverse floating- rate note.

- The maturity value of the note may change, such as when the principal at the maturity date is tied to the S&P 100 index.

When the retrospective interest method is used, the interest income for the year equals the difference between the amortized cost of the security at year-end versus at the beginning of the year, plus the cash received for the year on the note. Amortized cost is based on the discounted value of projected future cash flows using the effective yield. If a permanent decline in value occurs, a writedown of the amortized cost is required. The loss is reported in the income statement.

Bond Quotes

A basis point is one one-hundredth of one percentage point, usually used in quoting of spreads between interest rates or describing changes in yields of securities. Quotes for notes and bonds are expressed in thirty-seconds. However, quotes may be in sixty-fourths by using pluses. For example, a trade at 100 : 08 bid means a bid of 100 and 8 thirty-seconds. A quote of 103 : 12 + bid means a bid of 103 and 12½ thirty-seconds, or 103 25/64. Refer to the "bid" column in a financial newspaper and financial Web sites for the current average price for a note or bond.

Statement of Cash Flows

The purchase and sale of available-for-sale, held-to-maturity, and equity method securities are reported in the **Investing Activities** section of the statement of cash flows. The cash flows associated with the purchase and sale of trading securities and securities accounted for using the fair value options are shown in the Operating or Investing Activities section depending on the reason the securities were acquired. For available-for-sale securities, realized losses are added and realized gains are subtracted when computing cash from operating activities. With trading securities, unrealized gains are also subtracted, and unrealized losses are also added if those trading securities are considered to be part of operating activities. With equity method securities, an adjustment to operating cash flow must be made to reflect the fact that the cash received from the securities in the form of dividends is not equal to the income from the securities included in the computation of net income.

General Accounting for Investments

Dividend and interest income (revenue) are included in "Other (Financial) Income" as earned and as an element of net income.

EXAMPLE

An investor owns 1,000 shares of a stock. The company declares a $.30 dividend per share. The entry is:

Dividend receivable	300	
Dividend revenue		300

EXAMPLE

An investor owns a $20,000 face value bond having a coupon interest rate of 10% paid annually. The entry is:

Cash	2,000	
Interest income		2,000

Interest income is shown net of the amortization of discount or premium for held-to-maturity securities.

Realized gains and losses on the sale of securities for all three types (trading, available-for-sale, and held-to-maturity securities) are included as a separate item in the income statement in the year of sale. The gain or loss equals the difference between the net proceeds and the adjusted cost basis. The net proceeds equal the selling price less brokerage commissions less service fees less any transfer taxes. The adjusted cost basis equals the purchase price plus brokerage commissions plus service fees plus taxes.

EXAMPLE

An investor buys 100 shares of ABC stock having a market price of $20. The brokerage fee is $50. The investor later sells the shares at a market price of $25. The brokerage commission upon sale is $75. The net gain or loss equals:

Net sales proceeds (100 shares × $25) - $75	$2,425
Less: adjusted cost basis (100 shares × $20) + $50	2,050
Capital gain	$ 375

Gains and losses on financial instruments used to hedge trading securities should be included in the income statement. However, gains and losses on instruments that hedge available-for-sale securities should initially be presented as a separate item in the stockholders' equity section and then amortized as an adjustment to yield.

Permanent losses (e.g., due to bankruptcy, liquidity crisis) on either available-for-sale or held-to-maturity securities are considered a realized loss and included in earnings. The carrying amount of the

investment is similarly reduced. When the security is written down, fair value at that date becomes the new cost basis. For the purposes of determining permanent losses, declines are measured by individual security. Permanent losses in value of one security cannot be offset by gains in another. Factors in considering whether a permanent impairment in value has occurred include an adverse event or condition, how long and how much market value has been less than cost, financial status of issuing company, poor economic conditions, industry problems, reduction or cessation in dividends, missing interest payments, and investor's ability to wait for a possible recovery in value. A subsequent recovery (gain) in the fair value of available-for-sale securities which had been written down because of a permanent loss should be added to the investment account and included as a separate component in the stockholders' equity section of the balance sheet. The journal entry for a recovery in fair value is:

Available-for-sale securities
    Unrealized gain

Note: Even though a permanent loss on available-for-sale securities is presented in the income statement, recovery in fair value is reported in the stockholders' equity section and in the comprehensive income statement (other comprehensive income).

If held-to-maturity securities are similarly permanently written down as a loss, the fair value increase will not be reported in the balance sheet, though disclosure will usually be made in the footnotes.

EXAMPLE

A company held available-for-sale debt securities having an amortized cost of $250,000. The fair market value of the securities is $200,000. The unrealized loss on these securities presented in the comprehensive income statement (other comprehensive items) and as a reduction of stockholders' equity is $50,000. It is now determined that a permanent loss exists because the investor will not be able to collect all amounts due. Therefore, the unrealized loss of $50,000 is now considered a permanent loss to be included in earnings.

The entry is:

Permanent loss	50,000	
Valuation allowance	50,000	
Unrealized loss		50,000
Available-for-sale securities		50,000

The new cost basis of the debt securities is $200,000. Any later change in fair market value of the impaired securities is included in the stockholders' equity section and in the comprehensive income statement (other comprehensive income).

EXAMPLE

Available-for-sale securities were written down because of a permanent loss by $18,000. A subsequent recovery of such loss was $7,000. The appropriate journal entry for the recovery is:

Available-for-sale securities	7,000	
Unrealized gain		7,000

Unrealized (holding) gains and losses on trading securities and available-for-sale securities are not recognized for tax purposes until realized by sale. Therefore, differences between the tax basis and financial reporting basis of trading securities (shown in the income statement) and available-for-sale securities (presented in the stockholders' equity section) are temporary differences. A deferred tax liability (asset) is recognized for unrealized gains (losses).

Note: Permanent declines in value of available-for-sale and held-to-maturity securities also result in temporary differences because the loss is not deductible on the tax return until the securities are sold.

Deferred tax liabilities and deferred tax assets are reported in the balance sheet. The corresponding tax provisions will be presented in the income statement for trading securities or in the stockholders' equity section for available-for-sale securities. **Note:** No deferred taxes exist for temporary declines in price of held-to-maturity securities because no recognition is given for such a decline.

EXAMPLE

A trading security was bought at a cost of $200,000. At year-end, the fair market value of the security was $150,000, resulting in a temporary decline. The tax rate is 40%. The journal entries to record the fair value adjustment and the tax effect follow:

Unrealized loss	50,000	
Valuation allowance		50,000
Deferred tax asset	20,000	
Tax provision		20,000

If the security was available for sale instead of trading, the credit for $20,000 would go to unrealized loss (presented in the stockholders' equity section). If the security was held to maturity, no entry is made for temporary declines in price. However, if a permanent loss were incurred, deferred taxes would be recognized. In such a case, the entries would be:

Realized loss	50,000	
Held-to-maturity securities		50,000
Deferred tax asset	20,000	
Tax provision		20,000

The tax provision would be presented in the income statement for held-to-maturity securities.

In an unclassified balance sheet, the portfolio is considered noncurrent.

Equity securities acquired by exchanging noncash consideration (property or services) are recorded at either the fair market value of the consideration given or received, whichever is more clearly evident. Fair market value may be based on appraisal.

Blocks of Stock

A company's stock may be bought on different dates and then later sold. The sale can be based on specific identification (preferred), FIFO, or average cost. FIFO is the method typically used in practice. The realized gain or loss on sale is presented in the income statement.

EXAMPLE

On January 1, 2X13 an investor bought 100 shares of L Company Stock at $9 per share. On February 3, 2X13, another 200 shares were purchased at $10 per share. On March 6, 2X13, the investor sold 50 shares at $11 per share. The FIFO method is used. The journal entry is:

Cash (50 × $11)	550	
Investment in L Company (50 × $9)		450
Gain on sale		100

The T-account looks as follows:

L Company

1/1/2X13	100@$9	900	3/6/2X13	50@$9	450
2/3/2X13	200@$10	2,000			
	300	2,900			

Balance	250	2,450

Lump-Sum Purchase

If two or more stocks are bought for one price, the cost is allocated to the securities proportionately, based on their market values.

EXAMPLE

An investor pays $5,800 for 100 shares of stock A, having a market price per share of $40, and 200 shares of stock B, having a market price of $10 per share. The cost allocation follows:

Stock	*Market Value*	*Allocated Cost*
A 100 shares × $40	$4,000	$3,867[a]
B 200 shares × $10	2,000	1,933[b]
Total	$6,000	$5,800

[a] $4,000/$6,000 × $5,800 = $3,867

[b] $2,000/$6,000 × $5,800 = $1,933

The journal entry is:

Investment—stock A	3,867	
Investment—stock B	1,933	
Cash		5,800

If market value is available for one security but not the other, the incremental method must be used. Under this method, cost is first assigned to the market value of the security for which it is known, with the balance assigned to the other security.

EXAMPLE

An investor pays $50,000 for 1,000 shares of stock X with a market price of $30 and 300 shares of stock Y, which does not have a market price because it is a closely held company. The cost allocation follows:

	Stock	*Allocated Cost*
Stock X	1,000 shares @ $30	$30,000
Stock Y	Balancing figure	$20,000 ($50,000 - $30,000)
Total		$50,000

Exchange (Conversion) of Securities

A conversion of securities may include exchanging preferred stock or bonds for common stock. The security received is recorded at its market value. The difference between the market value of the security received and the cost basis of the security given up represents a gain or loss on conversion. The gain or loss is reported in the income statement.

EXAMPLE

An investor owns preferred stock costing $10,000, which he or she converts into 1,000 shares of common stock having a market price of $15 per share. The journal entry is:

Investment in common stock	15,000	
Investment in preferred stock		10,000
Gain—conversion of stock investment		5,000

Stock Dividends

A stock dividend increases the number of shares held without increasing the cost. Because total cost remains the same, the cost per share after the stock dividend is received decreases. A stock dividend involves only a memo entry.

EXAMPLE

An investor owns 100 shares of DEF Company at a total cost of $1,000. Therefore, the cost per share is $10. A 20% stock dividend is received, so the shares owned now are 120. It costs the

investor nothing to get those shares. Because total cost remains at $1,000, the cost per share decreases to $8.33 ($1,000/120). The T-account looks as follows:

Investment in DEF			
100	$10	$1,000	
20		0	
120	$8.33	$1,000	

EXAMPLE

On April 3, 2X13, Robert Company bought 1,000 shares of DEF common stock at $82 per share. On October 15, 2X13, Robert received 1,000 stock rights to buy an additional 1,000 shares at $95 per share. On October 30, 2X13, DEF common stock had a market value, rights on, of $100 per share, and the stock rights had a market value of $6 each. At October 30, 2X13, the investment in stock rights has a carrying value equal to $4,920, computed as follows:

Original cost of stock	$ 82,000
Ratio of value of stock rights to value of stock	× $6/$100
Investment in stock rights	$ 4,920

Preferred Stock Received for Common Stock Dividend

Instead of cash, a company may receive shares of preferred stock as its common stock dividend. The nonmonetary asset received (investment in preferred stock) should be recorded at the fair value of the asset received. Thus, the investment and related dividend income should be recorded at the fair market value of the preferred stock at the date of the transaction, as follows:

Investment in preferred stock

Dividend income on common stock

Stock Splits

A stock split increases the number of shares held without increasing the cost. After a stock split, the cost per share is proportionately reduced. A stock split involves only a memo entry.

EXAMPLE

An investor owns 500 shares of PQ Company at a total cost of $10,000. Therefore, the cost per share is $20. A 2-for-1 stock split is issued. As a result, the investor will now have 1,000 shares. Because total cost remains the same ($10,000), the cost per share is proportionately reduced to $10. The T-account looks as follows:

Investment in PQ Company

500	$20	$10,000	
1,000	$10	$10,000	

Reclassification Adjustments Relating to Investments

As indicated in previous discussions, any unrealized holding gains or losses relating to the available-for-sale portfolio are reported in an enterprise's **comprehensive income statement** as part of **other comprehensive income**. These gains or losses are then closed to the accumulated other comprehensive income section of stockholders' equity. However, when securities from this portfolio are actually sold, double counting may occur. This is due to the recognition of realized gains and losses from the sale of available-for-sale securities in the income statement (and comprehensive income statement) as well as their disclosure in comprehensive income from the current or prior periods. The latter may have occurred as part of the recognition of unrealized holding gains or losses derived from the mark-to-market entry made on the available-for-sale portfolio at the end of the current or prior periods. To ensure that such double counting does not occur when the sale of available-for-sale securities occurs, it is necessary to ascertain the extent of the duplication and record a reclassification adjustment in the comprehensive income statement. This adjustment may either be shown on the face of the financial statement in which comprehensive income is shown or be disclosed in the notes to the financial statements.

EXAMPLE

X Company has the following securities in its available-for-sale portfolio at December 31, 2X12 (this was the company's first year of operations):

	Cost	*Fair Value*	*Unrealized Gain (Loss)*
Y Company stock	$ 60,000	$40,000	$(20,000)
Z Company stock	50,000	20,000	(30,000)
	$110,000	$60,000	$(50,000)

In its comprehensive income statement for the year, 2X12, the unrealized holding losses of $50,000 will be included in other comprehensive income, as follows:

X Company
Statement of Comprehensive Income
For the Year Ended December 31, 2X12

Net income	$ XX,XXX
Other comprehensive income	
Unrealized holding losses on available for-sale securities	$(50,000)
Comprehensive income	$ XX,XXX

At the beginning of the next year, 2X13, X Company sells its Y Company stock and incurs a realized loss of $20,000 on the sale. At December 31, 2X13, the fair value of Z Company stock (the remaining security in its available-for-sale portfolio) dropped to $10,000 (from $20,000). This represented an additional $10,000 unrealized holding loss in the year 2X13 and is disclosed in X Company's statement of comprehensive income (as part of other comprehensive income). It is also assumed that X Company had net income of $150,000 for the year 2002, which included the realized loss of $20,000 from the sale of Y Company stock. The X Company comprehensive income statement for the year 2X13 appears as follows:

X Company
Statement of Comprehensive Income
for the Year Ended December 31, 2X13

Net income		$150,000
Other comprehensive income		
Less: unrealized holding losses on available for-sale securities	$10,000	
Add: reclassification adjustment for losses included in net income	20,000	10,000

Comprehensive income		$160,000

In the year 2X12, the unrealized loss of $20,000 was included in the X Company's comprehensive income statement. The next year, 2X13, the company sold its Y Company stock and incurred a realized loss of $20,000, which decreased its net income and comprehensive income for the period. A reclassification adjustment (shown in the preceding statement of comprehensive income) is required, causing an unrealized gain of $10,000 to avoid double counting.

Transfers of Securities between Categories

The reasonableness of a security's classification should be reevaluated at each reporting date. For example, there may have been a change in circumstances, such as a change in financial condition (e.g., cash flow, liquidity, profitability).

All types of transfers between categories should be accounted for at **fair market value** on the transfer date. This requirement ensures that a company cannot avoid fair value recognition by transferring a security from one category to another. If, for example, a security is transferred from the trading to the available-for-sale portfolio, it is recorded in the available-for-sale portfolio at fair value (at the date of transfer), and any unrealized holding gain or loss (due to the difference between fair value and cost) is recorded as part of net income and closed to retained earnings in stockholders' equity. Fair value at the date of transfer becomes the new cost basis of the security. At the next reporting date, an adjusting entry is made to record any new changes in the fair value of the available-for-sale portfolio. ASC 320-10-55 notes, however, that transfers of this nature should, in fact, be rare.

The same parameters apply to the transfer of a security from the available-for-sale to the trading portfolio. For a debt security transferred from the held-to-maturity to the available-for-sale portfolio, any unrealized holding gain or loss (due to the difference between cost and fair value increases and decreases) is disclosed in the comprehensive income statement as other comprehensive income and is ultimately transferred to the accumulated other comprehensive income section of stockholders' equity (as a separate component of stockholders' equity). A securities valuation account is also used in this transfer because its balance must always equal the balance in the unrealized holding gain or loss account (unlike the prior types of transfers, where net income was changed). Net income in this situation is not affected.

The same guidelines apply to the transfer of a debt security from the available-for-sale to the held-to-maturity portfolio except that any unrealized gain or loss at the date of transfer represents a component of stockholders' equity and is amortized over the remaining life of the debt security. A securities valuation account (held to maturity) is also used in this transfer. Both the unrealized holding gain or loss account and its equivalent securities valuation account (held to maturity) are amortized over the remaining life of the debt securities. The results of these calculations are netted against each other so

there is no effect on net income. In addition, if the debt security was originally purchased at a discount or premium, the discount or premium should be amortized over the life of the debt security as well. All of the aforementioned guidelines presume that end-of-period adjusting entries to report portfolio changes in fair value were not yet recorded.

Exhibit 7 presents the accounting for the transfers between categories.

EXHIBIT 7: TRANSFER BETWEEN CLASSIFICATIONS

	1	***2***	***3***	***4***
Nature of Transfer	**Trading *to* available for sale**	**Available for sale *to* trading**	**Held to maturity *to* available for sale**	**Available for sale *to* held to maturity**
How Measured	Transfer at market value, which becomes new cost basis at the date of transfer	Same as (1)	Transfer security at fair value on transfer date	Same as (3)
Effect on Income	Unrealized gain or loss is recognized as part of income	Same as (1)	None	None
Effect on Stockholders' Equity	Unrealized gain or loss is recognized as part of stockholders' equity	Same as (1)	The separate component of stockholders' equity is increased or decreased by the unrealized gain or loss at the date of transfer	Amortize balance of unrealized gain or loss as part of stockholders' equity over the remaining life of the security

EXAMPLE

On December 31, 2X13, a company elects to transfer from trading to available for sale one stock of many stocks. On the transfer date, the stock's cost is $100,000 and its market value is $120,000. The transfer will be made at fair market value, which becomes the new cost basis. Assuming that the adjusting entry to record any change of fair value for the current period has not been made, the entry is:

Available-for-sale securities	120,000	
Trading securities		100,000
Unrealized holding gain—net income		20,000

The unrealized holding gain increases net income for the period.

EXAMPLE

A company elects to transfer from available for sale to trading one stock in its portfolio. On the transfer date, cost equals $100,000 and market value equals $90,000 of that stock. Assuming that the adjusting entry to record any change of fair value for the current period has not been made, the entry is:

Account	Debit	Credit
Trading securities	90,000	
Unrealized holding loss—net income	10,000	
Available-for-sale securities		100,000

The unrealized loss will decrease net income for the period.

EXAMPLE

A company decides to transfer one of its corporate bonds in its portfolio from held to maturity to available for sale. The amortized cost is $40,000 and the fair market value is $55,000. The transfer is made at fair market value. Assuming that the adjusting entry to record any change of fair value for the current period has not been made, the entry is:

Account	Debit	Credit
Valuation adjustment (available for sale)	15,000	
Available-for-sale securities	40,000	
Unrealized holding gain—stockholders' equity		15,000
Held-to-maturity securities		40,000

Note that the unrealized gain of $15,000 will be reflected in the other comprehensive income section of comprehensive income as well as stockholders' equity.

Classification and Disclosure

As was discussed, companies that have investment securities typically have not just one or two investments but instead have complicated portfolios of investments. **Note disclosure** is necessary to give financial statement users a sufficient understanding of the performance and status of these portfolios. In addition, because the fair values of investment securities are determined in a variety of ways, financial statement users need disclosure to help them determine the reliability of the reported numbers. Realized gains and losses on the sale of Investment securities are reported in the income statement in the period of the sale. Unrealized gains and losses on trading securities are also reported in the income statement. Unrealized increases and decreases on securities classified as available for sale are reported as other comprehensive income and are accumulated in the Stockholders' Equity section of

the balance sheet. Companies are also required to give additional note disclosure regarding their investment portfolios, including details on Level 1, Level 2, and Level 3 fair values**.**

We have discussed the treatment of the gains and losses (both realized and unrealized) associated with selling, valuing, and/or reclassifying securities. Gains and losses from the sale of securities and unrealized gains and losses from changes in fair value while holding trading securities are reported in the income statement as Other Revenues and Expenses, or are combined with dividend and interest revenue and reported as Net Investment Income. Unrealized gains and losses on available-for-sale securities are reported in the Accumulated Other Comprehensive Income section of stockholders' equity and are included as Other Comprehensive Income in the computation of comprehensive income. As with any asset, significant permanent declines in the value of investments are recognized as a loss in the year they occur. **Note:** As a result of a permanent decline in fair value, the security should be written down to fair value, and the loss should be treated as a realized loss. Accordingly, the loss will flow through the income statement, and the new cost basis will not be adjusted for increases in the fair value of the security (assuming it is not designated as being hedged in a fair value hedge).

Berkshire Hathaway, for example, includes a one-line summary of all of its realized gains and losses for the year in its income statement and discloses further details in the notes. The relevant note disclosure for Berkshire Hathaway for 2009 is included in Exhibit 8. Note that Berkshire Hathaway has cumulative unrealized gains on its debt and equity investments totaling almost $36 billion. How is it possible that none of this unrealized amount shows up on Berkshire Hathaway's income statement? The company classifies its securities as either held to maturity (for some debt securities), available for sale (for most debt and equity securities), or equity method (for some large investments).

Although the unrealized increases associated with the available-for-sale securities are not reported on the income statement, they are included in the computation of comprehensive income. Berkshire Hathaway's statement of comprehensive income is included in Exhibit 9.

The total unrealized increase reported for the available-for-sale portfolio is $20,375 million ($17,607 million + $2,768 million). The "reclassification" item reported in the statement of comprehensive income includes the reversal of prior-year unrealized losses on securities that were sold during the year.

Note: Appropriate presentation of individual securities on the balance sheet depends on the intent of management. If management intends or is willing to sell the securities within one year or the current operating cycle, whichever is longer, the security is classified as a current asset. Because trading securities are short term by definition, they are always classified as current. Held-to-maturity securities are always classified as noncurrent unless they mature within a year. Available-for-sale securities are classified as current or noncurrent, depending on the intentions of management.

EXHIBIT 8: BERKSHIRE HATHAWAY-NOTE DISCLOSURE RELATING TO INVESTMENTS (PARTIAL)

4) Investments in fixed maturity securities

Investments in securities with fixed maturities as of December 31, 2009 are summarized below (in millions).

	Amortized Cost	Unrealized Gains	Unrealized Losses*	Fair Value
December 31, 2009				
U.S. Treasury, U.S. government corporations and agencies	$ 2,362	$ 46	$ (1)	$ 2,407
States, municipalities and political subdivisions	3,689	275	(1)	3,963
Foreign governments	11,518	368	(42)	11,844
Corporate bonds	13,094	2,080	(502)	14,672
Mortgage-backed securities	3,961	310	(26)	4,245
	$34,624	$ 3,079	$ (572)	$37,131

*Includes $471 million at December 31, 2009 related to securities that have been in an unrealized loss position for 12 months or more.

5) Investments in equity securities

Investments in equity securities as of December 31, 2009 are summarized below (in millions).

	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2009				
American Express Company	$ 1,287	$ 4,856	$ —	$ 6,143
The Coca-Cola Company	1,299	10,101	—	11,400
Kraft Foods Inc.	4,330	—	(789)	3,541
The Procter & Gamble Company	4,962	78	—	5,040
Wells Fargo & Company	7,394	2,721	(1,094)	9,021
Other	17,935	7,118	(1,164)	23,889
	$37,207	$24,874	$(3,047)	$59,034

**Included in Other assets.*

Unrealized losses at December 31, 2009 included $1,864 million related to securities that have been in an unrealized loss position for 12 months or more. Approximately 90% of the gross unrealized losses at December 31, 2009 were concentrated in four issuers. We use no bright-line test in determining whether impairments are temporary or other than temporary. We consider several factors in determining other-than-temporary impairment losses including the current and expected long-term business prospects of the issuer, the length of time and relative magnitude of the price decline and our ability and intent to hold the investment until the price recovers. In our judgment, the future earnings potential and underlying business economics of these companies are favorable and we possess the ability and intent to hold these securities until their prices recover. Changing market conditions and other facts and circumstances may change the business prospects of these issuers as well as our ability and intent to hold these securities until the prices recover. Accordingly, other-than-temporary impairment charges may be recorded in future periods with respect to one or more of these securities.

(6) Other Investments

A summary of other investments follows (in millions).

	Cost	Unrealized Gains/Losses	Fair Value	Carrying Value
December 31, 2009				
Fixed maturity and equity	$21,089	$ 5,879	$26,968	$26,014
Equity method	5,851	1,721	7,572	6,586
	$26,940	$ 7,600	$34,540	$32,600

Fixed maturity and equity investments in the preceding table include our investments in The Goldman Sachs Group, Inc. ("GS") and The General Electric Company ("GE"), which were acquired in 2008 and investments in Swiss Reinsurance Company Ltd. ("Swiss Re") and The Dow Chemical Company ("Dow") that were made in 2009. In addition, fixed maturity and equity investments include investments in Wm. Wrigley Jr. Company ("Wrigley") that we acquired in both 2008 and 2009.

(7) Investment gains/losses			
Investment gains/losses are summarized below (in millions).			
	2009	2008	2007
Fixed maturity securities —			
Gross gains from sales and other disposals	$ 357	$ 212	$ 657
Gross losses from sales and other disposals	(54)	(20)	(35)
Equity securities —			
Gross gains from sales and other disposals	701	1,256	4,880
Gross losses from sales	(617)	(530)	(7)
Other	(69)	255	103
	$ 318	$1,173	$5,598

Net investment gains/losses are reflected in the Consolidated Statements of Earnings as follows.

	2009	2008	2007
Insurance and other	$251	$1,166	$5,405
Finance and financial products	67	7	193
	$318	$1,173	$5,598

EXHIBIT 9: BERKSHIRE HATHWAY—STATEMENT OF COMPREHENSIVE INCOME

	2009	2008	2007
Comprehensive income attributable to Berkshire:			
Net earnings	$ 8,055	$ 4,994	$13,213
Other comprehensive income:			
Net change in unrealized appreciation of investments	17,607	(23,342)	2,523
Applicable income taxes	(6,263)	8,257	(872)
Reclassification of investment appreciation in net earnings	2,768	895	(5,494)
Applicable income taxes	(969)	(313)	1,923
Foreign currency translation	851	(2,140)	456
Applicable income taxes	(17)	118	(26)
Prior service cost and actuarial gains/ losses of defined benefit plans	(41)	(1,071)	257
Applicable income taxes	(1)	389	(102)
Other	(206)	(60)	(22)
Other comprehensive income, net	13,729	(17,267)	(1,357)
Comprehensive income attributable to Berkshire	$21,784	$(12,273)	$11,856

In summary, the following information should be disclosed about investments in equity and debt securities:

- Valuation basis used.
- Total portfolio market value.
- Method used to determine cost (e.g., FIFO, average cost, specific identification) in computing the realized gain or loss on sale of securities.

- Unrealized (holding) gains and losses for trading and available-for-sale securities.
- Reasons for selling or transferring securities.
- Gains and losses from transferring available-for-sale securities to trading included in the income statement.
- Market value and cost by major equity security.
- Fair value and amortized cost basis by major debt security type.
- Proceeds from selling available-for-sale securities, with associated realized gains and losses.
- Subsequent event disclosure in the form of significant changes in market value taking place after year-end but before the issuance of the financial statements.
- Name of companies owned when ownership is significant.

Disclosure for debt securities classified as available for sale or held to maturity should include contractual maturity dates.

Exhibit 10 presents an excerpt of Boeing's annual report.

Exhibit 10:
Boeing
2007 Annual Report

Note 10—Cash, Cash Equivalents, and Investments

Our investments, which are recorded in either Cash and cash equivalents, Short-term investments or Investments, consisted of the following at December 31:

	2007	*2006*
Cash and cash equivalents		
Cash and time deposits	$ 5,406	$ 5,710
Available-for-sale investments	134	118
Held-to-maturity investments	1,502	290
Total cash and cash equivalents	7,042	6,118
Short-term Investments		
Time deposits	1,025	
Available-for-sale investments	442	268
Held-to-maturity investments	799	
Total short-term investments	2,266	268
Investments		
Available-for-sale investments	2,982	3,076
Equity method investments	1,085	964
Other investments	44	45

Total investments	4,111	4,085
Total cash, cash equivalents, and investments	$13,419	$10,471

Available-for-Sale Investments

Our investments in available-for-sale debt and equity securities consisted of the following at December 31:

	2007			
	Cost	*Gross Unrealized Gain*	*Gross Unrealized Loss*	*Estimated Fair Value*
Debt:[1]				
Marketable Securities[2]	$3,385	$29	$(11)	$3,403
ETCs/EETCs	145		(2)	143
Equity	2	10		12
	$3,532	$39	$(13)	$3,558
	2006			
	Cost	*Gross Unrealized Gain*	*Gross Unrealized Loss*	*Estimated Fair Value*
Debt:[1]				
Marketable Securities[2]	$3,319	$ 4	$(25)	$3,298
ETCs/EETCs	145	7		152
Equity	4	8		12
	$3,468	$19	$(25)	$3,462

[1] At December 31, 2007, debt securities with estimated fair values of $574 and cost of $580 have been in a continuous unrealized loss position for 12 months or longer.

[2] The portfolio is diversified and highly liquid and primarily consists of investment grade fixed income instruments such as U.S. dollar debt obligations of the United States Treasury, other government agencies, corporations, mortgage-backed and asset-backed securities. We believe that the unrealized losses are not other-than-temporary. We do not have a foreseeable need to liquidate the portfolio and anticipate recovering the full value of the securities either as market conditions improve, or as the securities mature.

The contractual maturities of available-for-sale debt securities at December 31, 2007, were as follows:

	Cost	Estimated Fair Value
Due in 1 year or less	$ 578	$ 576
Due from 1 to 5 years	1,575	1,591
Due from 5 to 10 years	99	100
Due after 10 years	1,278	1,279
	$3,530	$3,546

Supplemental information about gross realized gains and losses on available-for-sale investment securities for the years ended December 31, are as follows:

	2007	*2006*	*2005*
Gains	$ 5	$56	
Losses, including impairments	(11)	(11)	$(64)
Net	$ (6)	$45	$(64)

Held-to-maturity investments. Our investments in held-to-maturity securities consist of commercial paper with maturities of less than one year. The held-to-maturity securities are recorded at their amortized cost of $2,301 and $290 as of December 31, 2007 and 2006, which approximates their fair value.

On December 1, 2006, we entered into a transaction with Lockheed Martin Corporation (Lockheed) to create a 50/50 joint venture named United Launch Alliance L.L.C. (ULA). ULA combines the production, engineering, test and launch operations associated with U.S. government launches of Boeing Delta and Lockheed Atlas rockets. ULA conducted 13 and one successful launches for the years ended December 31, 2007 and 2006. We and Lockheed each have agreed to provide ULA with initial cash contributions of up to $25, and we each have agreed to extend a line of credit to ULA of up to $200 to support its working capital requirements. See Note 21.

On July 24, 2007, we and Lockheed reached an agreement with respect to resolution of the final working capital and the value of the launch vehicle support contracts that each party contributed to form ULA. Effective August 15, 2007, the parties received all necessary approvals pursuant to the terms of the Consent Order with the U.S. Federal Trade Commission and the terms of the agreement, which resulted in additional contributions from both parties with Boeing agreeing to contribute an additional $97. Our additional contribution liability will be offset by future payments from ULA under the Inventory Supply Agreement.

The Sea Launch venture, in which we are a 40% partner with RSC Energia of Russia (25%), Aker ASA of Norway (20%), PO Yuzhmash (10%) and SDO Yuzhnoye (5%) of the Ukraine, provides ocean-based launch services to commercial satellite customers. The venture conducted zero, five and four successful launches for the years ended December 31, 2007, 2006 and 2005, respectively. A Sea Launch Zenit-3SL vehicle, carrying a Boeing-built NSS-8 satellite, experienced an anomaly during launch on January 30,

2007. The launch platform has been repaired and resumed flight operations on January 15, 2008, successfully launching a Boeing-built satellite. We have financial exposure with respect to the venture, which relates to guarantees provided by us to certain Sea Launch creditors, performance guarantees provided by us to a Sea Launch customer, and financial exposure related to advances and other assets reflected in the consolidated financial statements.

We suspended recording equity losses after writing our investment in and direct loans to Sea Launch down to zero in 2001 and accruing our obligation for third-party guarantees on Sea Launch indebtedness. We are not obligated to provide any further financial support to the Sea Launch venture. However, in the event that we do extend additional financial support to Sea Launch in the future, we will recognize suspended losses as appropriate. In addition, we continue to look at alternative capital structures for the venture.

Other investments. During 2005, we recorded an asset impairment charge of $42 in Other income related to the sale of certain investments in technology related funds for proceeds of $24.

Financial institutions should disclose their holdings in equity securities, corporate debt securities, mortgage-backed securities, U.S. government securities, foreign government securities, and other debt securities. Financial institutions should disclose fair value and amortized cost of debt securities in maturity groupings, including within one year, in 1 to 5 years, after 5 to 10 years, and after 10 years.

Review Questions

11. In 2X12, Lee Co. acquired, at a premium, Enfield, Inc. 10-year bonds as a long-term investment. At December 31, 2X13, Enfield's bonds were quoted at a small discount. Which of the following situations is the most likely cause of the decline in the bonds' fair value?

A. Enfield issued a stock dividend.

B. Enfield is expected to call the bonds at a premium, which is less than Lee's carrying amount.

C. Interest rates have declined since Lee purchased the bonds.

D. Interest rates have increased since Lee purchased the bonds.

12. An investor purchased a bond as a long-term investment on January 2. The investor's carrying amount at the end of the first year will be highest if the bond is purchased at a

A. Discount and amortized by the straight-line method.

B. Discount and amortized by the effective interest method.

C. Premium and amortized by the straight-line method.

D. Premium and amortized by the effective interest method.

13. In accordance with ASC 320, a reclassification of available-for-sale securities to the held-to-maturity category will result in

A. The amortization of an unrealized gain or loss existing at the transfer date.

B. The recognition in earnings on the transfer date of an unrealized gain or loss.

C. The reversal of any unrealized gain or loss previously recognized in earnings.

D. The reversal of any unrealized gain or loss previously recognized in other comprehensive income.

Comprehensive Example

Held-to-maturity securities for analytical purposes should be valued at market value rather than amortized cost to reflect current prices. However, this is not GAAP. Exhibit 11 shows a comprehensive example of the accounting and reporting of trading, available-for-sale, and held-to-maturity securities.

EXHIBIT 11: COMPREHENSIVE EXAMPLE OF ASC 320

The GI Corporation Makes the Following Debt and Equity Investments:

Bonds	Par value:	$200,000
	Nominal interest rate:	8%
	Market interest rate:	10%
	Years to maturity:	5
	Interest paid:	Annually
Stocks	Number of shares:	4,000
	Par value stock:	$ 20.00
	Purchase price:	$ 25.00

Purchase price of investments is calculated as follows:

Bonds	Present value of amount due at maturity	$124,184	
	Present value of interest payments	$ 60,653	
	Purchase priced of bonds		$184,837
Stocks	Purchase price of stocks [4,000 shares at $25 each]		$100,000
	Total purchase price of investments (Bonds & stocks):		$284,837

The bond discount will be amortized using the effective interest method over a period of five years as follows:

Year	(I) *Interest Income*	(II) *Cash Received*	(III) *Discount Amortization*	(IV) *Discount Remaining*	(V) *Carrying Amount*
1/1/2X12				15,163	184,837
12/31/2X12	18,484	16,000	2,484	12,679	187,321
12/31/2X13	18,732	16,000	2,732	9,947	190,053
12/31/2X14	19,005	16,000	3,005	6,942	193,058
12/31/2X15	19,306	16,000	3,306	3,636	196,364

12/31/2X16	19,636	16,000	3,636	-	200,000

[I] Interest income is calculated by multiplying previous year's carrying amount (V) by the market interest rate of 10%.

[II] Cash received is calculated by multiplying the par value of bonds by the nominal interest rate: 200,000 × 8%.

[III] Discount amortization is (I)-(II).

[IV] Discount remaining is prior year's carrying amount (V) minus current year's discount (III).

[V] Carrying amount is par value of bonds, $200,000, minus the discount remaining (IV).

Market values for the investments are as follows:

	12/31/2X12	12/31/2X13
Bonds	180,000	170,000
Stocks	150,000	125,000
Total investments	330,000	295,000

Dividend is paid on Common Stock as follows:

8/31/2X12	10.00 dollars per share
8/31/2X13	5.00 dollars per share

Trading Securities

It is assumed that these investments are classified as trading securities.

Date	Account	Debit	Credit
1/1/2X12	Investments—trading	$184,837	
	Cash		$184,837
	Purchase of bonds classified as trading		
1/1/2X12	Investments—trading	$100,000	
	Cash		$100,000
	Purchase of common stocks classified as trading		
8/31/2X12	Cash	$ 40,000	
	Dividend income		$ 40,000
	Dividends received on common stocks		
12/31/2X12	Investments—trading	$2,484	
	Cash	$ 16,000	
	Interest income		$ 18,484
	Interest received and amortization of bond discount		
12/31/2X12	Investments—trading*	$ 42,679	
	Unrealized gain on Investments*		$ 42,679

*The unrealized GAIN is calculated as follows:

Market value of bonds and stocks at 12/31/2X12	
[180,000 + 150,000]	330,000
Carrying value of bonds and stocks at 12/31/2X12	
[187,321 + 100,000]	287,321
Unrealized gain	$42,679

In the second year, the journal entries will be as follows:

8/31/2X13	Cash	$ 20,000	
	Dividend income		$ 20,000
	Dividends received on common stocks		
12/31/2X13	Investments—trading	$ 2,732	
	Cash	$ 16,000	
	Interest income		$ 18,732
12/31/2X13	Unrealized loss on investments**	$ 37,732	
	Investments—trading**		$ 37,732
	Adjustment to market value for trading investments		

**The unrealized loss is calculated as follows:

Market value of bonds and stocks at 12/31/2X13 [170,000 + 125,000]	295,000
Carrying value of bonds# and stocks at 12/31/2X13 [182,732 + 150,000]	332,732
Unrealized Loss	(37,732)

#The carrying value of bonds on 12/31/2X13 is calculated as follows:

Market value of bonds at 12/31/2X12:	180,000
Plus: bond discount amortization for year 2:	2,732
	182,732

The trading investments will be presented in the financial statements as follows:

	Year 1	*Year 2*
INCOME STATEMENT:		

Interest income	18,484	18,732
Dividend income	40,000	20,000
Unrealized gain (loss) on investments	42,679	(37,732)
BALANCE SHEET:		
Current Assets:		
Investments—trading	330,000	295,000
STATEMENT OF CASH FLOWS:		
Operating Activities:		
Interest	16,000	16,000
Dividends	40,000	20,000
Investment purchases	284,837	-

Available-for-Sale Securities

It is assumed that these investments are now classified as available for sale.

When securities are available for sale, the unrealized gain or loss is presented as part of "other comprehensive income" in the income statement.

The journal entries to record the unrealized gain or loss are:

12/31/2X12	Investments—available for sale	$ 42,679	
	Unrealized gain on investments		$ 42,679
	Adjustment to market value for available-for-sale investments		
12/31/2X13	Unrealized loss on investments	$ 37,732	
	Investments—available for sale		$ 37,732
	Adjustments to market value for available-for-sale investments		

The available-for-sale investments will be presented in the financial statements as follows:

	Year 1	*Year 2*
INCOME STATEMENT:		
Interest income	18,484	18,732
Dividend income	40,000	20,000
OTHER COMPREHENSIVE INCOME:		
Unrealized gain or (loss) on investments available for sale	42,679	(37,732)
BALANCE SHEET:		
Asset (current or long-term based upon intent):		
Investments—available for sale	330,000	295,000
STATEMENT OF CASH FLOWS:		

Operating Activities:		
Interest	16,000	16,000
Dividends	40,000	20,000
INVESTMENT ACTIVITIES:		
Investment Purchases	284,837	-

Securities Held to Maturity

It is assumed that the bonds are now classified as investments held to maturity. Recall that common stocks do not have a maturity date and are therefore not included in this example.

Journal entries for discount amortization and cash received are the same as entries for trading securities. However, no journal entries are required at the end of the year to record unrealized gain or loss.

The financial statement presentation for securities held to maturity is as follows:

For Bonds Only

	Year 1	*Year 2*
INCOME STATEMENT:		
Interest income	18,484	18,732
BALANCE SHEET:		
Asset:		
Investments—held to maturity	187,321	190,053
STATEMENT OF CASH FLOWS:		
Operating Activities:		
Interest	16,000	16,000
INVESTMENT ACTIVITIES:		
Investment purchases	184,837	-

Equity Method

ASC 323-10-15-8 covers the accounting, reporting, and disclosures under the equity method to account for investments in other companies. The investor is the owner and the investee is the company owned. The equity method is used if:

- An investor owns between *20% and 50%* of the investee's voting common stock.

- The investor owns less than 20% of the investee's voting common stock but has effective control (significant influence). Significant influence may be indicated by a number of factors, including substantial intercompany transactions, exchanges of executives between investor and investee, investor's significant input in the investee's decision-making process, investor's representation on the investee's board of directors, investee's dependence on investor (e.g., operational, technological, or financial support), and substantial ownership of the investee by investor relative to other widely disbursed shareholder interests. The factors indicating that significant influence may not exist, thereby precluding the equity method, are that significant influence exists by a small group of stockholders excluding the investor representing majority ownership of investee, the investee sues the investor, the investee makes a formal complaint to governmental bodies regarding the investor, and the investor is unable to obtain needed financial data from the investee to use the equity method. Under ASC 323-10-15-10, if there is a standstill agreement stipulating that either the investor has relinquished major rights as a stockholder or that significant influence does not exist, it may indicate that the equity method is not appropriate. ASC 323-10-15-10 also may preclude the equity method if the investor attempts unsuccessfully in obtaining representation on the investee's board of directors. ASC 323-10-15-3, *Investments— Equity Method and Joint Ventures: Overall*, states that when an investor has the ability to exercise significant influence over the operating and financial policies of an investee, the equity method of accounting should be applied only when the investor has an investment in common stock and/or an investment that is in-substance common stock. The equity method is not applicable to preferred stock.

- The investor owns in excess of 50% of the investee's voting common stock, but a negating factor exists, preventing consolidation. According to ASC 840-10-45, *Leases: Overall*, negating factors prohibiting consolidation might be temporary control, noncontrol, and foreign exchange restrictions. However, under ASC 840-10-45, the equity method is used to account for nonconsolidated majority-owned subsidiaries.

- There is a joint venture. A joint venture is an entity that is owned, operated, and jointly managed by a common group of investors.

The accounting under the equity method is illustrated in selected T-account form:

Investment in Investee

Cost	Ordinary loss
Ordinary profit	Extraordinary loss
Extraordinary gain	Dividends
	Permanent decline in market price
	Depreciation on excess of fair market value less book value of specific assets

Equity in Earnings of Investee

Depreciation expense on excess value Ordinary loss	Ordinary profit

Extraordinary Gain

	Extraordinary Gain

The accounting process as explained by these T-accounts involves the following:

- The cost of the investment includes brokerage charges. The investor recognizes its percentage ownership interest in the investee's ordinary earnings by debiting investment in investee and crediting equity in earnings of investee. The latter is like a revenue account.
- The investor's share in the investee's profits is determined after subtracting cumulative preferred dividends, whether or not declared. **Note:** The investor's share of investee earnings in excess of dividends paid is referred to as undistributed investee earnings. The investor's share is based on the investee's most recent income statement, provided the time lag in reporting each year is consistent. In other words, if the investor and investee have different year-ends, the investor may compute its share of investee's profits or losses based on the investee's financial statements for its fiscal year-end.
- Extraordinary gains or losses and prior-period adjustments are recognized by the investor exactly as presented on the investee's financial statements. Such items are separately reported if material.
- The investor's share of the investee's cash dividends and losses reduces the carrying value of the investment in investee account. The investor's share of the investee's net income is accounted for as an addition to the carrying amount of the investment on the investor's books. Under the fair value method, regular cash dividends received by the investor are recorded as income. **Note:** The final financial effect on the investor's financial statements is identical whether the equity method or full consolidation is used. The only difference lies in the detail within the financial statements.
- The excess paid by the investor for the investee's net assets is first assigned to the specific assets and liabilities and is depreciated. The unidentifiable part of the excess is goodwill. The investment in investee account is credited, and the equity in earnings account is debited for the depreciation on excess of fair market value less book value of specific assets acquired.

- Although the equity method makes no adjustment for temporary declines in market price of the investment, permanent declines in value are recognized by debiting loss and crediting investment in investee.

EXAMPLE

Mavis Company acquires 30% of Blake Company's stock under the equity method for $500,000. Blake's net income and dividends for the year are $100,000 and $20,000, respectively. The carrying value of the investment at year-end equals:

Initial cost	$500,000
Add: share of net income $100,000 × 30%	30,000
Less: share of dividends $20,000 × 30%	(6,000)
Carrying value—year-end	$524,000

If, at the beginning of the next year, Mavis sells 50% of its interest in Blake for $275,000, the journal entry for the sale would be:

Cash	75,000	
Investment in Blake (50% × $524,000)		262,000
Gain on sale of investment		13,000

Other accounting aspects exist. If the investor's share of the investee's losses exceeds the carrying value of the investment account, the equity method should be discontinued at the zero amount. Thereafter, the investor should not record additional losses unless it has guaranteed the investee's debts, is otherwise committed to provide additional financial support to the investee, or immediate profitability is forthcoming. If the investee later shows net income, the investor can reinstate using the equity method only after its share of profit equals the share of unrecorded losses when the equity method was suspended. If the investor sells the investee's stock, a realized gain or loss is recognized for the difference between the selling price and carrying value of the investment in investee account at the time of sale. The realized gain or loss appears in the investor's income statement.

ASC 323-10-35-37 and 35-39, *Investments—Equity Method and Joint Ventures: Overall*, provides that when an investor loses significant influence, the investor must offset its proportionate share of the investee's equity adjustments of other comprehensive income against the book value of the investment. If the offset reduces the book value to below zero, the investor should reduce the carrying value to zero with the remaining amount recognized as income.

The equity method basically uses the consolidation approach by eliminating intercompany profits and losses. Such profits and losses are eliminated by reducing the investment balance and the equity earnings in investee for the investor's share of the unrealized intercompany profits and losses. Investee capital transactions affecting the investor are treated as in consolidation. The investee is treated as if it were a consolidated subsidiary. For example, the purchase or sale by the investee of its treasury stock, which changes the investor's ownership interest, is accounted for by the investor as if the investee were a consolidated subsidiary. Use of the equity method generally results in the investor's stockholders' equity and net earnings being the same as if the investor and investee were consolidated. For example, if the investee issues its common stock to third parties at a price above book value, the investment value increases, with a related increase in the investor's paid-in-capital. Similar results occur when holders of options or convertible securities exchange them for investee's common stock.

EXAMPLE

An investor sells merchandise “downstream” to an investee. At year-end, $100,000 of profit resides in inventory from intercompany sales. The investor owns 30% of the investee. The tax rate is 25%. The elimination entry for intercompany profits is:

Equity in earnings of investee ($100,000 × 30%)	30,000	
Deferred tax asset ($30,000 × 25%)	7,500	
Investment in investee		30,000
Income tax expense		7,500

Assuming that the intercompany sales were “upstream” (investee to investor), the elimination entry would be:

Equity in earnings of investee ($30,000 × 1 - .25)	22,500	
Deferred tax asset	7,500	
Inventory		30,000

EXAMPLE

On January 3, 2X13, Klemer Corporation buys a 25% interest (4,000 shares) in Jones Company's outstanding stock for $160,000. The cost equals both the book and fair values of Klemer's interest in Jones's underlying net assets. On January 14, 2X13, Jones purchases 2,000 shares of its stock from other shareholders for $100,000. Because the price paid ($50 per share) is more than Klemer's per share carrying value of its interest of $40 per share, Klemer's has experienced a loss by the transaction. Further, Klemer's percentage interest in Jones has increased because the shares held by third parties have been reduced.

Klemer's new interest in Jones's net assets follows:

4,000 shares owned by Klemer × Jones's net assets

14,000 shares outstanding in total

.2857 × ($640,000 - $100,000) = $154,278

Klemer's interest has been decreased by $160,000 - $154,278, or $5,722. In consequence, the following entry is required:

Paid-in-capital (or retained earnings)	5,722	
Investment in Jones		5,722

Paid-in-capital is charged for the loss if such an account arose from previous similar transactions. If not, retained earnings is charged. If a gain arose, paid-in-capital would be credited.

A temporary tax difference arises under the equity method because the investor recognizes the investee's earnings for financial reporting purposes but recognizes dividend income on the tax return. This will cause a deferred tax liability.

If ownership falls below 20%, or if the investor loses effective control over the investee, the investor should stop recording the investee's earnings. The equity method is discontinued, but the balance in the investment account is retained. The market value method (under ASC 320-10-30-4) will then be applied in the future.

If the investor increases its ownership in the investee to 20% or more (e.g., 30%), the equity method should be used for current and future years. The effect of using the equity method instead of the market value method on previous years at the old percentage (e.g., 10%) should be recognized as a retroactive adjustment to retained earnings and other affected accounts (e.g., investment in investee). The retroactive adjustment on the investment, earnings, and retained earnings should be applied in a similar way as a step-by-step acquisition of a subsidiary.

The investor must disclose the following information in the footnotes, in separate schedules, or parenthetically:

- A statement that the equity method is being used.
- Identification of investee along with percent owned.
- Quoted market price of investee's stock.
- Investor's accounting policies.
- Significant subsequent events between the date and issuance of the financial statements.

- The reason for not using the equity method even though the investor owned 20% or more of the investee's common stock.
- The reason that the equity method was used even though the investor owned less than 20% of the investee's common stock.
- Summarized financial information as to assets, liabilities, and earnings of significant investments in unconsolidated subsidiaries.
- Significant realized and unrealized gains and losses applying to the subsidiary's portfolio taking place between the dates of the financial statements of the parent and subsidiary.
- Restatement of prior periods because of a change to the equity method.
- Significant effects of possible conversion and exercises of investee common stock.
- A statement when income taxes have not been provided for on a foreign subsidiary's undistributed profits and the reasons therefore. (The cumulative amount of undistributed earnings must be specified.)

Exhibit 12 presents an example of Caterpillar’s disclosure about the use the equity method.

Exhibit 12:
Caterpillar
2008 Annual Report

11. Investments in Unconsolidated Affiliated Companies

Our investments in affiliated companies accounted for by the equity method have historically consisted primarily of a 50 percent interest in Shin Caterpillar Mitsubishi Ltd. (SCM) located in Japan. On August 1, 2008, SCM redeemed half of Mitsubishi Heavy Industries Ltd.'s (MHI's) shares in SCM. As a result, Caterpillar now owns 67 percent of the renamed entity, Caterpillar Japan Ltd. (Cat Japan). Because Cat Japan is accounted for on a lag, Cat Japan's August 1, 2008 financial position was consolidated on September 30, 2008. Cat Japan's results of operations were consolidated in the fourth quarter. See Note 25 for details on this share redemption. In February 2008, we sold our 23 percent equity investment in A.S.V. Inc. (ASV) resulting in a $60 million pretax gain. Accordingly, the December 31, 2008 financial position and equity investment amounts noted below do not include ASV or Cat Japan.

Combined financial information of the unconsolidated affiliated companies accounted for by the equity method (generally on a lag of 3 months or less) was as follows:

Results of Operations of unconsolidated affiliated companies:			
	Years ended December 31,		
(Millions of dollars)	*2008*	*2007*	*2006*

Results of Operations:			
Sales	$3,727	$4,007	$4,420
Cost of sales	3,082	3,210	3,526
Gross profit	$ 645	$ 797	$ 894
Profit (loss)	$ 55	$ 157	$ 187
Caterpillar's profit (loss)	$ 37	$ 73	$ 81

Sales from SCM, while an unconsolidated affiliate, to Caterpillar of approximately $1.67 billion, $1.67 billion and $1.81 billion in 2008, 2007 and 2006, respectively, are included in the affiliated company sales. In addition, SCM purchases of Caterpillar product, while an unconsolidated affiliate, were $353 million, $268 million and $273 million in 2008, 2007 and 2006, respectively.

Financial Position of unconsolidated affiliated companies:

		December 31,	
(Millions of dollars)	*2008*	*2007*	*2006*
Financial Position:			
Assets:			
Current assets	$209	$2,062	$1,807
Property, plant and equipment—net	227	1,286	1,119
Other assets	26	173	176
	462	3,521	3,102
Liabilities:			
Current liabilities	173	1,546	1,394
Long-term debt due after one year	110	269	309
Other liabilities	35	393	145
	318	2,208	1,848
Ownership	$144	$1,313	$1,254

Caterpillar's investments in unconsolidated affiliated companies:

		December 31,	
(Millions of dollars)	*2008*	*2007*	*2006*
Investments in equity method companies	$66	$582	$542
Plus: Investments in cost method companies	28	16	20
Total investments in unconsolidated affiliated companies	$94	$598	$562

At December 31, 2008, consolidated “Profit employed in the business” in Statement 2 included $10 million representing undistributed profit of the unconsolidated affiliated companies.

EXAMPLE

On January 1, 2X13, ABC Company purchased 40,000 shares for a 30% interest in the common stock of XYZ Company at $35 per share. Brokerage fees were $7,000. During the year, XYZ's net income was $200,000 and dividends were $50,000. On January 1, 2X13, ABC received 20,000 shares of common stock because of a stock split by XYZ. On January 6, 2X13, ABC sold 4,000 shares at $25 per share of XYZ stock. The journal entries are:

1/1/2X13		
Investment in investee	1,400,000	
Cash		1,400,000
12/31/2X13		
Investment in investee	60,000	
Equity in earnings of investee		60,000
30% × $200,000 = $60,000		
Cash	15,000	
Investment in investee		
30% × $50,000 = $15,000		15,000
1/1/2X13 memo for stock split of 20,000 additional shares		
1/6/2X13		
Cash (4,000 × $25)	100,000	
Investment in investee*		96,320
Gain on sale of investment		3,680

* $1,445,000 balance ÷ 60,000 shares = $24.08; 4,000 shares × $24.08 =$96,320.

Investment in Investee

1/1/2X13	1,400,000	12/31/2X13	15,000
12/31/2X13	60,000		
	1,460,000		
Balance	1,445,000		

EXAMPLE

On January 1, 2X13, Gonzalez Corporation bought 200,000 shares of Richardson Corporation's 800,000 shares outstanding for $5,000,000. The book value of net assets acquired was $4,000,000. Of the $1,000,000 excess paid over book value, all of it is applicable to undervalued tangible assets. The depreciation period is 10 years. In 2X13, the investee's net income was $150,000, including an extraordinary loss of $10,000. Dividends of the investee paid on August 1, 2X13, were $80,000. The required journal entries for these events follow:

1/1/2X13		
Investment in investee	5,000,000	
Cash		5,000,000
8/1/2X13	20,000	
Cash		
Investment in investee		20,000
25% × $80,000 = $20,000		
12/31/2X13		
Investment in investee	40,000	
Equity in earnings of investee		40,000
$160,000 × 25% = $40,000		
Extraordinary loss	2,500	
Investment in investee		2,500
$10,000 × 25% = $2,500		
Equity in earnings of investee	100,000	
Investment in investee		100,000
Computations follow:		
Depreciation on undervalued depreciable assets		
$1,000,000/10 years		$ 100,000

EXAMPLE

An investor purchases 500,000 shares of an investee at an average cost per share of $5, or $2,500,000. The investee's total shares outstanding are 2,000,000. Therefore, the investor's percentage ownership interest is 25% (500,000/2,000,000). The *overall value* of the investee equals $10,000,000, computed as follows:

Actual cost/Percentage ownership

$2,500,000/25% = $10,000,000

If the book value of the net assets of the investee is $7,000,000, the excess of fair market value over book value is $3,000,000 ($10,000,000 - $7,000,000). The excesses of fair value over book value attributable to land and building are $500,000 and $1,000,000, respectively. This $3,000,000 excess is assigned to the investee's net assets as follows:

Excess			$3,000,000
Excess of fair market value over book value attributable to			
Land		$500,000	
Fixed assets	1,000,000		
Less: deferred income taxes			
30% × $1,500,000	(450,000)		1,050,000
Total goodwill of investee company			$1,950,000

The investor's share of the total goodwill of the investee company would be $487,500 ($1,950,000 × 25%). **Note:** Deferred income taxes are based on the investee's effective tax rate of 30% applicable to the excess of fair value over book value of investee's net assets.

Note: Under ASC 825-10-15-4 and 15-5 and 825-10-35-4, *Financial Instruments: Overall*, a company using the equity method can elect to use the fair value option. If that option is selected, the Investment in Investee account will reflect temporary changes in market value of the investee. The resulting unrealized (holding) loss or gain will be presented as a separate item in the income statement. For example, if the fair market value of the investee decreases, the investor will debit unrealized loss and credit the Investment in Investee account (or a Valuation Allowance account) for the decrease in value. On the other hand, if there is an increase in fair market value, the Investment in Investee account (or Valuation Allowance account) would be debited and unrealized gain would be credited for the increase in fair market value.

According to **Accounting Standards Update (ASU)** No. 2009-09 (September 2009) (ASC 505, *Equity*) (ASC 323, *Investments—Equity Method and Joint Ventures*), *Accounting for Investments—Equity Method and Joint Ventures and Accounting for Equity-Based Payments to Non-Employees*, companies should classify any income or expense in the same income statement caption as equity in earnings of investee for investor stock-based compensation based on the investor's stock granted to employees of an equity method investee (ASC 323-10-25-3).

SEC registrants can anticipate the SEC to challenge accounting by the grantee or grantor in transactions involving equity instruments granted to other than employees if their accounting does not reflect the same commitment date or similar values (ASC 505-50-25-2).

Exhibit 13 spells out the accounting and reporting for **equity securities** by category.

EXHIBIT 13:
ACCOUNTING AND REPORTING FOR EQUITY SECURITIES BY CATEGORY

Category	Valuation	Unrealized Holding Gains or Losses	Other Income Effects
Holdings less than 20%			
1. Available-for-sale	Fair value	Recognized in "Other comprehensive income" and as separate component of stockholders' equity	Dividends declared; gains and losses from sale.
2. Trading	Fair value	Recognized in net income	Dividends declared; gains and losses from sale.
Holdings between 20% and 50%	Equity	Not recognized	Proportionate share of investee's net income.
Holdings more than 50%	Consolidation	Not recognized	Not applicable.

Investments by Banks in Debt Securities

Banks can only invest in debt securities that satisfy their suitability criteria. Banks may buy:

- *Revenue Anticipation Notes (RANs*). These are short-term debt securities pledged with specific source revenues, such as sales taxes.
- *Tax Anticipation Notes (TANs*). These are short-term debt securities used to finance expenditures pending the pledged receipt of anticipated real estate taxes.
- *Bond Anticipation Notes (BANs*). These are a community's short-term debt securities repaid from amounts received from permanent financing.

Banks may invest in all federal government securities without limitation except for those of the Tennessee Valley Authority, which is limited to 10% of capital and surplus. Banks may invest in state and municipal bonds as follows:

- General obligation municipals may be bought by banks in unlimited amounts.
- Revenue bonds issued by municipals may be bought by banks only up to 10% of capital and surplus.

Banks may invest in corporate debt securities with the following restrictions:

- Banks are not legally allowed to invest in junk bonds because of the high risk.
- National banks cannot invest in privately placed corporate debt because of limited marketability due to the number and type of potential investors. However, a national bank may buy privately placed corporate securities and consider them loans.

The yield on government agency investments exceed the yield on U.S. Treasury investments. The reasons for the higher yield are that there is less liquidity and more risk with agency issues, the interest income is often taxable, and many agencies' debts are not guaranteed by the U.S. government.

Banks can deduct for tax purposes 80% of the interest expense on deposits used to buy obligations of "small issuer" municipalities (those in which debt obligations do not exceed $10 million per year).

Amortization of discount or premium is based on the effective interest method. Amortization is from the date of purchase to the maturity date. However, if it is probable that the security will be redeemed before maturity, amortization will be from the purchase date to the call date.

Gains and losses on sale of securities are reported at the trade date. However, if immaterial, the settlement date may be used.

Investment in Certain Entities that Calculate New Asset Value per Share (or its Equivalent)

An investor may invest in entities (investees) that allow the investor to redeem its investments directly with the investee. Many of these investments do not have readily determinable fair values. Examples of these investees (also called alternative investments) are hedge funds, private equity funds, real estate funds, and venture capital funds. Many of these investees provide their investors with a net asset value per share (or its equivalent).

The net asset value per share (or its equivalent) provided by the investee may not represent fair value of the investor's investment in all cases. Certain aspects of the investment (such as restrictions on redemption at the measurement date) and transaction prices from principal-to-principal or brokered transactions my require adjustments to net asset value per share to estimate fair value of the investment.

Disclosure should be made of any restrictions on the investor's ability to redeem its investment on the measurement date. Disclosure is required of unfunded commitments and the investment strategies of investees. An example of an unfunded commitment is a contract by the investor to invest additional capital at a later date to fund investments that the investee will make.

The amendment to this update improves financial reporting by allowing use of a practical expedient, with appropriate disclosures, when measuring the fair value of an alternative investment that does not have a readily determinable fair value.

The amendments to this update apply to all reporting entities holding an investment required or allowed to be measured or disclosed at fair value on a recurring or nonrecurring basis and, as of the reporting entity's measurement date, if the investment satisfies both of the following conditions:

1. The investment does not have a readily determinable fair value.

2. The investment is in an entity that has all of the attributes specified in ASC 946-10-15-2 or, if one or more of the attributes specified in that paragraph are not present, is in an entity for which industry practice is to issue financial statements using the measurement principles in ASC 946. An example is certain investments in real estate funds that measure investment assets at fair value on a recurring basis. ASC 946-10-15-2 limits the scope of ASC 946 to investment companies having the following attributes:

   a. Unit of ownership is in the form of units of investments, such as shares of stock.

   b. Pooling of funds exist.

   c. Reporting entity is the primary one.

   d. Investment activity is primarily investment in assets, usually in securities of other entities not under common management.

The amendments to the update are effective for periods ending after December 15, 2009 (ASC 820, *Fair Value Measurements and Disclosures*) (ASC 820-10) (ASC 946, *Financial Services—Investment Companies*) (ASC 946-10-15-2).

IFRS Connection

The accounting for investment securities is discussed in IAS 27 (*Consolidated and Separate Financial Statements*), IAS 28 (*Accounting for Investments in Associates*), and IAS 39 (*Financial Instruments: Recognition and Measurement*). The accounting and reporting under IFRS and U.S. GAAP are for the most part very similar, although the criteria used to determine the accounting is often different. Specifically:

- The accounting for trading, available-for-sale, and held-to-maturity securities is essentially the same between IFRS and U.S. GAAP.
- Gains and losses related to available-for-sale securities are reported in other comprehensive income under U.S. GAAP. Under IFRS, these gains and losses are reported directly in equity
- Both IFRS and U.S. GAAP use the same test to determine whether the equity method of accounting should be used—that is, significant influence with a general guide of over 20 percent ownership. IFRS uses the term associate investment rather than equity investment to describe its investment under the equity method.

- Reclassifications of securities from one category to another generally follow the same accounting under the two GAAP systems. Reclassification in and out of trading securities is prohibited under IFRS. It is not prohibited under U.S. GAAP, but this type of reclassification should be rare.
- Under IFRS, both the investor and an associate company should follow the same accounting policies. As a result, in order to prepare financial information, adjustments are made to the associate's policies to conform to the investor's books.
- 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.
- IFRS and U.S. GAAP 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. The differences relate to disclosures and scope exceptions.
- U.S. GAAP does not permit the reversal of an impairment charge related to available-for-sale debt and equity investments. IFRS follows the same approach for available-for-sale equity investments but permits reversal for available-for-sale debt securities and held-to-maturity securities.

Examples from Annual Reports

Review the following 3 examples from actual annual reports to see how 3 companies accounted for their investments.

Corning

2008 Annual Report

3. Short-term Investments

The following is a summary of the fair value of available-for-sale securities (in millions):

	December 31,	
	2008	*2007*
Bonds, notes and other securities		
U.S. government and agencies	$737	$ 179
States and municipalities		46
Asset-backed securities	5	301
Commercial paper		239
Other debt securities	201	535
Total short-term investments	$943	$1,300

Gross realized gains and losses in 2008 were $6 million and $59 million, respectively. Realized losses in 2008 included other-than temporary impairments of $37 million for financial industry securities and $22 million of losses from the sale of asset-back debt securities and debt securities of financial institutions as Corning reduced its exposure to these sectors. Gross realized gains and losses in 2007 and 2006 were not significant.

Gross unrealized gains and losses at December 31, 2008 were $2 million and $58 million, respectively, and were included in accumulated other comprehensive income. Unrealized losses included temporary impairments of asset-backed securities with a fair value of $40 million at December 31, 2008. Because we believe the $87 million cost-basis of these asset-backed securities, which are collateralized by mortgages, is recoverable in the long-term we have classified these securities as long-term assets. It is possible that a significant degradation in the delinquency or foreclosure rates in the underlying mortgages could cause further temporary or other-than-temporary impairments in the future. Gross unrealized gains and losses at December 31, 2007 were $4 million and $14 million, respectively.

The following table summarizes the contractual maturities of available-for-sale securities at December 31, 2008 (in millions):

Less than one year	$ 732
Due in 1-5 years	196
Due in 5-10 years	
Due after 10 years	15
Total	$ 943

Proceeds from sales and maturities of short-term investments totaled $2.1 billion, $2.9 billion and $2.0 billion in 2008, 2007 and 2006, respectively.

Schlumberger

2008 Annual Report

5. Investments in Affiliated Companies

The MI-SWACO drilling fluids joint venture is owned 40% by Schlumberger and 60% by Smith International, Inc. Schlumberger records income relating to this venture using the equity method of accounting. Schlumberger's investment in the joint venture on December 31, 2008 and 2007 was $1.3 billion and $1.2 billion, respectively. Schlumberger's equity income from this joint venture in 2008 was $210 million, $174 million in 2007 and $135 million in 2006. Schlumberger received cash distributions from the joint venture of $57 million in 2008 and $40 million in 2007. There were no such distributions in 2006.

Schlumberger's joint venture agreement with Smith International, Inc. contains a provision under which either party to the joint venture may offer to sell its entire interest in the venture to the other party at a cash purchase price per percentage interest specified in an offer notice. If the offer to sell is not accepted, the offering party will be obligated to purchase the entire interest of the other party at the same price per percentage interest as the prices specified in the offer notice.

Goodyear Tire & Rubber

2007 Annual Report

Note 8. Investments

Investments and Acquisitions

We have funded approximately 33% of the obligations under our Supplemental Pension Plan as of December 31, 2007 (approximately 37% at December 31, 2006) using a trust. The trust invests in debt and equity securities and funds current benefit payments under the Supplemental Pension Plan. No contributions were made to the trust in 2007 or 2006. The debt securities have maturities ranging from March 20, 2008 through September 1, 2036. The fair value of the trust assets was $21 million and $25 million at December 31, 2007 and 2006, respectively, and was included in Other Assets and Prepaid Pension Assets on the Consolidated Balance Sheets. We have classified the trust assets as available-for-sale, as provided in SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (“SFAS No. 115”). Accordingly, gains and losses resulting from changes in the fair value of the trust assets are deferred and reported in AOCL on the Consolidated Balance Sheets. At December 31, 2007 and 2006, AOCL included a gross unrealized holding gain on the trust assets of $4 million ($2 million after tax) and $5 million ($2 million after-tax), respectively.

We owned 3,421,306 shares of Sumitomo Rubber Industries, Ltd. (“SRI”) at December 31, 2007 and 2006 (the “Sumitomo Investment”). The fair value of the Sumitomo Investment was $31 million and $44 million at December 31, 2007 and 2006, respectively, and was included in Other Assets and Prepaid Pension Assets on the Consolidated Balance Sheets. We have classified the Sumitomo Investment as available-for-sale, as provided in SFAS No. 115. At December 31, 2007, AOCL included gross unrealized holding gains on the Sumitomo Investment of $14 million ($15 million after-tax), compared to $28 million ($29 million after-tax) at December 31, 2006.

In January 2006, we acquired the remaining 50% ownership interest in our South Pacific Tyres (“SPT”) joint venture. In connection with the acquisition we paid approximately $40 million and repaid approximately $50 million of outstanding loans. As a result of the acquisition, we recorded goodwill of approximately $12 million and indefinite lived intangible assets of $10 million. The purchase price was allocated based on 50% of the assets acquired and liabilities assumed.

Dividends received from our consolidated subsidiaries were $562 million, $247 million and $290 million in 2007, 2006 and 2005, respectively, which included stock dividends of $16 million in 2005. Dividends received from our affiliates accounted for using the equity method were $3 million, $5 million and $7 million in 2007, 2006 and 2005, respectively.

Review Questions

14. On January 2, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for $400,000, which equaled the carrying amount and the fair value of the interest purchased in Rea's net assets. Well did not elect the fair value option. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of $500,000 for the year and paid dividends of $150,000. In its December 31 balance sheet, what amount should Well report as investment in Rea?

A. $450,000

B. $435,000

C. $400,000

D. $385,000

15. When an investor uses the equity method to account for investments in common stock, the investment account will be increased when the investor recognizes

A. A proportionate interest in the net income of the investee.

B. A cash dividend received from the investee.

C. Periodic amortization of the goodwill related to the purchase.

D. Depreciation related to the excess of fair value over the carrying amount of the investee's depreciable assets at the date of purchase by the investor.

16. Green Corp. owns 30% of the outstanding common stock and 100% of the outstanding noncumulative nonvoting preferred stock of Axel Corp. In Year 1, Axel declared dividends of $100,000 on its common stock and $60,000 on its preferred stock. Green exercises significant influence over Axel's operations and uses the equity method to account for the investment in the common stock. What amount of dividend revenue should Green report in its income statement for the year ended December 31, Year 1?

A. $0

B. $30,000

C. $60,000

D. $90,000

Glossary

Amortized cost. The acquisition cost adjusted for the amortization of discount or premium, if appropriate.

Available-for-sale securities. Securities not classified as held-to-maturity or trading securities.

Bifurcation. The process of separating the host security from the embedded derivative in a hybrid security for accounting purposes.

Call option. A call option is a derivative that gives the holder the right, but not the obligation, to buy shares at a preset price.

Call flow hedge. Cash flow hedges are derivatives used to hedge exposures to cash flow risk, which is exposure to the variability in cash flows.

Consolidated financial statements. Financial statements which disregard the distinction between separate legal entities and treat the parent and subsidiary corporations as a single economic entity.

Controlling interest. When one corporation acquires a voting interest of more than 50% in another corporation.

Debt securities. Instruments representing a creditor relationship with an enterprise and including U.S. government securities, municipal securities, corporate bonds, convertible debt, commercial paper, and all securitized debt instruments.

Derivative financial instruments. Innovative financial instruments that derive their value from the value of some underlying asset (i.e., interest rates, Dow-Jones averages).

Embedded derivative. When a hybrid security is comprised of a host security and a derivative, the part associated what the derivative is called an embedded derivative.

Equity method. method of valuing securities whereby the investor's proportionate share of the earnings (losses) of the investee and deceased by all dividends received by the investor from the investee.

Equity securities. Securities representing ownership interest such as common, preferred, or other capital stock.

Fair value. The amount at which a financial instrument could be exchanged in a current transaction between willing partners, other than in a forced or liquidation sale.

Fair value hedge. A derivative used to hedge or offset the exposure to changes in the fair value of a recognized asset or liability or of an unrecognized firm commitment.

Futures contract. A firm contractual agreement between a buyer and seller for a specified asset on a fixed date in the future.

Hedging. The action taken to offset risk.

Held-to-maturity securities. Securities that the enterprise has the positive intent and ability to hold to maturity.

Holding gain or loss. The net change in the fair value of a security from one period to another, exclusive of dividend or interest revenue recognized but not received.

Impairment. A loss in value that is other than temporary.

Interest rate swap. A transaction between two parties who swap interest payments based on fixed or floating rates.

Intrinsic value. The difference between the market price and preset strike price at any point in time.

Parent. Now called *acquirer,* a corporation that has acquired a controlling interest in another corporation (the subsidiary or *acquiree).*

Put option. The option to sell shares at a present price which increases in value when the underlying asset decreases in value.

Security. A share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that: (a) is represented by an instrument or is registered by the issuer, (b) is commonly traded, and (c) is divisible into a distinct class or interest.

Subsidiary. Now called *acquiree,* the corporation that has been acquired by a parent corporation.

Time value. Refers to the option's value over and above its intrinsic value.

Trading securities. Securities bought and held primarily for sale in the near term to generate income on short-term price differences.

Underlying. specified interest rate, security price, commodity price, index or prices or rates, or other market-related variable.

Warrant. A certificate presenting stock rights which states the number of shares that the holder of the right may purchase and also the price at which they may be purchased.

Appendix

Note: Skim through this section for more annual report references.

Annual Report Reference Materials

Qualcomm

2004 Annual Report

Note 2. Marketable Securities

Marketable securities were comprised as follows (in millions):

	Current		*Noncurrent*	
	September 30,		*September 30,*	
	2004	*2003*	*2004*	*2003*
Held-to-maturity				
Certificates of deposit	$-	$5	$-	$-
U.S. Treasury and federal agency securities	-	1	70	130
Corporate bonds and notes	10	161	60	70
	10	167	130	200
Available-for-sale:				
U.S. Treasury and federal agency securities	520	696	-	-
Foreign government bonds	8	-	-	-
Corporate bonds	2062	1118	3	22
Mortgage and asset-backed securities	2056	486	-	-
Non-investment grade debt securities	-	39	571	459
Equity mutual funds	-	-	296	-
Equity securities	112	10	653	130
	4758	2349	1523	611
	4768	2516	1653	811

As of September 30, 2004, the contractual maturities of debt securities were as follows (in millions):

	Years to Maturity					
	Less than One Year	One to Five Years	Five to Ten Years	Greater than Ten Years	No Single Maturity Date	Total
Held-to-maturity	$ 10	$ 130	$ -	$ -	$ -	$ 140
Available-for-sale	826	1,820	495	25	2,054	5,220
	$836	$1,950	$495	$25	$2,054	$5,360

Securities with no single maturity date include mortgage-and asset-backed securities.

Available-for-sale securities were comprised as follows at September 30 (in millions):

	Cost	Unrealized Gains	Unrealized Losses	Fair Value
2004				
Equity securities	$1,003	77	$(19)	$1,061
Debt securities	5,208	27	(15)	5,220
Total	$6,211	$104	$(34)	$6,281
2003				
Equity securities	$ 104	$ 37	$ (1)	$ 140
Debt securities	2,758	69	(7)	2,820
Total	$2,862	$106	$ (8)	$2,960

The fair values of held-to-maturity debt securities at September 30, 2004 and 2003 approximate cost.

For the years ended September 30, 2004, 2003, and 2002, the Company recorded realized gains and losses on sales of available-for-sale marketable securities as follows (in millions):

	Gross Realized Gains	Gross Realized Losses	Net realized Gains
2004	$105	$(17)	$88
2003	82	(13)	69
2002	23	(11)	12

The following table shows the gross unrealized losses and fair values of the Company's investments in individual securities that have been in a continuous unrealized loss position deemed to be temporary for less than 12 months, aggregated by category, at September 30, 2004 (in millions):

Fair	*Fair Value*	*Unrealized Losses*
U.S. Treasury and federal agency securities	$ 309	$(1)
Corporate bonds and notes	1,261	(4)
Mortgage and asset-backed securities	559	(2)
Non-investment grade debt securities	108	(7)
Equity mutual funds	296	(7)
Equity securities	196	(13)
	$2,729	$(34)

At September 30, 2004, the Company did not have any investments in individual securities that have been in a continuous loss position to be temporary for more than 12 months.

Investment Grade Debt Securities. The Company's investments in investment grade debt securities consist primarily of investments in certificates of deposit, U.S. Treasury and federal agency securities, foreign government bonds, mortgage and asset-backed securities, and corporate bonds and notes. The unrealized losses on the Company's investments in investment grade debt securities were caused by interest rate increases. Due to the fact that the decline in market value is attributable to changes in interest rates and not credit quality, and because the severity and duration of the unrealized losses were not significant, the Company considered these unrealized losses to be temporary at September 30, 2004.

Non-Investment Grade Debt Securities. The Company's investments in non-investment grade debt securities consist primarily of investments in corporate bonds. The unrealized losses on the Company's investment in non-investment grade debt securities were caused by credit quality and industry or company specific events. Because the severity and duration of the unrealized losses were not significant, the Company considered these unrealized losses to be temporary at September 30, 2004.

Marketable Equity Securities. The Company's investments in marketable equity securities consist primarily of investments in common stock of large companies and equity mutual funds. The unrealized losses on the Company's investment in marketable equity securities were caused by overall equity market volatility and industry specific events. The duration and severity of the unrealized losses in relation to the carrying amounts of the individual investments were consistent with typical equity market volatility. Current market forecasts support a recovery of fair value up to (or beyond) the cost of the investment within a reasonable period of time. Accordingly, the Company considered these losses to be temporary at September 30, 2004.

6. Investments in Equity Securities

In accordance with Statement 115 and based on our intentions regarding these instruments, we classify all marketable equity securities as available-for-sale. Marketable equity securities are included in intangible and other assets in the accompanying consolidated balance sheets and all unrealized holding gains (losses) are reflected net of tax in stockholders' equity. If we determine that an investment has an other than temporary decline in fair value, generally defined as when our cost basis exceeds the fair value for approximately six months, we recognize the investment loss in other income, net. We periodically evaluate our investments to determine if impairment charges are required.

The following table shows the net carrying value of our equity securities as of May 31, 2003, 2002 and 2001 and unrealized gains (losses), net of tax, for fiscal 2003, 2002 and 2001:

(Dollars in millions)	*Fair Value Basis*	*Unrealized Gains (Losses) in Stockholders' Equity, net of tax*
May 31, 2003		
Liberate Technologies	$ 90	$ 25
Other investments	65	1
Total	$155	$ 26
May 31, 2002		
Liberate Technologies	$135	$ 27
Other investments	86	(4)
Total	$221	$ 23
May 31, 2001		
Liberate Technologies	$282	$(27)
Other investments	133	(42)
Total	$415	$(69)

In the fourth quarter of 2002, we recognized a $173.5 million impairment charge relating to an other than temporary decline in the fair value of our investment in Liberate Technologies. We concluded that our investment was other than temporarily impaired because our cost basis exceeded the publicly traded market value of the Liberate Technologies common stock for approximately six months. Due to further declines in the market value of Liberate Technologies, we recognized additional impairment charges of $87.2 million in the first six months of fiscal 2003. During the second half of fiscal 2003, the market value of our investment in Liberate Technologies increased by $41.7 million, which is reflected within stockholders' equity as an unrealized gain on equity securities, net of taxes. The carrying value of

our remaining investment in Liberate Technologies as of May 31, 2003 was $89.8 million, which includes the unrealized gain of $41.7 million.

Prior to January 2001, we recorded our investment in Liberate Technologies using the equity method. In January 2001, we created an irrevocable trust (the “Liberate Trust”) to hold all of our shares (the “Liberate Shares”) of Liberate Technologies. The trustees of the Liberate Trust must vote the Liberate Shares in the same proportion as all the other stockholders of Liberate Technologies (determined as of the last business day prior to a Liberate Technologies Stockholders' Meeting or the earliest time thereafter that the voting results are provided to the Trustee). We control the timing of the sales of the Liberate Shares, subject to a standstill agreement with Liberate Technologies and the trustee of the Liberate Trust, and receive the proceeds of any such sales. The Liberate Trust terminates only after all shares have been sold. The standstill agreement prohibits us from acquiring any common shares or voting shares of Liberate Technologies or other securities or rights convertible or exchangeable for such shares and limits our ability to sell the Liberate Shares to: (1) sales in compliance with the volume and manner of sale limitations of Rule 144 under the Securities Act; (2) sales pursuant to a firm commitment, underwritten distribution to the public; (3) sales to a person who will own 10% or less of the total voting power of Liberate Technologies after such sale; (4) sales pursuant to a tender or exchange offer to the Liberate Technologies stockholders that is not opposed by Liberate Technologies Board of Directors; or (5) sales pursuant to the written consent of Liberate Technologies. The standstill agreement terminates two years after the termination of the Liberate Trust or sooner if Liberate Technologies is dissolved, liquidated or wound up, substantially all Liberate Technologies assets are sold or another entity acquires Liberate Technologies by merger or consolidation. Accordingly, effective February 1, 2001, we began to account for our ownership interest in Liberate Technologies as available for sale securities under Statement 115. As of May 31, 2003, our ownership interest in Liberate Technologies was approximately 32.1%.

In fiscal 2003, 2002 and 2001 we recognized $23.9 million, $70.0 million and $17.1 million, respectively, of impairment losses related to our other investments, which include investments in privately held companies, venture funds and publicly traded companies. We determined that the decreases in the fair value of these investments were other than temporary based upon the financial condition and near term prospects of the underlying investees, changes in the market demand for technology being sold or developed by the underlying investees and our intent regarding providing future funding to the underlying investees. The carrying value of our remaining other investments as of May 31, 2003 and 2002 was $64.8 million and $85.7 million, respectively.

Abbott Laboratories

2003 Annual Report

Note 3—Investment Securities

(dollars in thousands)

The following is a summary of investment securities at December 31:

Current Investment Securities	*2003*	*2002*	*2001*
Time deposits and certificates of deposit	$291,297	$120,000	$20,000
Other, primarily debt obligations issued or guaranteed by various governments or government agencies	-	141,677	36,162
Total	$291,297	$261,677	$56,162
Long-term Investment Securities	*2003*	*2002*	*2001*
Equity securities	$381,053	$222,667	$343,115
Time deposits and certificates of deposit	9,729	-	100,000
Corporate debt obligations	-	-	70,000
Debt obligations issued or guaranteed by various governments or government agencies	15,575	28,112	134,099
Total	$406,357	$250,779	$647,214

Of the investment securities listed above, $15,575, $247,998, and $323,974 were held at December 31, 2003, 2002, and 2001, respectively, by subsidiaries operating in Puerto Rico under tax incentive grants expiring in 2015 and 2020.

Abbott reviews the carrying value of investments in equity securities each quarter to determine whether an other than temporary decline in market value exists. Abbott considers factors affecting the investee, factors affecting the industry the investee operates in, and general equity market trends. Abbott considers the length of time an investment's market value has been below carrying value and the near-term prospects for recovery to carrying value. When Abbott determines that an other than temporary decline has occurred, the investment is written down with a charge to Other (income) expense, net.

Gross unrealized holding gains (losses) on current and long-term held-to-maturity investment securities totaled $1,400 and $(2,200), respectively, at December 31, 2003; $1,500 and $(8,500), respectively, at December 31, 2002; and $2,000 and $(17,200), respectively, at December 31, 2001. Gross unrealized holding gains (losses) on available-for-sale equity securities totaled $162,700 and $(4,000), respectively, at December 31, 2003; $24,400 and $(9,200), respectively, at December 31, 2002; and $57,000 and $(1,800), respectively, at December 31, 2001. For current and long-term held-to-maturity securities and available-for-sale equity securities, the adjusted cost basis of the investments have been above the market value for less than one year as of December 31, 2003.

Caterpillar

2004 Annual Report

13. Available-for-Sale Securities

Cat Insurance and Caterpillar Investment Management Ltd. Had investments in certain debt and equity securities at December 31, 2004, 2003 and 2002, that have been classified as available-for-sale in accordance with SFAS 115 and recorded at fair value based upon quoted market prices. These fair values are included in Other assets' in Statement 3. Gains and losses arising from the revaluation of available-for-sale securities are included, net of applicable deferred income taxes, in equity ("Accumulated other comprehensive income" in Statement 3). Realized gains and losses on sales of investments are generally determined using the specific identification method for debt instruments and the FIFO method for equity securities. Realized gains and losses are included in "Other income (expense)" in Statement 1.

		December 31, 2004	
(Millions of dollars)	*Cost Basis*	*Unrealized Pre-Tax Net Gains (Losses)*	*Fair Value*
Government debt	$239	$(1)	$238
Corporate bonds	342	-	342
Equity securities	203	21	224
	$784	$ 20	$804

		December 31, 2003	
(Millions of dollars)	*Cost Basis*	*Unrealized Pre-Tax Net Gains (Losses)*	*Fair Value*
Government debt	$102	$ -	$102
Corporate bonds	288	3	291
Equity securities	191	21	212
	$581	$24	$605

		December 31, 2003	
(Millions of dollars)	*Cost Basis*	*Unrealized Pre-Tax Net Gains (Losses)*	*Fair Value*
Government debt	$ 89	$ -	$ 89
Corporate bonds	208	1	209
Equity securities	220	(51)	169
	$517	$(50)	$467

Investments in an unrealized loss position that are not other-than-temporarily impaired

	*Less than 12 months**	*December 31, 2004 More than 12 months**	*Total**

(Millions of dollars)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Government debt	166	1	9	-	175	1
Corporate bonds	156	2	35	1	191	3
Equity securities	46	1	2	-	48	1
Total	369	4	46	1	414	5

* Indicates length of time that individual securities have been in a continuous unrealized loss position.

The fair value of available-for-sale debt securities at December 31, 2004, by contractual maturity, is shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay and creditors may have the right to call obligations.

(Millions of dollars)	*Fair Value*
Due in one year or less..	$ 30
Due after one year through five years..	$273
Due after five years through ten years..	$ 50
Due after ten years	$227

Proceeds from sales of investments in debt and equity securities during 2004, 2003, and 2002 were $408 million, $329 million, and $288 million, respectively. Gross gains of $8 million, $3 million, and $9 million and gross losses of $6 million, $2 million, and $2 million have been included in current earnings as a result of these sales for 2004, 2003, and 2002, respectively.

During 2003 and 2002, we recognized pretax charges in accordance with the application of SFAS 115 for “other than temporary” declines in the market value of securities in the Cat Insurance and Caterpillar Investment Management Ltd. investment port-folios of $33 million and $41 million, respectively. During 2004, there were no pretax charges for “other than temporary” declines in the market value of securities.

Schering-Plough

2003 Annual Report

Equity Income from Cholesterol Joint Venture. The Company and Merck & Co., Inc. (Merck) have agreements to jointly develop and market ZETIA (ezetimibe) as a once-daily monotherapy, as co-administration of ZETIA with statins, and ezetimibe as a once-daily fixed-combination tablet with

simvastatin (*Zocor*), Merck's cholesterol-modifying medicine. The agreements also involve the development and marketing of a once-daily, fixed-combination tablet containing CLARITIN and *Singulair. Singulair* is Merck's once-daily leukotriene receptor antagonist for the treatment of asthma and seasonal allergic rhinitis. In January 2002, Schering-Plough/Merck Pharmaceuticals reported on results of Phase III clinical trials of a fixed-combination tablet containing CLARITIN and *Singulair*, which did not demonstrate sufficient added benefits in the treatment of seasonal allergic rhinitis.

The agreements generally provide for equal sharing of development costs and for co-promotion of approved products by each company in the United States and in most other countries of the world, except Japan. In Japan, no agreement exists. In general, co-promotion provides that each company will provide equal physician marketing efforts and that each company will bear the cost of its own sales force in marketing the products. In general, the agreement provides that the venture will operate in a "virtual" mode to the maximum degree possible by relying on the respective infrastructures of the two companies. However, the companies have agreed to share certain costs, but these costs are limited to a portion of the costs of manufacturing, the cost of a specialty sales force and certain specially identified promotion costs. It should be noted that the Company incurs substantial costs, such as selling costs, that are not reflected in Equity income from cholesterol joint venture and are borne entirely by the Company. The agreements do not provide for any jointly owned facilities and, as such, products resulting from the collaboration will be manufactured in facilities owned by either Merck or the Company.

During 2003, the Company earned a milestone of $20 that relates to certain European approvals of ZETIA. Under certain other conditions, Merck could pay additional milestones to the Company totaling $132.

Prior to 2003, the venture was in the research and development phase and the Company's share of research and development expense in 2002 and 2001 of $69 and $86, respectively, was reported in "Research and development" in the Statements of Consolidated Operations. The venture has now moved beyond the research and development phase. ZETIA was launched in late 2002, and a U.S. marketing application for the combination of ezetimibe/simvastatin was submitted to the FDA in September 2003. To reflect the venture's first full year of commercial operations, the Company adopted the equity method of accounting effective as of the beginning of 2003. Under that method, the Company records its share of the operating profits less its share of the research and development costs in "Equity income from cholesterol joint venture" in the Statements of Consolidated Operations. Prior year amounts have not been affected.

Equity income from cholesterol joint venture for the year ended December 31, 2003 was $54. Included in this amount are the Company's share of operating profits of $113, the $20 milestone receipt, less its share of research and development costs of $79.

Note 14 Investments and Related-Party Transactions

Equity Investments

At December 31, 2003, Occidental's equity investments consisted of a 22-percent interest in Lyondell acquired in August 2002, a 24.5-percent interest in the entity that will own the pipeline being constructed by Dolphin Energy, the operator of the Dolphin Project, and other various partnerships and joint ventures, discussed below. Equity investments paid dividends of $81 million, $22 million and $27 million to Occidental in 2003, 2002 and 2001, respectively. Cumulative undistributed earnings since acquisition, in the amount of $55 million, of 50-percent-orless-owned companies have been accounted for by Occidental under the equity method. At December 31, 2003, Occidental's investments in unconsolidated entities exceeded the underlying equity in net assets by $471 million, of which $356 million represents goodwill that will not be amortized and $115 million represents intangible assets, which will be amortized over the life of the underlying lease of the assets, when placed into service.

In October 2003, Occidental purchased an additional 2.7 million shares of Lyondell common stock for $12.40 a share, totaling approximately $33 million. At December 31, 2003, Occidental owned 22 percent (39.5 million shares) of Lyondell stock.

The following table presents Occidental's percentage interest in the summarized financial information of its equity method investments:

For the years ended December 31, (in millions)	*2003*	*2002*	*2001*
Revenues	**$1,179**	$1,782	$2,223
Costs and expenses	**1,188**	2,043	2,315
Net loss	**$ (9)**	$(261)	$ (92)

Balance at December 31,	**2003**	2002
Current assets	**$ 349**	$ 421
Non-current assets	**$1,691**	$1,946
Current liabilities	**$ 407**	$ 225
Long-term debt	**$ 960**	$1,458
Other non-current liabilities	**$ 377**	$ 404
Stockholders' equity	**$ 365**	$ 280

In Ecuador, Occidental has a 14-percent interest in the Oleoducto de Crudos Pesados (OCP) Ltd. oil export pipeline. Occidental made capital contributions of $64 million in 2003 and as of December 31, 2003, has contributed a total of $73 million to the project. Occidental reports this investment in its consolidated statements using the equity method of accounting.

The project was funded in part by senior project debt. The senior project debt is to be repaid with the proceeds of ship-or-pay tariffs of certain upstream producers in Ecuador, including Occidental. Under their ship-or-pay commitments, Occidental and the other upstream producers have each assumed their respective share of project-specific risks, including operating risk and forcemajeure risk. Occidental would be required to make an advance tariff payment in the event of prolonged force majeure, upstream expropriation events, bankruptcy of the pipeline company or its parent company, abandonment of the project, termination of an investment guarantee agreement with Ecuador, or certain defaults by Occidental. This advance tariff would be used by the pipeline company to service or prepay project debt. Occidental's obligation relating to the pipeline company's senior project debt totaled $108 million, and Occidental's obligations relating to performance bonds totaled $14 million at December 31, 2003. As Occidental ships product using the pipeline, its overall obligations will decrease with the reduction of the pipeline company's senior project debt.

Occidental has a 50-percent interest in Elk Hills Power LLC (EHP), a limited liability company that operates a gas-fired, power-generation plant in California. EHP is a VIE under the provisions of FIN 46. Occidental has concluded it is not the primary beneficiary of EHP and, therefore, accounts for this investment using the equity method. In January 2002, EHP entered into a $400 million construction loan facility, which was amended in May 2003 to increase the facility to $425 million. Upon construction completion on July 17, 2003, the facility converted to a $415 million term loan, 50 percent of which is guaranteed by Occidental.

Available-for-Sale Securities

Investments in unconsolidated entities also include Occidental's investment in Premcor, Inc., which became a publicly traded company in April 2002. Occidental accounts for its investment in Premcor as available for sale and this investment is carried at fair value. Prior to becoming public, Occidental carried its investment in Premcor at cost. As of December 31, 2003 and 2002, the fair value of the investment in Premcor was $235 million and $172 million, respectively, with cumulative unrealized after-tax gains of $89 million and $65 million, respectively, in OCI.

Related-Party Transactions

During 2003, 2002 and 2001, Occidental entered into the following transactions and amounts due from/to with its related parties and had the following amounts outstanding:

For the years ended December 31, (in millions)	*2003*	*2002*	*2001*
Purchases	$707	$604	$660

Sales	502	284	252
Services	1	7	7
Amounts due from	34	43	14
Amounts due to	21	70	35

General Mills

2003 Annual Report

4. Investments in Joint Ventures

We have a 50 percent equity interest in Cereal Partners Worldwide (CPW), a joint venture with Nestlé that manufactures and markets ready-to-eat cereals outside the United States and Canada. We have a 40.5 percent equity interest in Snack Ventures Europe (SVE), a joint venture with PepsiCo that manufactures and markets snack foods in continental Europe. We have a 50 percent equity interest in 8th Continent, LLC, a domestic joint venture formed in fiscal 2001 with DuPont to develop and market soy foods and beverages. As a result of the Pillsbury acquisition, we have 50 percent interests in the following joint ventures for the manufacture, distribution and marketing of Häagen-Dazs frozen ice cream products and novelties: Häagen-Dazs Japan K.K., Häagen-Dazs Korea Company Limited, Häagen-Dazs Taiwan Limited, Häagen-Dazs Distributors (Thailand) Company Limited, and Häagen-Dazs Marketing & Distribution (Philippines) Inc. We also have a 50 percent interest in Seretram, a joint venture with Co-op de Pau for the production of *Green Giant* canned corn in France. In July 2003, we purchased the remaining 50 percent interest in the Taiwan venture.

The joint ventures are reflected in our financial statements on an equity accounting basis. We record our share of the earnings or losses of these joint ventures. (The table that follows reflects the joint ventures on a 100 percent basis.) We also receive royalty income from certain joint ventures, incur various expenses (primarily research and development) and record the tax impact of certain joint venture operations that are structured as partnerships.

Our cumulative investment in these joint ventures (including our share of earnings and losses) was $372 million, $326 million, and $218 million at the end of fiscal 2003, 2002, and 2001, respectively. We made aggregate investments in the joint ventures of $17 million, $38 million, and $25 million in fiscal 2003, 2002 and 2001, respectively. We received aggregate dividends from the joint ventures of $95 million, $17 million, and $3 million in fiscal 2003, 2002 and 2001, respectively.

Summary combined financial information for the joint ventures on a 100 percent basis follows. Since we record our share of CPW results on a two-month lag, CPW information is included as of and for the 12 months ended March 31. The Häagen-Dazs and Seretram joint ventures are reported as of and for the 12 months ended April 30, 2003 and for the six months ended April 30, 2002. The SVE and 8th Continent information is consistent with our May year-end.

Combined Financial Information—Joint Ventures—100 Percent Basis

IN MILLIONS, FISCAL YEAR	*2003*	*2002*	*2001*
Net Sales	**$2,159**	$1,693	$1,468
Gross Profit	**952**	755	664
Earnings before Taxes	**178**	94	61
Earnings after Taxes	**125**	78	48

IN MILLIONS, FISCAL YEAR ENDED	*2003*	*2002*
Current Assets	**$681**	$587
Noncurrent Assets	**868**	712
Current Liabilities	**679**	630
Noncurrent Liabilities	**9**	9

Our proportionate share of joint venture net sales was $997 million, $777 million, and $666 million for fiscal 2003, 2002, and 2001, respectively.

Merck

2003 Annual Report

4. Joint Ventures and Other Equity Method Affiliates

In 1982, Merck entered into an agreement with Astra AB (Astra) to develop and market Astra's products under a royalty-bearing license. In 1993, the Company's total sales of Astra products reached a level that triggered the first step in the establishment of a joint venture business carried on by Astra Merck Inc. (AMI), in which Merck and Astra each owned a 50% share. This joint venture, formed in 1994, developed and marketed most of Astra's new prescription medicines in the United States including *Prilosec*, the first of a class of medications known as proton pump inhibitors, which slows the production of acid from the cells of the stomach lining.

In 1998, Merck and Astra completed the restructuring of the ownership and operations of the joint venture whereby the Company acquired Astra's interest in AMI, renamed KBI Inc. (KBI), and contributed KBI's operating assets to a new U.S. limited partnership, Astra Pharmaceuticals L.P. (the Partnership), in exchange for a 1% limited partner interest. Astra contributed the net assets of its wholly owned subsidiary, Astra USA, Inc., to the Partnership in exchange for a 99% general partner interest. The

Partnership, renamed AstraZeneca LP (AZLP) upon Astra's 1999 merger with Zeneca Group Plc (the AstraZeneca merger), became the exclusive distributor of the products for which KBI retained rights.

While maintaining a 1% limited partner interest in AZLP, Merck has consent and protective rights intended to preserve its business and economic interests, including restrictions on the power of the general partner to make certain distributions or dispositions. Furthermore, in limited events of default, additional rights will be granted to the Company, including powers to direct the actions of, or remove and replace, the Partnership's chief executive officer and chief financial officer. Merck earns ongoing revenue based on sales of current and future KBI products and such revenue was $1.9 billion, $1.5 billion, and $1.9 billion in 2003, 2002, and 2001, respectively, primarily relating to sales of *Nexium* and *Prilosec*. In addition, Merck earns certain Partnership returns, which are recorded in Equity income from affiliates. Such returns include a priority return provided for in the Partnership Agreement, variable returns based, in part, upon sales of certain former Astra USA, Inc. products, and a preferential return representing Merck's share of undistributed AZLP GAAP earnings. These returns aggregated $391.5 million, $640.2 million, and $642.8 million in 2003, 2002, and 2001, respectively. The decrease in 2003 is attributable to a reduction in the preferential return, primarily resulting from the impact of generic competition for *Prilosec*. The AstraZeneca merger triggers a partial redemption of Merck's limited partnership interest in 2008. Upon this redemption, AZLP will distribute to KBI an amount based primarily on a multiple of Merck's average annual variable returns derived from sales of the former Astra USA, Inc. products for the three years prior to the redemption (the Limited Partner Share of Agreed Value).

In conjunction with the 1998 restructuring, for a payment of $443.0 million, which was deferred, Astra purchased an option (the Asset Option) to buy Merck's interest in the KBI products, excluding the gastrointestinal medicines Nexium and Prilosec. The Asset Option is exercisable in 2010 at an exercise price equal to the net present value as of March 31, 2008 of projected future pretax revenue to be received by the Company from the KBI products (the Appraised Value). Merck also has the right to require Astra to purchase such interest in 2008 at the Appraised Value. In addition, the Company granted Astra an option to buy Merck's common stock interest in KBI at an exercise price based on the net present value of estimated future net sales of Nexium and Prilosec. This option is exercisable two years after Astra's purchase of Merck's interest in the KBI products.

The 1999 AstraZeneca merger constituted a Trigger Event under the KBI restructuring agreements. As a result of the merger, in exchange for Merck's relinquishment of rights to future Astra products with no existing or pending U.S. patents at the time of the merger, Astra paid $967.4 million (the Advance Payment), which is subject to a true-up calculation in 2008 that may require repayment of all or a portion of this amount. The True-Up Amount is directly dependent on the fair market value in 2008 of the Astra product rights retained by the Company. Accordingly, recognition of this contingent income has been deferred until the realizable amount, if any, is determinable, which is not anticipated prior to 2008.

Under the provisions of the KBI restructuring agreements, because a Trigger Event has occurred, the sum of the Limited Partner Share of Agreed Value, the Appraised Value and the True-Up Amount is

guaranteed to be a minimum of $4.7 billion. Distribution of the Limited Partner Share of Agreed Value and payment of the True-Up Amount will occur in 2008. AstraZeneca's purchase of Merck's interest in the KBI products is contingent upon the exercise of either Merck's option in 2008 or AstraZeneca's option in 2010 and, therefore, payment of the Appraised Value may or may not occur.

In 1989, Merck formed a joint venture with Johnson & Johnson to develop and market a broad range of nonprescription medicines for U.S. consumers. This 50% owned venture was expanded into Europe in 1993, and into Canada in 1996. Sales of product marketed by the joint venture were $445.8 million for 2003, $413.0 million for 2002, and $395.0 million for 2001.

In 1994, Merck and Pasteur Mérieux Connaught (now Aventis Pasteur) established an equally-owned joint venture to market vaccines in Europe and to collaborate in the development of combination vaccines for distribution in Europe. Joint venture vaccine sales were $669.0 million for 2003, $546.4 million for 2002, and $499.6 million for 2001.

In 1997, Merck and Rhône-Poulenc (now Aventis) combined their animal health and poultry genetics businesses to form Merial Limited (Merial), a fully integrated animal health company, which is a stand-alone joint venture, equally owned by each party. Merial provides a comprehensive range of pharmaceuticals and vaccines to enhance the health, well-being and performance of a wide range of animal species. Merial sales were $1.8 billion for 2003, $1.7 billion for 2002, and $1.6 billion for 2001.

In 2000, the Company and Schering-Plough Corporation (Schering-Plough) entered into agreements to create separate equally-owned partnerships to develop and market in the United States new prescription medicines in the cholesterol-management and respiratory therapeutic areas. In 2001, the cholesterol management partnership agreements were expanded to include all the countries of the world, excluding Japan. In October 2002, ezetimibe, the first in a new class of cholesterol-lowering agents, was approved in the United States as Zetia and in Germany as Ezetrol. Zetia was launched in the United States in November 2002. In 2003, following the successful completion of the European Union Mutual Recognition Procedure, Ezetrol had been launched in five European countries— Germany, the United Kingdom, Switzerland, Sweden and the Netherlands. Sales totaled $469.4 million in 2003 and $25.3 million in 2002. In September 2003, Merck/Schering-Plough Pharmaceuticals submitted a New Drug Application to the U.S. Food and Drug Administration (FDA) for Vytorin, which contains the active ingredients of both Zetia and Zocor. In November 2003, the filing was accepted by the FDA for standard review. Similar applications have been filed in other countries outside the United States.

In January 2002, the Merck/Schering-Plough respiratory partnership reported on results of Phase III clinical trials of a fixed combination tablet containing Singulair and Claritin, Schering-Plough's nonsedating antihistamine, which did not demonstrate sufficient added benefits in the treatment of seasonal allergic rhinitis.

Investments in affiliates accounted for using the equity method, including the above joint ventures, totaled $2.2 billion at December 31, 2003 and 2002, respectively. These amounts are reported in Other assets. Dividends and distributions received from these affiliates were $553.4 million in 2003, $488.6 million in 2002, and $572.2 million in 2001.

Note 4—Investments in and Advances to Affiliates

The Company has ownership interests in non-majority-owned affiliates accounted for under the equity method. The Company had 83 and 85 unconsolidated affiliates as of June 30, 2005 and 2004, respectively, located in North and South America, Africa, Europe and Asia. During fiscal 2005, the Company acquired controlling interests in 3 previously unconsolidated affiliates, made initial investments in 7 unconsolidated affiliates and disposed of its investments in 6 affiliates. The following table summarizes the combined balance sheets and the combined statements of earnings of the Company's unconsolidated affiliates as of and for each of the three years ended June 30, 2005, 2004, and 2003.

	2005	2004 *(in thousands)*	2003
Currents assets................................	**$ 6,240,670**	$ 5,159,660	
Non-current assets..........................	**7,384,141**	8,305,256	
Current liabilities.............................	**4,746,450**	3,983,022	
Non-current liabilities	**1,912,285**	1,939,453	
Minority interests	**430,530**	369,991	
Net assets..	**$ 6,535,546**	$ 7,172,450	
Net sales..	**$20,214,914**	$17,744,217	$17,181,800
Gross profit	**2,310,413**	1,991,947	2,037,875
Net income (loss)	**757,539**	819,201	(62,707)

Undistributed earnings of the Company's unconsolidated affiliates as of June 30, 2005, is $436 million.

Two foreign affiliates for which the Company has a carrying value of $406 million have a market value of $384 million based on quoted market prices and exchange rates at June 30, 2005.

Review Question Answers

1. Investments in equity securities that have readily determinable fair values may be classified as I) Available-for-sale securities; II) Held-to-maturity securities; or III) Trading securities

A. Incorrect. Equity securities also may be classified as trading.
B. Incorrect. Only debt securities may be classified as held-to-maturity.
C. **Correct.** ASC 320 applies to equity securities with readily determinable fair values. Equity securities held principally for sale in the near term are classified as trading securities. Equity securities (not classified as trading securities) are classified as available-for-sale securities. Held-to-maturity securities are debt securities only.
D. Incorrect. Equity securities are classified as trading or available-for-sale, but only debt securities may be classified as held-to-maturity.

2. On December 31, Ott Co. had investments in trading securities as follows: Man Co. with cost = $10,000 and fair value = $8,000; Kemo Inc with cost = $9,000 and fair value = $11,000; and Fenn Corp with cost = $11,000 and fair value = $ 9,000. Total cost = $30,000 and total Fair Value = $28,000. Ott's December 31 balance sheet should report the trading securities as

A. Incorrect. The amount of $26,000 is the lower of cost or fair value determined on an individual security basis.
B. **Correct.** Trading securities are reported at fair value, and unrealized holding gains and losses are included in earnings. Consequently, the securities should be reported as $28,000.
C. Incorrect. The amount of $29,000 is the average of the aggregate cost and aggregate fair value.
D. Incorrect. The aggregate cost is $30,000.

3. At year end, Slim Co. held several investments with the intent of selling them in the near term. The investments consisted of $100,000, 8%, five-year bonds, purchased for $92,000, and equity securities purchased for $35,000. At year-end, the bonds were selling on the open market for $105,000, and the equity securities had a market value of $50,000. What amount should Slim report as trading securities in its year-end balance sheet?

A. Incorrect. The fair value of the bonds is also included.
B. Incorrect. Trading securities are reported at their fair value, not historical cost.

C. Incorrect. The bonds should be measured at fair value, not historical cost.
D. **Correct.** Trading securities are debt securities (not classified as held-to-maturity) and equity securities with readily determinable fair values that are bought and held primarily for sale in the near term. Hence, the bonds and the equity securities are trading securities. They are initially recorded at cost but are subsequently measured at fair value at each balance sheet date. Quoted market prices in active markets are the best evidence of fair value. Based on market quotes at year-end, the bonds had a fair value of $105,000, and the equity securities had a fair value of $50,000. The total is $155,000.

4. A company should report the marketable equity securities that it has classified as trading at

A. Incorrect. Trading securities are recorded at fair value.
B. Incorrect. Trading securities should be recorded at fair value with unrealized gains/losses recognized in earnings.
C. Incorrect. Unrealized holding gains and losses on trading securities should be included in earnings.
D. **Correct.** Trading securities are those held principally for sale in the near term. They are classified as current and consist of debt securities and equity securities with readily determinable fair values. Unrealized holding gains and losses on trading securities are reported in earnings. On a statement of financial position, these securities are reported at fair value.

5. On July 2, Year 4, Wynn, Inc. purchased as a short-term investment a $1 million face value Kean Co. 8% bond for $910,000 plus accrued interest to yield 10%. The bonds mature on January 1, Year 11, and pay interest annually on January 1. On December 31, Year 4, the bonds had a fair value of $945,000. On February 13, Year 5, Wynn sold the bonds for $920,000. In its December 31, Year 4, balance sheet, what amount should Wynn report for the bond if it is classified as an available-for-sale security?

A. Incorrect. The amount of $910,000 is the cost (accrued interest is not recorded as part of the cost but as an adjustment of interest income).
B. Incorrect. The sale price is $920,000.
C. **Correct.** Available-for-sale securities should be measured at fair value in the balance sheet. Hence, the bond should be reported at its fair value of $945,000 to reflect the unrealized holding gain (change in fair value).
D. Incorrect. The amount of $950,000 equals the cost plus accrued interest (the total price paid) on July 2, Year 4.

6. The following information pertains to Lark Corp.'s available-for-sale securities on Dec 31 of each year: Year 2 Cost = $100,000 and Fair Value = $90,000; Year 3 Cost = $100,000 and Fair Value = $120,000. Differences between cost and fair values are considered to be temporary. The decline in fair value was properly accounted for at December 31, Year 2. Ignoring tax effects, by what amount should other comprehensive income (OCI) be credited at December 31, Year 3?

A. Incorrect. Unrealized holding gains on available-for-sale securities are recognized.
B. Incorrect. This figure is merely the recovery of the previously recognized unrealized holding loss. The recognition of gain is not limited to that amount.
C. Incorrect. The excess of fair value over cost is $20,000.
D. **Correct.** Unrealized holding gains and losses on available-for-sale securities, including those classified as current assets, are not included in earnings but ordinarily are reported in OCI, net of tax effects (ignored in this question). At December 31, Year 2 (assuming the securities are not designated as being hedged in a fair value hedge), OCI should have been debited for $10,000 for the excess of cost over fair value to reflect an unrealized holding loss. At December 31, Year 3, OCI should be credited to reflect a $30,000 unrealized holding gain ($120,000 fair value at 12/31/Year 3 - $90,000 fair value at 12/31/Year 2).

7. Kale Co. purchased bonds at a discount on the open market as an investment and has the intent and ability to hold these bonds to maturity. Absent an election of the fair value option (FVO), Kale should account for these bonds at

A. Incorrect. The discount will be amortized over the term of the bonds.
B. **Correct.** Absent an election of the fair value option (FVO), investments in debt securities must be classified as held-to-maturity and measured at amortized cost in the balance sheet if the reporting entity has the positive intent and ability to hold them to maturity.
C. Incorrect. Trading and available-for-sale securities are accounted for at fair value absent an election of the FVO.
D. Incorrect. Inventory is accounted for at lower of cost or market.

8. Investments classified as held-to-maturity securities should be measured at

A. Incorrect. The acquisition cost of held-to-maturity securities is adjusted for amortization.
B. **Correct.** Debt securities classified as held-to-maturity are measured at amortized cost.
C. Incorrect. Held-to-maturity securities are written down below amortized cost only when a decline in fair value below amortized cost is other than temporary.
D. Incorrect. Debt securities classified as held-to-maturity are reported at amortized cost.

9. When the fair value of an investment in debt securities exceeds its amortized cost, how should each of the following debt securities be reported at the end of the year, given no election of the fair value option?

A. Incorrect. Available-for-sale securities are recorded at fair value.
B. **Correct.** Investments in debt securities must be classified as held-to-maturity and measured at amortized cost in the balance sheet if the reporting entity has the positive intent and ability to hold them to maturity. Marketable equity securities are classified as either trading or available-for-sale. Equity securities that are not expected to be sold in the near term should be classified as available-for-sale. These securities should be reported at fair value, with unrealized holding gains and losses (except those on securities designated as being hedged in a fair value hedge) excluded from earnings and reported in OCI.
C. Incorrect. Held-to-maturity securities are recorded at amortized cost.
D. Incorrect. Available-for-sale securities are recorded at fair value, and held-to-maturity securities are recorded at amortized cost.

10. An available-for-sale debt security was purchased on September 1, 2X12 between interest dates. The next interest payment date was February 1, 2X13. Because of a permanent decline in fair value, the cost of the debt security substantially exceeded its fair value at December 31, 2X12. On the balance sheet at December 31, 2X12, the debt security should be carried at

A. Incorrect. Interest paid is part of the cost.
B. **Correct.** As a result of a permanent decline in fair value, the security should be written down to fair value, and the loss should be treated as a realized loss. Accordingly, the loss will flow through the income statement, and the new cost basis will not be adjusted for increases in the fair value of the security (assuming it is not designated as being hedged in a fair value hedge).
C. Incorrect. The investment should be written down to reflect the permanent impairment of value. Interest paid is part of the cost.
D. Incorrect. The investment should be written down to the fair value not the cost, to reflect the permanent impairment of value.

11. In 2X12, Lee Co. acquired, at a premium, Enfield, Inc. 10-year bonds as a long-term investment. At December 31, 2X13, Enfield's bonds were quoted at a small discount. Which of the following situations is the most likely cause of the decline in the bonds' fair value?

A. Incorrect. A stock dividend has no effect on quoted fair values of bonds.
B. Incorrect. Bonds expected to be called at a premium would not be quoted at a discount.
C. Incorrect. If interest rates decline below the stated rate, the bonds will be quoted at an even higher premium.
D. **Correct.** To adjust the yield on a bond investment to equal the market rate, the price of the bond must fluctuate inversely with the market rate because the nominal interest rate is fixed. Bonds selling at a premium have a nominal rate in excess of the market rate. If the market rate subsequently increases, the price of the bonds must decrease to provide a yield equal to the new market rate.

12. An investor purchased a bond as a long-term investment on January 2. The investor's carrying amount at the end of the first year will be highest if the bond is purchased at a

A. Incorrect. A bond purchased at a premium has a higher carrying amount than one purchased at a discount.
B. Incorrect. A bond purchased at a discount has a lower carrying amount than one purchased at a premium.
C. Incorrect. In the first year, straight-line amortization of premium exceeds amortization under the interest method.
D. **Correct.** When a bond is purchased at a premium (discount), its initial carrying amount is greater (less) than the maturity amount. The carrying amount of a bond acquired at a premium will decrease over time as the premium is amortized. Under the effective interest method, interest revenue is equal to the carrying amount of the bond at the beginning of the interest period multiplied by the yield rate of interest. The amount of periodic amortization is the excess of the nominal interest received over the interest revenue. Because the carrying amount of the bond will decrease over time, the amount of interest revenue will also diminish. Subtracting the decreasing interest revenue from the constant periodic cash flow results in increasing amounts of premium amortization over the term of the bond. Under the straight-line method of amortization, equal amounts are amortized over the life of the bond. Accordingly, the least amount of premium will be amortized in the first year under the interest method, and the result will be the highest carrying amount of the bond at the end of this year.

13. In accordance with ASC 320, a reclassification of available-for-sale securities to the held-to-maturity category will result in

A. **Correct.** The unrealized holding gain or loss on the date of transfer for available-for-sale securities transferred to the held-to-maturity category continues to be reported in OCI, assuming these securities were not designated as being hedged in a fair value hedge, in which case the unrealized holding gain or loss would have previously been recognized in earnings. However, it is amortized as an adjustment of yield in the same manner as the amortization of any discount or premium. This amortization offsets or mitigates the effect on interest income of the amortization of the premium or discount. Fair value accounting may result in a premium or discount when a debt security is transferred to the held-to-maturity category.
B. Incorrect. Only transfers to the trading securities category result in immediate recognition in earnings of an unrealized gain or loss.
C. Incorrect. No reversals are required by reclassification.
D. Incorrect. The reclassification does not require reversal of any previously recognized amounts.

14. On January 2, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for $400,000, which equaled the carrying amount and the fair value of the interest purchased in Rea's net assets. Well did not elect the fair value option. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of $500,000 for the year and paid dividends of $150,000. In its December 31 balance sheet, what amount should Well report as investment in Rea?

A. Incorrect. The amount of $450,000 does not deduct Well's dividends.
B. **Correct.** The equity method should be used because Well Co. exercises significant influence over Rea. The investment in Rea equals $435,000 [$400,000 investment + ($500,000 net income x 10%) - ($150,000 of dividends x 10%)].
C. Incorrect. The amount of $400,000 does not include Well's share of net income or deduct Well's dividends.
D. Incorrect. The amount of $385,000 does not include Well's share of net income.

15. When an investor uses the equity method to account for investments in common stock, the investment account will be increased when the investor recognizes

A. **Correct.** Under the equity method, the investor's share of the investee's net income is accounted for as an addition to the carrying amount of the investment on the investor's books. Losses and dividends are reflected as reductions of the carrying amount.

B. Incorrect. Recognition of a cash dividend received from the investee reduces the carrying amount.
C. Incorrect. Goodwill is not amortized. Moreover, equity method goodwill is not separately reviewed for impairment because it is not separate from the investment.
D. Incorrect. Recognition of depreciation related to the excess of fair value over the carrying amount of the investee's depreciable assets at the date of purchase by the investor reduces the carrying amount.

16. Green Corp. owns 30% of the outstanding common stock and 100% of the outstanding noncumulative nonvoting preferred stock of Axel Corp. In Year 1, Axel declared dividends of $100,000 on its common stock and $60,000 on its preferred stock. Green exercises significant influence over Axel's operations and uses the equity method to account for the investment in the common stock. What amount of dividend revenue should Green report in its income statement for the year ended December 31, Year 1?

A. Incorrect. The preferred, not the common, dividends should be credited to revenue.
B. Incorrect. $30,000 is Green's share of the common dividends. The cash dividends on common stock should be credited to the investment account.
C. **Correct.** Under the equity method, the receipt of a cash dividend from the investee should be credited to the investment account. It is a return of, not a return on, the investment. However, the equity method is not applicable to preferred stock. Thus, Green should report $60,000 of revenue when the preferred dividends are declared.
D. Incorrect. $90,000 is the sum of the preferred dividends ($60,000) and 30% of the common dividends ($100,000 x 30%).