CHAPTER 4
LONG TERM INVESTMENTS

Generally, investments that are readily marketable and that may be sold without disrupting business relationships or impairing the operations of the business enterprise are classified as short-term investments and investments made to foster business relationships with other enterprises are classified as long-term investments.

Investors make investments in investee company securities:

E.g.
- Stocks (common and/or preferred stock)
- Bonds
- Mortgage notes
- Long-term receivables

Objectives of Long-term Investments in Financial Assets

A business enterprise may make long-term investments in the securities of other corporations for many reasons.

1) To create close ties with major suppliers, creditors, customers or any other party.

   ⇒ Gives an investor a degree of influence or control over the mgt of the investee

2) To generate investment income
   - Dividend/Interest revenue
   - Capital gain (appreciation in value)

Investments can be made in either debt securities (such as bond) or equity securities (such as stocks).

1) Debt Security – any security representing a creditor relationship with an entity.

E.g. Government treasury bonds
Corporate bonds
Convertible preferred stock

2) Equity Security – any security representing an ownership interest in an entity.

E.g. Common stock

Preferred stock

1. Accounting for Long-term investments in 'Common Stocks'

a. Acquisition Cost

The cost of an investment in equity securities includes:

- The acquisition price, plus
- Brokerage fees and other expenditures incurred in the transaction.

If assets other than cash are given in payment for the securities and the current fair value of such non-cash assets is unknown, the current market price of the securities may be used to establish the cost of the securities acquired and the value of the non-cash assets given in exchange.

If two or more securities are acquired for a lump sum, the total cost should be allocated among the various securities based on their relative market value.

b. Levels of Control

There are three levels of control or influence that an investor company can have over an investee company.

i. Controlling interest

- Represented by an investment in which the investor owns more than 50% of the voting stock of the investee.
- The investor has an absolute control over the investee.
- The investor corporation is referred to as a parent and the investee as the subsidiary.
- Consolidated financial statements are generally prepared, i.e. The financial statements of the two corporations are

combined into one as if they were one economic entity with the interest of shareholders of the invest company other than the investor reported as a special item called minority shareholder interest.

ii. Significant influence

- An investment in equity securities in which the investor holds form 20% to 50% of the voting stock of the investee.
- Accounted for using the equity method.

iii. No significant influence

- Investments in equity securities in which the investor holds less than 20% of the voting stock of the invest.
- Accounted for using the cost method.

c. Measuring Return on Investment

- Three different accounting methods exist, depending on which return an investor wishes to measure:

i. Cost method
   - Investment income only of dividends received.
   - Used when no significant influence exists

ii. Equity method
   - Investment income consists of the investor's proportionate share of the investee's net income. (20% - 50%)

iii. Market value method
   - Investment income includes:
     a. Dividends received and
     b. Changes in the market value of the investment.

d. Accounting for Investment income

1. Market Value Method

- Investment account is debited for Acquisition Cost

Investment in investee	xx	
Cash		xx

- The carrying amount of the investment account is adjusted by the change in the market value of the security.
- Usually applicable for trading securities

2) Cost method

- Criteria for application
  - Is appropriate when the investor has no significant control over the investee company (i.e. < 20%), and
  - If the investment is in a non-voting stock (preferred) or in debt securities.

- Application

i. Upon acquisition:

Investment in investee	xx	
Cash		xx

ii. Subsequent to Acquisition

- Dividends received

Cash	xx	
Dividend revenue		xx

- Liquidating dividends are not revenues

⇒ i.e. distribution of investee's earnings realized prior to the time the stock was acquired.

E.g. Investee's data for year 1:

Net income	200,000
Dividends	300,000

The investor acquired 15% of the voting stock of investee Co.

⇒ The investor's share:

Cash dividends = 15% x 300,000 = $ 45,000

Dividend Revenue = 15% x 200,000 = 30,000

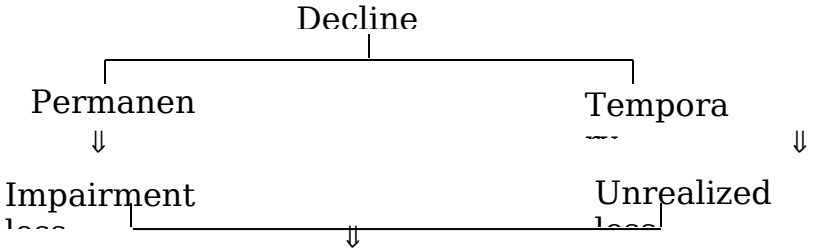
Liquidating Dividends = 15% x (300,000 – 200,000) = $ 15,000

Cash	45,000	
Dividend Revenue		30,000
Investment in investee		15,000

Carrying amount of the Investment account

⇒ Carried at Lower of Cost or Market (LCM)

Permanent Decline in value of investment



FASB statement No. 12 “Accounting for Certain Marketable Securities”

⇒ “… If the decline is judged to be other than temporary, the cost basis of the individual security shall be written down to a new cost basis and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in market value”.

Realized loss in value of Long-term Investment	xx	
Investment in Investee		xx

Considerations to be looked into for the determination of the existence of permanent decline in value:

- The length of time the security has been owned.

- The length of time the market value of the security has been below the investor's cost and the extent of the decline.
- The financial condition and prospects of the investee.
- The financial condition of the investor
- The materiality of the decline in value of the investment in relation to the net income and stockholders' equity of the investor.

Valuation at LCM

Special Accounting procedures are required by SFAS No. 12 when the aggregate market value of a non current portfolio of marketable equity securities accounted for by the cost method, is below the aggregate cost, such a portfolio is valued at the lower of cost or market. However, in contrast to the valuation of the current portfolio of marketable equity securities the unrealized loss in value of a non-current portfolio of marketable equity securities is not included in net income. Instead, the unrealized loss is reported as a reduction of stockholders' equity.

Disposal / Sale

- Gain / Loss = Proceeds - Carrying Amount of the investment.
- To determine the Carrying Amount, any of the cost flow assumptions can be used, though the use of specific identification is recommended.

3. Equity method

 Criteria for Application

- Used when the investor is deemed to have a significant influence over the investee company.

"Equity methods of accounting for Investments in common stock" – APB in its opinion no.18 took a position that on investment (direct or indirect) of 20% or more of the voting stock of an

investee should lead to a presumption that in the absence of the contrary an investor has the ability to exercise significant influence over an investee. However, if the investor owns 20% or more of the voting stock but is unable to exercise significant influence over the investee, use of the cost method is required.

- Application
  - Upon Acquisition

Investment in Investee xx
Cash xx

  - Subsequent to Acquisition
    - The investment account is adjusted for:
      - The share of investee's net income - increase the carrying amount
      - The cash dividends received - decrease the carrying amount

⇒ Earnings = % age of ownership x (NI – Dividend on preferred stock).

Earnings Investment in investee xx
Investment Income xx

Dividends Received Cash xx
Investment in investee xx

Disposal – is the same as the cost method except that the carrying amount is adjusted for the amount at the date of disposal.

Comparison of cost of investment with equity acquired.

Cost of investment >< = Book Value of net assets of investee company

This difference is accounted for as:

- Excess of Cost over BV of net assets or
- Excess of BV of net assets over Cost of investment

Date of Acquisition Investment in investee xx
Cash xx

- Subsequent to acquisition, the difference will be amortized and it will affect the Carrying Amount of the investment account.

Computation

Cost of investment			xx
Investee's owner's equity		xx	
% of ownership		xx	
Equity Acquired			xx
Difference			xx

The amortization period will be over the life of the assets in question including goodwill.

Case 1. If Cost > BV

Investment income	xx	
Investment investee		xx

Case 2. If BV > Cost

Investment investee	xx	
Investment income		xx

Summary of equity method

Investment in investee

Original cost	Share of loss
Share of income	Amortization of
Amortization of BV	cost in excess of
in excess of cost	Book Value
	Cash dividends
	received
	Disposal

Investment Income

Share of Loss	Share of Income
Amortization of Excess of over	Amortization of Excess of BV
Cost over the BV	cost

Long-term Investment in bonds

A bond contract represents a promise to pay an amount of money at maturity and a series of interest payments (usually every six months) during the terms of the contract. Investors acquire corporate bonds to earn of return on investment (interest).

Acquisition Cost

The cost of investment in bonds is the present value of future cash receipts pursuant to the bond contract, measured in terms of the market rate of interest at the time of investment. The stated (nominal) rate of interest in the bond contract measures the cash to be received periodically by the investor.

Case 1- If the market rate equals the nominal rate, the bond will be acquired at the face amount.

Case 2 – If the make rate of interest exceeds the nominal rate, the bond may be acquired at a discount, because the investment is demanding a higher return than the bond contract offers; therefore, to equate the yield on the bond with the market rate of interest, the bond is acquired at a price below face amount.

Case 3 – If the market rate of interest is below the nominal rate, the investor will be willing to pay a premium for the bond, that is , a price above face amount.

Example

On January 2, year 3, olive Company acquired as a long –term investment 100 of $1,000 face amount, 8% bond of Edgar Company maturing on January 2, year 13 and 7%, 10% for calculate premium and discount of the company respectively. Interest on the bonds is payable annually on each January 2, beginning year 4.

Case 1- yield rate = 8%

PV of $ 100,000 face value discounted at 8%

100,000 (1 + 0.08)	$ 46,319

PV of ordinary annuity of 10 rents of $ 8000

$$\frac{8000(1 - (1.08)^{-10}}{0.08}$$ 53,681

Acquisition price of bonds $ 100,000

Investment in Edgar Co. Bonds

Cash 100,000

Case 2 – yield rate = 10%

PV of $100,000 at 10% for 10 periods 38,554

PV of $8,000 ordinary annuity at 10% for 10 periods 49,156

Acquisition price $ 87,710

Case 3 – Yield rate = 7%

PV of $ 100,000 50,835

PV of $ 8000 56,189

$ 106,724

Acquisition of bonds between interest dates

The investor who acquires a bond between interest dates must pay the previous owner the market price of the bond plus the interest accrued since the last interest payment. The investor is paying the previous owner of the bond the interest applicable to the first portion of the interest and will in turn collect that portion plus the additional interest earned by holding the bond until the next interest payment date.

Example

Assume that Olive Company acquired Edger Company bonds on June 30, year 3 and that the yield rate was 10%.

Accrued interest = 100,000 x 0.08 x 6/12 = $ 4,000

Investment in Edger Co. Bonds 87,710

Interest receivable 4,000

Cash 91,710

NOTE: The accrued interest paid is not part of the acquisition cost. On the date of acquisition of bonds, the investment ledger amount is debited for the cost of acquiring the bonds including brokerage and other fees, but excluding any interest.

The discount or premium will be amortized to reflect the change in the carrying amount of the bonds based on the effective rate of interest prevailing at the time of acquisition.

The periodic interest payments provided for in a bond contract represent the total interest revenue to an investor holding a bond to maturity only if the investor acquired the bond at its face amount. If an investor acquires a Bond at a premium, the amount received on maturity of the bond will be less than the amount of the initial investment, thus reducing the commutative interest revenue by the amount of the premium. Similarly, if the bond is acquired at a discount, the amount received at maturity will be larger than the initial investment, thereby increasing the cumulative interest revenue by the amount of the discount.

Methods of discount accumulations (premium amortization)

1) Interest method

- Produces a constant rate of return on the investment in bonds investment in bonds i.e. the periodic interest revenue always represents the same percentage return on the carrying amount of the investment.

2) Straight line method

- The discount or premium is spread uniformly over the term of the bonds.
- Although the bonds may be sold by the investor or redeemed by the issuer prior to maturity, the accumulation or amortization always is based on the years remaining to maturity

Illustration

Noria Company acquired as a long-term investment $500,000 face amount of Tork Company bonds on September 30, year 2. The bonds have a 14% nominal rate with interest payable semiannually on March 31 and September 30. The remaining term of the bonds is 10 years; the bonds have an effective yield to maturity of 16% compounded annually.

Instruction

a. Compute the amount that Noria Company paid for the Tork Company bonds.
b. Record the acquisition of the bond.
c. Record the first two years' transactions under both the interest method and the straight line method. Noria's fiscal ends on September 30.

Solution

a. Acquisition cost of the bond

Present Value of $500,000 discounted at 8% for 20 six-month periods	$107,250
Add: Present value of ordinary annuity of 20 rents of $35,000 (semi-annual interest payments) discounted at 8%	343,635
Acquisition price of bonds (discount of $29,117)	$450,885

b. To record the long-term investment in bond

Year 2	Investment in Tork Company Bonds	450,885	
September 30	Cash		450,885

Entries to record Bond Discount Amortization:

i. Interest Method

1. To record the receipt of the first interest payment on March 31, year 2.

Year 2	Cash	35,000	
March 31	Investment in Tork Company Bond*		1,070

Investment Revenue

36,070

* [(450,885 x 0.08) – 35,000]

2. To record the receipt of the second interest payment on September 30, year 2.

Cash 35,000

Investment in Tork Company Bond* 1156

Interest Revenue

36156

* [(450885 + 1,070) x 0.08 – 35,000]

3. To record the receipt of the third interest payment on March 31, year 3.

Cash 35,000

Investment in Tork Company Bonds* 1248

Interest Revenue 36248

*[(450,885 + 1,070 + 1156) x 0.08 – 35,000]

Question: Repeat the same for the fourth, fifth, sixth, and seventh receipts of interest.

ii. Straight line method

The entry will be the same as the discount will be amortized equally for each interest period. The entry of the following will therefore be made for each payment:

Cash 35,000

Investment in Tork Company Bonds* 2,455

Interest Revenue 37,455

* 49,115 / 20 = $2455 [rounded]

Exercise

Do the following independently:

1. Repeat the above procedures assuming that the yield to maturity (YTM) is rather 12%.
2. If Noria had acquired the bonds on December 31, year 2, determine and record the cash paid for the acquisition of the bond.

Disposal

- Compare Carrying Amount with proceeds to determine gain/loss.

  Gain ⇒ If proceeds > Carrying Amount

  Loss ⇒ If Carrying Amount > proceeds

Special problems in accounting for long-term investments in securities

a. Cost identification

Investments in securities may pose a problem as to which costs should be offset against revenue in the period of sale. Because securities usually are identified by a certificate number, it would be possible to use specific identification of stock certificates to establish the cost of securities sold. However, an alternative cost flow assumption might be adopted. The alternative methods of cost flow include:

(1) FIFO – The first shares acquired are assumed to be the first ones sold

(2) LIFO – The last shares acquired are assumed to be the first ones sold

(3) Weighted-average cost-each share is assigned the same cost basis. Income tax rules require the use of either the specific identification method or the FIFO method to measure the gain or loss.

The specific identification method usually is more advantageous for income tax purposes, because it allows the investor to select for sale the securities that will have the most desirable tax consequences.

b. Accounting for stock dividends and stock splits

Although a stock dividend might be different from stock splits from the point of view of the issuer, the two are virtually identical from the point of view of the investor. In both cases, the investor has more shares than before the split or dividend, but at the same to be cost. The investor's accounting for a stock split is the same as for a stock dividend of the same class of stock. Only a memorandum entry is made to record the number of new shares received, and the cost (or carrying value) per share is recomputed.

A stock dividend is a proportional distribution of shares of the corporation's stock to its shareholders (investors). The investor neither receives assets form the corporation nor owns more of the issuing corporation; they merely have more shares to represent the same prior proportional ownership. A stock split occurs when a corporation increases the number of issued shares of stock and reduces the par or stated value proportionally.

Example

Assume that Belay Company purchased 1, 000 shares of common stock, par Br. 5 of Chala Corporation at Br. 90 per share. Subsequently, Belay Company received a 50 percent common stock dividend. Belay later sold 200 of the common shares at Br. 75 per share. Belay's entries are as follows:

At the acquisition dates:

Long-Term investment in common stock of Chala Corporation 90, 000

Cash (Br. 90 x 1, 000) 90, 000

At the date of stock dividend:

Memorandum entry only: Received 50% common stock dividend of 500 shares (1, 000 x 50%) from Chala Corporation, revised cost per share = Br. 90, 000 ÷ (1, 000 + 500 = 1, 500) = Br. 60

At the date of sale of 200 common shares:

Cash (200 x Br. 75) 15, 000

LT investment in common stock of Chala Corporation (200 x Br. 60) 12, 000

Gain on sales of investments (15, 000 – 12, 000) 3, 000

c. Stock warrants and stock rights

A stock warrant is a certificate issued by a corporation conveying to the owner rights to acquire additional shares of its common stock at a specified price in a specified time period.

- ***Stock right*** – the right to acquire additional shares
- ***Stock warrant*** – a certificate representing the stock rights

The warrant states the number of shares that the holder of the right may purchases and also the price at which they may be purchased.

Stock right have three important dates: (1) the date the right offering is announced, (2) the date as of which the certificates or rights are issued, and (3) the date the rights expire. From the date the right is announced until it is issued, the share of stock and the right are not separable, and the share is described as rights-on; after the certificate or right is received and up to the time it expires, the share and right can be sold separately.

c. Accounting for stock warrants Acquired for Cash

The accounting problems involved when an investor acquires warrants in the open market are similar to those relating to the acquisition of any security. The acquisition price, plus brokerage fees and other acquisition costs, is debited to investments in stock warrants, and cash is credited. When warrants are acquired in conjunction with the acquisition of other securities, the total cost must be allocated to the various securities included in the package, based on relative market values.

When the warrants are used to acquire common stocks the initial cost of the warrants used plus the cash paid is the cost of the stock. The investments in common stock ledger account is debited; cash and investment in stock warrants are credited. If the market price of the common stock differs from this combined cost, this fact is disregarded until the stock is sold, at which time a gain or loss is recognized.

d. Accounting for stock warrants Acquired from Issuer

Stock warrants for rights are distributed to the stockholders of a corporation in proportion to their holdings of common stock. The receipt of stock warrants for rights may be compared with the receipt of a stock warrants for rights may be compared with the receipt of a stock dividend. The issuer distributes no assets; instead, a method has been provided for an additional investment by the present stockholders. Until the stockholders elect to exercise or sell their warrants, their investment in the corporation is represented by (1) shares of common stock that here been acquired, and (2) stock warrants for rights to acquire additional shares of common stock at a

price below the current market price. The cost of the original common stock investment consists now of the cost of the original investment is apportioned between these two parts of the investment on the basis of relative market values. The common stock will trade in the market on a "rights-on" basis until the ex-rights date, at which time the stock sells "ex-rights" and the stock warrants have a market of their own. Relative market value allocation may be used to apportion the cost between the common stock and the stock warrants as follows:

Cost assigned To stock warrants = $\left[\begin{array}{l}\text{Cost of original}\\ \text{investment}\\ \text{Common Stock}\end{array}\right]$ X



Illustration

1. G.G Company purchased 500 shares J.J. Corporation common stock at Br. 93 per share.
2. Later in the year of purchase, G.G. Company receives 500 stock rights that entitle it to acquire 100 shares of J.J. Corporation common stock at a price of Br. 100 shares of J.J. Corporation common stock at a price of Br. 100 per share. Each stock right conveys to purchase one-fifth (1/5) of a share of J.J. Corporation common stock. At the date J.J. Corporation first trades ex-rights, it has a market price of Br. 120 per share, and each stock right has a market value of Br. 4.
3. Later G.G. exercised 400 rights and acquired 80 shares (400 x 1/5) of J.J. Corporation at the price of Br. 100 per share and sold the remaining 100 rights for Br. 4.50 per right.

Required

Prepare Journal entries to record the above transactions and information

Solution

(1) Investment in J.J. Corporation common stock	46, 500	
Cash (Br. 93 x 500)		46, 500

(2) Total market value of common shares held: (500 x Br. 120) = Br. 60, 000

Total market value of stock rights held: (500 x Br. 4) 2, 000

Total market value of investment Br. 62, 000

* Cost to be allocated to = Br. 46, 500 x $\frac{Br.2,000}{Br.62,000}$ = Br. 1, 500

investments in stock rights

* Cost to be allocated to = Br. 46, 500 x $\frac{Br.60,000}{Br.62,000}$ = Br. 45, 000

investments in common shares

So, the cost per share of common stock now = $\frac{Br.45,000}{500}$ = Br. 90

Cost per rights = $\frac{Br.1,500}{500}$ = Br. 3

Journal entry to record acquisition of stock rights:

Investment in J.J. Corporation stock rights	1, 500	
Investment in J.J. Corporation common stock		1, 500

(3) (i) To record the acquisition of 80 shares through exercising the rights:

Investment in J.J. Corporation stock rights (400 x Br. 3)	1, 200	
Loss on sale of stock right (8000-1200)	6800	
Cash (80 x Br. 100)		8000

(ii) To record the sale of the 100 stock rights

Cash (100 x Br. 4.50)	450	
Investment in J.J. Corporation stock rights (100 x Br. 3)		300
Gain on sale of stock right (450 – 300)		150

e. Convertible Securities

An investor may invest in bonds or preferred stocks that are convertible to the common stock of the investee at the option of the investor. The characteristics of convertible securities are discussed in

the next unit. At this point, we consider the action to be taken by investors who exercise the conversion option (feature) and relive common stock in exchange for convertible bonds or convertible preferred stock.

The market value of the common stock received may differ materially from the carrying amount of the converted securities. Two methods (approaches) are used to account for the converted securities. These are:

(1) Carrying amount (book value) method – The carrying amount of the convertible securities is assigned to the common stock acquired in exchange. Thus, no gain or loss is recorded at the time of conversion.

(2) Market value method – The common stock acquired in exchange for convertible securities is recorded at the market value with the gain or loss to be recorded at the time of conversion.

- The first method is more acceptable than the second method