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## **UNIT 10: SHORT - TERM INVESTMENTS**

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### **10.0 AIMS AND OBJECTIVES**

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This unit aims at discussing the problems of accounting for short - term investment (recording, valuation and disclosure)

After studying this chapter, you will

- know why firms invest in short - term securities
- understand the initial recording of short - term investment
- be able to know valuation of short - term investments
- be familiar with disclosure requirement for short - term investments

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### **10.1 INTRODUCTION**

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Companies use cash to acquire assets and to pay expenses and obligations, good managers plan to maintain a cash balance large enough to meet expected payments plus some surplus for unexpected needs. Also, idle cash balance may exist during some months of each year because of seasonal fluctuations in sales volume. Rather than leave this unneeded cash in checking accounts that pay low rate of interest at best, most companies invest them in securities that earn higher returns and that can be quickly sold when cash is needed. Such securities are known as short - term investments or temporary investments.

Short - term investments consist of marketable debt securities and marketable equity securities. These investments are usually low risk and can be quickly and easily converted to cash.

The objectives of acquiring short - term investments are to maximize the return on assets and to minimize the risk of loss from price fluctuations. The investment media typically used are certificates of deposits (promissory notes issued by banks for varying period of time). Commercial paper (short - term unsecured promissory notes issued by corporations and sold at discount by government) and bonds (both government and corporate) with near - term maturities (in order to minimize price fluctuations)

The problems of accounting for investments involve recording, valuation (measurement) and disclosure (accounting methods used).

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## **10.2 RECORDING TRANSACTIONS IN SHORT - TERM INVESTMENTS**

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At acquisition, short - term investments are recorded at cost, the price of the item in the market plus any costs incident to the acquisitions, such as brokerage commission and transfer taxes.

### **10.2.1 Investment in bonds**

Bonds acquired between interest dates are traded on the basis of the market price plus the interest accrued since the most recent interest payment. The accrued interest is a separate asset acquired with the bonds. The cost of these two assets should be separated in the accounting records to achieve a clear picture of the results of the investment in bonds.

When short - term investments are sold; the difference between the carrying amount and the proceeds is recognized as a gain or a loss. A business enterprise that has numerous short-term investments may have a single short - term investments (or marketable securities) controlling account in the general ledger and a subsidiary ledger account for each individual investment showing cost, maturity date, interest or dividends earned, and gain or loss on disposal.

Gain or loss is the result of a change in the market price of bonds, which may have occurred for a number of reasons. The two most likely causes are the change in the level of interest rates and investor appraisal of bond issue.

#### **Illustration**

ABC Corporation purchased Br. 3000 par value 6% bonds of XYZ Corporation on October 1, 1994 at 103 (103%) of face amount plus accrued interest. The bonds were issued a number of years ago by XYZ Corporation, and interest is paid each February 1, and August 1. Brokers fees and other related costs incident to the purchase were Br. 50

On May 1, 1995 ABC Corporation sold the above bonds at 103 ½ plus accrued interest for three months. Cost of sale was Br. 70

**Required:** Prepare journal entries to record the above transactions of ABC corporation

**Solution:**

(1) Acquisition of short - term investment in bonds is recorded as

|        |                                     |      |
|--------|-------------------------------------|------|
| 1994   | Short - term investment bonds ----- | 3140 |
| Oct. 1 | Interest receivable -----           | 30   |
|        | Cash -----                          |      |
|        |                                     | 3170 |

The cost of the short - term investment is determined as

$$\begin{aligned}
 &= \text{Market price} + \text{incidental acquisition costs} \\
 &= 1.03 \times \text{Br. } 3000 + \text{Br. } 50 = \text{Br. } 3090 + 50 = \text{Br. } \underline{3140}
 \end{aligned}$$

The cash paid is equal to cost plus accrued interest i.e.

$$\begin{aligned}
 &= \text{Br. } 3140 + \text{Br. } 3000 \times 6/100 \times 2/12 \\
 &= \text{Br. } 3140 + \text{Br. } 30 \\
 &= \text{Br. } \underline{3170}
 \end{aligned}$$

(2) To record accrued interest for 3 months at the end of the fiscal period.

|         |                                                        |     |
|---------|--------------------------------------------------------|-----|
| 1994    | Interest Receivable -----                              | 45* |
| Dec. 31 | Interest revenue -----                                 | 45  |
|         | * Br. $3000 \times 6/100 \times 3/12 = \text{Br. } 45$ |     |

(3) To record the closing entry

|         |                        |    |
|---------|------------------------|----|
| 1994    | Interest revenue ----- | 45 |
| Dec. 31 | Income summary -----   | 45 |

(4) To record the reversing entry

|        |                           |    |
|--------|---------------------------|----|
| 1995   | Interest revenue -----    | 45 |
| Jan. 1 | Interest receivable ----- | 45 |

The journal entry to record the cash collection is

|        |                           |    |
|--------|---------------------------|----|
| 1995   | Cash -----                | 90 |
| Feb. 1 | Interest receivable ----- | 30 |
|        | Interest revenue -----    | 60 |

On May 1, 1995 ABC Co. sold the bond. The journal entry to record the sale is:

|       |                                             |       |
|-------|---------------------------------------------|-------|
| 1995  | Cash -----                                  | 3080* |
| May 1 | Loss on sale of short-term investment ----- | 105** |
|       | Short-term investment-bonds -----           |       |
| 3140  |                                             |       |
|       | Interest revenue -----                      | 45    |

\* Cash received = Proceed + Accrued interest  
= (1.035 x Br. 3000 - Br. 70) + Br. 45  
= Br. 3035 + Br. 45  
= Br. 3080

\*\* Gain/Loss = Proceed - Cost  
= Br. 3035 - Br. 3140  
= Br. 105

### **Discount and premium on short-term Investment in Bonds**

In accounting for short-term investment in bonds, it is usually unnecessary to amortize premiums or to accumulate discounts. Such temporary investments generally have near-term maturities, consequently any premium or discount is likely to be negligible. The holding period by the investor also is likely to be short, which means that any change in market price usually is attributable to changes in interest rates and risk factors rather than to the approach of the maturity date. In theory, the amortization of premium or the accumulation of discount on short-term investments in bonds always

is proper, but as a practical matter such amortization or accumulation would add little to the accuracy of financial statements.

### **Check your progress - 1**

1. Define the term bond.

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2. On February 1, Ahamo Company purchased 9% marketable bonds of Nicoli Company having a per value of Br. 300, 000 at 99 plus occurred interest. Interest is payable on April 1 and October 1.

#### **Required:**

- a) Compute the amount Ahamo Co. will pay on February 1.
- b) How much interest income will Ahamo Company record on April 1?

### **10.2.2 Investment in Commercial paper and Treasury Bills**

Unlike bonds, commercial paper and Treasury bills are non interests bearing. The interest revenue earned on these investments is measured by the discount (the difference between the face amount and the issuance price). The discount is accumulated in short-term investment ledger account and recorded as interest revenue at the end of each accounting period during the stated term of the commercial paper or Treasury bills.

#### **Illustration:**

On Nov. 1, 1998 SOS Company acquired a treasury bill for a face amount of Br. 100,000 for Br. 94,000 cash for 3 months period.

**Required:** Record the necessary journal entries for the short-term investment in treasury bills.

**Solution:**

To record acquisition of Br. 100,000 face amount of 3 months Treasury bills

|        |                                               |        |
|--------|-----------------------------------------------|--------|
| 1998   | Short-term investments (Treasury bills) ----- | 94,000 |
| Nov. 1 | Cash -----                                    |        |
|        |                                               | 94,000 |

To record accrued interest for two months

|         |                                              |       |
|---------|----------------------------------------------|-------|
| 1998    | Short-term investment (Treasury bills) ----- | 4000* |
| Dec. 31 | Interest revenue -----                       |       |
|         |                                              | 4000  |

$$*4000 = \left( \frac{100000 - 94000}{3} \right) 2$$

To record accrued revenue for one month

|         |                                              |      |
|---------|----------------------------------------------|------|
| 1995    | Short-term investments (Treasury bill) ----- | 2000 |
| Jan. 31 | Interest revenue -----                       | 2000 |

To record receipt of cash at the end of 3<sup>rd</sup> month (maturity date)

|         |                                              |         |
|---------|----------------------------------------------|---------|
| 1999    | Cash -----                                   | 100,000 |
| Jan. 31 | Short-term investments (Treasury bill) ----- |         |
|         |                                              | 100,000 |

**N.B.** The monthly interest revenue can be computed (1) by straight-line method in which the total discount will be divided by the number of months the short-term investment is outstanding i.e. equal interest revenue will be recorded each month. For example, in the above example the amount of discount (Br. 6000 = Br. 100,000 - 94,000) is divided by three months i.e. by the number of months the short-term investment is outstanding or (2) by interest method in which the effective rate of interest per period is applied to the carrying amount of the short-term investment at the beginning of each period.

## **Check your progress - 2**

1. Distinguish between the interest method and the straight-line method of accumulating discount of accumulating discount and amortizing a premium?

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### **10.3 VALUATION OF SHORT-TERM INVESTMENTS**

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Normally, an asset is recorded at cost, and this cost is associated with the revenue generated from the use of the asset. If the asset loses its value without generating revenue, the cost is written off as a loss. The revenue realization principle usually allows recognition of increases in the value of an asset only when it is sold. Whether realization should be limited to the point of sale for short-term investments is a question worth considering. By definition, short-term investments are readily salable at a quoted market price. This same characteristics usually is not found in inventories or plant assets. This basic difference between these type of assets suggest that the traditional tests of revenue realization should not control the valuation of short-term investments.

#### **10.3.1 Valuation at Market Value**

The use of market price to value short-term investments at the end of an accounting period has some advantages:

1. The income statement will show the results of decisions to hold or sell such investments period by period (For example, if the market price rises in one accounting period and falls in the next, the gain from holding short-term investments in the first period and the loss sustained by failure to sell at the higher price will be disclosed)

2. Valuation at current market price eliminates the anomaly of carrying identical securities at different amounts because they were acquired at different prices
3. Market value is more meaningful to creditors who use the current section of the balance sheet to judge the debt-paying ability of the business enterprise.

The following example illustrates the issues that would arise if the market value were used as the basis for valuation of short-term investments. On December 31, year 1, Dixon Foundry has a portfolio of short-term investments that cost Br. 148,000 and had a market value of Br. 151,500. The question at issue is whether on December 31, year 1, there has been a gain of Br. 3,500 (Br. 151,500 - Br. 148,000 = Br. 3,500). If we follow the traditional tests of revenue realization, no gain would be recognized until the investments are sold. If valuation at market price is accepted, the following journal entry would be recorded:

|                                                      |       |
|------------------------------------------------------|-------|
| Short-term investments -----                         | 3,500 |
| Gain in market value of short-term investments ----- |       |
|                                                      | 3,500 |

To record increase in value of short-term investments

Thus, the gain would be recognized in the accounting period in which the price increased rather than in the period in which investments are sold.

On March 28, year 2, the investments are sold for Br. 149,800. Has there been a gain or loss on the sale of investment? If the traditional revenue realization principle were followed, the increase in market price was not recognized earlier, because a sale has now taken place, a gain of Br. 1800 (Br. 149,800 - Br. 148,000) is recognized. If the investments were valued at market price on December 31, year 1, the

journal entry to record the sale on March 25, year 2, would show a loss of Br. 1,700 (Br. 151,500 - Br. 149,800) sustained since December 31, year 1.

The question which must be answered is, "what events gives rise to the recognition of gains or losses from holding short-term investments?". The traditional answer has been "sale of the investments" but the logic of this answer is questionable. Rather the current market value of investment is the most relevant valuation since it is most likely to aid users in making decision.

### **10.3.2 Valuation at Cost or at Lower of Cost or Market**

Despite the forcefulness of the arguments in fauor of reporting short-term investments at market value, most business enterprises reported marketable securities at cost until the FASB issued statement No. 12, "Accounting for certain marketable securities," in 1975. However, valuation at lower of cost or market was required when the decline in market value was substantial and was not "due to a mere temporary condition"

Recoveries in the market value of short-term investments that had been written down generally were not recognized.

Because of the wide diversity of accounting practices applied to short-term and long-term investments in marketable securities, the FASB attempted to answer the following two questions in statement No. 12

1. Under what circumstances should marketable equity securities be written down below cost?
2. Should marketable equity securities that had been written down be written up at a later date?

The FASB defined the following terms relating to marketable equity securities:

**1. Equity Securities:** - include instruments representing ownership shares or the right to acquire or dispose of ownership shares at fixed or determinable prices.

Equity securities include common stocks, most preferred stock (including convertible preferred stocks), stock warrants, and call or put options. The following are not equity securities. Preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor, treasury stock, and convertible bonds.

**2. Marketable:** - means that sales prices (or bid and ask prices) are currently available for an equity security on a national securities exchange or in the publicity reported over-the-counter market.

**3. Market price** refers to the price of a single share or unit of a marketable equity securities.

**4. Market value** refers to the aggregate of the market price times the number of shares or units of each marketable equity security in a portfolio.

**5. Cost** refers to the original cost of marketable equity security, unless a new cost basis has been assigned or recognition of an impairment of value that was deemed. Other than temporary. In such cases, the new cost basis is the cost.

**6. Valuation allowance** for a marketable equity securities portfolio represents the net unrealized loss in that portfolio.

**7. Carrying amount** of a marketable equity securities portfolio is the amount at which that portfolio of marketable equity securities is reported in the balance sheet,. That is cost reduced by the valuation allowance.

**8. Realized gain or loss** represents the difference between the net proceeds from the sale of a marketable equity security and its cost. (Such gain or loss results only on sale of a security)

**9. Net unrealized gain or loss** on a marketable equity securities portfolio represents on any date the difference between the aggregate market value and aggregate cost. (Such gain or loss is recognized for financial accounting only at the end of an accounting period and is not a factor in the computation of taxable income).

### **Accounting for current marketable equity securities**

The FASB stated that the carrying amount of marketable equity securities should be the lower of its aggregate cost or market value, as determined on each balance sheet date. The amount, if any, by which the aggregate cost of the portfolio exceeds market value is accounted for by use of a valuation allowance. The treatment of changes in the valuation allowance depends on whether the securities are current or non current assets. In the case of a classified balance sheet, marketable equity securities are grouped into separate current and non-current portfolios for the purpose of comparing aggregate cost and market value. In the case of an unclassified balance sheet, marketable equity securities are treated as non current assets.

Realized gains and losses from sale of current or non current marketable equity securities are included in the determination of net income of the accounting period in which they occur changes in the valuation allowance for a marketable equity securities portfolio included in current assets also are included in net income of the period in which they occur.

Such changes in the valuation allowance result in unrealized gains and losses. A recovery in the aggregate market value of securities that had been written down to a market value below cost requires the

recognition of an unrealized gain that is included in net income. However, increases in the aggregate market value of the current portfolio of marketable equity securities above aggregate cost are not recognized in the accounting period. Unrealized losses on securities held in the non-current portfolio are not included in net income of the accounting period in which they occur; such losses are reported as direct reductions in stock holders' equity and the adjusted valuation allowance is deducted from the cost of the non current marketable equity securities).

If there is a change in the classification of a marketable equity security between current and non-current, the security should be transferred between the corresponding portfolios at the lower of its cost or market value on the date of transfer. If market value is less than cost, the market value becomes the new cost basis; and the difference is recorded as a realized loss.

Unrealized gains and losses on marketable equity securities are not used to compute taxable income. Such gains and losses result in temporary difference between taxable income and pretax accounting income reported in the income statement. Income tax allocation procedures are applied to determine whether a net unrealized gain or loss should be affected by the applicable tax effect.

**Illustration:**

Assume the following information and transactions of DOT Corporation.

1. On December 31, 1995 the following balances are found:

Portfolio of short-term investments:

|                               | <u>Co</u> |
|-------------------------------|-----------|
| <u>st</u> <u>Market value</u> |           |

Capital stock, A corporation (500 shares at Br. 25 Cost and Br. 15 market price)  
 Br. 12,500      Br. 7,500

Capital stock, B corporation (400 shares at Br. 30 Cost and Br. 32 market price) -----  
12,000      12,800

Aggregate cost and market, respectively -----Br. 24,500  
 Br. 20,300

Portfolio of long-term investments:

Capital stock, Z Corporation (300 shares at Br. 50 Cost and Br. 40 market price) Br.  
 15,000      Br. 12,000

2. April 1, 1996 DOT corporation purchased 200 shares of C corporation capital stock as short-term investment for Br. 35 per share including broker's commissions and other related costs.

3. May 1, 1996 DOT corporation reclassified all the B corporation stock from a current asset to a non-current asset. It was decided to hold the stock for at least 2 years. Market price of B corporations stock on May 1, 1996 was Br. 29 per share.

4. October 1, 1996 DOT corporation sold 100 shares of A corporation stock at Br. 19 (net) per share.

5. On December 31, 1996 the following balances are found:

Portfolio of short-term investments:

C

ost      Market price

Capital stock, A corporation (400 shares at Br. 25 Cost and Br. 19 market price) Br.  
 10,000      Br. 7,600

Capital stock, C Corporation (200 shares at Br. 35 Cost and Br. 36 market price)  
7,000      7,200

Aggregate cost and market, respectively Br.  
 17,000      Br. 14,800

Portfolio of long-term investments:

Capital stock, Z Corporation (300 shares at Br. 50 Cost and Br. 40 market price)  
 15,000      12,000

Capital stock, B Corporation (400 shares at Br. 29 Cost (new cost basis),

And                      Br.                      30                      market                      price)  
11,600      12,000

Aggregate cost and market price, respectively  
26,600 Br. 24,000

Br.

**Required:** Based on the above data, prepare the necessary journal entries (to adjust the investment accounts) assuming that DOT Corporation did not own securities prior to 1995. N. B. The lower of aggregate cost or market is used to compute the amount of the valuation allowance applicable to current securities.

**Solution:**

1. On December 31, 1995, a valuation allowance of Br. 4200 is required for marketable equity securities included in the current portfolio to reflect the excess of total cost, Br 24,500, over total market value, Br. 20,300. The unrealized loss of Br. 4200 is included in net income of 1995. The journal entry to record the unrealized loss and the valuation allowance is:

1995 Unrealized loss in value of short-term marketable equity securities ----- 4200

Dec. 31 Allowance to Reduce short-term marketable equity securities ----- 4200

**N.B.** unrealized loss in value of short-term marketable equity securities is an income statement account (i.e. reported on the income statement) and allowance to reduce short-term marketable equity securities is a contra short-term investment account (i.e. reported as deduction from short -term investment on the balance sheet)

For long-term investments, the journal entry is

1995 Unrealized capital loss -----300

Dec. 31 Allowance to Reduce long-term marketable equity securities -----300

**N.B.** Unrealized capital loss is stockholders' equity account and Allowance to Reduce long-term marketable equity securities is reported as contra long-term investment account.

2. The purchase of 200 shares of C corporation capital stock as short-term investment is recorded as:

|         |                                           |
|---------|-------------------------------------------|
| 1996    | Short-term investment C Corporation ----- |
| 70000   |                                           |
| April 1 | Cash -----                                |
| 7000    |                                           |

3. The classification of B corporation stock from current asset to non-current asset is recorded as:

|             |                                                                          |
|-------------|--------------------------------------------------------------------------|
| 1996        | Long-term investment B Corporation -----                                 |
| 11,600      |                                                                          |
| May 1       | Realized loss on reclassification of securities $(30 - 29) \times (400)$ |
| -----400    |                                                                          |
|             | Short-term investment B Corporation                                      |
| -----12,000 |                                                                          |

4. The sale of A corporation stock resulted in a realized loss of Br. 600 [Br.  $(25 - 19) \times 100$ ]. The loss is included in net income of 1996. The journal entry to record the sale is

|            |                                                           |
|------------|-----------------------------------------------------------|
|            | Cash -----1,900                                           |
| 1996       | Realized loss on sale of short-term marketable securities |
| -----600   |                                                           |
| Oct. 1     | Short-term investment A corporation                       |
| -----2,500 |                                                           |

5. On December 31, 1996, there has been a market recovery during 1996, as evidenced by the need to reduce the valuation allowance from Br. 4200 to Br. 2200. The difference of Br. 2000 is an unrealized gain and is included in net income for 1996. The journal entry to record the reduction in the valuation allowance for short-term marketable equity securities is:

1996                      Allowance to reduce short-term marketable equity securities -----2000

Dec. 31                      Unrealized gain in value of short-term marketable equity securities ---2000

For long-term marketable equity securities, the journal entry is

Allowance to reduce long-term marketable equity securities -----400

Unrealized capital loss -----400

### **Check your progress - 3**

1. After the foregoing journal entries have been posted, what is the balance of short-term marketable equity securities and Allowance to reduce short-term marketable equity securities on December 31, 1996?

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## **10.4 DISCLOSURE ISSUES**

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The following information with respect to marketable equity securities included in the current portfolio is disclosed either in the financial statements or in a note to the financial statements:

1. As of the date of each balance sheet presented, aggregate cost and aggregate market value, with identification as to which is the carrying amount.
2. As of the date of the latest balance sheet presented, the gross unrealized gains representing the excess of market value over cost for all marketable equity securities in the portfolio, and the gross unrealized losses representing the excess of cost over market value for all marketable equity securities in the portfolio.

3. For each accounting period for which an income statement is presented:
  - A. Net realized gain or loss included in the determination of net income.
  - B. The basis on which cost was determined in the computation of realized gain or loss (that is, average cost FIFO or other methods used)

Financial statements are not adjusted for realized gains or losses or for changes in market prices when such events occur after the date of the financial statements but prior to their issuance. However, significant net realized and net unrealized gains and losses arising after the date of the financial statements, but prior to their issuance, applicable to securities owned on the date of the most recent balance sheet, are disclosed.

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## **10.5 SUMMARY**

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Temporary investments consist of marketable debt securities and marketable equity securities. To be classified as a temporary investment, an item must be readily marketable and intended to be converted into cash within one year or the operating cycle, whichever is longer.

Marketable equity securities are recorded at cost when acquired. When a balance sheet is prepared, the lower of its aggregated cost or market value. If the total cost of the portfolio exceeds the total market value of the portfolio, the difference is shown in a valuation allowance account in the current asset section of the balance sheet. Any change

in the valuation allowance account must be taken into account in the determination of net income of the period in which the change occurs.

If the valuation allowance account increases, an unrealized loss on valuation of marketable equity securities will be included on the income statement. If the valuation allowance account decreases, the income statement will show a recovery of an unrealized loss on valuation of marketable equity securities, classified as "other income". It is important to note that the recovery of loss on valuation of marketable equity securities can never exceed the amount included in the valuation allowance account. Thus, the recovery is recognized only to the extent unrealized losses were previously recognized. For example, assume the valuation allowance account has a credit balance of Br. 25,000 representing past recognition of unrealized losses. If during the current year the marketable equity securities portfolio shows total market value exceeding total cost by Br. 36,000, the "recovery" account would be credited for Br. 25,000 and the "valuation allowance" account would be debited for Br. 25,000

When marketable equity securities are sold, cash is debited for the total proceeds less any selling costs incurred. The marketable equity securities account is credited for the cost of the securities, and any difference between the net proceeds and cost is shown as a realized gain or loss. At the date of sale no regard is given to unrealized losses or recoveries or the amount accumulated in the valuation allowance account.

Marketable debt securities are generally accounted for at cost. However, applications of the lower of costs or market approach to debt securities that are readily marketable and classified as current assets is acceptable.

Balance sheet disclosures related to marketable equity securities include: the aggregate cost, the aggregate market value, gross unrealized gains, and gross unrealized losses. For each period for which an income statement is prepared disclosures should be made of the net realized gain or loss, the basis on which cost was determined in computing realized gain or loss, and the change in valuation allowance included in net income.

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## 10.6 ANSWERS TO CHECK YOUR PROGRESS

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1. i. Bond is a form of interest bearing note employed by corporations to borrow money

ii. (a) Face Value -----Br. 300,000

% of par value -----0.99

Payment for face amount -----297,000

Add: interest accrued since last interest date

(4 months) Br. 300,000 x 0.09 x  $\frac{1}{2}$  x  $\frac{4}{6}$  -----9000

Total amount paid -----Br. 306,000

(b) Interest payment received on April 1 -----Br. 13,500

(Br. 300,000 x 0.09 x  $\frac{1}{2}$ )

Less: Interest accrued on February 1 -----9000

Interest income recorded April 1 -----Br. 4,500

2. Under the straight-line method, the discount or premium is spread uniformly over the terms of the investment. The interest method produces a constant rate of return on the investment. That is, the periodic interest revenue always represents the same percentage return on the carrying amount of the investment. Under the interest method, the interest revenue is computed for each interest period by multiplying the balance of

the investment account by the effective interest rate at the time the investment was made.

3.

| Short term marketable equity securities |                         | Allowance to Reduce short-term |        |
|-----------------------------------------|-------------------------|--------------------------------|--------|
| marketable equity security              |                         |                                |        |
| Beg. Bal. --24,500                      | 12,000 - classification | Dec. 31 - 2,000                | 4,200  |
| - Dec. 31, 1995                         |                         |                                |        |
| Purchase ----7,000                      | 2,500 - sale            | 1996                           |        |
|                                         |                         |                                | 18,000 |
| 2,200                                   |                         |                                |        |

## 10.7 MODEL EXAMINATION QUESTIONS

### I. True / False

- \_\_\_\_\_ 1. According to statements of financial Accounting standards (SFAS) NO. 12, marketable equity securities should be reported on the balance sheet at the lower of aggregate cost or market.
- \_\_\_\_\_ 2. If a marketable equity security is transferred from the current to the non current portfolio or vice versa, the security is transferred at its original cost.
- \_\_\_\_\_ 3. At the date of sale of a particular marketable equity security, the difference between the net proceeds from the sale of the security and its cost is recognized as a realized gain or loss without regard to any previously recognized unrealized gains or losses.
- \_\_\_\_\_ 4. Under SFAS No. 12, the excess of aggregate market over cost (unrealized gains) of marketable equity securities

classified as current assets is included in net income, but only to the extent of previously recognized unrealized losses.

- \_\_\_\_\_ 5. Investment in bonds should be recorded on the date of acquisition at maturity value, as this is the amount recorded by the issuer in the bonds payable account.

## **II. Multiple Choices**

- \_\_\_\_\_ 1. With respect to marketable equity securities, which of the following is not required financial statement disclosure?
- A. The number of marketable equity security holdings included in the marketable equity security portfolio at year-end.
  - B. The net realized gain or loss included in net income
  - C. The basis on which cost was determined in computing realized gain or loss
  - D. The change in the valuation allowance included in net income
  - E. All of the above
- \_\_\_\_\_ 2. For marketable equity securities properly classified as current assets, the net unrealized loss associated with an increase in the valuation allowances should be:
- A. Included in net income as an extra ordinary loss
  - B. Included in net income before extra ordinary items
  - C. Ignored since a later market change may prevent the loss from being realized
  - D. Excluded from net income, but shown on the balance sheet as a reduction of stock holders' equity
- \_\_\_\_\_ 3. An analysis of Beat Corporation's short-term marketable equity securities portfolio acquired in 1994 reveals the following totals on December 31, 1994:

Aggregate cost of portfolio -----Br. 90,000  
 Aggregate market value of portfolio -----80,000  
 Aggregate lower of cost or market  
 Value applied to each security in the  
 Portfolio -----76,000

The amount of the valuation allowance that Beat Company should record on December 31, 1994 is:

- A. Br. 0                                      C. Br. 10,000                                      E. None of the above  
 B. Br. 4,000                                      D. Br. 14,000

\_\_\_\_\_ 4. Interest revenue on short-term investment in commercial paper is measured by the

- A. Discount  
 B. Face amount times the nominal interest rate  
 C. Face amount times the effective interest rate  
 D. Present value times the effective interest rate  
 E. All of the above

\_\_\_\_\_ 5. What is the price that should be paid for Br. 25,000 of 9% bonds, interest payable semiannually, and maturing in 8 years, if a 12% yield is desired:

- A. Br. 21,210    B. Br. 10,105.90    C. Br. 11,125    D. 10,000    E. None of the above

### III. Exercises

1. On May 31, Reon Company invests Br. 49,000 in Treasury bills. The bills mature in 120 days at Br. 50,000. Prepare entries to record the purchases on June 1, the adjustment to accrue interest on June 30, which is the end of the fiscal period, and the receipt of cash at the maturity date of September 28.

2. On February 1, year 2, Grace Company acquired for Br. 84,000 commercial paper of Deon Company with a face amount of Br. 90,000

due June 1, year 2. The discount rate was 20% a year, and the effective interest rate was 1.14% per month.

Prepare journal entries on February 1 and February 28, year 2, for Grace company, which has a February 28 fiscal year. Use the interest method to compute interest revenue and round all amounts to the nearest dollar.

3. Dashen company began investing idle cash in marketable equity securities in year 3. The cost and market value of the securities held in its current portfolio at the end of its December 31 fiscal years were as follows:

| End of year | Cost        | Market Value |
|-------------|-------------|--------------|
| 3           | Br. 200,000 | Br. 210,000  |
| 4           | 310,000     | 260,000      |
| 5           | 280,000     | 210,000      |
| 6           | 400,000     | 425,000      |

Prepare journal entries for Dashen Company at the end of each year to adjust the valuation allowance to reduce current marketable equity securities to market value.

4. On January 2, year 8, Miami company, which adjusts its accounting records and prepare financial statements at the end of each month, acquired for cash 1000 shares of common stock of three companies as short-term investments, as follows:

|                                              |               |
|----------------------------------------------|---------------|
|                                              | <u>Co</u>     |
| <u>st*</u>                                   |               |
| 1,000 shares of F company common stock ----- | Br.           |
| 12,000                                       |               |
| 1,000 shares of G company common stock ----- | 14,000        |
| 1,000 shares of H company common stock ----- | <u>16,000</u> |
| Total                                        | Br.           |
| 42,000                                       |               |

\* Includes brokerage commission

On February 14, year 8, Meami sold 500 shares of G company common stock for Br. 6,200 net of the brokerage commission. Market values per share of the three common stock were as follows on January 31 and February 28, year 8:

|                            | <u>January 31, year 8</u> |
|----------------------------|---------------------------|
| <u>February 28, year 8</u> |                           |
| F company common stock     | Br. 13                    |
| Br. 11                     |                           |
| G company common stock     | 12                        |
| 11                         |                           |
| H company common stock     | 15                        |
| 16                         |                           |

**Required:** Prepare journal entries for Meami Company on January 2, January 31, as February 14, and February 28, year 8.

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## 10.8 GLOSSARY

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1. Certificate of deposit: interest bearing promissory note issued by a bank.
2. Commercial paper: short term unsecured promissory note issued at discount by a corporation
3. Equity security: instruments representing ownership shares or the right to acquire or dispose of ownership shares at fixed or determinable price
4. Short-term investment: investment is stocks, bonds and other short-term papers that can be readily sold at quoted market price
5. Treasury bill: a short-term unsecured promissory note issued at discount by government.

