ADVANCED ACCOUNTING

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SUSAN S. HAMLEN

Advanced Accounting

Fourth Edition

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PREFACE

Welcome to *Advanced Accounting*. This book covers reporting for mergers and acquisitions, foreign currency transactions, hedges, state and local governments, not-for-profit organizations, plus specialized topics. Discussion of each topic focuses on key concepts, with many illustrations from practice, using familiar organizations. Emphasis is on the logic behind reporting standards and requirements, presented in a student-friendly way. Coverage is completely updated for the newest FASB and GASB pronouncements and proposals, as well as relevant IFRS. Illustrations of business practice are taken from current financial statements and events.

The text has extensive student and instructor support. PowerPoint slides, eLecture videos, guided examples, and online homework and quizzes provide students with additional learning resources, and allow instructors to use class time efficiently and effectively.

TARGET AUDIENCE

Advanced Accounting is intended for use, at either the undergraduate or graduate level, in the course commonly known as advanced accounting. It is also designed to be used in courses focusing on mergers and acquisitions that are often part of the MBA curriculum or that are offered as a nondegree, professional development program.

HOW THIS BOOK EFFECTIVELY TEACHES ADVANCED ACCOUNTING TOPICS

Conceptual Focus

Conceptual explanations focus on the logic underlying reporting standards. Each topic is developed by explaining the underlying business activity, the reporting goals, and how standards and procedures achieve these goals, using language students can understand. Illustrations from actual practice enhance understanding and familiarize students with the information presented in real financial statements. Reporting requirements are increasingly complex and require substantial **judgment** in their application. And standards change every year. Conceptual understanding prepares students to evaluate and effectively apply future standards throughout their professional careers.

Logical Flow of Topical Coverage

The organization of chapters reflects the logical flow of topics:

- **Mergers and acquisitions** material is covered in Chapters 1–6.
- **International subsidiary translation and consolidation**, **foreign currency transactions and hedging,** and **other financial derivatives** (futures, options, and swaps) are in Chapters 7–9.

- Reporting standards for **state and local government and NFP organizations** are in Chapters 10–13.
- **Partnerships**, **bankruptcy and reorganization**, and the **SEC** are covered in Chapters 14–16.

Relevant Real Company Illustrations

Each chapter begins with a description of a familiar **focus company**, and how its activities and reporting practices relate to that chapter's topics. For example, in Chapter 2, **IBM**'s extensive acquisitions illustrate accounting for mergers and acquisitions. Noncontrolling interests are common in the resort industry, and in Chapter 5 **Las Vegas Sands Corporation** illustrates reporting for noncontrolling interests in subsidiaries. In Chapter 9, **Kellogg's** hedging practices illustrate hedge accounting for futures, options and swaps. In Chapter 13, **Beta Alpha Psi**'s financial statements illustrate NFP reporting standards. Throughout each chapter, examples from actual practice highlight major topics, using either the focus company or other companies in the same industry.

Following is a list of focus companies by chapter.

Chapter 1	Coca-Cola	**Chapter 9**	Kellogg's
Chapter 2	IBM	**Chapter 10**	Mecklenburg County, NC
Chapter 3	General Motors	**Chapter 11**	Alameda County, CA
Chapter 4	AT&T	**Chapter 12**	St. Louis, MO
Chapter 5	Las Vegas Sands Corporation	**Chapter 13**	Beta Alpha Psi
Chapter 6	Nike	**Chapter 14**	Suburban Propane Partners
Chapter 7	Wal-Mart	**Chapter 15**	Mad Catz and Toys "R" Us
Chapter 8	McDonald's	**Chapter 16**	Securities and Exchange Commission

Emphasis on Current Issues and Trends

Business Applications

Taken from current news and actual financial statements, Business Application boxes illustrate reporting practices, current issues, and controversies. Here is an example from Chapter 2, in the section covering valuation methods for assets acquired and liabilities assumed in a business combination.

BUSINESS APPLICATION Oracle's Measurement of Contingent Liabilities Assumed

In its fiscal 2016 10-K report, **Oracle Corporation** describes its process for valuing contingent liabilities assumed in an acquisition:

> We estimate the fair values of our cloud SaaS and PaaS, software license updates and product support, and hardware support obligations assumed. The estimated fair values of these performance obligations are determined utilizing a cost build-up approach. The cost build-up approach determines fair value by estimating the costs related to fulfilling the obligations plus a normal profit margin. The estimated costs to fulfill the obligations are based on the historical direct costs related to providing the services including the correction of any errors in the products acquired. The sum of these costs and operating profit approximates, in theory, the amount that we would be required to pay a third party to assume the performance obligations.

Thus once Oracle has determined that these obligations must be reported at the date of acquisition, it uses a *cost approach* to value contingent obligations assumed in an acquisition.

Assignments with the MBC in the margin are available in myBusinessCourse. eLecture videos MBC are available for the chapter Learning Objectives, and Guided Examples MBC for the in-chapter Reviews are available for you to assign students.

Solutions Manual: Created by the textbook author, the *Solutions Manual* contains complete solutions to all the assignments in the textbook.

Test Bank: Written by the textbook author, the test bank includes a variety of multiple-choice questions and problems, at various levels of difficulty.

Excel Templates: Excel spreadsheets for select assignments are provided on the book's Website. These spreadsheets will save time in data entry and allow students to dedicate additional time to learning the material. The Excel spreadsheets are identified by the Excel icon.

PowerPoint: Edited by the textbook author, the PowerPoint slides outline key elements of each chapter.

Computerized Test Bank: This computerized version of the test bank enables an instructor to add and edit questions; create up to 99 versions of each test; attach graphic files to questions; import and export ASCII files; and select questions based on type or learning objective. It provides password protection for saved tests and question databases and is able to run on a network.

Website: All instructor materials are accessible via the book's website (password protected). **www.cambridgepub.com**

For Students

eLectures: Each chapter's Learning Objective includes an eLecture video available in our online learning management system, myBusinessCourse (see below for more information).

Guided Examples: Guided Example videos are available for each in-chapter Review, also in myBusinessCourse (see below for more information).

myBusinessCourse: Is a web-based learning and assessment program intended to complement your textbook and faculty instruction. This easy-to-use program provides you with additional help when your instructor is not available. Guided Example videos MBC are available for all in-chapter Reviews, and eLecture videos are MBC available for each Learning Objective. With Instructor-Led MBC courses, assignments with the MBC in the margin are also available and are automatically graded. Access is free with new copies of this textbook (look for page containing the access code towards the front of the book). If you buy a used copy of the book, you can purchase access at **www.mybusinesscourse.com**.

Homework MBC

Excel Templates: Excel spreadsheets for select assignments are provided on the book's Website. These spreadsheets will save time in data entry and allow students to dedicate additional time to learning the material. The Excel spreadsheets are identified by the Excel icon.

Website: Practice quizzes, Excel templates, and other useful links are available to students free of charge on the book's Website.

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Reporting Perspectives

Reporting Perspectives comment on topics such as the strengths and weaknesses in reporting standards, motivations for changes in standards, ethical issues, implications for information quality, and proposals for new standards. The following is an example from Chapter 4.

Reporting Perspective

The Private Company Council (PCC) develops U.S. GAAP alternatives for private companies. A simplified alternative for recognition of acquired identifiable intangibles was discussed in Chapter 2. In 2014, the FASB approved the PCC's proposal to simplify goodwill reporting as follows:

- Goodwill is amortized on a straight-line basis over 10 years or less.
- Test goodwill for impairment at either the company or reporting unit level, and only when a "triggering event" indicates possible impairment.
- When testing goodwill for impairment, the company has the option to perform a qualitative test. If impairment is more likely than not, goodwill impairment is the amount by which the company or reporting unit's book value exceeds its fair value.

IFRS

Extensive discussion and illustration of international financial reporting standards and proposals appear in each of the business combinations, foreign currency translation and transactions, and futures, options and swaps chapters. The following is an excerpt from Chapter 5.

INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR NONCONTROLLING INTERESTS

LO4 Explain IFRS for noncontrolling interests.

IFRS 3(R) presents IFRS for valuing and reporting noncontrolling interests in consolidated financial statements. Although IFRS agrees with U.S. GAAP that the noncontrolling interest should be reported at acquisition-date fair value, *IFRS 3(R)* actually allows the acquirer to choose between **two different valuation methods**:

1. Value the noncontrolling interest at **full fair value** at the acquisition date, as in U.S. GAAP.
2. Value the noncontrolling interest at its share of the **fair value of the subsidiary's identifiable net assets** at the acquisition date.

Using valuation method #2, the noncontrolling interest is not allocated any goodwill: only the controlling interest's share of goodwill is recognized. Therefore the IFRS alternative reports goodwill and noncontrolling interests at *lower amounts* on the consolidated balance sheet than under U.S. GAAP.

Illustrations of IFRS in practice are also provided. Here is an excerpt from Chapter 3.

BUSINESS APPLICATION Consolidation Policy Under IFRS

The financial statements and footnote disclosures of IFRS companies are often more detailed than those of U.S. companies. For example, many IFRS companies routinely list the names and ownership interests of their consolidated companies. An example is **Orange SA**, the major telecommunications provider in France. In its 2016 financial statements, Orange SA lists its fully consolidated companies. Orange SA owns 50 percent or less of many of these subsidiaries. Examples include:

- Telefony Podlaskia, Poland, 45.24% owned
- Orange Bissau, Guinea, 38.10% owned
- Sonatel, Senegal, 42.33% owned
- Orange Mali, 29.65% owned

Orange SA's footnote disclosures explain some of the reasons for consolidation. Sonatel is consolidated because "Orange SA controls Sonatel and its subsidiaries . . . under the terms of the shareholders' agreement. . . ." On the other hand, Orange SA does not consolidate its 100% ownership of Compagnie

Clear and Logical Development of Business Combinations Topics

Reporting issues related to business combinations cover a variety of topics. Consolidation procedures are difficult to comprehend and can be confusing to students. Emphasis in this text is on the **measurement aspects** of combinations—reporting assets and liabilities acquired, determining acquisition cost, valuing noncontrolling interests, and eliminating intercompany accounts. The consolidation chapters start with the reasons why companies should consolidate and the goals of consolidation, and then explain how consolidation procedures achieve these goals.

To make consolidation procedures more comprehensible, eliminations subsequent to acquisition (covered in Chapters 4–6) presume that the parent uses the **complete (full) equity method**. Exclusive use of the complete (full) equity method allows students to focus on the goals of consolidation and the key issues in consolidation procedures. Once students develop a solid understanding of the consolidation process, changes in procedures required when the parent uses the **cost method** can be introduced. The appendix to Chapter 4 explains the eliminating entries necessary to adjust the parent's accounts to the complete equity method before proceeding as usual with consolidation.

Additional Pedagogy

To reinforce concepts presented in each chapter and ensure student comprehension, each chapter has two or more **In-Chapter Review Problems** that require students to recall and apply the accounting techniques and concepts described in the chapter. The solutions to the review problems are included after each chapter's assignments. The following example is from Chapter 2.

REVIEW 1 • Reporting Assets Acquired and Liabilities Assumed

IBM acquires SoftCloud Technologies in an acquisition reported as a merger, for $1.2 billion in cash on February 15, 2018. At the acquisition date, the reported assets and liabilities of SoftCloud have fair values as follows:

(in millions)	**Fair value**
Cash and receivables	$ 400
Inventories	800
Property, plant and equipment	3,500
Accounts payable	300
Long-term debt	3,850

In addition, the following items are not currently reported on SoftCloud's balance sheet:

(in millions)	**Fair value**
Favorable lease agreements	$150
Skilled workforce	15
Favorable press reviews on products	5

Required: Prepare the entry IBM makes to record its acquisition of SoftCloud.

Solutions are located after the chapter assignments.

Learning Objectives identify the primary learning outcomes for each chapter. An end-of-chapter **Review of Key Concepts** summarizes the key topics of each chapter.

Extensive End-of-Chapter Material

End-of-chapter **questions, exercises and problems** cover all major topics and have a range of difficulty levels, allowing students ample opportunity to practice their understanding of the chapter. Some problems require students to use real company data in applying their knowledge.

Certain **business combination problems continue from chapter to chapter**. For example, P3.2 covers consolidation at the date of acquisition, and P4.9 covers consolidation of the same two companies in subsequent years. P4.3 covers subsequent year consolidation of a wholly owned subsidiary, and P5.7 addresses subsequent year consolidation of the same subsidiary, when the subsidiary has outside ownership. In P2.6, an acquisition is reported as a merger, and in P3.12 the same acquisition is reported as a stock investment and consolidation. P3.4, P4.5, P5.4 and P5.5 use the same acquisition data to illustrate consolidation of a bargain purchase at the date of acquisition, subsequent years, and with a noncontrolling interest. Each of these problems can also be assigned separately. In working through these problems, students gain a clearer understanding of accounting for business combinations, and how concepts learned in each chapter fit together.

In the **state and local government chapters**, three problems for the same county take the student through preparation of financial statements for the general fund (P10.17), for other governmental and proprietary funds (P11.17), and culminating in preparation of the county's government-wide statements, with reconciliations (P12.17). These problems can be assigned individually or as a class project.

STUDENT-FRIENDLY FEATURES OF THIS TEXT

- In the consolidation chapters, **color** is used pedagogically to identify eliminating entries, both in journal form and in the consolidation working papers, making it easier for students to navigate the complexities of consolidation procedures.
- All consolidation chapters emphasize consolidation of the **statement of income and comprehensive income**. Because in practice companies use a variety of formats to present consolidated operating results, the working paper consolidates the **trial balances** of the parent and subsidiary, which students then package into financial statements in whatever format desired. This approach increases students' flexibility and understanding of basic concepts.
- Discussion of consolidation policy emphasizes the goal of consolidating **controlled entities**, and shows how FASB updates on consolidation policy illustrate this goal.
- **Measurement issues** in identifying and valuing acquired assets and liabilities and consideration paid are discussed in detail. Cost, market, and income approaches are explained and illustrated. Common reporting issues in practice, including **identifiable intangibles**, **deferred taxes**, and **stock options**, are covered, with examples from practice.
- In the governmental and not-for-profit chapters, concepts are illustrated with **actual financial statements** of cities, counties, states, and a variety of NFP organizations, with emphasis on ways in which the information provided by these entities differs from regular businesses, reasons why this information is required, and the judgments and choices involved.
- The **commonality of reporting issues** for different types of entities—businesses, NFPs, governments, and even partnerships—is emphasized. Examples include consolidation policy, acquisition reporting, and hedge accounting.

NEW TO THIS EDITION

The text is **completely updated** for new standards, proposals, and other relevant events as of 2018. Major updates are:

- Chapter 1: *ASU 2016-01* and *ASU 2016-13*, **investments in debt securities and equity securities** with no significant influence; impairment testing for debt securities, and changes in the comparison of GAAP and IFRS for these investments.
- Chapter 2: **Definition of a business** (*ASU 2017-01*) determining when *ASC Topic 805* requirements apply; reporting the **effects of measurement period changes** on subsequent income (*ASU 2015-16*).
- Chapter 4: Simplified **goodwill impairment test** (*ASU 2017-04*) and updated comparison of GAAP and IFRS for identifiable intangibles and goodwill.
- Chapters 8 and 9: **New hedging model** (*ASU 2017-12*).

- Chapters 10-12: **GAAP hierarchy** (*SGAS 76*), **component unit** display (*SGAS 80*), accounting for **fiduciary activities** (*SGAS 84*), **leases** (*SGAS 87*), **defined benefit pensions and OPEBs** (*SGAS 68* and *SGAS 75*).
- Chapter 13: Completely updated for the new **NFP reporting model** (*ASU 2016-14*), including examples and illustrations from practice.
- All **illustrations**, **current practices**, and **reporting perspectives** are completely updated, and include new issues and examples.
- There are over **130 new exercises and problems**, and a **net increase of over 65** exercises and problems, at various levels of difficulty.
- The number of questions included in myBusinessCourse has been more than doubled with this new edition, as well.

In addition, **new material** has been added, based primarily on suggestions from adopters, including these topics:

Mergers and acquisitions

- Consolidation procedures for **VIEs**
- **Step acquisitions**
- Expanded explanation of the differences in reporting **acquisition of a business versus an asset**
- **Pushdown accounting** for subsidiaries (*ASU 2014-17*) and implications for consolidation procedures
- Expanded explanation of **intercompany transaction eliminations**
- Expanded explanation of **consolidated statement of cash flows**

Hedge accounting

- Rewritten explanation of **swap accounting** and **hedging with options**

State and local governments

- Reporting for **asset retirement obligations**
- Expanded coverage of **deferred inflows/outflows**
- **Comprehensive problem** combining concepts of general fund reporting, reporting for other funds, and development of government-wide financial statements

NFP organizations

- Expanded coverage of **health care NFPs** and intermediate performance measures

Bankruptcy and reorganization

- **Liquidation basis of accounting** (*ASU 2013-07*)

SEC

- **Comment letters** on periodic filings

SUPPLEMENT PACKAGE

For Instructors

Homework MBC

myBusinessCourse: A web-based learning and assessment program intended to complement your textbook and classroom instruction. This easy-to-use program grades homework automatically and provides students with additional help when you are not available. Visit **www.mybusinesscourse.com** to sign up or to learn more about this program's features and benefits. In addition, detailed diagnostic tools assess class and individual performance. myBusinessCourse is ideal for online courses, blended courses, and traditional face-to-face courses for which you want to offer students more resources to succeed.

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CHAPTER 1

Intercorporate Investments: An Overview

LEARNING OBJECTIVES

LO1 Describe the reporting for intercorporate debt investments and intercorporate equity investments with no significant influence. (p. 5)

LO2 Explain the reporting for equity method intercorporate investments. (p. 9)

LO3 Describe the reporting for controlling interests in other companies. (p. 15)

LO4 Discuss International Financial Reporting Standards (IFRS) for intercorporate investments. (p. 17)

THE COCA-COLA COMPANY

www.coca-cola.com

The Coca-Cola Company is the world's largest beverage company. In addition to Coca-Cola, its brands include Sprite, Dasani, and Minute Maid. Coca-Cola produces beverage syrup in concentrated form, and sells it to bottlers. The bottlers mix the syrup with water and other ingredients, and bottle or can the finished beverages for delivery to retailers, restaurants, and food distributors.

Coca-Cola's investments in its bottlers and other companies take a variety of forms. At the end of 2016, Coca-Cola owned several legally separate bottling companies, including Coca-Cola Refreshments Canada and BCI Coca-Cola Bottling Company of Los Angeles. These companies are **subsidiaries** of Coca-Cola Company. Coca-Cola has a **significant interest** in some of its bottlers through equity ownership. It is involved in several **joint ventures**, where Coca-Cola shares decision-making authority with another company, and has certain financial relationships with other companies, called **variable interests**, which must be disclosed in its financial statements. Coca-Cola also holds **debt investments** in other companies, and equity interests with no significant influence. These accounts appear as current and noncurrent assets on Coca-Cola's balance sheet.

Coca-Cola's financial statements illustrate the variety of intercorporate investments held by companies. Each investment type involves a different set of reporting requirements. This chapter presents an overview of reporting for the major types of investments in other companies. *Source*: The Coca-Cola Company 2016 annual report.

CHAPTER ORGANIZATION

Introduction	Intercorporate debt investments and equity investments with no significant influence	Investments with significant influence	Controlling investments	International Financial Reporting Standards
• Motivations for intercorporate investments • Types of investments	• Trading debt investments • Available-for-sale debt investments • Held-to-maturity debt investments • Equity investments	• Equity method investments • Joint ventures	• Mergers, consolidations, and asset acquisitions • Stock acquisitions • Variable interest entities	• Debt investments and equity investments with no significant influence • Investments with significant influence • Joint ventures • Controlling investments

INTRODUCTION

Companies invest in other companies for many reasons, using a variety of financing arrangements, operating relationships and legal structures. Intercorporate investments are pervasive business activities, affect financial performance in profound ways, and have detailed and complex reporting requirements. How firms value investments and report gains and losses depends on the purpose of the investment and whether the investor has significant influence or control over the investee.

Motivations for Intercorporate Investments

Intercorporate investments achieve a variety of business purposes.

- A company purchases debt or equity securities of another company as a temporary investment of excess cash or as part of a longer-term risk-adjusted portfolio, expecting to receive dividends and capital gains.
- A company makes strategic investments to develop relationships with suppliers or customers or to gain access to new product or geographic markets.
- A company obtains a controlling interest in another company to facilitate activity along its supply chain.

The Coca-Cola Company holds investments in the securities of other companies for the purpose of generating investment income and capital gains. In its December 31, 2016, balance sheet, investments in debt securities totaled close to $5 trillion, and investments in equity securities totaled over $2 trillion. These investments are reported in various asset lines on its balance sheet.

Coca-Cola uses the **equity method** to account for investments in which it has significant influence. In 2016, Coca-Cola had a 29 percent ownership interest in Coca-Cola Amatil, one of the largest bottlers in the Asia-Pacific region, a 28 percent interest in the bottler Coca-Cola FEMSA, operating in Latin America, and a 23 percent interest in Coca-Cola Hellenic, operating in 28 established, developing, and emerging European markets. Coca-Cola holds these investments for strategic reasons and exerts significant influence over the operations of these companies. Coca-Cola shares decision making authority in joint ventures with other companies. In 2016, Beverage Partners Worldwide was a 50/50 joint venture between Coca-Cola and Nestlé S.A., distributing Nestea products primarily in Europe and Canada. This investment was also reported using the equity method.

Coca-Cola has controlling interests in close to 60 companies worldwide. It acquires other companies to increase market share, expand its presence in new markets, and improve the functioning of its supply chain. For example, a major acquisition in 2016 was the purchase of Xiamen Culiangwang Beverage Technology Company, Ltd., a company that produces protein beverages in China. Most of these companies are controlled through stock investments. However, in some cases Coca-Cola has financial relationships with other companies that give it the power to direct company activities and expose it to their benefits and losses, without any ownership interests. Regardless of the method of achieving control, the individual assets and liabilities of all these companies are included with Coca-Cola's assets and liabilities on its balance sheet, through a process known as **consolidation**. There is no separate investment line for these companies.

Types of Investments

For reporting purposes, intercorporate investments are divided into the following categories:

- *Trading* debt securities are held on a short-term basis to generate profits through realized gains. Investors typically buy and sell these securities frequently.
- *Held-to-maturity* debt investments are intended to be held to maturity. Companies hold these investments for the interest and principal payments.
- *Available-for-sale* investments are debt securities held for income or gains in value that are not classified as trading or held-to-maturity.
- Investments in *equity securities*, where the investor has no *significant influence* are held for income and capital gains.
- *Equity method* investments are equity investments that provide the investor with a significant influence over the investee. This category includes *joint ventures*, where the investor shares joint control of an entity.
- Debt or equity securities can be held as *hedges* of the investor's financial risk. For example, a U.S. company with payables denominated in euros may neutralize the risk of a weakening U.S. dollar by investing in euro-denominated debt securities, which gain in value to offset the loss on the payables if the U.S. dollar weakens.
- A company can acquire some or all of the assets and liabilities of another business to expand into new markets, develop new products or services, or for other strategic purposes. These transactions are *mergers*, *consolidations*, or *asset acquisitions* depending on the acquisition structure.
- A company can gain a *controlling interest* in another legally separate company, either through ownership of all or the majority of its voting stock—termed a *stock acquisition*—or through a legal agreement that gives the investor the right to the majority of the investee's risks and rewards. These acquired companies are called *subsidiaries*. Entities controlled through a legal agreement rather than equity ownership are also known as *variable interest entities*.

FASB ASC Topic 825 allows companies to elect fair value reporting (the "fair value option") for eligible intercorporate investments. These include all investments in debt or equity securities, except investment in equity securities where the investor has a controlling interest in the investee. Controlling equity investments require consolidation of the investee's accounts with that of the investor, a topic introduced later in this chapter and covered in detail in Chapters 2 through 7 of this text. Investments for which the fair value option is chosen are reported at fair value, with all value changes reported in income as incurred. The discussion that follows assumes the investor does *not* elect the fair value option where appropriate.

Reporting requirements for noncontrolling intercorporate investments have significantly changed in recent years, in large part due to the reporting weaknesses identified during the global financial crisis originating in 2008. This chapter reflects standards issued as of 2017, and effective in subsequent years.

INTERCORPORATE DEBT INVESTMENTS AND EQUITY INVESTMENTS WITH NO SIGNIFICANT INFLUENCE

LO1 Describe the reporting for intercorporate debt investments and intercorporate equity investments with no significant influence.

Many businesses invest in the debt securities of other companies to generate investment income and capital gains. Examples include commercial paper, corporate bonds, and redeemable preferred stock. Equity investments held for income and gains typically take the form of shares of a company's common or preferred stock, but can also be put or call options on the shares, allowing the investor to sell or buy shares at a fixed price.

ASC Topic 320 describes the reporting requirements for investments in debt securities. It divides investments with readily determinable market values into three categories: trading, available-for-sale, and held-to-maturity investments. *ASC Topic 321* describes reporting requirements for investments in equity securities with no significant influence. Because intermediate accounting courses detail the reporting for these investments, we provide only a brief discussion.

Trading Investments

Trading investments appear on the balance sheet as current assets reported at fair value, with gains and losses reported on the income statement as market prices change. Interest income is reported in income as earned. An illustration is based on the information in Exhibit 1.1.

EXHIBIT 1.1 Debt Securities Portfolio

Security	Date Acquired	Cost	Dec. 31, 2018 Fair Value	Date Sold	Selling Price
A.	10/15/18	$100,000	$125,000	1/15/19	$120,000
B.	10/15/18	500,000	485,000	1/15/19	496,000
C.	10/15/18	200,000	N/A	12/5/18	214,000

When these securities are classified as trading securities, the journal entries related to these securities are as follows:

2018			
Oct. 15	Investment in trading securities	800,000	
	Cash		800,000
	To record investment in trading securities costing a total of $800,000 in cash.		
2018			
Dec. 5	Cash	214,000	
	Investment in trading securities.		200,000
	Gain on trading securities (income)		14,000
	To record sale of trading security C.		
2018			
Dec. 31	Investment in trading securities	10,000	
	Gain on trading securities (income)		10,000
	To record unrealized value change in securities A and B; unrealized gain of $25,000 on security A and unrealized loss of $15,000 on security B.		
2019			
Jan. 15	Cash	616,000	
	Investment in trading securities.		610,000
	Gain on trading securities (income)		6,000
	To record sale of trading securities A and B; cash received = $120,000 + $496,000, credit to Investment = $125,000 + $485,000.		

All unrealized and realized gains and losses on trading securities are reported on the income statement.

Available-for-Sale Investments

Investments in available-for-sale (AFS) securities are debt securities reported at fair value as current or noncurrent assets on the balance sheet. As market prices change, unrealized gains and losses on AFS securities are reported in other comprehensive income (OCI), which is closed to accumulated other comprehensive income (AOCI) in the equity section of the balance sheet. When AFS securities are sold, the related unrealized gain or loss is recategorized from AOCI to the income statement. As a result, the entire gain or loss appears in income when the securities are sold. Interest income is reported in income as earned.

Assume that the securities in Exhibit 1.1 are classified as AFS securities. Journal entries are as follows:

2018			
Oct. 15	Investment in AFS securities	800,000	
	Cash		800,000
	To record investment in AFS securities A, B and C.		
2018			
Dec. 5	Cash	214,000	
	Investment in AFS securities		200,000
	Gain on AFS securities (income)		14,000
	To record the sale of AFS security C. When AFS securities are purchased and sold in the same reporting period, gains and losses can be reported directly in income without going through OCI.		
2018			
Dec. 31	Investment in AFS securities	10,000	
	Gain on AFS securities (OCI)		10,000
	To record unrealized value changes for AFS securities A and B in OCI; OCI is closed to AOCI on the balance sheet.		
2019			
Jan. 15	Cash	616,000	
	Reclassification of gain on AFS securities (OCI)	10,000	
	Investment in AFS securities		610,000
	Gain on AFS securities (income)		16,000
	To record sale of AFS securities A and B.		

Note that the effect of the January 15, 2019 entry is to *reduce* OCI by $10,000. To put this in perspective, look at Coca-Cola's 2016 Statement of Comprehensive Income.

The Coca-Cola Company and Subsidiaries
Consolidated Statements of Comprehensive Income

Year Ended December 31, (In millions)	2016	2015	2014
Consolidated Net Income	**$6,550**	$7,366	$7,124
Other comprehensive income:			
Net foreign currency translation adjustment	**(626)**	(3,959)	(2,382)
Net gain (loss) on derivatives	**(382)**	142	357
Net unrealized gain (loss) on available-for-sale securities	**17**	(684)	714
Net change in pension and other benefit liabilities	**(53)**	86	(1,039)
Total Comprehensive Income	**5,506**	2,951	4,774
Less: Comprehensive income (loss) attributable to noncontrolling interests	**10**	(3)	21
Total Comprehensive Income Attributable to Shareowners of the Coca-Cola Company	**$5,496**	$2,954	$4,753

Each type of other comprehensive income appears as one line. Coca-Cola's 2016 net unrealized gain on available-for-sale securities of $17 million consists of two parts: (1) unrealized gains and losses on AFS securities held by Coca-Cola at December 31, 2016, and (2) reclassifications from other comprehensive income for AFS securities sold during 2016. The footnotes to Coca-Cola's 2016 financial statements report $101 million in realized gains on AFS securities, which *reduces* other comprehensive income. Therefore 2016 unrealized *gains* on AFS securities held at year-end must be $118 million. In our example, the 2018 Statement of Comprehensive Income reports an unrealized *gain* of $10,000 for AFS securities held at year-end. The 2019 Statement of Comprehensive Income reports the reclassification of the unrealized gain to income when the securities are sold, as a *reduction* in other comprehensive income.

The principal difference in reporting for trading and available-for-sale investments is the timing of gain and loss recognition on the income statement. For trading securities, gains and losses affect net income *as prices change*. For AFS securities, gains and losses affect net income *when they are sold*. Note that in the previous illustration, the gain reported in 2019 income is the difference between the selling price and the original cost of the investment ($16,000 = $616,000 − $600,000).

Impairment Testing for AFS Securities Although available-for-sale debt securities are carried at fair value on the balance sheet, we need to identify any declines in value meeting the conditions for impairment. Impairment losses caused by deterioration of the investee's ability to pay principal and interest (credit losses) are reported on the income statement, not in other comprehensive income. Accumulated expected credit losses are reported in an allowance account, which reduces the investment balance. The details of the impairment testing process are complex and beyond the scope of this overview chapter. The major points, found in *ASC Topic 326*, are described here.

- The investment is impaired if its fair value is below its cost.
- An impairment loss, equal to the difference between cost and fair value, is reported in income when the investor intends to sell the security, or it is more likely than not that the security will be sold before the loss is recovered. This loss directly reduces the investment balance.
- If the investor intends to hold the security and not sell it before the loss is recovered, the impairment loss is still recorded, but it is divided into two parts. The loss attributable to a decline in the present value of expected future cash flows from the investment (credit loss), is reported in income and reduces the investment through an allowance account. Reversals of credit losses also go through income. Any market-related loss, for example a decline in fair value caused by a rise in market interest rates, is reported in other comprehensive income and is a direct write-down of the investment balance.

Suppose the $15,000 decline in value of AFS security B at December 31, 2018, is determined to be a credit loss. The entry to adjust securities A and B to fair value is:

2018			
Dec. 31	Investment in AFS securities	25,000	
	Impairment loss on security B (income)	15,000	
	Gain on security A (OCI)		25,000
	Allowance for credit losses (security B)		15,000
	To record unrealized gain on security A and impairment loss on security B.		

Note that the amount of the impairment loss reported on the income statement is the decline in value below *cost*, not carrying value. If unrealized gains or losses have previously been recorded, and the security incurs a credit loss, any amounts recorded in AOCI are reclassified to income as appropriate. Suppose an AFS investment, carried at $200,000, was originally acquired for $160,000. Therefore unrealized gains of $40,000 have previously been reported in OCI. Its fair value is currently $90,000. The $70,000 loss (= $160,000 − $90,000) is determined to be a credit loss. The entry to record the impairment loss is:

Reclassification of gain on AFS securities (OCI)	40,000	
Impairment loss on AFS securities (income)	70,000	
Investment in AFS securities		40,000
Allowance for credit losses		70,000
To record impairment loss on AFS securities.		

The investment is reported at a net amount of $90,000, consisting of $160,000 cost less an allowance for credit losses of $70,000.

Held-to-Maturity Investments

Investments in held-to-maturity (HTM) securities are reported at amortized cost. No gains or losses are reported unless the securities are not held to maturity as intended, and this only occurs under limited circumstances, such as financial distress on the part of the issuer. When debt securities are purchased above or below face value, the premium or discount is amortized over time as interest income is reported.

Assume investment of $965,349 in a $1,000,000 face value corporate bond on January 1, 2018, a price producing a 6 percent yield to maturity. The bond pays 5 percent interest annually on December 31, matures on December 31, 2021, and is classified as an HTM security. We use the effective interest method to amortize the discount. Journal entries to maturity are as follows:

2018			
Jan. 1	Investment in HTM securities	965,349	
	Cash		965,349
	To record investment in HTM securities.		
2018			
Dec. 31	Cash	50,000	
	Investment in HTM securities	7,921	
	Interest income		57,921
	To record interest income for 2018; $50,000 = 5% × $1,000,000; $57,921 = 6% × $965,349.		
2019			
Dec. 31	Cash	50,000	
	Investment in HTM securities	8,396	
	Interest income		58,396
	To record interest income for 2019; $58,396 = 6% × $973,270 ($965,349 + $7,921).		
2020			
Dec. 31	Cash	50,000	
	Investment in HTM securities	8,900	
	Interest income		58,900
	To record interest income for 2020; $58,900 = 6% × $981,666 (= $973,270 + $8,396).		
2021			
Dec. 31	Cash	50,000	
	Investment in HTM securities	9,434	
	Interest income		59,434
	To record interest income for 2021; $59,434 = 6% × $990,566 (= $981,666 + $8,900).		
2021			
Dec. 31	Cash	1,000,000	
	Investment in HTM securities		1,000,000
	To record receipt of the face value of the matured bond.		

Impairment Testing for HTM Investments Although companies normally report HTM securities at amortized cost, an allowance must be set up to reflect expected credit losses. This allowance reduces the reported value of the investment, and is measured using the current expected credit loss (CECL) model. This approach estimates expected credit losses over the life of the investment. Changes in expected credit losses, whether they be gains or losses, are reported currently in income.

In the illustration above, assume that a significant decrease in the bond issuer's profitability, and analysts' severe downgrade of company prospects, results in expected credit losses of $300,000 as of December 31, 2019. The investor reports the impairment loss in income, as follows:

2019			
Dec. 31	Impairment loss on HTM securities (income)	300,000	
	Allowance for credit losses		300,000
	To record expected credit losses on HTM securities.		

Equity Investments

The reporting for equity investments with no significant interest is covered by *ASC Topic 321*. Those investments with readily determinable fair values follow the same reporting as for trading debt securities. The investments are reported at fair value, with changes in value reported in income as they occur. There is no need for impairment testing, since all changes in value are reported in income.

REVIEW 1 • Trading, AFS, and HTM Debt Investments

Assume **The Coca-Cola Company** makes the following intercorporate debt investments on January 2, 2019:

Security	Type	Cost
A.	Trading	$ 300,000
B.	AFS	1,000,000
C.	HTM	486,384

Securities A and B are purchased at par value. Security C is a 3-year $500,000 face value corporate bond paying 4% interest annually on December 31 and yielding 5% to maturity. Coca-Cola sells Security A for $265,000 on June 15, 2019, and acquires Security D on October 15, 2019, for $250,000. Security D is classified as a trading security, purchased at par value.

December 31, 2019, fair values are as follows:

Security	Type	Fair Value
B.	AFS	$920,000
C.	HTM	495,000
D.	Trading	260,000

Cash interest of $12,000 is received on the investments in Securities B and D on December 1, 2019. Interest of $20,000 is received on Security C on December 31, 2019. No changes in value are credit-related.

Required: Prepare all entries related to the above investments for 2019.

Solutions are located after the chapter assignments.

INVESTMENTS WITH SIGNIFICANT INFLUENCE

LO2 Explain the reporting for equity method intercorporate investments.

Unless a company elects the *ASC Section 825-10-25* fair value option, *ASC Topic 323* requires that the **equity method** be used to account for equity investments that allow the investor to exercise *significant influence* over the operating and financial decisions of the investee. **Significant influence** is assumed to be present if the investor owns between 20 and 50 percent of the investee's voting stock. However, this is only a guideline to aid in assessing significant influence. The Codification offers indicators of the investor's ability to exert significant influence, including:

- representation on the investee's board of directors
- involvement in the development of investee operating and financial policies
- significant transactions between investor and investee

The *key issue* is whether the investor *in fact* exerts significant influence over the investee's operations. Significant influence may exist with less than 20 percent ownership of the investee's voting shares, or there may be circumstances where a large minority ownership does not indicate significant influence. *ASC para. 323-10-15-10* provides guidance on this point. For example, if the investor has given up significant shareholder rights, has tried but failed to gain representation on the investee's board, or if other owners not influenced by the investor control the investee's operations, the equity method is not appropriate even if the investor holds 20 to 50 percent of the voting stock.

Accounting Using the Equity Method

When the investor can influence the investee's operating and financial decisions and the amount and timing of dividends the investee pays, performance of the investment is not accurately measured by dividend payout. Instead, investment performance should parallel the investee's performance. The equity method achieves this goal with the following procedures:

- Increase (decrease) the investment account by the investor's share of the investee's income (loss).
- The investor reports its share of the investee's income (loss) in income.
- Reduce the investment account for dividends from the investee.

The investor's investment balance therefore changes in proportion to the changes in the investee's retained earnings.

Suppose that on January 2, 2019, The Coca-Cola Company acquires 300,000, or 30 percent, of the voting shares of Rocky Mountain Bottlers for $40 per share, a total of $12 million in cash. Coca-Cola has a significant influence over Rocky Mountain, and therefore the equity method is appropriate. Rocky Mountain reports net income of $2 million for the year ended December 31, 2019. It declares a cash dividend of $0.50 per share on November 1, 2019, and pays the dividend on December 2, 2019. Coca-Cola records the following entries for 2019 relative to its equity method investment in Rocky Mountain:

2019			
Jan. 2	Investment in Rocky Mountain Bottlers	12,000,000	
	Cash		12,000,000
	To record the investment.		
2019			
Nov. 1	Dividends receivable	150,000	
	Investment in Rocky Mountain Bottlers		150,000
	To record the declared dividend; $150,000 = $0.50 × 300,000.		
2019			
Dec. 2	Cash	150,000	
	Dividends receivable		150,000
	To record receipt of the declared dividend.		
2019			
Dec. 31	Investment in Rocky Mountain Bottlers	600,000	
	Equity in net income of Rocky Mountain Bottlers (income)		600,000
	To accrue the earnings of the investee; $600,000 = 30% × $2,000,000.		

The December 31, 2019, investment balance, reported on Coca-Cola's balance sheet in noncurrent assets, is $12,450,000 (= $12,000,000 − $150,000 + $600,000). Equity in net income of Rocky Mountain Bottlers of $600,000 appears as a component of Coca-Cola's income for 2019.

Equity in Net Income Calculation

The discussion above computed equity in net income as the investor's share of the investee's reported net income, based on the assumption that the investee's reported net income accurately measures the performance of the investment. When investment cost differs from the investee's book value, or the investor and investee transact business with each other, the investor must make adjustments to the investee's reported income.

At the date of acquisition, investment cost usually exceeds the investor's share of the book value of the investee, calculated as its reported assets less liabilities. The investee reports its noncurrent assets such as plant and equipment at cost less accumulated depreciation, not current fair value. Internally developed intangible assets, such as favorable contractual agreements, customer base, technology and reputation do not appear as assets on the investee's balance sheet. For these reasons an investee's shares usually sell at a price in excess of book value.

Companies take large noncontrolling interests in other entities for strategic reasons that facilitate business activities between the companies. Common transactions involve intercompany sales of raw materials or finished goods inventories. For example, Coca-Cola sells syrup to its 29-percent-owned bottler, Coca-Cola Amatil. When related entities sell merchandise to each other, the profit on these transactions is not considered to be earned until the merchandise is sold to an unrelated outside party.

Amortization of Investment Cost in Excess of Book Value Acquired To accurately measure investment performance, we must consider any investment cost in excess of investee book value, known as *basis differences*. The investee's reported income reflects appropriate write-offs of its reported assets, in the form of depreciation, amortization, and impairment losses. If investment cost reflects additional assets not recorded on the investee's books, equity in net income should in turn reflect write-offs of these additional assets. In the previous discussion, we calculated Coca-Cola's share of Rocky Mountain Bottlers' income as a proportion of Rocky Mountain's reported net income. If Coca-Cola's investment cost at the date of investment differs from its share of Rocky Mountain's underlying book value, we must make adjustments to accurately measure investment performance.

Suppose that on January 2, 2019, Rocky Mountain's book value is $30 million. Coca-Cola therefore paid $3 million (= $12 million − 30% × $30 million) more for its 30 percent investment than its share of Rocky Mountain's reported book value. Analysis of Rocky Mountain's assets and liabilities reveals that its plant and equipment is reported at $1 million less than its fair value. It also has unreported technology valued at $5 million. We can explain the $3 million excess over acquired book value as follows:

Price paid		$12,000,000
Share of Rocky Mountain's net assets acquired:		
Book value (30% × $30,000,000)	$9,000,000	
Revaluation of plant and equipment (30% × $1,000,000)	300,000	
Unreported technology (30% × $5,000,000)	1,500,000	10,800,000
Goodwill		$ 1,200,000

Of the total $3 million excess cost, $1,800,000 (= $300,000 + $1,500,000) is explained by specific asset undervaluations. The remaining unexplained cost is attributed to goodwill, representing the additional cost not explained by underreported or unreported identifiable assets.

Rocky Mountain does not report depreciation or amortization of the additional assets embedded in Coca-Cola's investment cost, because these assets do not appear on Rocky Mountain's books. Coca-Cola therefore adjusts its equity in the net income of Rocky Mountain for basis difference write-offs. Equity in net income is adjusted for write-offs of *identifiable assets*, but any adjustment for goodwill impairment is *prohibited*.

Continuing Coca-Cola's investment in 30 percent of Rocky Mountain Bottlers' voting stock, assume that the revalued plant and equipment has a remaining life of 10 years as of January 2, 2019, straight-line, and the previously unreported technology is a limited life intangible asset with a five-year life. Coca-Cola's 2019 equity in the net income of Rocky Mountain Bottlers is reduced by $30,000 in depreciation on the plant and equipment revaluation (= $300,000/10) and by amortization of previously unreported technology of $300,000 (= $1,500,000/5). In practice, however, the investor often attributes the excess cost entirely to goodwill. This shortcut avoids any income adjustments for revaluation write-offs.

Unconfirmed Inventory Profits An investor may sell inventory to its investee, termed **downstream** sales, or an investee may sell merchandise to the investor, termed **upstream** sales. Both companies record the sales on their own books as if they are selling to outside customers. If both companies sell the merchandise at a markup over cost, they will report a gross margin on these intercompany sales as part of their income. However, if the merchandise is not yet sold to an unrelated outside party at year-end, this gross margin is not yet earned and must be removed when calculating equity in the net income of the investee.

Suppose that during 2019 Rocky Mountain Bottlers sells merchandise to Coca-Cola (upstream) at an average markup of 20 percent on cost. Coca-Cola still holds $210,000 of this inventory at year-end. During 2019 Coca-Cola sells merchandise to Rocky Mountain (downstream) at an average markup of 25 percent on cost. Rocky Mountain holds $100,000 of this inventory at year-end. The total unconfirmed profit on the ending inventories is as follows:

Unconfirmed gross profit on $210,000 upstream sales:
$210,000 − $210,000/1.20 = $35,000

Unconfirmed gross profit on $100,000 downstream sales:
$100,000 − $100,000/1.25 = $20,000

Coca-Cola's 2019 equity in the net income of Rocky Mountain Bottlers is reduced by $10,500 (= 30% × $35,000) and $6,000 (= 30% × $20,000). When the inventories are sold to outside customers, the profit is confirmed and equity in net income is increased by $10,500 and $6,000.

To summarize, Coca-Cola's equity in the 2019 net income of Rocky Mountain is calculated as follows: