Overview

There are a variety of reasons why companies choose to invest in other companies rather than buy back their own shares or dividend excess cash to shareholders. The accounting for such transactions is frequently as simple as doing basically the opposite of what was done by the company issuing the securities which you learned in the prior two chapters. But there are some major exceptions and issues to be explored.

Based on the kind of security (debt or equity) purchased, the amount of securities held (as a percentage of the available equity securities outstanding in a single company), and the intent with which the security is held, the accounting can defer.

Debt securities can basically be thought of as loaning the issuer money, even when they are purchased on the open market and not directly from the issuer. The number of debt securities held in a single company does not change the accounting, because ownership of the company does not take place by merely loaning money to another company. What can change the accounting with debt securities is intent. Are the held debt securities going to be sold in the near future? Are they not going to be sold in the near future but before maturity? Or are they going to be held until the issuer pays back the face amount? The accounting varies based on which of those three questions gets the “yes.”

A similar process is undertaken for equity securities but with an added wrinkle and a key difference. The difference is that equity securities can not be held until maturity because equity securities never mature. There is no fixed date in which a company must buy back common stock from shareholders, unlike the terms with a bond issuance which always have such a date. But there is another question that takes the place of the “Will it be held to maturity?” question, which is, “How much of the other company is owned?” The accounting will differ at three levels: less than 20 percent ownership, 20 percent to 50 percent ownership (significant influence), and over 50 percent ownership (control).
Significant influence requires the use of the equity method to account for those securities. Control requires consolidated financial statements for the companies. In any event, companies with investments in other companies must disclose significant information about them in notes to the financial statements so that readers of the statements can better understand the composition of the investments listed on the face of them.

Learning Objectives

Refer to the Review of Learning Objectives at the end of the chapter. It is crucial that this section of the chapter is second nature to you before you attempt the homework, a quiz, or exam. This important piece of the chapter serves as your CliffsNotes or “cheat sheet” to the basic concepts and principles that must be mastered.

If after reading this section of the chapter you still don’t feel comfortable with all of the Learning Objectives covered, you will need to spend additional time and effort reviewing those concepts that you are struggling with.

The following “Tips, Hints, and Things to Remember” are organized according to the Learning Objectives (LOs) in the chapter and should be gone over after reading each of the LOs in the textbook.

Tips, Hints, and Things to Remember

LO1 – Determine why companies invest in other companies.

**Why?** Companies sometimes have excess cash reserves. These cash surpluses can be planned or mere windfalls from recent operations doing better than expected. Companies then have choices to make. They can dividend the cash to shareholders or they can use the extra cash to support future operations and growth. Sometimes the extra cash isn’t immediately needed as the future growth or expansion project is still quarters or years away. Therefore, a company doesn’t want to dividend the cash that will be needed or it won’t be available when the time comes.

A company doesn’t want to just have the cash sit there until it is needed. If the cash is needed in the short term, they may invest the cash into some sort of short-term investment that will yield some interest and cause the cash to grow. However, they may also choose to invest in other companies for the dividends those stocks pay or in the hopes that the stocks will appreciate.
Finally, a company may be investing in a supplier or a customer with the ultimate objective of controlling the investment’s business decisions as well. A significant percentage of the company will likely need to be acquired to meet these ends. That can happen over a short- or long-term purchasing pattern.

LO2 – Understand the varying classifications associated with investment securities.

How? The following decision flowchart illustrates the steps needed to determine how a security should be classified and reported on the financial statements.

1. Is it a debt or equity item?
   - Yes: Debt
   - No: Equity

2. Will it be sold in the near future?
   - Yes: (3) Report changes in value on the income statement. *
   - No: Proceed to the next question.

3. Is it being held to maturity?
   - Yes: (1) Report at amortized cost and do not recognize gains or losses for temporary changes in value.
   - No: (2) Report changes in value in stockholders' equity. *

(1) Held-to-maturity securities
(2) Available-for-sale securities
(3) Trading securities

*Exception: If the investment is in equity securities and more than 20% of the investee company is owned, then the equity method (covered in LO4) is used.
LO3 – Account for the purchase of debt and equity securities.

How? Accounting for the purchase of securities is easy if you understand how to account for the issuance of securities. Basically, all that changes here is the entries are flip-flopped. Instead of debiting Cash and crediting a liability or equity account(s), you credit Cash and debit an investment account.

For debt securities purchased on a date other than the date in which interest is paid, interest is also being purchased. You can either debit Interest Receivable or Interest Revenue for the amount of interest that is being obtained with the security. It doesn’t matter which so long as you recognize the correct amount of interest revenue for the period between the purchase and the interest receipt by “fixing” the Interest Revenue account balance at the point the cash is owed from the investee.

LO4 – Account for the recognition of revenue from investment securities.

How? Once again, if you understand the prior chapter on bonds, this learning objective is not difficult. The amount of interest expense that was recognized on bonds by the issuer is going to be the amount of interest revenue recognized on debt securities by the investor.

Under the equity method, the investment account is reduced for dividends received and increased for the portion of income the investee earns multiplied by the ownership percentage. For the second entry, the credit goes to a revenue account which will effectively increase the investor’s income and stockholders’ equity.

LO5 – Account for the change in value of investment securities.

How? Held-to-maturity securities are not revalued when they change in value. A gain or loss on these securities takes place only if they are reclassified as “available for sale” or “trading” or if they are actually sold. If they are held to maturity, there will be no gain or loss.

As mentioned in the flowchart on page 14-3, unrealized gains or losses on trading securities are reflected on the income statement (and the investment on the balance sheet is increased/decreased). Unrealized gains or losses on available-for-sale securities are reflected in stockholders’ equity with a corresponding increase/decrease in the investment balance.
LO6 – Account for the sale of investment securities.

**How?** When securities are sold, assuming they are sold for an amount different than their book value, an amount is always reported on the income statement. The prior classifications of “available for sale” or “trading” no longer make a difference. Cash (reduced by commissions) receives a debit, the investment is taken off the books with a credit, and the difference is the realized gain or the loss. If the difference is a missing debit, then a loss results. If it is a missing credit, then a gain is recognized. Losses, like expenses, are debits and gains, like revenue, are credits.

LO7 – Record the transfer of investment securities between categories.

**How?** Generally, the category in which a security is being transferred to is how it should be recorded. There are two exceptions, as can be seen in Exhibit 14-13 in the textbook. When a security is going from “trading” to another category, any unrealized gains or losses are recognized before the new treatment begins. The second is when a security is going to “held to maturity.” The unrealized change in stockholders’ equity gets amortized over the time until maturity. In all other situations, previously recognized changes are not reversed or amortized away.

LO8 – Properly report purchases, sales, and changes in value of investment securities in the statement of cash flows.

**How?** As you learned in an earlier chapter, the purchase and sale of investment securities are usually investing activities. However, there is one exception: the purchase and sale of trading securities which are considered operating activities.

Unrealized gains and losses do not affect cash and, hence, should not show up in the statement of cash flows. Therefore, if the indirect method is used, gains and losses (both realized and unrealized) should be taken out of net income. The amount of cash that actually went out for a purchase or came in on a sale is what should be reported on the statement of cash flows.

LO9 – Explain the proper classification and disclosure of investments in securities.

LO10 – Account for the impairment of a loan receivable.
The following sections, featuring various multiple choice questions, matching exercises, and problems, along with solutions and approaches to arriving at the solutions, is intended to develop your problem-solving and critical-thinking abilities. While learning through trial and error can be effective for improving your quiz and exam scores, and it can be a more interesting way to study than merely re-reading a chapter, that is only a secondary objective in presenting this information in this format.

The main goal of the following sections is to get you thinking, “How can I best approach this problem to arrive at the correct solution—even if I don’t know enough at this point to easily arrive at the proper results?” There is not one simple approach that can be applied to all questions to arrive at the right answer. Think of the following approaches as possibilities, as tools that you can place in your problem-solving toolkit—a toolkit that should be consistently added to. Some of the tools have yet to even be created or thought of. Through practice, creative thinking, and an ever-expanding knowledge base, you will be the creator of the additional tools.

Multiple Choice

**MC14-1 (LO2)** Which category includes only debt securities?
- a. held-to-maturity securities
- b. available-for-sale securities
- c. trading securities
- d. equity method securities

**MC14-2 (LO2)** Which of the following is the minimum criteria that must be met for the equity method of accounting to be used?
- a. An investment is composed of common stock and it is the investor's intent to vote the common stock.
- b. The investor's ownership ensures a source of supply such as raw materials.
- c. The investment enables the investor to exercise significant influence over the investee.
- d. The investment gives the investor voting control over the investee.
MC14-3 (LO3) On March 1, 2011, Chesnut, Inc., purchased as a temporary investment $100,000, face amount, 12% U.S. Treasury notes, which pay interest semiannually on January 1 and July 1. The notes were purchased at 102. Which of the following journal entries correctly records this purchase?

a. Investment in Trading Securities 100,000
   Interest Receivable 2,000
   Premium on Trading Securities 2,000
   Cash 104,000

b. Investment in Trading Securities 102,000
   Interest Receivable 2,000
   Cash 104,000

c. Investment in Trading Securities 100,000
   Interest Receivable 2,000
   Cash 102,000

d. Investment in Trading Securities 102,000
   Cash 102,000

MC14-4 (LO4) When an investor owns 11 percent of an investee company and classifies the securities as available for sale, cash dividends received by the investor from the investee should normally be recorded as

a. a deduction from the Investment in Available-for-Sale Securities account.

b. Dividend Revenue.

c. an addition to the Investment in Available-for-Sale Securities account for the investor's share of the investee's profit or loss.

d. a deduction from the Investment in Available-for-Sale Securities account for the investor's share of the investee's profit or loss.

MC14-5 (LO5) Changes in the fair value of securities are reported in the income statement for:

a. marketable equity securities.

b. available-for-sale securities.

c. trading securities.

d. held-to-maturity securities.
MC14-6 (LO6) Jensch Corporation purchased the following portfolio of trading securities during 2011 and reported the following balances at December 31, 2011. No sales occurred during 2011. All declines are considered to be temporary.

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market Value at 12/31/11</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$84,000</td>
<td>$82,000</td>
</tr>
<tr>
<td>Y</td>
<td>$130,000</td>
<td>132,000</td>
</tr>
<tr>
<td>Z</td>
<td>32,000</td>
<td>28,000</td>
</tr>
</tbody>
</table>

The only transaction in 2012 was the sale of security Z for $34,000 on December 31, 2012. The market values for the other securities on December 31, 2012, were the same as at December 31, 2011. Marino’s entry to record the sale of security Z would include a
a. credit of $6,000 to Realized Gain on Sale of Trading Securities.
b. debit of $2,000 to Realized Gain on Sale of Trading Securities.
c. $2,000 debit to Market Adjustment—Trading Securities.
d. $4,000 debit to Market Adjustment—Trading Securities.

MC14-7 (LO7) In May 2010, Anna Corporation bought 100,000 shares of Blackstone Corporation’s listed stock for $450,000 and classified the shares as available-for-sale securities. The market value of these shares had declined to $300,000 by December 31, 2010. Anna changed the classification of these shares to trading securities in July 2011, when the market value of this investment in Blackstone's stock had risen to $345,000. How much should Anna include as a loss on transfer of securities in its determination of net income for 2011?

a. $0  
b. $45,000  
c. $105,000  
d. $150,000

MC14-8 (LO8) Omar Company reports its income from its investment in KatWok Company under the equity method. Omar recognized income of $150,000 from its investment in KatWok during the current year. No dividends were declared or paid by KatWok during the year. Omar would show the $150,000 in its statement of cash flows for the current year prepared under the indirect method as:

a. cash from investing activities.  
b. a reduction of the investment account.  
c. a deduction from net income in the Operating Activities section.  
d. an adjustment in the Investing Activities section.

MC14-9 (LO9) Which of the following statements is NOT true?

a. Trading securities can be classified as current or noncurrent depending on management's intent.  
b. Held-to-maturity securities can be classified as current.  
c. Available-for-sale securities can be classified as noncurrent.  
d. Available-for-sale securities can be classified as current.
MC14-10 (LO10) A loan is considered to be impaired when which of the following criteria is met?

a. A required payment under the loan agreement is not made.
b. The present value of the future payments is less than the total of the payments.
c. It is possible that a creditor will be unable to collect all amounts due.
d. It is probable that a creditor will be unable to collect all amounts due.
Matching

Matching 14-1 (LO1, LO2, LO3, LO4, LO5, LO6, LO7, LO8, LO9, LO10) Listed below are the terms and associated definitions from the chapter for LO1 through LO10. Match the correct definition letter with each term number.

___ 1. available-for-sale securities
___ 2. control
___ 3. equity method securities
___ 4. parent company
___ 5. equity method
___ 6. significant influence
___ 7. held-to-maturity securities
___ 8. subsidiary company
___ 9. equity securities
___ 10. debt securities

a. the method of accounting for long-term investments in the stock of another company where significant influence exists (generally, 20%–50% ownership); the initial investment is recorded at cost but is increased by a proportionate share of investor’s income and decreased by dividends and a proportionate share of losses to reflect the underlying claim by the investor on the net assets of the investee company
b. a company that exercises control over another company through majority ownership (more than 50%) of the other company’s voting stock
c. investment securities not intended for immediate trading but, in the case of debt securities, not intended to be held until maturity
d. debt securities purchased by a company with both the intent and ability to hold the securities until they come due
e. financial instruments issued by a company that typically have the following characteristics: (1) a maturity value, (2) an interest rate (either fixed or variable) that specifies the periodic interest payments, and (3) a maturity date
f. a company that is owned or controlled by another company
g. equity securities purchased with the intent of being able to control or significantly influence the operations of the investee
h. the ability of an investor to impact the operating, investing, and financing decisions of an investee but not absolutely determine those decisions
i. securities that represent ownership in a company; these shares of stock typically carry with them the right to collect dividends and to vote on corporate matters
j. the ability of an investor to decisively influence the operating, investing, and financing decisions made by an investee
Problems

Problem 14-1 (LO4, LO5) On January 1, 2011, Ellie Corporation acquired 10,000 shares of Ryan Services, Inc.’s, common stock for $1,300,000 as a long-term investment. Data from Ryan’s 2011 financial statements include the following:

- Net income $330,000
- Less cash dividends paid $160,000
- Increase in retained earnings $170,000

The market value of Ryan Services, Inc.’s, common stock on December 31, 2011, had dropped to $125 per share. Ellie does not have any other noncurrent investments in securities.

Prepare all of the necessary journal entries for Ellie’s investment in Ryan Services, Inc.’s, common stock for the entire year assuming the following:

1. 2 percent of Ryan Services Inc. was acquired, and Ellie doesn’t plan to sell the Ryan stock in the near future.
2. 22 percent of Ryan Services Inc. was acquired, and Ellie doesn’t plan to sell the Ryan stock in the near future.

Problem 14-2 (LO5) Lux Company carries the following marketable equity securities on its books at December 31, 2011, and 2012. All securities were purchased during 2011, and there were no beginning balances in any market adjustment accounts.

Trading Securities:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market 12/31/11</th>
<th>Market 12/31/12</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Company</td>
<td>$ 50,000</td>
<td>$ 26,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>B Company</td>
<td>26,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>C Company</td>
<td>70,000</td>
<td>60,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Total</td>
<td>$146,000</td>
<td>$126,000</td>
<td>$130,000</td>
</tr>
</tbody>
</table>

Available-for-Sale Securities:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market 12/31/11</th>
<th>Market 12/31/12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y Company</td>
<td>$420,000</td>
<td>$360,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Z Company</td>
<td>100,000</td>
<td>120,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Total</td>
<td>$520,000</td>
<td>$480,000</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

Less than one percent of each of the five companies is owned by Lux.
1. Give the journal entries necessary to record the valuations for both trading and available-for-sale securities at December 31, 2011, and 2012.

2. What net effect would these valuations have on 2011 and 2012 net income?

**Problem 14-3 (LO7)** Lee Company had the following portfolio of securities at the end of its first year of operations:

<table>
<thead>
<tr>
<th>Year-End Security</th>
<th>Classification</th>
<th>Cost</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Trading</td>
<td>$18,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>B</td>
<td>Trading</td>
<td>$25,000</td>
<td>$27,000</td>
</tr>
</tbody>
</table>

1. Provide the journal entry necessary to adjust the portfolio of securities to market value.

2. Awhile after adjusting the securities to the end-of-year market, Lee elects to reclassify Security B as an available-for-sale security. On the date of the transfer, Security B's market value has decreased to $26,500. Provide the journal entry to reclassify Security B.

**Solutions, Approaches, and Explanations**

**MC14-1**

**Answer:** a

**Approach and explanation:** Debt securities can be choices a, b, and c. Equity securities can be choices b, c, and d. Therefore, the only choice that is a possibility for debt, but not for equity, is choice a. Equity securities never mature so they can’t be held until maturity even if the holder plans to never sell them.

**MC14-2**

**Answer:** c

**Approach and explanation:** Choice a could be correct, but that isn’t always the case. For instance, if a company purchases 3 percent of the shares in Microsoft, they may intend to always vote those shares, but they still don’t have enough influence in the company for the equity method to be used under GAAP.

Choice b could also be correct, but that isn’t always the case. Again, a company could purchase enough shares to ensure sources of supply but not enough shares (a 20 percent interest) for the equity method of accounting to be required. If it takes more than 50 percent ownership to ensure the supply of raw materials, then that goes well beyond the minimum needed for use of the equity method.

“Significant influence” is the 20 percent threshold that causes the equity method to kick in. Hence, choice c is the correct one.
Choice \(d\) is beyond the minimum. Once an investment has reached “control” (more than 50 percent ownership), consolidation of financial statements is required. This can be 30 to 80 percent more ownership than the minimum required for usage of the equity method.

**MC14-3**

Answer: b

Approach and explanation: When a security sells at a number other than 100, the difference is not attributable to interest. Instead, it has to do with the change in market interest rates since the securities were originally issued. If the security was held to maturity, 100 would be paid (not 102 in this case). But since these securities are trading securities, they are recorded at cost—not at the maturity value with a premium. Therefore, choice \(a\) is incorrect.

Since two months’ worth of interest has accrued on this investment, the new investor (Chesnut, Inc.,) will be paying not only 102 percent of the maturity value but also two months of interest, or $2,000. Therefore, the total amount paid in cash is $104,000—not $102,000. Thus, choices \(c\) and \(d\) can be eliminated.

Another answer that would have been correct is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Trading Securities</td>
<td>102,000</td>
</tr>
<tr>
<td>Interest Revenue</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>104,000</td>
</tr>
</tbody>
</table>

Had the original entry been made in the above format and the security was still being held on July 1, 2011, then the July 1 entry would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>6,000</td>
</tr>
<tr>
<td>Interest Revenue</td>
<td>6,000</td>
</tr>
</tbody>
</table>

That would leave a net amount in Interest Revenue of $4,000, which is the amount earned \((12\%/12 \text{ months in a year} \times 4 \text{ months} \times $100,000)\) for the period March 1 to July 1.

**MC14-4**

Answer: b

Approach and explanation: Available-for-sale securities are the “normal” investments of most companies. The accounting for dividends received is simple. Debit Cash and credit Dividend Revenue. That is it. There are no adjustments to the Investment in Available-for-Sale Securities account, when the equity method is not used, when dividends are received, or when the investee reports its profit.
**MC14-5**

Answer: c  
Approach and explanation: Choice a is sometimes correct. But marketable equity securities includes not only trading securities but also available-for-sale securities, which are not reported on the income statement until sold. Therefore, choice c is the best choice.

Choice b could never be correct as changes in the fair value of available-for-sale securities are reported only on the balance sheet.

Changes in the fair value of held-to-maturity securities are not reported anywhere. Interest income is received on held-to-maturity securities only. If they are sold before maturity, only then would something appear on the income statement.

**MC14-6**

Answer: d  
Approach and explanation: Sometimes you are given more data than you need to solve a problem. This is to test your ability to focus on the correct details and omit the “noise”—a required task in your accounting career. Since the actual question you are answering deals only with security Z, cross out securities X and Y so that you don’t accidentally use the numbers for them in your calculation.

Even though the question only asks for the entry to record the sale, it may be useful to write out all of the entries for security Z to make sure that your bases are covered. They would be as follows:

During 2011:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Trading Securities</td>
<td>32,000</td>
</tr>
<tr>
<td>Cash</td>
<td>32,000</td>
</tr>
</tbody>
</table>

End of 2011:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Loss on Trading Securities</td>
<td>4,000</td>
</tr>
<tr>
<td>Market Adjustment—Trading Securities</td>
<td>4,000</td>
</tr>
</tbody>
</table>

December 31, 2012:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>34,000</td>
</tr>
<tr>
<td>Market Adjustment—Trading Securities</td>
<td>4,000</td>
</tr>
<tr>
<td>Realized Gain on Sale of Trading Securities</td>
<td>2,000</td>
</tr>
<tr>
<td>Investment in Trading Securities</td>
<td>32,000</td>
</tr>
<tr>
<td>Unrealized Gain on Trading Securities</td>
<td>4,000</td>
</tr>
</tbody>
</table>
Going through all of the journal entries above may help you to avoid the pitfall of picking choice a, which at first glance looks like a good choice. After all, if the security was written down by $4,000 in 2011, shouldn’t the realized gain be $6,000? No. The realized gain is always the difference between cost and sales price, even if the security has been written up or down (or both) in the interim.

Two things have to come off the books when the sale is made: the original investment account and the Market Adjustment account. The Market Adjustment account is a contra-asset account if it has a credit balance. Similar to Accumulated Depreciation, it must be removed when the asset associated with it is no longer owned by the company. It must be removed if it has a debit balance (with a credit) as well.

**MC14-7**

Answer: c

Approach and explanation: Again, it’s a good idea to write out all of the journal entries—especially if you are having problems coming up with what the entry on the conversion is.

**May 2010:**

| Investment in Available-for-Sale Securities | 450,000 |
| Cash | 450,000 |

**December 31, 2010:**

| Unrealized Decrease in Value of Available-for-Sale Securities | 150,000 |
| Market Adjustment—Available-for-Sale Securities | 150,000 |

**July 2011:**

| Investment in Trading Securities (at FMV) | 345,000 |
| Market Adjustment—Available-for-Sale Securities | 150,000 |
| Unrealized Loss on Transfer of Securities | 105,000 |
| Investment in Available-for-Sale Securities | 450,000 |
| Unrealized Decrease in Value of Available-for-Sale Securities | 150,000 |
The major difference between MC14-7 and MC14-6 is that the account “Unrealized Decrease (or Increase as the case may be)…” is a balance sheet account, whereas “Unrealized Loss (or Gain as the case may be)…” is an income statement account for trading securities. Therefore, when a security is moved from available for sale to trading, three balance sheet accounts must be removed: the Investment in Available-for-Sale Securities account, the Market Adjustment—Available-for-Sale Securities account, and the Unrealized Decrease in Value of Available-for-Sale Securities account. In MC14-6, with trading securities, there are only two balance sheet accounts that must be removed if a trading security is sold or converted into another category.

MC14-8
Answer: c
Approach and explanation: There are three key items to pull out of the question. The first is that the equity method is being used, so KatWok’s income is going to affect Omar’s income. The second is that no cash was received by Omar from KatWok. The third is that the indirect method is being used for the statement of cash flows.

With those factors in mind, you should then proceed to analyze the effects on the three kinds of activities. When cash isn’t being paid or received, the Investing Activities and Financing Activities sections will not be affected. That isn’t always, or even usually, the case for the Operating Activities section when the indirect method is being used. Remember from a prior chapter that the Operating Activities section starts with net income and adjusts for noncash related items that affected net income.

Depreciation expense is the most common adjustment, using the indirect method, to the Operating Activities section. It is always a positive adjustment because depreciation expense reduces net income but does not reduce cash. Something similar, but going in the opposite direction, is happening here. Omar Company is including $150,000 in net income under the equity method but isn’t receiving any cash. Therefore, the $150,000 should be backed out of net income, with a deduction, to begin to arrive at actual operating cash flow.

MC14-9
Answer: a
Approach and explanation: The question is asking for the statement that is not true, so make sure to carefully read each choice and identify three as true and one as false. Cross the ones that you are sure are true off to help narrow your choices.

Held-to-maturity securities are usually classified as noncurrent. However, if they are coming due in the next year, they should be classified as current. Therefore, choice b is true. Cross it off.
Available-for-sale securities can be classified as current or noncurrent depending on management’s intent. If they are being held for immediate sale, then they should be put in the trading securities category. However, if they aren’t being held for immediate sale but, instead, are going to be sold in six months to pay for a debt coming due at that time, then they should be classified as current and remain in the available-for-sale category. Therefore, both choices c and d are correct and should be crossed off the list of viable choices.

Trading securities, by definition, are going to be sold in the near future—much less than a year—so they will always be current. If management intends to wait a year to sell some trading securities, then the trading securities should be reclassified as available-for-sale securities. Choice a is, therefore, not true and the correct answer.

MC14-10
Answer: d

Approach and explanation: Choice a could be correct, in some instances, but only if the required payment indicated that it was probable that the creditor will be unable to collect. If, instead, the required payment is just late and all the amounts are still expected to be collected, then no impairment of the loan need be made.

Choice b is a correct statement, but it has nothing to do with loan impairment. The present value of any loan is less than the total of the future payments since present values are smaller numbers than future values or the future amounts involved in a cash flow (annuity).

Matching 14-1
1. c
2. j
3. g
4. b
5. a
6. h
7. d
8. f
9. i
10. e

Complete these terminology matching exercises without looking back at the textbook or on to the glossary. After all, you probably won’t have those as a reference at test time. Learning through trial and error causes the item to be learned better and to stick in your memory longer than if you just look at the textbook, glossary, or a dictionary and “cook book” the answers. Sure you may get the answer correct on your first attempt, but missing something is sometimes best for retention. Don’t be afraid of failure while studying and practicing.
Problem 14-1
1. Investment in Available-for-Sale Securities 1,300,000
   Cash 1,300,000
   Cash 3,200\textsuperscript{a}
   Dividend Revenue 3,200
   Unrealized Decrease in Value of Available-for-Sale Securities 50,000\textsuperscript{b}
   Market Adjustment—Available-for-Sale Securities 50,000
\textsuperscript{a}$160,000 \times 0.02 = $3,200$
\textsuperscript{b}$[10,000 \text{ shares} \times ($1,300,000/10,000 - $125)] = $50,000$

2. Investment in Ryan Services, Inc. 1,300,000
   Cash 1,300,000
   Cash 35,200\textsuperscript{a}
   Investment in Ryan Services, Inc. 35,200
   Investment in Ryan Services, Inc. 72,600\textsuperscript{b}
   Income from Investment in Ryan Services, Inc. 72,600
\textsuperscript{a}$160,000 \times 0.22 = $35,200$
\textsuperscript{b}$330,000 \times 0.22 = $72,600$
Problem 14-2

1. 2011
   Dec. 31 Unrealized Loss on Trading Securities 20,000
       Market Adjustment—Trading Securities 20,000
   31 Unrealized Decrease in Value of Available-for-Sale Securities 40,000
       Market Adjustment—Available-for-Sale Securities 40,000

2012
   Dec. 31 Market Adjustment—Trading Securities 4,000
       Unrealized Gain on Trading Securities 4,000
   31 Unrealized Decrease in Value of Available-for-Sale Securities 240,000
       Market Adjustment—Available-for-Sale Securities 240,000

2. The effect of the valuation entries on 2011 net income is that there would be a recognized decline of $20,000 in the value of the trading securities. The effect of the valuation entries on 2012 net income is that there would be a recognized increase of $4,000 in the value of the trading securities. Net income is not affected by the change in value of the available-for-sale securities.
Problem 14-3
1. Market Adjustment—Trading Securities 7,000
   Unrealized Gain on Trading Securities 7,000

2. Investment in Available-for-Sale Securities—
   Security B 26,500
   Unrealized Loss on Transfer of Securities 500
   Investment in Trading Securities—Security B 25,000
   Market Adjustment—Trading Securities 2,000

The entry reclassifies the security as available-for-sale at the current fair value of $26,500 and removes the historical cost of the trading security of $25,000.

Unrealized Loss on Transfer of Securities represents the difference between the fair value at the beginning of the period (the last time the security was adjusted to market) and the fair value on the date of transfer. This amount is reported on the income statement. Future market adjustments will not be reported on the income statement now that this is an available-for-sale security. Rather, they will show up on the balance sheet in the Owner’s Equity section as Unrealized Increase (Decrease) in Value of Available-for-Sale Securities.

Glossary

Note that Appendix C in the rear portion of the textbook contains a comprehensive glossary for all of the terms used in the textbook. That is the place to turn to if you need to look up a word but don’t know which chapter(s) it appeared in. The glossary below is identical with one major exception: It contains only those terms used in Chapter 14. This abbreviated glossary can prove quite useful when reviewing a chapter, when studying for a quiz for a particular chapter, or when studying for an exam which covers only a few chapters including this one. Use it in those instances instead of wading through the 19 pages of comprehensive glossary in the textbook trying to pick out just those words that were used in this chapter.

available-for-sale securities Investment securities not intended for immediate trading but, in the case of debt securities, not intended to be held until maturity.
control The ability of an investor to decisively influence the operating, investing, and financing decisions made by an investee.

debt securities Financial instruments issued by a company that typically have the following characteristics: (1) a maturity value, (2) an interest rate (either fixed or variable) that specifies the periodic interest payments, and (3) a maturity date.
derecognition  The process of designing QSPEs (qualifying special purpose entity) to use as financing vehicles to get cash through borrowing without showing the borrowing on the balance sheet.

equity method  The method of accounting for long-term investments in the stock of another company where significant influence exists (generally, 20%–50% ownership); the initial investment is recorded at cost but is increased by a proportionate share of investor’s income and decreased by dividends and a proportionate share of losses to reflect the underlying claim by the investor on the net assets of the investee company.

equity method securities  Equity securities purchased with the intent of being able to control or significantly influence the operations of the investee.

equity securities  Securities that represent ownership in a company. These shares of stock typically carry with them the right to collect dividends and to vote on corporate matters.

held-to-maturity securities  Debt securities purchased by a company with both the intent and ability to hold the securities to maturity.

parent company  A company that exercises control over another company, known as a subsidiary, through majority ownership (more than 50%) of the subsidiary’s voting stock.

significant influence  The ability of an investor to impact the operating, investing, and financing decisions of an investee but not absolutely determine those decisions.

subsidiary company  A company that is owned or controlled by another company, known as the parent company.