Question #1 of 92

Question ID: 1208777

Under IFRS, where an investor owns a significant number (39%) of the voting shares of an investee but has no involvement in policy making and no Board of Directors' representation, which of the following investment classifications is *most* appropriate to characterize the situation?

A) Investment in associates.

B) Significant influence.

C) Investment in financial assets.

Explanation

Investment in financial assets is the correct classification here because there is no significant influence (i.e. no involvement in policy marking, no Board of Directors' representation). Although the ownership interest level is significant at 39% (it is between 20% and 50%), the lack of control classifies the investment as an investment in financial assets.

Significant influence is not in investment classification per se. It is a measure of relative degree of influence.

(Study Session 5, Module 13.1, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #2 of 92

Question ID: 1208824

When comparing companies that hold equity investments in other corporations, which of the following statements is *most* accurate? All else being equal, return on asset measures for a firm using the acquisition method will appear:

A) same as for a comparable firm using the equity method.

B) more favorable than those for a comparable firm using the equity method.

C) less favorable than those for a comparable firm using the equity method.

Explanation

All else being equal, return on asset measures for a firm using consolidation will appear less favorable than those for a comparable firm using the equity method. This is because the choice of accounting method will affect the book value of assets, while the level of net income remains the same.

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #3 of 92

Question ID: 1208770

Accounting standards for intercorporate investments establish different categories of securities with distinct ways of treating them on the financial statements of the company. One category requires the securities to be carried at fair value on the balance sheet with unrealized gains and losses excluded from the income statement. This category of security classification is called debt:

A) and equity securities classified as fair value through OCI.

B) and equity classified as fair value through P&L securities.

C) securities classified at amortized cost.

Explanation

If securities are designated as debt and equity securities classified as fair value through OCI they are to be carried at fair value on the balance sheet with unrealized gains and losses excluded from the income statement (but go into equity via OCI).

(Study Session 5, Module 13.1, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #4 of 92

Question ID: 1208815

Under IFRS rules, which of the following accounting treatments is *most* preferred for joint ventures where there is shared control?

A) Acquisition method.

B) Proportionate consolidation method.

C) Equity method.

Explanation

Only equity method is now permitted under both IFRS and U.S. GAAP.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Omricon Capital Associates specializes in making investments in the small cap market sector. In some cases the firm operates as a supplier of private equity for restructurings. In this instance, the firm views itself as having a value investment focus. In others, it acts as a venture capital firm. Here, the investment focus is usually growth. Finally, in some cases it simply takes passive investment positions in publicly-traded firms. The positions in marketable securities are sometimes considered trading positions, and other times the view is to hold for a longer period until valuation parameters are met or exceeded.

Omricon's chief compliance officer, Raymond "Buzz" Richards has recently become concerned that the firm may not be correctly following the relevant accounting standards for these investments. To ensure that the rules are being effectively adhered to, he is seeking advice from the accounting firm of Merz-Brokaw and Associates on the matter. Sally Lee is the Merz-Brokaw partner heading up the consulting team assigned to review the situation.

The size of the investments ranges from a few percent of the firm's outstanding equity, to positions of greater than 50%. Richards says that it has always been his understanding that the percentage of the equity held is the major determinant with respect to which accounting method applies. Lee reminds him that the firm's intent for its investments also plays a role in determining how they are accounted for.

Some of the firm's investments have not worked out as planned. Richards has conferred with the firm's portfolio managers regarding securities being held by the firm that are worth less than when they were acquired, and has presented a list of these investments to Lee. His concern is what this implies for the accounting for these investments. Lee tells him that the issue here is whether or not the security can be considered impaired, and that designating a security as impaired implies that the decline in value is permanent.

Top managers at Omricon have asked Lee to help them evaluate the impact of the choice of accounting method on the firm's profitability. Some members of the management team are of the belief that the accounting method does not affect financial measures because these are driven by underlying economic factors. Others believe that these measures can be affected by the accounting method chosen.

Question #5 - 7 of 92

Question ID: 1208800

Assuming no significant influence exists, which of the following statements concerning percentage ownership and accounting method is *most* accurate?

A) When the ownership is less than 20%, both US GAAP and IFRS require the equity method.

B) When the ownership is less than 20%, US GAAP requires the investment in financial assets method, IFRS the equity method.

C) When the ownership is less than 20%, both US GAAP and IFRS require the investment in financial assets method.

Explanation

When the percentage ownership is less than 20% (with no significant influence over the investee firm), both US GAAP and IFRS require the investment in financial assets method.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #6 - 7 of 92

Question ID: 1208810

For instances in which Omricon holds exactly 50% of the outstanding equity of the investee firm's equity (i.e., the investee firm is a joint venture), which of the following statements is *most* accurate?

A) IFRS requires that the equity method be used; US GAAP permits a choice between the equity method and proportional consolidation.

B) Both US GAAP and IFRS require that the equity method be used.

C) IFRS and US GAAP both permit a choice between the equity method and proportional consolidation.

Explanation

Equity method is required accounting method under both IFRS and U.S. GAAP for joint ventures.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #7 - 7 of 92

Question ID: 1208811

Relative to consolidation, using the equity method of accounting for investments results in:

A) ROA being higher and leverage being higher than under consolidation.

B) ROA being lower and leverage being higher than under consolidation.

C) ROA being higher than under consolidation.

Explanation

Since consolidation results in inclusion of investee's assets in the investor's balance sheet, the total assets would be higher under consolidation as compared to equity method. Net income is same under either methods. ROA would be higher under equity method as compared to under consolidation. Leverage effects will depend on the debt of the investee company. Under consolidation, all of investee's debt would be included in investors balance sheet. However, total equity in the consolidated balance sheet will also be higher due to inclusion of minority interest.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

On January 9, 2006, Company X paid $2,000,000 for 100,000 shares of stock in Company S. Originally the company classified the shares as fair value through OCI. As of December 31, the stocks were valued at $2,200,000. In 2006, Company S had earnings per share of $0.90 and paid dividends per share of $0.20. In late December 2006 the company wonders what would be the change if the company had classified the shares as fair value through P&L.

Question #8 - 9 of 92

Question ID: 1208793

What is the impact if the company had originally classified the shares as fair value through P&L on the value of the assets of Company X?

A) $200,000.00

B) $0.00

C) $70,000.00

Explanation

If the company had originally classified the shares as fair value through P&L, the value of the assets would be the same (i.e., fair value) but the net income would have been different.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

[SchweserNotes - Book 2]

Question #9 - 9 of 92

Question ID: 1208794

If the shares were classified as fair value through P&L, what would have been the impact on the income and the stockholders' equity of Company X?

A) Income will rise by $200,000, but stockholders' equity will not change.

B) Income and stockholder's equity will rise by $200,000.

C) Stockholders' equity will rise by $200,000, but income will not change.

Explanation

The unrealized gain of $200,000 would have been reported on the income statement. Assets and equity would be the same under either classification.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #10 of 92

Question ID: 1208841

Under which of the following is a minority interest account *most likely* to appear on the consolidated balance sheet?

I. The acquisition method.
II. Equity method.

A) I only.

B) Both I and II.

C) II only.

Explanation

Minority interest is included in the parent's company's equity under consolidation method only.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

Question #11 of 92

Question ID: 1208862

Which of the following statements about variable interest entities (VIE) are correct or incorrect?

Statement #1:	One potential benefit of a VIE is a lower cost of capital since the assets and liabilities of the VIE are isolated in the event the sponsor experiences financial difficulties.
Statement #2:	The organizational form of a VIE must be either a partnership or a joint venture and it is necessary for the VIE to have separate management and employees.

A) Both are correct.

B) Both are incorrect.

C) Only one is correct.

Explanation

Statement #1 is a correct statement. A lower cost of capital is a potential benefit of forming a VIE. Statement #2 is an incorrect statement. The organizational form can be a corporation, partnership, joint venture or trust. It is *not* necessary for the VIE to have separate management and employees.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

On December 15, 2009, the Zeisler Company faces a financial crisis. Zeisler's industry has gone into recession and net income has declined to nearly zero. Jeremiah Welch, the company's CFO, is extremely concerned that, when the final figures for 2009 come in, the poor operating results will throw the firm into violation of its debt covenants, which specify that it must meet a certain return on assets (ROA) and not exceed a certain debt-to-asset ratio. A violation of either covenant would trigger a provision in the lending agreement allowing lenders to put Zeisler's debt back to the firm and likely force Zeisler into bankruptcy.

With only two weeks before the close of the firm's fiscal year on December 31, there is no way to avoid bankruptcy through improved operations. Welch calls an emergency meeting with Olivia Dupree, the firm's controller, to come up with a plan of action to keep Zeisler out of bankruptcy. He explains to Dupree that they need to increase Zeigler's reported ROA and reduce its reported debt-to-assets ratio relative to the numbers that would otherwise be reported for 2009.

Dupree suggests that Zeisler's equity investments might be useful in staving off bankruptcy. Zeisler acquired 100,000 shares of the Market Square Corporation on January 1, 2009, at $25 per share. Market Square paid dividends during 2009 of $1.50 per share and was expected to have earnings for 2009 of $2.50 per share. Zeisler also holds 250,000 shares of General Nuclear, purchased for $72 per share. General Nuclear has no dividends and is expected to report a loss for 2009. Both securities are classified on the financial statements as FVOCI.

Dupree added that Zeisler also holds several million dollars of Market Square's debt securities, classified at amortized cost. The holding in Market Square represents a small fraction of Zeisler's total fixed-income investments, all of which are also classified at amortized cost. The investment in Market Square's debt differs significantly from Zeisler's other investments in fixed-income securities in that Market Square's debt is trading slightly above Zeisler's cost while Zeisler's other fixed-income investments are all trading significantly below Zeisler's cost because of a general increase in market interest rates. Welch points out, however, that even if the firm were to sell all its marketable securities, the proceeds would not be sufficient to pay off the debt and avert bankruptcy.

Dupree left the meeting with Welch for a moment to check the stock market. She found that Market Square was trading at $35 per share and General Nuclear was at $43. This new information gave Dupree an idea.

Dupree suggested to Welch, "We could classify our equity investment in Market Square as FVPL before year-end. That will help raise our ROA for this year." Welch pointed out that a classification of the equity investment as FVPL instead of FVOCI would reduce Zeisler's reported net income because the firm would be required to stop including the dividends it receives from Market Square in net income.

Question #12 - 16 of 92

Question ID: 1208787

What is the investment income that Zeisler Company will report for the year 2009 on its investment in Market Square Corporation shares if it continues to account for the shares as an FVOCI investment?

A) $200,000.00

B) $250,000.

C) $150,000.

Explanation

The investment income includes dividends, interest, and realized gains. In this case, the investment income from Market Square Corporation would be the dividends it paid to the number of shares Zeisler owns:

100,000 shares × $1.50 per share = $150,000.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #13 - 16 of 92

Question ID: 1208788

If Zeisler were to account for the Market Square Corporation shares as FVPL, assuming that the securities do not change in value between the December 15th meeting and the end of the year, the carrying amount of these shares on Zeisler's December 31, 2009 balance sheet would be:

A) $2.75 million. ✗

B) $2.50 million. ✗

C) $3.50 million. ✓

Explanation

Regardless of the FVOCI or FVPL classification, securities are carried at fair market value:

100,000 shares × $35 per share = $3,500,000.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #14 - 16 of 92

Question ID: 1208789

If Zeisler reclassified the common stock of General Nuclear as FVPL, what effect would it have on Zeisler's 2009 income statement?

A) None, reclassification is prohibited under IFRS 9. ✓

B) Net income would increase. ✗

C) Reclassifying the security would have no effect on the income statement because gains and losses would be recognized in equity.

Explanation

Initial designation for equity securities is irrevocable under IFRS 9 and hence reclassification is prohibited.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #15 - 16 of 92

Question ID: 1208790

Regarding the statements made by Dupree and Welch about reclassifying Zeisler's equity investment in Market Square to FVPL (assuming it is allowed):

A) Welch's statement is correct; Dupree's statement is incorrect.

B) Welch's statement is incorrect; Dupree's statement is incorrect.

C) Welch's statement is incorrect; Dupree's statement is correct.

Explanation

Welch's statement is incorrect because dividends and interest are recognized as income both under FVPL and FVOCI classifications.

Dupree's statement is correct. If the securities were originally classified as FVPL, it will significantly raise Zeisler's near-zero net income by allowing Zeisler to recognize the unrealized gain in income when the security is reclassified. It will have no material effect on asset value because the shares will be carried at fair market value regardless of the classification. Consequently, the equity securities of Market Square would help increase Zeisler's ROA by raising net income and having little effect on assets.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #16 - 16 of 92

Question ID: 1208791

If Zeisler were to account for the Market Square Corporation shares using the equity method, assuming that the securities do not change in value between the December 15th meeting and the end of the year, the carrying amount of these shares on Zeisler's December 31, 2009 balance sheet would be:

A) $2.75 million.

B) $3.50 million.

C) $2.60 million.

Explanation

Under the equity method the market value of the stock is ignored but the proportionate share of the earnings are added to the original investment and the proportionate share of the dividends are subtracted from the earnings. Hence, we have the original investment + (earnings − dividends) = total value of the investment.

[(100,000 shares)($25)] + [(100,000 shares)($2.50 earnings − 1.50 dividend)] = $2,600,000.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Prior to 2007, Company X (reporting under U.S. GAAP) had never made any acquisitions of other companies. However, on January 2, 2007, it went on a buying spree, purchasing 10% of Company A for $10,000; 30% of Company B for $20,000; 40% of Company C for $80,000; and 70% of Company D for $168,000.

Below are the balance sheets for the five companies (in thousands) just prior to the purchase.

Company	***X***	***A***	***B***	***C***	***D***
Cash	400	10	20	30	40
Other assets	1,600	90	180	270	360
Total assets	2,000	100	200	300	400
Liabilities	300	40	80	120	160
Equity	1,700	60	120	180	240
Total	2,000	100	200	300	400

During 2007, the companies generated the following sales, income, and dividends:

Company	***X***	***A***	***B***	***C***	***D***

Revenue	2,000	100	200	300	400
Net income	200	10	20	30	40
Dividends		4	8	12	16

The company accounts for the acquisitions based on typical ownership proportion guidelines. Investment in financial assets are classified as FVOCI.

Question #17 - 22 of 92

Question ID: 1208843

After the acquisitions, the other assets reported by Company X will be:

A) $1,962,000.00

B) $2,070,000.00

C) $1,878,000.00

Explanation

Company X will treat the acquisition of Company A as an investment in financial assets, the acquisitions of Companies B and C using the equity method, and the acquisition of Company D using the acquisition method. The investments in Companies A, B, and C, will be reported, while Company D's financial statements will be consolidated with Company X. The other asset balance will be the starting balance plus the investments in Companies A, B, and C, plus the other asset amount for Company D, which equals 1,600,000 + 10,000 + 20,000 + 80,000 + 360,000 = 2,070,000.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #18 - 22 of 92

Question ID: 1208844

After the acquisitions, the liabilities reported by company X will be:

A) $480,000.

B) $460,000.

C) $300,000.

Explanation

Liabilities will be equal to the starting balance plus the liability balance for Company D, which equals 300,000 + 160,000 = 460,000.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #19 - 22 of 92

Question ID: 1208845

After the acquisitions, minority interest reported by Company X will be:

A) $0.

B) $72,000.

C) $168,000.

Explanation

Minority interest will be equal to the proportion not owned of Company D multiplied by the equity of Company D, which is (1 − 0.7) × 240,000 = 72,000.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #20 - 22 of 92

Question ID: 1208846

Company X will report revenue for 2007 of:

A) $2,280,000.

B) $2,400,000.

C) $2,000,000.

Explanation

Revenues will equal the revenue of Company X and D, which is 2,000,000 + 400,000.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #21 - 22 of 92

Question ID: 1208847

Company X will report income for 2007 of:

A) $247,000.

B) $246,400.

C) $258,400.

Explanation

Income will equal the income of X, plus 10% of the dividends for A, plus 30% of the income of B, plus 40% of the income of C, plus the income of D less the minority interest, which is 200,000 + (0.1 × 4,000) + (0.3 × 20,000) + (0.4 × 30,000) + (40,000) − (0.3 × 40,000) = 246,400.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #22 - 22 of 92

Question ID: 1208848

The change in the investment in the associates account (the account that reflects all non-consolidated investments in other companies) between January 3 and December 31 is:

A) $27,600.

B) $11,400.

C) $10,800.

Explanation

The investment in the associates account will increase from the proportionate income of Companies B and C, and will decrease from the dividends received from Companies B and C. The changes will be (0.3 × 20,000) + (0.4 × 30,000) − (0.3 × 8,000) − (0.4 × 12,000) = 10,800.

(Study Session 5, Module 13.5, LOS 13.a)

Related Material

SchweserNotes - Book 2

On January 9, 20X6, Company X, reporting under IFRS, purchased $1,000,000 of government bonds at par and 100,000 shares of stock in Company S for $2,000,000. The stock investment was held at fair value through OCI while the bonds were held at amortized cost.

As of December 31, the bonds were valued at $900,000, and the stocks were valued at $2,200,000. The bonds paid $50,000 of interest and the stocks paid $20,000 of dividends. In 2006, Company S had earnings per share of $0.90.

Question #23 - 27 of 92

Question ID: 1208781

The marketable securities balance amount shown on the balance sheet is:

A) $3,000,000.00

B) $3,100,000.00

C) $3,200,000.00

Explanation

The bonds are classified as debt securities at amortized cost. Since the bonds were purchased at par, the amortized cost = cost (par). The stocks are valued at market value.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #24 - 27 of 92

Question ID: 1208782

The impact of the investment in financial assets on net income is:

A) $70,000.

B) $140,000.

C) $270,000.

Explanation

The bonds are classified at amortized cost, and the income generated from them is $50,000. The stocks are classified as fair value through OCI, and reported at fair value on the balance sheet. The unrealized gain is reported in equity as part of OCI and not on the income statement. The effect of the stocks on income is the $20,000 of dividends.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #25 - 27 of 92

Question ID: 1208783

In late 2006, Company X decided to reclassify the investments in stock. What classification can the company classify the investment in stocks to?

A) Reclassification would not be allowed.

B) Fair value through profit or loss only.

C) fair value through profit or loss or amortized cost.

Explanation

The initial choice of classification into fair value through OCI is irrevocable and reclassification is not allowed for equity securities.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #26 - 27 of 92

Question ID: 1208784

The appropriate classification for the investment in government bonds would be:

A) Amortized cost, fair value through OCI, or fair value through profit or loss.

B) Amortized cost or fair value through profit or loss.

C) Amortized cost or fair value through OCI.

Explanation

Under IFRS 9 debt securities can be classified at amortized cost (if they meet business model and cash flow characteristic test), fair value through OCI, or fair value through profit or loss.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #27 - 27 of 92

Question ID: 1208785

Assuming that the investments were initially classified as fair value through profit or loss. The company can reclassify:

A) Debt security only if the business model has changed.

B) Equity security but only into fair value through OCI.

C) Both debt and equity securities into fair value through OCI.

Explanation

Reclassification of equity securities under the standards is not permitted as the initial designation (FVPL or FVOCI) is irrevocable. Reclassification of debt securities from amortized cost to FVPL (or vice versa) is permitted only if the business model has changed.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #28 of 92

Question ID: 1208833

Which of the following methods of accounting for investments will reflect the highest assets and liabilities on a company's balance sheet?

A) Acquisition method.

B) Equity method.

C) Both methods result in reporting the same balances for assets and liabilities.

Explanation

The consolidation method will reflect the highest assets and liabilities. The equity method would reflect the lowest.

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #29 of 92

Question ID: 1208807

Harter Company recently acquired a 40% stake in Compton Corp. for $40 million in cash by borrowing at 10%. Harter will account for this acquisition using which of the following methods:

A) Acquisition Method.

B) Equity method.

C) Held to maturity debt securities method.

Explanation

The 40% ownership stake would indicate that significant influence has been gained over the affiliate company. The equity method would be used.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #30 of 92

Question ID: 1208804

Company A acquired a 50% stake in Company T on January 1, 2003 by paying T's shareholders $100,000 in cash. Pre-acquisition balance sheets for the two firms are presented below:

Balance Sheet		
	Company A	***Company T***
Current assets	$400,000	$60,000
Fixed assets	600,000	100,000
Total	$1,000,000	$160,000
Current liabilities	$50,000	$ 30,000
Common stock	350,000	60,000
Retained earnings	600,000	70,000
Total	$1,000,000	$160,000

The fair values of company T assets and liabilities was same as the book value. Company A reports under U.S. GAAP. What are the post-acquisition balance sheet values for total assets for Company A under the equity and acquisition methods of accounting respectively?

A) $1,000,000 and $1,095,000.

B) $1,060,000 and $1,095,000.

C) $1,000,000 and $1,130,000.

Explanation

Using the equity method will result in a decrease of the current asset account to $300,000 because of the cash outflow. However, a new non-current asset called "Investment in Company T" will be added to the balance sheet. This amount will be $100,000, so the total assets will remain unchanged. Under U.S. GAAP, only full goodwill is allowed. Full goodwill = fair value of company T – Book value of company T. Fair value of company T = (100,000 / 0.50 = 200,000). Book value of company T = 130,000 (total stock holder's equity = common stock + retained earnings). Goodwill = 70,000. Under acquisition, total assets will be $1,130,000 (70,000 + 400,000 + 60,000 + 600,000 + 100,000 – 100,000).

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Evergreen Brothers is a large producer of bedding plants and shrubs that are sold to various retail nurseries and home improvement stores located across the western coast of the United States with approximately $85 million in annual sales. Evergreen grows its products at two facilities, one in Northern California and the other in the Southern part of the state. Each production facility currently distributes its products within an approximate 150 mile radius of its location. All aspects of the shipping and delivery of products have historically been provided by an independent, third-party distribution company.

Because of impressive growth in the company's sales over the past several years, management has decided to pursue plans to bring "in-house" the distribution of the company's products. They believe that the projected decreased freight costs as well as the increased efficiencies in more actively managing the distribution of their production should immediately yield increased profit margins. As an initial step, Evergreen has negotiated the price for ten delivery trucks, which could provide all distribution capacity needed for the company's Northern production facility for the upcoming season. Current plans are to continue the use of the independent distribution company for the needs of the firm's Southern facility for at least the next several years.

Under advice from the company's CFO, Evergreen has created a new special purpose entity (SPE), QuickTime, Inc., which will serve as the entity that will purchase the trucks from the dealer. The purchase will be financed through a combination of debt and equity, with the dealer lending 75% of the total cost. The loan is collateralized by both the trucks and Evergreen's guarantee of the debt, as required by the dealer.

Evergreen has arranged for an outside investor to provide the remaining 25% of the upfront costs of the equipment in exchange for 100% of QuickTime's nonvoting stock. In addition, the outside investor is guaranteed an 8% annual return for the life of the financing term. At the end of seven years, QuickTime will be liquidated and Evergreen will have the option of purchasing the equipment for its fair value at that time. The proceeds of the liquidation will be used to repurchase the outside investor's stock at par value. In the event that the liquidation value is insufficient to buy back the outside investor's stock, Evergreen has committed to fund the shortfall.

Management has given its tentative approval of the project and the proposed structure. Questions remain, however, as to the effect of the creation of QuickTime on Evergreen's financial statements. With the relatively recent issuance of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities" (FIN 46(R)), the management of Evergreen has not had prior experience with the new consolidation requirements for SPEs.

Question #31 - 36 of 92

Question ID: 1208868

Which of the following statements regarding special purpose entities (SPEs) is *least* accurate?

A) In general, the equity investors in an SPE can expect to receive a limited rate of return on their investment in exchange for limited risk exposure.

B) An SPE can be formed to isolate specific assets from the sponsor, thus lowering the cost of capital by protecting the assets of the SPE in the event the sponsor

C) An SPE can be established as one of several legal forms, such as corporations, partnerships, or trusts, but must establish separate management from that of

Explanation

An SPE can take on one of many legal forms, but does not necessarily have to have separate management or employees from that of the sponsor.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #32 - 36 of 92

Question ID: 1208869

In exchange for providing lower-cost financing to an SPE, lenders typically require additional financial support from a sponsor, which may be in the form of additional collateral or guarantees. In return, the sponsor will typically receive which of the following risk and return profiles?

A) Pro-rata share of the actual returns on the project and a pre-determined fixed level of risk on the project.

B) Pro-rata share of the actual risks and returns on the project.

C) Pro-rata share of the actual risk and a pre-determined fixed rate of return on the project.

Explanation

By transferring the variability in the risk of a project to a sponsor, a lender can provide a lower cost of financing to the company that creates the SPE. In return, the sponsor will receive pro-rata profits or other residual interests in the project.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #33 - 36 of 92

Question ID: 1208870

According to FIN 46(R), if an SPE is to be considered a variable interest entity (VIE), it must meet which of the following conditions?

A) The equity investors in the VIE must bear all of the SPE's risk up to a pre-determined level as outlined in the governing documents.

B) The total at-risk equity of the SPE is not sufficient to finance the entity's activities without additional subordinated financial support.

C) The SPE must be consolidated by the primary beneficiary, whose status as primary beneficiary is defined by the level of the firm's percentage of voting

Explanation

To qualify as a VIE under FIN 46(R), any one of four conditions must be met, one of which is the presence of an insufficient at-risk equity investment.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #34 - 36 of 92

Question ID: 1208871

In order to be considered a VIE under FIN 46(R), an entity must meet certain conditions. Which of the following statements about QuickTime is *most* accurate? Under FIN 46(R), QuickTime is:

A) considered a VIE because outside investors share the residual gains and losses at liquidation with Evergreen.

B) considered a VIE because the outside investor's capital contribution is not sufficient to finance QuickTime's operations.

C) not considered a VIE because the outside investor does not have any decision making rights.

Explanation

The outside investor contributed 25% of the necessary capital, but this was not sufficient because the dealer additionally required Evergreen's guarantee in order to close the deal. This condition satisfies the requirements established by FIN 46(R) in order to be classified as a VIE.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #35 - 36 of 92

Question ID: 1208872

As outlined in FIN 46(R), the primary beneficiary of a VIE is that entity which meets which of the following conditions?

A) Has exposure to the majority of the loss risks or receives the majority of the residual benefits of the VIE.

B) Holds the majority voting control of the VIE and shares management with the VIE.

C) Holds the majority voting control of the VIE and has separate management from the VIE.

Explanation

Unlike past accounting treatments of VIEs where consolidation was based upon voting control, FIN 46(R) recognizes the primary beneficiary of a VIE as that entity that absorbs the majority of the risks and enjoys the majority of the benefits of the VIE. The primary beneficiary is required to consolidate the VIE on their financial statements.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #36 - 36 of 92

Question ID: 1208873

Assuming that QuickTime is considered a VIE in accordance with FIN 46(R), which of the following statements regarding the consolidation of QuickTime on Evergreen's financial statements is *most* accurate?

A) Evergreen is exposed to the majority of QuickTime's risks and rewards, so Evergreen must consolidate QuickTime on its financial statements.

B) The truck dealer is supplying the financing for the majority (75%) of QuickTime's debt, so Evergreen may not consolidate QuickTime on its financial statements.

C) Because the outside investor holds only nonvoting stock, Evergreen holds the majority controlling financial interest in QuickTime and must consolidate

Explanation

Before the issuance of FIN 46(R), consolidation was based upon possession of voting control of an entity. FIN 46(R) uses a risk/reward approach when determining which firm must consolidate the VIE on its financial statements. Since Evergreen is the sole entity exposed to variability in QuickTime's net income, as well asset value, QuickTime should be consolidated on their financial statements.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #37 of 92

Question ID: 1208839

The consolidation method results in:

A) same net income and shareholders' equity as the equity method.

B) same equity as the cost method.

C) same net income as the equity method but different shareholders' equity.

Explanation

Consolidation results in the **SAME** net income and higher equity as compared to the equity method.

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Birch Corporation is a large conglomerate based in the U.S. that has grown primarily through acquisition. On the first day of this reporting year, January 1, 2012, Birch acquired 1,500,000 shares of the common stock of TRQ Inc. TRQ Inc. produces high quality fabrics for use in the fashion industry. Exhibit 1 shows key numbers from TRQ Inc.'s accounts.

Exhibit 1 - TRQ Financial Statement Extracts

TRQ Inc	
Income – year ending 31 Dec 12	$700,000
Dividend paid	$210,000
Number of common shares in issue	6,000,000
Number preferred shares in issue	3,000,000
Total number of shares in issue	9,000,000

Both Birch and TRQ prepare their accounts using US GAAP.

Dan Fitzroy is the CFO of Birch, and is currently preparing with a meeting with the auditors to discuss the correct treatment of the TRQ investment in Birch's group accounts. Fitzroy is of the opinion that the equity method of accounting should be used for the following reasons:

1. The proportion of TRQ's common shares owned by Birch suggests that Birch has significant influence over TRQ's operations
2. The lack of ownership of preferred shares suggests that Birch has no significant influence over TRQ's operations
3. The proportion of TRQ's total shares owned by Birch suggests that Birch has significant influence over TRQ's operations

Fitzroy has to present to the board on the implications of the decision once he has spoken to the auditors. He intends to discuss the following impacts on the financial statements:

Impact One

If the auditors rule that the TRQ investment should be accounted for as a subsidiary rather than an associate, the group's liquidity ratios will be unaffected

Impact Two

If the auditors rule that the TRQ investment should be accounted for as a subsidiary rather than an associate, the group's net profit margin will be lower

Fitzroy also intends to ask the auditors about another potential acquisition that Birch may potentially make this year. The company under consideration is Tyrobin Inc., a small U.S. based company in the pharmaceutical industry.

Fitzroy has observed the note shown in exhibit two in the company's footnotes for last year. He is unsure how it would be accounted for in the event of a 100% acquisition of Tyrobin's share capital by Birch.

Exhibit Two – Tyrobin Footnote

Note 45 Contingent Liabilities

Tyrobin is involved in various legal proceedings considered typical to its business, including actual or threatened litigation and/or actual or potential government investigations relating to product liability, infringement of IP rights, the validity of certain patents and competition laws. All of the claims involve highly complex issues.

Often these issues are subject to substantial uncertainties and, therefore, the probability of a loss, if any, being sustained and an estimate of the amount of any loss is difficult to ascertain. Consequently, for a majority of these claims, it is not possible to make a reasonable estimate of the expected financial effect, if any, that will result from ultimate resolution of the proceedings.

Question #38 - 43 of 92

Question ID: 1208850

Assuming the equity method of accounting is used, what will be the reported investment income for Birch?

A) $115,000.00

B) $60,000.00

C) $175,000.00

Explanation

Under the equity method, dividends are not included as income to the acquirer. ($700,000 × 0.25) = $175,000 will be the reported investment income for Birch.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #39 - 43 of 92

Question ID: 1208851

Assuming the equity method of accounting is used, what will be the cash flow received by Birch, due to their investment in TRQ?

A) $227,500.

B) $65,400.

C) $52,500.

Explanation

The cash flow to Birch will be the dividend received ($700,000)(0.30)(0.25) = $52,500.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #40 - 43 of 92

Question ID: 1208852

If the consolidation method is used, how much of TRQ's net income will Birch recognize in the group income statement?

A) $175,000

B) $122,500

C) $700,000

Explanation

Birch would recognize 25% of the net income = $700,000 × 0.25 = $175,000. This would be recognized line by line to include the full $700,000, then 75% would be removed as belonging to the non controlling interest.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #41 - 43 of 92

Question ID: 1208853

Which of Fitzroy's reasons would most likely support the equity accounting method being appropriate for TRQ?

A) Reason 1

B) Reason 2

C) Reason 3

Explanation

Birch owns 1,500/6,000 = 25% of the common shares of TRQ. This suggests significant influence which would make equity accounting appropriate. The percentage of preferred shares owned is not relevant.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #42 - 43 of 92

Question ID: 1208854

Which of the impacts Fitzroy intends to present to the board is most likely correct?

A) Neither impact is correct

B) Impact two only

C) Impact one only

Explanation

If TRQ is a subsidiary it will be consolidated on a line by line basis. This will affect liquidity ratios. Revenue will be increased but net income unaffected by the treatment as in both cases (associate and subsidiary) Birch's share of TRQ's net income will be included in the income statement.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #43 - 43 of 92

Question ID: 1208855

If Birch were to acquire 100% of the share capital of Tyrobin, how would the issues detailed in Exhibit 2 be treated when accounting for the business acquisition?

A) The contingent liabilities would be charged immediately as an expense to the group income statement.

B) The contingent liabilities would not be recognized in the balance sheet or income statement on acquisition.

C) The contingent liabilities would be measured at their fair value and shown as a liability in the group accounts.

Explanation

As the financial effect of the contingent liabilities cannot be reasonably estimated, under U.S. GAAP they should not be included.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #44 of 92

Question ID: 1208816

Equity method is:

A) recommended under IFRS and U.S. GAAP for jointly controlled entities.

B) required under IFRS and under U.S. GAAP for jointly controlled entities.

C) recommended under U.S GAAP for jointly controlled entities, but is not normally permitted under IFRS.

Explanation

Equity method is required under both U.S. GAAP and IFRS for jointly controlled entities.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #45 of 92

Question ID: 1208866

Firm A recently leased equipment used in its manufacturing plant. If the leased asset is worth less than $100,000 at the end of the lease, Firm A will pay the lessor the difference.

Firm B provided debt financing to an unrelated entity. The debt has a provision whereby Firm B cannot be repaid until all other senior debt is satisfied.

Do Firm A and Firm B have a variable interest?

A) Neither have a variable interest.

B) Both have a variable interest.

C) Only one has a variable interest.

Explanation

A lease residual guarantee and subordinated debt are both examples of variable interests. Firm A will experience a loss if the leased asset is worth less than $100,000 at the end of the lease. Firm B will experience a loss if the senior debt is not paid in full.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #46 of 92

Question ID: 1208864

Which of the following statements about special purpose entities (SPE) are correct or incorrect?

Statement #1:	The sponsor usually maintains the decision-making power and voting control over the SPE.
Statement #2:	The equity owners of an SPE usually receive a rate of return that is tied to the performance of the SPE.

A) Only one is correct.

B) Both are incorrect.

C) Both are correct.

Explanation

Both statements are incorrect. The sponsor does not usually have voting control over the SPE; the activities of an SPE are specifically detailed in governing documents created at the origination of the SPE. The structure of the SPE transfers the risks and rewards from the equity owners to the variable interest owners. In return, the equity owners usually receive a fixed rate of return.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #47 of 92

Question ID: 1208858

Mashburn Company acquired 25% of the 100,000 outstanding shares of Humm Co. on January 1 for $250,000 in cash. Humm Co. earned $1 per share and had a dividend payout ratio of 40%. As of December 31, Humm Co. shares were trading in the open market at $12 per share. Calculate the income statement treatment of the Humm Co. investment as of December 31.

A) $75,000.

B) $10,000.

C) $25,000.

Explanation

Under the equity method, the investor recognizes its pro-rata share of the affiliate's income on the income statement. Since Mashburn owns 25,000 shares of Humm and Humm earned $1, the income statement impact of the investment is $25,000.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #48 of 92

Question ID: 1208796

Milburne Company purchased 1,000 shares of Marino Co. for $20 per share on January 1 classified as FVPL. By December 31, shares of Marino were trading at $15 per share in the open market. Marino Co. has 100,000 shares outstanding with a dividend yield of 2% at year end. The impact of the Marino holding on the Milburne income statement is:

A) −$5,000.

B) −$5,300.

C) −$4,700.

Explanation

Since these securities are to be classified as FVPL securities, both the dividend received and the unrealized loss are posted to the income statement. The dividend is computed as 0.02 × $15 × 1,000 = $300 whereas the unrealized loss is $5,000 = ($15 - $20) × 1,000. The net income statement impact is $300 - $5,000 = -$4,700.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #49 of 92

Question ID: 1208865

Mustang Corporation formed a special purpose entity (SPE) for purposes of providing research and development. An unrelated firm absorbs the expected losses of the SPE and the independent shareholders of the SPE receive the expected residual returns. Is the SPE considered a variable interest entity (VIE) according to FASB Interpretation No. 46(R) and is consolidation required by Mustang, respectively?

A) Yes ; Yes.

B) No ; No.

C) Yes ; No.

Explanation

Since the shareholders do not absorb the expected losses, the SPE is considered a VIE. The unrelated firm (not Mustang) that absorbs the losses is the primary beneficiary and must consolidate the VIE.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

The Anderson Company acquired 100,000 shares of the Birschbach Company on January 1, 2012, at $25 per share. The market price of a share of Birschbach stock on December 31, 2012, was $35 per share. During 2012, Birschbach paid dividends of $1.50 per share and had earnings of $2.50 per share.

The Anderson Company did not buy or sell any additional shares in 2013. The market price of Birschbach stock on December 31, 2013 was $42.50 per share. During 2013 Birschbach paid dividends of $1.75 per share and had earnings of $2.25 per share.

Question #50 - 55 of 92

Question ID: 1208798

If the Anderson Company accounts for the Birschbach shares as fair value through profit or loss securities, the carrying amount of these shares on Anderson's balance sheet at the end of 2012 is:

A) $2.6 million.

B) $2.5 million.

C) $3.5 million.

Explanation

Securities are measured at fair market value.

(100,000)($35) = $3,500,000

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #51 - 55 of 92

Question ID: 1208799

If Anderson Company accounts for the Birschbach Company shares as classified as fair value through OCI, the carrying amount of these shares on Anderson's balance sheet at the end of 2012 is:

A) $2.6 million.

B) $3.5 million.

C) $2.5 million.

Explanation

Fair value through OCI securities are measured at fair market value.

(100,000)($35) = $3,500,000

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #52 - 55 of 92

Question ID: 1208800

If Anderson Company accounts for the Birschbach Company shares using the equity method, the carrying amount of these shares on Anderson's balance sheet at the end of 2012 is *closest* to:

A) $2.8 million.

B) $2.6 million.

C) $3.5 million.

Explanation

Under the equity method, market value is ignored. The carrying value of the shares is: the original investment + proportional share of earnings − dividend received.

[(100,000)($25)] + [(100,000)($2.50 − 1.50)] = $2,600,000

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #53 - 55 of 92

Question ID: 1208801

For the year 2012, the investment income that Anderson Company reports on its investment in Birschbach Company shares, if Anderson classifies the shares as fair value through OCI, is:

A) $250,000.

B) $150,000.

C) $100,000.

Explanation

Under the fair value through OCI classification, unrealized gains and losses are not recognized on the income statement, so the only impact on the income statement is the dividend received:

(100,000 shares)($1.50 per share) = $150,000

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #54 - 55 of 92

Question ID: 1208802

If the investment in Birschbach Company is classified as fair value through profit or loss, transactions that impact the income statement include:

A) an unrealized gain of $1,000,000 and dividend income of $150,000.

B) earnings of $250,000 and dividend income of $150,000.

C) an unrealized gain of $1,000,000 and earnings of $250,000.

Explanation

Securities classified as fair value through profit or loss are reported at fair value, with unrealized gains and losses included in income. Unrealized gains and losses and dividends received are both recognized in the income statement, however earnings are not.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #55 - 55 of 92

Question ID: 1208803

If Anderson Company accounts for the Birschbach Company shares using the equity method, the change in carrying value from 2012 to 2013 is *closest* to:

A) +$50,000.

B) +$225,000.

C) +$2,650,000.

Explanation

For the equity method, the ending carrying value on the balance sheet is the beginning carrying value plus a proportion of earnings minus a proportion of dividends. For the Anderson Company, the change in the carrying value is the difference between the earnings per share and the dividends per share. Dividends per share in 2013 were $1.75 per share and the earnings per share were $2.25 per share. 100,000 shares × ($2.25 – $1.75) = +$50,000. The actual carrying value on the balance sheet is $2,600,00 + $225,000 - $175,000 = $2,650,000.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #56 of 92

Question ID: 1208863

Barrett Inc. is advised by its banker to create a special purpose entity (SPE) to convert its existing $15 million loan off-balance sheet. Under the terms of the deal, SPE would obtain a loan for $15 million from the bank with Barrett providing loan guarantee. Barrett would then sell $15 million of accounts receivable to the SPE and use the proceeds to pay off the current loan. Barrett prepares its financial statements under U.S. GAAP. Which of the following statements is *most accurate* regarding the impact of such an arrangement on Barrett's ratios?

A) Barrett's leverage would decrease and receivable turnover would increase.

B) Barrett's leverage as well as receivables turnover would remain the same.

C) Barrett's leverage would remain the same while receivable turnover would increase.

Explanation

Under U.S. GAAP, the sponsor needs to consolidate SPEs using acquisition method. The underlying loan and accounts receivable would then be included in the consolidated balance sheet and none of the financial ratios would be affected.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #57 of 92

Question ID: 1208806

Acme Corporation purchases a 3% interest in Bandy Company to become the single largest shareholder of Bandy. Acme will hold a seat on the Board of Directors of Bandy. Acme will account for its investment in Bandy using the:

A) acquisition method.

B) equity method.

C) lower of cost or market method.

Explanation

Even though Acme's interest is low at only 3%, they have significant influence by having a seat on Bandy's Board of Directors. As such, they must use the equity method.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #58 of 92

Question ID: 1208860

Maverick Incorporated formed a special purpose entity (SPE) to purchase and lease a 50,000 acre ranch. The SPE financed 95% of the purchase price with debt. The remaining 5% was financed with equity capital received from two separate independent investors. The lender would not make the loan without Maverick's guarantee. How should Maverick treat the SPE in its financial statements if Maverick is the lessee?

A) Maverick must consolidate the SPE.

B) No firm must consolidate the SPE.

C) Each equity investor must proportionately consolidate the SPE.

Explanation

The 5% at-risk equity investment is not sufficient to support the activities of the SPE without Maverick's guarantee. Thus, the SPE is considered a variable interest entity (VIE). Since Maverick is responsible for the guarantee, Maverick is the primary beneficiary and must consolidate the SPE.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #59 of 92

Question ID: 1208778

Company X owns 15% of company S and exerts significant influence over the operations of the company. The book value of the investment on December 31, 2001, is $48,000. In 2002, company S earned $100,000 and paid dividends of $20,000. The value of the investment account on December 31, 2002, is:

A) $60,000.

B) $63,000.

C) $48,000.

Explanation

Because company X exerts significant influence over company S, the investment will be treated using the equity method, even though the ownership is less than the 20% guideline. The value of the investment account is equal to the beginning balance plus the proportionate income of company S minus the dividends received from company S, which equals 48,000 + (0.15 x 100,000) − (0.15 x 20,000) = 60,000.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #60 of 92

Question ID: 1208857

Company X owns 15% of company S and exerts significant influence over the operations of the company. The book value of the investment on December 31, 2008, is $48,000. In 2009, company S earned $100,000 and paid dividends of $20,000. The impact of the investment on the income statement of company X is:

A) $15,000.

B) $3,000.

C) $12,000.

Explanation

Because company X exerts significant influence over company S, the investment will be treated using the equity method, even though the ownership is less than the 20% guideline. The impact on the income statement is the proportionate income of company S, which is 0.15 × 100,000 = 15,000.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Global Life Insurance (GLI) holds a wide range of assets in a range of different portfolios across its various divisions. Some of these assets are held long term to meet future liabilities, whereas others are held short term to make profits and meet shorter term liquidity needs.

GLI set up a small portfolio of U.S. equities in one of its smaller divisions last year. GLI's chief investment officer has recently contacted the accounting department to discuss the correct treatment of the portfolio in the group accounts.

Details of the portfolio's transactions and results for the previous period are shown below in Exhibit 1.

Exhibit 1 - Equity Portfolio Results

	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Shares purchased	1,000	(200)	700	0

(sold)				
Total shares quarter-end	1,000	800	1,500	1,500
Purchase price	50.00		45.00	
Sale price		45.00		
Quarter-end market price	52.00	43.00	52.00	60.00
Total dividends	500	400	750	750

The chief investment officer's also provides the following extract from the portfolio's investment policy statement:

IPS Extract

1. The portfolio should consist solely of U.S. mid-cap equities.
2. The number of transactions in the portfolio should be kept to a minimum. Shares should not be purchased on a speculative basis for short term profits.
3. The anticipated average holding period for securities in the portfolio is 3.5 − 4 years.
4. Securities should only be sold to meet urgent liquidity needs.

Another reporting issue the accounting department is looking at concerns a fixed income portfolio. An overview of the portfolio is given in Exhibit 2:

Exhibit 2 – Fixed Income Portfolio

Par Value	$25,000,000
Coupon rate	5% (paid semi-annually)
Current Market Value	$27,000,000

The portfolio consists of $1000 par value, 5 year bonds issued by RTF Inc. They were purchased on the date of issue 1st January 2012 for $25,893,577. For the year ending 31st December the bonds were classed as held to maturity.

The chief investment officer believes a more appropriate classification would be fair value through profit or loss, as he is not convinced the bonds will be held for the remaining 3 years.

Question #61 - 65 of 92

Question ID: 1208772

What is the income from the equity portfolio if the securities are classified as FVPL or FVOCI?

	FVPL	FVOCI
A)	-$6,600	$1,400
B)	$19,900	$19,900
C)	$19,900	$1,400

Explanation

FVPL income is calculated as dividends plus all gains and losses (realized and unrealized). Total dividends are 2,400. GLI realized a loss on the sale of 200 shares at 45.00 per share for a total realized loss of 1,000. GLI has an unrealized gain of 8,000 (800×(60-50)) on the shares purchased in Q1 and 10,500 (700×(60-45)) the shares purchased in Q3, or total unrealized gains of 18,500. Therefore, total income under the FVPL classification is 19,900 (2,400 - 1,000 + 18,500).

Under the FVOCI classification income is calculated as dividends plus realized gains and losses. Therefore, total income is 1,400 (2,400 + (-1,000)).

(Study Session 5, Module 13.1, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #62 - 65 of 92

Question ID: 1208773

What is the balance sheet carrying value of the securities under each of the classifications at year-end?

	FVPL	FVOCI
A)	$90,000	$71,500
B)	$90,000	$90,000
C)	$71,500	$71,500

Explanation

Under the trading and available-for-sale classifications the balance sheet carrying values are the market values of the shares or 90,000 = (1,500 × 60).

(Study Session 5, Module 13.1, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #63 - 65 of 92

Question ID: 1208774

What is the rate of return (income/year-end carrying value) under each of the three methods?

	FVPL	FVOCI
A)	2.67%	2.67%
B)	22.11%	1.56%
C)	23.22%	23.22%

Explanation

FVPL = 22.11% (19,900/90,000)

FVOCI = 1.56% (1,400/90,000)

(Study Session 5, Module 13.1, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #64 - 65 of 92

Question ID: 1208775

If the fixed income portfolio outlined in Exhibit 2 is remains classified as amortized cost, which of the following is *closest* to the interest income reported in the income statement for the year ending 31st December 2013?

A) $1,088,000

B) $1,079,000

C) $1,086,000

Explanation

The bonds will be accounted for using the amortized cost method. Interest will be calculated using the yield at the date of purchase.

Yield at date of purchase can be calculated as follows:

10 N, −25,893,577 PV, 625,000 PMT, 25,000,000 FV

CPT I/Y = 2.1%. This is semiannual. The annual yield is 4.2%.

	Asset	Interest (2.1%)	Coupon
6m	25,893,577	543,765	625,000
1yr	25,812,342	542,059	625,000
18m	25,729,401	**540,317**	625,000
2yr	25,644,718	**538,539**	625,000

Total interest in 2013 (i.e., year 2) is $540,317 + $538,539 = $1,078,856.

(Study Session 5, Module 13.1, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #65 - 65 of 92

Question ID: 1208776

If the bonds are reclassified as suggested by the chief investment officer, which of the following statements is *most likely* correct?

A) The difference between the purchase price and fair value will be shown in other comprehensive income.

B) The difference between the amortized cost and fair value will be shown in other comprehensive income.

C) The difference between the amortized cost and fair value will be shown in net income.

Explanation

The bonds will be shown at amortized cost. When reclassified to FVPL, the bond will be restated at fair value and the difference taken to the income statement.

(Study Session 5, Module 13.1, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #66 of 92

Question ID: 1208874

Which of the following statements regarding special purpose entities (SPEs) is *least* accurate?

A) According to U.S. GAAP, a special purpose entity is classified as a variable interest entity (VIE) if it has at-risk equity that is sufficient to finance its own

B) According to U.S. GAAP, if a SPE is considered a VIE, it must be only consolidated by the primary beneficiary.

C) Under IFRS, a special purpose entity must be consolidated by the entity which exercises control over that entity.

Explanation

Under U.S. GAAP rules, a VIE could include a SPE that has at-risk equity that is insufficient to finance the entity's activities without additional financial support.

(Study Session 5, Module 13.9, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #67 of 92

Question ID: 1208823

Which of the following methods of accounting for investments will reflect the highest net income on a company's income statement?

A) Both methods report the same net income.

B) Acquisition method.

C) Equity method.

Explanation

Both methods will report the same net income.

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #68 of 92

Question ID: 1208779

Cosmo Inc. (Cosmo) invests in two portfolios – Portfolio 1 and Portfolio 2. Portfolio 1 contains securities classified as fair value through P&L. Portfolio 2 contains equity securities classified as fair value through OCI. Which of the following treatments of Cosmo's reporting of the investments in Portfolios 1 and 2, respectively, is *most* accurate?

	Portfolio 1	Portfolio 2
A)	Unrealized amounts reported on	Assets reported at
B)	Unrealized amounts reported on	Assets reported at
C)	Unrealized amounts reported on	Assets reported at

Explanation

Portfolio 1 contains FVPL. Therefore, the unrealized gains and losses would be reported immediately in the income statement.

Portfolio 2 contains FVOCI. Therefore, the securities (assets) would be reported at fair value.

(Study Session 5, Module 13.2, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #69 of 92

Question ID: 1208840

When comparing companies that hold equity investments in other corporations, which of the following statements is *most* accurate? All else being equal, leverage measures for a firm using consolidation will appear:

A) more favorable than those for a comparable firm using the equity method.

B) more or less favorable depending on the leverage of the investee company.

C) less favorable than those for a comparable firm using the equity method.

Explanation

Under consolidation, the debt of the subsidiary is included in the parent company balance sheet. Parent company's equity is also increased due to minority interest. The impact on leverage will depend on the leverage employed by the subsidiary.

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #70 of 92

Question ID: 1208832

Under U.S. GAAP rules, where an investor owns 41% of the voting shares of an investee and is able to control the investee, which of the following methods of accounting is *most* appropriate to use?

A) Equity method.

B) Acquistion method.

C) Proportionate consolidation method.

Explanation

It is possible to control with less than a 50% ownership interest. In this case, the investment is still considered controlling and the acquisition method would be most appropriate.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #71 of 92

Question ID: 1208856

Carter Schmitz, Inc. (Schmitz) purchased 200 shares of Intelismart at $21 a share in June 2006 and classifies 80 shares as fair value through profit or loss securities and holds the remaining 120 shares as classified as fair value through OCI. Intelismart's closing price was $26 on December 31, 2006, and Schmitz did not sell any of its shares.

What amount should Schmitz report on this investment under the income statement?

A) $600.

B) $400.

C) $1,000.

Explanation

The unrealized gain on the 120 shares available for sale is $600 (26 - 21 = 5 × 120 shares). There is also an unrealized gain of $400 (5 × 80) related to the 80 shares that are classified as fair value through profit or loss which would be reported on the income statement. For securities classified as fair value through profit or loss, realized and unrealized gains and losses are reported on the income statement. For securities classified as fair value through OCI, only realized gains and losses are reported on the income statement.

(Study Session 5, Module 13.6, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #72 of 92

Question ID: 1208795

Fiduciary Investors held two portfolios of marketable equity securities:

> $50 million in Portfolio A was accounted for as available-for-sale.
>
> $50 million in Portfolio B was accounted for as amortized cost securities.

Assume that Fiduciary reclassified securities ($10 million carrying value, $8 million market value) from Portfolio B into Portfolio A. If no previous write downs were made, Fiduciary must:

A) charge $2 million to the equity section of its balance sheet.

B) do nothing to its income statement or equity section of its balance sheet.

C) charge $2 million to its income statement.

Explanation

Reclassification of debt securities into FVPL is allowed if the business model has changed. Unrealized gain or loss on reclassification is recognized in the income statement.

(Study Session 5, Module 13.2, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #73 of 92

Question ID: 1208861

Which of the following statements regarding asset securitizations and special purpose entities (SPEs) is *most* accurate?

A) When receivables are securitized, the sponsor reports the cash inflow as an investing activity in the cash flow statement.

B) If the sponsor has no recourse, then the transaction is nothing more than a collateralized borrowing.

C) The SPE usually issues debt to purchase receivables from the sponsor.

Explanation

SPEs are often created to securitize assets, usually receivables of the sponsor. Typically, the SPE issues debt to purchase the receivables from the sponsor and the debt is repaid as the receivables are collected.

When the receivables are securitized, the sponsor removes the receivables from the balance sheet and reports the cash inflow as an operating activity in the cash flow statement. If the sponsor still has recourse, the transaction is nothing more than a collateralized borrowing.

(Study Session 5, Module 13.9, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #74 of 92

Question ID: 1208805

GTH Corporation has just purchased 18% of the common stock of Pittor Corporation, one of their major suppliers, making GTH the largest single shareholder in Pittor. The primary motivation for the purchase is that managerial problems at Pittor have resulted in quality control difficulties, thereby affecting the reliability of several critical component parts for GTH products. At the time of the purchase, GTH management announced they plan to be an active investor and exercise significant influence on Pittor so the quality problems can be resolved. Given these circumstances, the accounting method used to record the intercorporate investment will *most likely* be the:

A) acquisition method.

B) investment in financial assets method.

C) equity method.

Explanation

Normally, due to the less than 20% ownership stake, investment in financial assets accounting would be used to record this investment. However, percentage ownership rules are guidelines only and the appropriate accounting method is dependant on the degree of influence the acquirer intends to exert. In this case, GTH has announced their desire to exert significant influence, hence, the equity method is the appropriate choice.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Assume that on the balance sheet date shown below TME Corporation acquires 70% of Abcor, Inc. common stock for $25,000 in cash.

Pre-acquisition Balance Sheets

December 31, 2001

	TME Corp.	***Abcor, Inc.***
Current assets	$80,000	$38,000
Other assets	28,000	15,000
Total assets	$108,000	$53,000
Current liabilities	$60,000	$32,000
Common stock	15,000	14,000
Retained earnings	33,000	7,000
Total liabilities and equity	$108,000	$53,000

Question #75 - 77 of 92

Question ID: 1208836

What will be the post-acquisition current ratio, using both the acquistion method and the equity method, respectively, for TME? *The choices below represent Acquisition and Equity, respectively.*

A) 1.04, 1.11.

B) 1.21, 1.02.

C) 1.01, 0.92.

Explanation

With the acquisition method: The current assets are ($80,000 + $38,000 - $25,000) = $93,000. The current liabilities are ($60,000 + $32,000) = $92,000. The current ratio is $93,000/$92,000 = 1.01. With the equity method: The current assets are ($80,000 - $25,000) = $55,000. The current liabilities are $60,000. The current ratio is $55,000/$60,000 = 0.92.

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #76 - 77 of 92

Question ID: 1208837

Using the acquistion method to account for the acquisition, what will be the post-acquisition current assets of TME?

A) $105,000.

B) $93,000.

C) $118,000.

Explanation

Using the acquisition basis of accounting, the post-acquisition level of the current assets is the amount of the current assets prior to acquisition minus the amount of cash used for the acquisition. ($80,000 + 38,000 – 25,000) = $93,000.

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #77 - 77 of 92

Question ID: 1208838

Using the acquistion method to account for the acquisition, which of the following is *closest* to the post-acquisition amount that will be recorded as the minority interest under US GAAP?

A) $21,000.

B) $10,700.

C) $6,300.

Explanation

Since only 70% of Abcor was purchased by TME there is a minority interest that must be accounted for, equal to the percentage of Abcor not owned by TME times Abcor's fair value.

Abcor's fair value = 25,000/0.7 = 35,714.29

Under US GAAP, only full goodwill.

Minority interest = 35,714.29 (0.3) = 10, 714.29

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Joseph Haggs, CFA, is an analyst working for Garvess Jones, a large publicly traded investment-baking firm. Haggs covers the Internet sector. Recently, one of the more successful companies Haggs covers, Simpson Corporation, made an aggressive move to acquire another Internet company, Bailey Corporation (BC). BC is a company specializing in graphics and animation on the World Wide Web and has 1,000,000 shares outstanding. Simpson also holds minimal investments in other technology companies both public and private. In 1999 Simpson saw an opportunity to substantially increase its share in BC. Simpson feels that their sophisticated animation can greatly improve Simpson's market share and sees an acquisition as an opportunity to expand their business. The relevant financial data are in the following tables.

Bailey Corporation

Selected Financial Data, Years Ended December 31

(in Thousands)

Item	1998	1999	2000
Sales	$50,000	$60,000	$70,000
Less: cost of goods sold (COGS)	37,000	43,700	47,250
Earnings before interest & taxes (EBIT)	13,000	16,300	22,750
Less: Interest	10,000	13,000	19,000
EBT	3,000	3,300	3,750
Less: Taxes	1,000	1,100	1,250
Net Income	$2,000	$2,200	$2,500
Dividends Paid	$1,000	$1,200	$1,500

Total Shares Outstanding	1,000,000

Simpson's Purchase Transactions in BC's Stock

Date	January 1, 1998	January 1, 1999	January 1, 2000
Number of Shares	10,000	290,000	700,000
Price per Share	10	11	15

Because this is the largest acquisition in Simpson's history, Mr. Haggs' supervisor has asked him to prepare a report for Garvess Jones' clients detailing the affects of the acquisition on Simpson's financial statements.

Question #78 - 81 of 92

Question ID: 1208826

Haggs wonders which accounting method Simpson uses to calculate the book value of the BC investment for the year ending December 31, 1999. Which is the correct method?

A) Investment in Financial Assets method.

B) Equity method.

C) Acquisition method.

Explanation

When a company owns an influential but non-controlling interest in another company, commonly 20-50%, it must account for it under the equity method.

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #79 - 81 of 92

Question ID: 1208827

Haggs wonders which accounting method Simpson uses to calculate the book value of the BC investment for the year ending December 31, 1998. Which is the correct method?

A) Equity method.

B) Acquisition method.

C) Investment in Financial Assets method.

Explanation

When a company owns a non-influential and non-controlling interest in another company the investment must be carried at fair value. Simpson must carry its BC investment at fair value for 1998.

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #80 - 81 of 92

Question ID: 1208828

Haggs wonders which accounting method Simpson uses to calculate the book value of the BC investment for the year ending December 31, 2000. Which is the correct method?

A) Equity method.

B) Proportional consolidation method.

C) Acquisition method.

Explanation

When a company's interest in another exceeds 50% it is considered to have controlling interest and must consolidate the financial statements.

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #81 - 81 of 92

Question ID: 1208829

Haggs wants to make sure that he assumes the proper accounting method when he does his analysis. The acquisition of BC stock will lead to Simpson's total net cash flow equaling which of the following for the year ending December 31, 1999?

A) $−2,830,000.

B) $360,000.

C) $−3,190,000.

Explanation

Simpson paid a total of \$−3,190,000 (290,000 shares × \$11) however, they also received a dividend from BC of \$360,000. For 1999 Bailey Corporation is paying \$1.20 in dividends per share (1,200,000 / 1,000,000). As of December 1999, Simpson has purchased 300,000 shares of BC (= 290,000 + 10,000). So dividends received is 300,000 × \$1.20 = \$360,000. This will make the total cash flow for the year \$−2,830,000.

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #82 of 92

Question ID: 1208834

A company reports an intercorporate investment using the acquisition method. Which of the following statements is *most* accurate?

A) The use of the equity method by a company will generally report the same results. ✗

B) The use of the acquisition method by a company will generally report the less favorable results. ✓

C) The use of the acquisition method by a company will generally report the more favorable results. ✗

Explanation

The equity method will provide more favorable results, while the acquisition method will provide less favorable results. (Under the equity method, liabilities and leverage are lower than under the acquisition method, while net profit margin, ROE, and ROA are higher.)

(Study Session 5, Module 13.4, LOS 13.c)

Related Material

SchweserNotes - Book 2

Rocky Mountain Air Cargo is a privately held commercial aviation company serving the western United States. It publishes financial statements in accordance with U.S. GAAP and uses a fiscal year that matches the calendar year.

Rocky Mountain was in good financial shape heading into 2003, with assets of \$50 million at the beginning of the fiscal year. That year, it earned \$3 million in net income and was easily able to maintain its traditional 50% dividend payout ratio. However, Rocky Mountain had a very difficult year in 2004, reporting a loss of \$800,000. It managed to pay \$1 million in dividends, but the decision to pay dividends in such a weak financial year further undermined the company's fiscal stability.

Flitenight Air Lines, a publicly-traded aviation firm serving the central and Midwestern United States, wanted to expand its range of service by coordinating its flight schedule with airlines serving different geographic regions of North America. One of these airlines was Rocky Mountain Air Cargo.

To cement the relationship, Flitenight's CEO, John "Bulldog" Basten, decided to make a significant investment in Rocky Mountain Air Cargo. He was easily able to convince both boards of the wisdom of the deal, and, in his usual brash style, personally negotiated the terms with his counterpart at Rocky Mountain, Buck Matthews. Flitenight Air Lines acquired a 20% stake in Rocky Mountain Air Cargo (with an option to purchase 40% more) for $10 million cash. The deal closed on January 1, 2003 and Flitenight accounted for the investment using the equity method.

Basten was not happy to find that he had invested right at the peak of Rocky Mountain's profitability and wound up with a money-losing airline. He had a difficult conversation with Matthews in early 2005, complaining about the impact of the Rocky Mountain investment on Flitenight's financials. Basten pointed out that he had a loss on his books: the original $10 million investment in Rocky Mountain was carried at only $9,940,000 on Flitenight's December 31, 2004 balance sheet. Matthews countered that this was just an accounting entry: on a cash basis, Flitenight had a gain of 5% on its investment over the two years.

Matthews' insistence that the investment had earned money for Flitenight did not sit well with Basten. Basten decided that Rocky Mountain was clearly being mismanaged and concluded it was time to gain control of the company.

Basten assured Neil Glenn, the Chairman of Flitenight's board, that he could turn Rocky Mountain around. He promised Glenn that, in 2005, Rocky Mountain would once again achieve $3 million in earnings and a 50% payout ratio. "With those results," Basten promised Glenn, "our asset accounts will value the Rocky Mountain investment at $10,240,000 on our December 31, 2005 balance sheet – so we'll show a gain on our original investment." Glenn was skeptical of anyone's ability to turn the airline around so quickly. Even so, Glenn assured Basten, "If it takes you longer to turn it around, at least we'll have the dividend income on our 2005 cash flow statements."

Basten notified Matthews and Rocky Mountain's board that Flitenight intended to exercise its option. At the direction of Basten and Glenn, Flitenight purchased the additional shares for cash and gained control of Rocky Mountain on December 31, 2004.

Question #83 - 87 of 92

Question ID: 1208818

In 2003, Flitenight would reflect its investment in Rocky Mountain on its income statement by recording:

A) −$200,000.

B) $600,000.00

C) $300,000.00

Explanation

Under the equity method, Flitenight would record $600,000 (= $3 million × 0.2) on its 2003 income statement as its share of Rocky Mountain's earnings. The dividends received by Flitenight are already included as part of its share of Rocky Mountain's net income in the equity method.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #84 - 87 of 92

Question ID: 1208819

If Flitenight were to account for its Rocky Mountain investment as an investment in financial assets instead of the equity method, Flitenight's 2004 income statement would reflect its investment in Rocky Mountain by including which of the following?

A) Only a loss of $160,000.

B) Nothing, since the cost of the acquisition is not adjusted until the asset is sold.

C) Only income of $200,000.

Explanation

If Flitenight accounted for its Rocky Mountain investment as an investment in financial assets, in 2004 it would record on its income statement $200,000 (= $1 million × 0.2) in dividends. That method would not be a permissible choice for Flitenight, however, since it controls more than 20% of Rocky Mountain.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #85 - 87 of 92

Question ID: 1208820

Under the acquisition method, minority interest is considered:

A) equity under IFRS and US GAAP.

B) a liability under IFRS and US GAAP.

C) equity under IFRS and a liability under US GAAP.

Explanation

Under the acquisition method, minority interest is now considered equity under IFRS and US GAAP. Prior to SFAS 160 minority interest was considered either a liability or a mezzanine(hybrid) item under US GAAP.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #86 - 87 of 92

Question ID: 1208821

Regarding Basten's and Matthews' statements about the gain/loss that Flitenight had at the end of 2004 on its investment in Rocky Mountain, which is *most* accurate?

A) Basten's statement is correct and Matthews' statement is correct.

B) Basten's statement is correct and Matthews' statement is incorrect.

C) Basten's statement is incorrect and Matthews' statement is correct.

Explanation

If Flitenight accounted for its Rocky Mountain investment using the equity method, the value of the investment as of December 31, 2004, would be:

Flitenight's original \$10 million investment + (Flitenight's share of Rocky Mountain's 2003 earnings less dividends Flitenight received in 2003) + (Flitenight's share of Rocky Mountain's 2004 earnings less dividends Flitenight received in 2004).

Since we know that Flitenight owns 20% of Rocky Mountain and consequently receives 20% of the dividends that Rocky Mountain pays, we can calculate:

Value of Rocky Mountain on Flitenight's books at the end of 2004 =

\$10 million + (0.20 × \$3 million in 2003 earnings − 0.20 × \$1.5 million in 2003 dividends) + (0.20 × −\$800,000 in 2004 earnings − 0.20 × \$1 million in 2004 dividends) =

\$10 million + (\$600,000 − \$300,000) + (−\$160,000 − \$200,000) =

\$10,000,000 + \$300,000 − \$360,000 = \$9,940,000

Basten's statement is correct.

On a cash basis, Flitenight spent \$10 million to acquire its stake in Rocky Mountain, and received \$500,000 (= \$300,000 in 2003 dividends + \$200,000 in 2004 dividends) in dividends over the two years. \$500,000 in cash return on a \$10,000,000 cash investment equals 5% over the two years. Matthews' statement is also correct.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #87 - 87 of 92

Question ID: 1208822

Regarding Basten's and Glenn's statements about the impact of Rocky Mountain on Flitenight's 2005 balance sheet and cash flow statement, which is *most* accurate?

A) Basten’s statement is correct and Glen’s statement is correct. ✗

B) Basten’s statement is incorrect and Glen’s statement is correct. ✗

C) Basten’s statement is incorrect and Glen’s statement is incorrect. ✓

Explanation

The equity method of accounting is used when the parent has significant influence over the investee but does not exercise control. The acquistion method is required when the parent controls, directly or indirectly, more than 50% of the voting stock.

Once Flitenight exercised its option to purchase the additional 40% of Rocky Mountain's stock (for total ownership of 60%) on December 31, 2004, it could no longer use the equity method and had to switch to the acquistion method. In the acquistion method, Flitenight's investment in Rocky Mountain is no longer listed as a separate asset on the balance sheet (all of Rocky Mountain's assets and liabilities are combined with Flitenight's, with the minority interest shown as equity), so Basten's statement is incorrect. In the acquistion method, parent company cash flows exclude those between parent and investee, so Glenn's statement is also incorrect.

(Study Session 5, Module 13.4, LOS 13.b)

Related Material

SchweserNotes - Book 2

Question #88 of 92

Question ID: 1208859

Milburne Company purchased 1,000 shares of Marino Co. for $20 per share on January 1. By December 31, shares of Marino were trading at $15 per share in the open market. Marino Co. has 100,000 shares outstanding with a dividend yield of 2% at year end. Milburne choose FVOCI classification for these shares. The impact of the Marino holding on the Milburne income statement is:

A) -$5,000. ✗

B) -$4,700. ✗

C) $300. ✓

Explanation

These securities are to be classified as FVOCI and hence, all unrealized gains and losses are taken to OCI in shareholder's equity on the balance sheet. Hence, the only income statement impact is the $300 dividend = 0.02 × $15 × 1,000.

(Study Session 5, Module 13.6, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #89 of 92

Question ID: 1208830

On December 31, 2008 Company P invests $5,000 in Company S in exchange for 25% of the company. During 2009, Company S earns $2,000 and pays a dividend of $500. If Company P uses the equity method of accounting, what values will be reported on the balance sheet and income statement? How much cash will be recognized from the investment?

	Balance Sheet	Income Statement	Cash
A)	$5,500	$0	$0
B)	$5,375	$125	$125
C)	$5,375	$500	$125

Explanation

The carrying value on the balance sheet is $5,375, the income statement will show $500 of income, and the cash recognized is equal to the dividend of $125.

Using the equity method, for 2008, Company P will:

Recognize $500 ($2000 × 0.25) on its income statement as equity in the net income of Company S.
Increase the investment in the Company S account on the balance sheet to $5,500, reflecting its share of the net assets of Company S.
Receive $125 in cash dividends from Company S and reduce its investment in Company S by that amount to reflect the decline in the net assets of Company S due to the dividend payment.

At the end of 2008, the carrying value of Company S on Company P's balance sheet will be ($5,000 original investment + $500 proportional share of Company S earnings – $125 dividend received = $5,375).

(Study Session 5, Module 13.3, LOS 13.c)

Related Material

SchweserNotes - Book 2

Question #90 of 92

Question ID: 1208831

Sawbuck Corporation recently acquired a 60% stake in Rawboard Inc. for $70 million in newly issued common stock. Given this information, which of the following methods should be used to account for the acquisition of Rawboard?

A) Acquisition.

B) The pooling of interest method.

C) Proportionate consolidation.

Explanation

When the parent company has at least a 50% ownership stake and control over the subsidiary, the acquisition method is used.

(Study Session 5, Module 13.4, LOS 13.a)

Related Material

SchweserNotes - Book 2

Luna Life Insurance is a publicly traded corporation with total assets in excess of $500 million. Joy Manning, CFA, has served as Luna's chief investment officer for the past decade. Recent poor performance of Luna investment portfolio has led to the formation of a special task force to review Luna's investment holdings as well as its operating policies. The task force is composed of two current Luna board members (who are not employees of Luna) and three independent investment professionals. Their assignment is to thoroughly review Luna's financial statements for evidence of impropriety or mishandling of corporate assets. The task force is expected to complete their review within one month and report back to Luna's board of directors shortly thereafter.

Luna's most recent financial statements reflect approximately $200 million in various equity holdings and $100 million in debt instruments. A broad classification of the portfolio (in millions of $) as of December 31, 2006 is as follows:

	Held-to-Maturity	*Available-for-Sale*	*Trading*
Equity	$0	$125	$75
Debt	$50	$25	$25

In the footnotes, there is a reference to $10 million of available-for-sale securities that were transferred to the held-to-maturity portfolio last year. The securities were transferred at fair market value, and an unrealized loss of $1 million was included in that period's income. Several members of the task force believe the transaction deserves further analysis to determine if the securities' transfer between portfolios was executed in accordance with SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities" as Manning has represented.

Also, in 2006, Luna transferred $5 million of shares in ABC Corp from the available-for-sale portfolio to the trading portfolio. In association with this transaction, $1 million in unrealized gains were included in the year's income. The task force observes that after the transfer, there are $2.5 million of ABC Corp remaining in the available-for-sale portfolio. Manning has stated that the firm's desire to reduce exposure to the equity market was the reason for selling only a portion of the position in ABC Corp.

In addition, the group is performing its own analysis on the impact of last year's acquisition of a 20% stake in Instate, a regional provider of commercial insurance. Instate reported $15 million in earnings for the year ending December 31, 2006, and paid approximately $1 million in dividends. Manning directed Luna's accountants to record the purchase using the equity method, and thus has included a proportional share of Instate's net income for the year. The acquisition was effective as of January 1st of 2006, and operating results for the investment stake in Instate are incorporated into Luna's 2006 financial statements. The group will perform basic analysis both with and without the operating results of Instate in order to better evaluate what financial impact the inclusion of Luna's results had on Instate's overall performance.

Question #91 - 92 of 92

Question ID: 1208813

Which of the following investments would *most likely* be reported under the equity method?

A) An investment in 5% of the equity of an entity that gives the owner significant influence over that entity. ✓

B) An investment in 40% of the equity of an entity that gives the owner control over that entity. ✗

C) An investment in 80% of the equity of an entity that gives the owner control over that entity. ✗

Explanation

The parent-company must have significant influence over the management of the affiliate. Control would require the consolidation method.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2

Question #92 - 92 of 92

Question ID: 1208814

Luna has recorded its investment in Instate utilizing the equity method of accounting for intercorporate investments. According to FASB, which of the following statements *most* accurately reflects the impact on an investor's financial statements by using the equity method?

A) Market values can be compared with the carrying amount for analysis purposes, but only market values may be used in the financial statements.

B) The investing firm can include a proportionate share of the investee's income in its earnings, regardless of whether or not there are actual cash flows (i.e.

C) The investing firm will not make any adjustments to its financial statements to reflect its proportionate share of the investee's net assets, but will reference the

Explanation

The proportionate share of the investee's income is included in the parent's income statement. Changes in the market value of the investee are not reflected in the investing firm's income statement so long as the decline in value is not considered to be permanent.

(Study Session 5, Module 13.3, LOS 13.a)

Related Material

SchweserNotes - Book 2