Appendix C – Investments
MGMT 1A

Current Assets = CinAMPs

The "i" and the "n" are silent – "I" stands for "Investment Securities" (or "Investments" for short)

I. Investment Securities = Temporary investments in highly marketable s*tocks*, b*onds*, and n*otes*. *Easy to sell, actively traded on an exchange. I can go to Charles Schwab, and buy shares of GOOG*
   A. Short Term Investments – also called "Marketable Securities"
      1. Readily convertible to c*ash* (i.e., Management intends to convert within *one* year)
      2. Initial maturity of *>3 months*
         a. Cash Equivalents – Short term investments with an initial maturity of *< 3 months.* Cash equivalents are NOT investment securities. *Presented in the B/S and SOCF with "Cash".*
      3. A current asset following cash and before receivables *More liquid than receivables, less liquid than cash.*
   B. Long Term Investments
      1. Not readily convertible to cash / not intended to be converted to cash within one year.
      2. Management intends to hold for *> 1* year.
      3. A long term *(non-current)* asset
   C. Types of investment securities
      1. E*quity* investments – S*tocks* *Ownership of shares (pieces) of a Company.*
         a. D*ividends* paid from a Company's r*etained* e*arnings*
         b. G*row (buy low and sell high, make a profit)*
         c. C*ontrol*
      2. D*ebt* investments – B*onds* and N*otes*
         a. I*nterest*

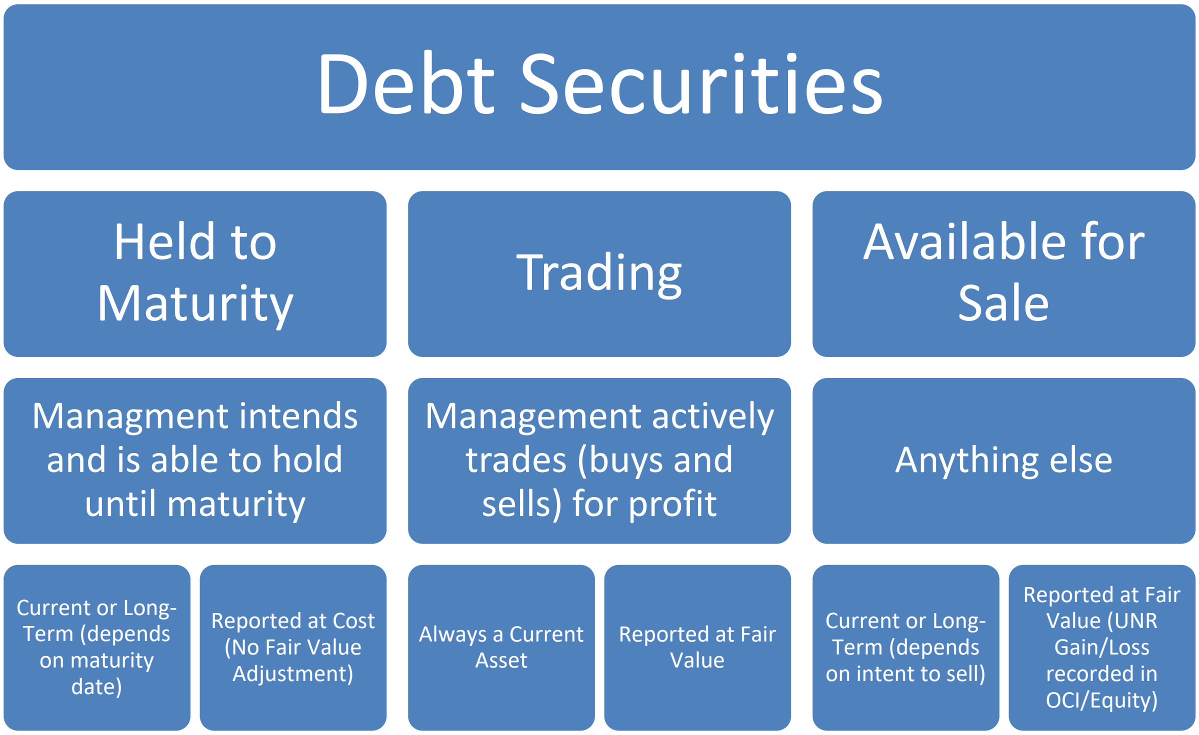
D. Classification and Reporting depends on:
   1. Security Type - D*ebt* or E*quity*
   2. I*ntent* to hold *(Debt)*
   3. Percent O*wnership (Equity)*

E. Gains and Losses
   1. Fair market value (FMV) = what a willing participant in an open market would be willing to pay for an asset
   2. FMV of investments is constantly changing:
      a. Google – Historical Data

Date	Price
11/1/19	$1,304.96
12/1/19	$1,337.02
1/1/20	$1,434.23
2/1/20	$1,339.33
3/1/20	$1,161.75

   3. Realized gain/loss – Company sells an investment security for more/less than it is carried on the books *Realized = it ACTUALLY HAPPENED*
      a. Triggered by the s*ale* of an investment
   4. Unrealized gain/loss – An investment security has a FMV that is more/less than it is carried on the books *Unreal = Nothing REALLY happened*
      a. Triggered by p*eriod-end* r*eporting* requirements
      b. Valuation Allowance: This account does not have a normal balance *Could be a DR or CR*
         i. Increases/Decreases the value of investment securities on the B*alance* S*heet*
      c. Unrealized Gain/Loss: This account does not have a normal balance *Could be a DR or CR*
         i. Presented on the I*ncome* S*tatement* in the "Other *Income/Expense*" category.

II. Debt Securities (Bonds and Notes)



A. "Issue Bonds" = "Borrow Money"

Investors (Corporations, the general public) can purchase a Company's bonds.

When a Company issues bonds, they are not giving away ownership of the Company – they are borrowing money from the investor.

B. Semi-Annual Interest = P*rincipal ** R*ate ** T*ime*

Interest = the cost of borrowing money; the return the investor collects over the life of the bond

C. Example: On _1/1/Y1_, Company issues a _3_ year _$1M_ bond with a _10%_ interest rate. The bond pays interest semi-annually.

1. What would be the journal entry to record the purchase of this bond on _1/1/Y1_?
   1/1/Y1 DR: Investment in Bonds $1,000,000
   CR: Cash $1,000,000
   (To record purchase of bonds)
2. How much is the interest on this bond for 1 year? *P * R * T = $1M * 10% * 1 = $100,000*
3. What will be the semi-annual payments? *Semi-annual means twice a year.*
   Each payment will be $50,000 ($100,000/2) on June 30, on Dec 31.
   *Can also calculate as P * R * T = $1,000,000 * 10% * ½ year*
4. What would be the journal entry to record the receipt of the first semi-annual interest payment on _6/30/Y1_?
   6/30/Y1 DR: Cash $50,000
   CR: Bond Interest Income $50,000
   (To record collection of semi-annual interest)
5. Maturity: When bonds mature we record the proceeds (assuming interest was already recorded). What would be the journal entry to record the maturity of the bond on _12/31/Y3_?
   12/31/Y3 DR: Cash $1,000,000
   CR: Investment in Bonds $1,000,000
   (Received cash from matured bond)

D. Fair Value Adjustment (Bonds classified as T*rading* and A*vailable for Sale* ONLY)

1. When Bonds are purchased, we record the investment "At cost" (how much cash was paid)
2. Adjust stocks and bonds to their market value at period end
   This is a BIG DEAL in accounting. For the most part we have been recording everything at historical cost (i.e., what we paid for it). BUT: the FASB has made a big push over the last decade to record assets at their fair values. This causes gains and losses in the I/S.
3. Example C Continued: At the end of *Y1* the $1,000,000 bond had a FMV of *$1,032,000*. Prepare the adjusting journal entry to record the period-end fair value adjustment. (Assume the bond is classified as a *Trading* security.)
   A: 12/31/Y1 DR: Valuation Allowance – Trading Securities $32,000 ← 1,032,000 – 1M
   CR: Unrealized Gain $32,000
   (Record unrealized gain in bonds classified as trading securities)

   **** Your book calls the "Valuation Allowance" Account "Fair Value Adjustment – Trading".*

4. Example C3 Continued: At the end of *Y2* the $1,000,000 bond had a FMV of *$975,000*. Prepare the adjusting journal entry to record the period-end fair value adjustment. (Assume the bond is classified as a *Trading* security.)
   DR: Unrealized Loss $57,000 ← $1,032,000 - $975,000
   CR: Valuation Allowance – Trading Securities $57,000
   (Record unrealized gain in bonds classified as trading securities)

   How do we go from a Gain (CR) of 32 to a Loss (DR of 25)? Have to DR: Gain 32 + 25 = 57

5. One difference - A4S Securities
   a. We *do NOT* use Unrealized Gain/Loss - an I/S account
   b. Instead, we use *Other Comprehensive Income (OCI)* - an equity account on the B/S
   (advanced concept, don't need to know any more about it for our class)

III. Equity Securities (Stocks)

Equity Investments		
Insignificant Influence	Significant Influence	Controlling Influence
Under 20% ownership	20-50% ownership	More than 50% ownership
Fair Value Method	Equity Method	Consolidation Method

A. I*nsignificant* Influence *We use the fair value method.*

1. Acquisition: Recorded at *Cost* (including any commissions or brokerage fees paid)
   a. On *9/1* we purchase *300* shares of stock at *$20* per share, plus *$45* commission.

      9/1 DR: Investment in Stock $6,045
      CR: Cash $6,045
      (Purchased 300 shares of stock)

2. Recording Dividends: The Company periodically distributes some of its retained earnings to its shareholders
   a. On *12/31* we receive a cash dividend of *$0.40* per share.

      12/31 DR: Cash $120
      CR: Dividend Income $120

      Alternatively, the company declares the dividend but does not pay right away.

      12/31 DR: Dividend receivable $120
      CR: Dividend Income $120

      and then later when paid:

      DR: Cash $120
      CR: Dividend receivable $120

3. Adjust to *Fair Market Value* periodically (just like Bonds classified as trading securities)
   a. At 12/31/Y1 the fair value of the shares is *$30* per share.

      *($30 * 300 shares = $9,000)*
      A: 12/31/Y1 DR: Valuation Allowance $2,955
      CR: Unrealized Gain $2,955 ← reported on the I/S
      (Record unrealized gain on stock investments)

4. Selling stock investments
   a. On *2/16/Y2* we sell *100* shares at *$22* per share less a $*25* commission.

      *DR: Cash $2,175 ← ($22 * 100) - $25*
      *CR: Investment in Stock $2,015 ← 6,045 * 1/3*
      CR: Gain on sale $160

   Notice that the commission is NOT recorded separately, and becomes a part of the cost basis/carrying value of the securities

   *Also – we ignore the "Valuation Allowance" – this adjustment is not recorded on an investment-by-investment basis; it is recorded for the portfolio **as a whole**. (When we record fair value at the next period end, those shares will not be in the portfolio, and if there was no other change, we'd end up reversing the Unrealized Gain relating to those stocks which had been sold).*

B. S*ignificant* Influence – Equity Method Accounting

1. Acquisition – record at c*ost*:
   a. On *1/1/Y1* we acquired *3,000* shares (*30%*) of Moon & Star Co. at a total cost of *$70,000*. Prepare the journal entry to record the acquisition.

1/1/Y1 DR: Investment Securities $70,000
CR: Cash $70,000
(To record purchase of 3,000 shares of Moon & Star Co.)

2. Recording share of earnings – Earnings i*ncrease* the carrying value of the investment: *When the investee (Moon & Star) reports its earnings, the investor records its' share (in the same proportion as ownership %)*
   a. On *12/31/Y1*, Moon & Star Co. reports net income of *$20,000*. Prepare the journal entry to record our share of earnings:

*12/31/Y1 DR: Investment in Stock $6,000 ← 30% ownership * $20,000 earnings*
CR: Investment Income $6,000
(To record 30% equity in investee's (Moon & Star Co.) earnings)

3. Recording share of dividends – Dividends d*ecrease* the carrying value of the investment:
   a. On *1/9/Y2*, Moon & Star Co. pays a total of *$10,000* in cash dividends on its common stock. Prepare the journal entry to record our share of dividends.

*1/9/Y2 DR: Cash $3,000 ← 30% ownership * $10,000*
CR: Investment in Stock $3,000
(To record 30% share of dividend paid by Moon & Star Co.)

4. Reporting equity method investments: We DO NOT adjust equity method investments to fair value at period-end.
   a. Book value = Cost + our share of net income – our share of dividends.

$70,000 + $6,000 - $3,000 = $73,000 book value

5. Selling equity method investments - Gain or loss = p*roceeds* – c*arrying* v*alue (book value)*
   a. On *1/10/Y2*, we sell our *3,000* shares of Moon & Star Co. stock for *$80,000*. Prepare the journal entry to record the sale.

1/10/Y2 DR: Cash $80,000
CR: Realized Gain $7,000
CR: Investment in Stock $73,000 ($70 + $6 - $3)
(Sold 3,000 shares of Moon & Star Co. stock)

   b. What if we had only sold *1,500* shares for *$40,000*?

DR: Cash $40,000
CR: Realized Gain $3,500
CR: Investment in Stock $36,500 ($70 + $6 + $3) / 2
(Sold ½ of Moon & Star Co. shares)

   c. What if we had sold *3,000* shares for *$70,000* instead?

DR: Cash $70,000
DR: Realized Loss $3,000
CR: Investment in Stock $73,000 ($70 + $6 - $3)

C. Controlling Influence – Consolidation Method

1. Controlling Investor = P*arent* (e.g. *Amazon*): Maintains own independent accounting records

2. Investee = S*ubsidiary* (e.g. *Whole Foods*): Maintains own independent accounting records

3. Consolidated Financial Statements = As if the business were ONE entity

    a. Individual Assets & Liabilities – combined into 1 balance sheet

    b. Revenues & Expenses – combined into 1 income statement
    (Consolidated FS is outside the scope of this course – just need to know the rule)