

Chapter 22: Investments in Stocks and Bonds of Other Companies

Classifications of Investments

- **Common stock** is the ownership unit of a corporation
 - that common stockholders are the owners of a corporation.
 - have the right to vote on corporate policies and the right to share in the corporation's net income by receiving dividends
- **bonds** are a type of note in which a company agrees to pay the holder the face value on the maturity date and to pay interest on the face value periodically at a specified rate.
 - Bondholders are creditors of a company
 - Cannot vote
 - "share" in the company's income by receiving interest
- A company (*investor*) may choose to invest in the common stock of another company (called the *investee*)
- How the investor company accounts for its investments in stock depends on its "influence" over the investee
- *Influence* is defined by the percentage ownership the investor company has; percentage ownership relates to the number of votes the investor company has.
- If an investor company has **no significant influence** over the investee (less than 20% ownership), it has an investment in "available-for-sale stock."
 - The investor company typically makes this investment to receive dividends and participate in an increase in the market value of stock.
 - The company reports this investment on its balance sheet using the *market value method*.
- If the investor company has **significant influence** over the investee (between 20% and 50% ownership), it has an equity investment.
 - It has larger ownership (equity) interest in the investee and that larger interest provides it with significant influence
 - The investor company reports this investment using the equity method.
- If the investor company has **control** over the investee (more than 50% ownership), the investee is no longer a separate *economic* entity from the investor company, so the investor company prepares *consolidated* financial statements.
- A company may choose to invest in another company's bonds.
 - How a company reports its investments in bonds depend on how long it expects to hold the bonds
 - If the company expects to sell the bonds before maturity date, it calls them "available-for-sale bonds" and reports this investment using the market value method.
 - If the company expects to hold the bonds for their entire life, it calls them "held-to-maturity bonds" and reports this investment using the amortized cost method.

Market Prices of Stocks and Bonds

- A **stockbroker** is a person or company that buys and sells (trades) stocks and bonds for other people or companies.
- The stocks and bonds of large corporations are traded on organized securities exchanges, such as the New York Stock Exchange, the Tokyo Stock Exchange, or the Oslo Stock Exchange.
- The stocks and bonds of other corporations are traded in the over-the-counter method, such as NASDAQ, in which brokers deal directly with each other rather than through a stock exchange
- Market prices of stocks/bonds are quoted daily
- Quoted market prices show the prices an investor had to pay to purchase (or would receive to sell) the securities on the date the prices were quoted.
 - In addition, the investor must pay a fee to the stockbroker to make a purchase or sale.

- o Thus, when a company purchases securities, it records the purchase in an Investment account (asset) at the cost of acquisition, which is the quoted market price on the date of the purchase plus any commissions paid to stockbrokers, and any transfer or sales taxes that are imposed.
- o Market value=fair value

Market Value Method

- A company uses the market value method for investments in **available-for-sale securities**.
 - o Common stock or bonds
 - o Common stock available for sale → the investor does not have significant influence because it owns less than 20% of the investee
 - o Bonds available for sale → investor does not expect to hold the bonds until their maturity date
- Available-for-sale securities are sometimes called marketable securities
- An investor company records dividend revenue on stock paid by the investee when it receives the dividends.
- The investor records interest revenue on bonds in the period the interest is earned.
 - o Interest is earned over time continuously, whereas dividends are discretionary periodic payments.
- An investor reports investments in available-for-sale securities (both stocks and bonds) at their *market value* at year-end.
- An investor computes the gain or loss on the sale of securities by comparing the cash received from the sale with the cost of the securities that it sold.

o EX 1: On January 1st, Unlimited Decadence had excess cash to invest, and purchased 200 shares of Fox Company common stock for \$4,000 and 8 bonds of Crow Company for \$8,000. The bonds have a face value of \$8,000, have a contract rate of 10%, and pay interest semiannually on June 30 and December 31. Unlimited Decadence records the investment on January 1, 2011 at a cost of \$12,000, as follows:

	Assets	=	Liabilities	+	Stockholder's Equity
<u>Cash</u>	<u>Investments in</u>				
	<u>Available-for-Sale</u>				
	<u>Securities</u>				
-\$12,000	+\$12,000				

- o Unlimited Decadence has exchanged one current asset, Cash, for another asset, Investments in Available-for-Sale Securities.
- The company reports its investment as a current asset because it intends to sell the securities within one year.
- If the company intended to keep its investment for at least one year, it would report the investment as a noncurrent asset.
- A company's **investments portfolio** includes all of its investments in the securities of other companies.
 - o Thus, Unlimited Decadence's \$12,000 portfolio of investments in available-for-sale securities on January 1, 2011 consists of 200 shares of common stock costing \$4,000 and 8 bonds costing \$1,000.
- Recording Dividends and Interest
 - o A company records dividend revenue when it receives the cash dividend.
 - o From EX 1:
 - If Unlimited Decadence receives \$200 of dividends on the Fox Company common stock during 2011, it records the receipt as follows:

Asset = Liabilities + Stockholders' Equity

	Revenues	- Expenses
<u>Cash</u>	<u>Dividend Revenue</u>	
+\$200	+\$200	

- o A company records *interest* revenue as the interest is earned during the year.
- o From EX 1:
 - Unlimited Decadence records \$400 [$\$8,000 \text{ face value} \times (10\% \text{ contract rate} \div 2)$] of the interest revenue semiannually on June 30 and December 31 as follows:

	Assets	=	Liabilities	+	<u>Stockholders' Equity</u>
					<u>Net Income</u>
					Revenues - Expenses
<u>Cash</u>					<u>Interest Revenue</u>
+\$400					+\$400

- Reporting Ending Market Value

- o At the end of the year, a company reports its portfolio of investments in available-for-sale securities on its ending balance sheet at the market value of the portfolio.
- o If the market value of the portfolio is greater than the cost, the company increases its Investments account and also increases an *Unrealized Increase* in Market Value of Investments account for the difference between the market value and the cost.
- o If the market value of the portfolio is less than the cost, the company decreases its Investments account and increases an *Unrealized Decrease* in Market Value of Investments account for the difference between the cost and market value.
- o Both the *Unrealized Increase* and *Unrealized Decrease* accounts are stockholders' equity accounts that represent the "gain" or "loss" from the change in market value.
- o The "gain" or "loss" is called "unrealized" because the company has not sold the securities and has not collected cash relating to the change in market value.
- o The company does not include the change in value in its income statement.
- o These accounts are included in a section of the stockholders' equity on its balance sheet, called "accumulated other comprehensive income."
- o From EX 1:
 - Suppose that at the end of 2011, the Fox Company stock has a market value of \$4,600 and the Crow Company bonds have a market value of \$7,900. Unlimited Decadence prepares a schedule of the change in market value of its investments as we show below:

Schedule to Compute Market Value of Investments in Available-for-Sale Securities

<u>Security</u>	<u>1/1/11 Cost</u>	<u>12/31/11 Market Value</u>	<u>Increase (Decrease)</u>
Fox stock	\$4,000	\$4,600	\$600
Crow bonds	8,000	7,900	(100)
Totals	<u>\$12,000</u>	<u>\$12,500</u>	<u>\$500</u>

- Based on the schedule, Unlimited Decadence records the following information in its accounts on December 31, 2011.

Assets	=	Liabilities	+	<u>Stockholders' Equity</u>
				<u>Accumulated Other Comprehensive Income</u>
				(Loss)
<u>Investments in</u>				<u>Unrealized Increase</u>
<u>Available-for-Sale</u>				<u>in Market Value</u>
<u>Securities</u>				<u>of Investments</u>
Bal \$12,000				
+500				+\$500
Bal \$12,500				