LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Demonstrate how to identify and account for investments classified for reporting purposes as held-to-maturity.
2. Demonstrate how to identify and account for investments classified for reporting purposes as available-for-sale.
3. Demonstrate how to identify and account for investments classified for reporting purposes as trading securities.
4. Explain what constitutes significant influence by the investor over the operating and financial policies of the investee.
5. Understand the way investments are recorded and reported by the equity method.
6. Explain the adjustments made in the equity method when the fair value of the net assets underlying the investment exceeds their book value.

CHAPTER HIGHLIGHTS

Many companies invest in securities, such as stocks and bonds, issued by other entities. The motivation for such an investment might be (a) to earn a return on temporarily idle cash or (b) to obtain a favorable business relationship with another firm (perhaps a major customer or supplier). Such investments may be short-term or long-term.

The investment initially should be recorded at cost (including incidental costs such as brokers' fees) in accordance with the cost principle, as in the acquisition of any asset. Following the acquisition, the appropriate accounting for an investment depends upon the nature of the investment as differentiated below:
# Investments

<table>
<thead>
<tr>
<th>Types of Securities</th>
<th>Characteristics</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>The investor <em>controls</em> the investee</td>
<td>Consolidation</td>
</tr>
<tr>
<td>Equity</td>
<td>The investor can &quot;significantly influence&quot; the operating and financial policies of the investee</td>
<td>Equity Method</td>
</tr>
</tbody>
</table>

If neither consolidation nor the equity method is appropriate, we have an "investment security" to be accounted for as follows:

<table>
<thead>
<tr>
<th>Types of Securities</th>
<th>Characteristics</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>Investor has the &quot;positive intent and ability&quot; to hold to maturity</td>
<td>Hold-to-Maturity Amortized cost</td>
</tr>
<tr>
<td>Debt or equity*</td>
<td>Held in active trading account for immediate resale</td>
<td>Trading Security Fair value (with unrealized gains and losses included in earnings)</td>
</tr>
<tr>
<td>Debt or equity*</td>
<td>Investments not classified in another category</td>
<td>Available-for-Sale Fair value (with unrealized gains and losses excluded from earnings and reported in shareholders' equity)</td>
</tr>
</tbody>
</table>

* If the fair value is not determinable and the equity method is not appropriate, these should be reported at original cost.
PART A: ACCOUNTING FOR INVESTMENT SECURITIES

For reporting purposes, all investments in debt securities and investments in equity securities that have readily determinable fair values (except those for which the equity method or consolidation is appropriate) are classified in one of three categories and accounted for differently depending on the classification as shown in the graphic above. These are described below.

Securities Held-to-Maturity

A bond or other debt security, unlike a share of stock, matures on a specified date. If an investor has the "positive intent and ability" to hold debt securities to their scheduled maturity, those investments are classified as "held-to-maturity." These investments are recorded at cost. That cost is not adjusted for changes in the fair value of the securities. Holding gains or losses from market price changes are ignored.

Securities Classified As Available-For-Sale

For investments of unspecified length, market returns due to changes in fair values offer an indication of management's success in managing its investments. It's appropriate, then, to adjust those investments to fair value when market prices change.

Investments in debt and equity securities that won't be held to their scheduled maturity and don't meet the strict definition of trading securities are classified as "available-for-sale." These investments are reported at their fair values. Holding gains and losses from holding on to securities during periods of price change are not included in the determination of income for the period. Instead, they are reported as a separate component of shareholders' equity, part of Accumulated other comprehensive income.

Here's an example:

ILLUSTRATION

SECURITIES AVAILABLE-FOR-SALE:

Blanchard Transport Company occasionally buys securities to be available for sale as circumstances warrant. The intent is not to profit from short-term differences in price and not necessarily to hold debt securities to maturity. The company's fiscal year ends on December 31. Assume Blanchard had no investments at the beginning of the year.
Investments

2006

To record the purchase on March 12 of 2 million NXX common shares for $72 million, including brokerage fees and commissions.

<table>
<thead>
<tr>
<th>Investment in NXX shares</th>
<th>$72</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>72</td>
</tr>
</tbody>
</table>

To record cash dividends of $3 million received on October 9 on the investment in NXX common shares.

<table>
<thead>
<tr>
<th>Cash</th>
<th>$3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment revenue</td>
<td>3</td>
</tr>
</tbody>
</table>

To record on December 31 the necessary adjusting entry when the market price of NXX stock was $37 per share.

| Fair value adjustment     | 2   |
| Net unrealized holding gains and losses | 2 |
| ([$37 x 2 million shares] - $72 million) | 2 |

**2006 Income Statement** ($ in millions)

| Investment revenue | $3 |

Note: Unlike for trading securities, unrealized holding gains and losses are not included in income for securities available-for-sale.

**2006 Balance Sheet** ($ in millions)

| Assets: Investment in NXX shares | 74 |

<table>
<thead>
<tr>
<th>Shareholders' equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated other comprehensive income</td>
</tr>
<tr>
<td>Net unrealized holding gain on investments</td>
</tr>
</tbody>
</table>
2007

To record the sale on January 14 of 1 million of the NXX common shares for $38 per share.

| Cash (1 million shares x $38) | 38 |
| Gain on sale of investments (difference) | 2 |
| Investment in NXX shares ($72 million cost x 1/2) | 36 |

**Trading Securities**

Trading securities are actively managed in a trading account for the purpose of profiting from short-term price changes. Keep in mind that relatively few investments are classified this way because only banks and other financial operations invest in securities in the way necessary to be categorized as trading securities.

Like securities available-for-sale, they are reported at their *fair values*. Unlike for securities available-for-sale, holding gains and losses for trading securities are *included in earnings*. This is appropriate because trading securities are actively managed for the purpose of profiting from short-term market price changes. Thus, gains and losses that result from holding trading securities during market price changes represent measures of success or lack of success in doing so.

Note that each of the transactions in the securities available-for-sale illustration and the adjustments to *fair value* would be recorded in precisely the same way for trading securities. The only difference is the way the holding gains and losses would be reported.

**2006 Income Statement** ($ in millions)

| Investment revenue | $3 |
| Unrealized holding gain on investments | 2 |

Note: Unlike for securities available-for-sale, unrealized holding gains and losses are *included* in income for trading securities.

**2006 Balance Sheet** ($ in millions)

| Investment in NXX shares | 74 |

**Shareholders’ equity:**

No effect
Investments

Financial Statement Presentation and Disclosure

Trading securities always are current assets – by definition. Available-for-sale and held-to-maturity securities can be either current or noncurrent depending on when they are expected to be sold or mature.

A transfer of a security between reporting categories is accounted for at fair value and in accordance with the new reporting classification.

Inflows and outflows of cash from buying and selling trading securities are considered operating activities on the statement of cash flows. However, because available-for-sale and held-to-maturity securities are not purchased primarily to be sold in the near term, cash flows from their purchase, sale, and maturity are reported as investing activities.

Disclosure notes for each year presented should include:

- Aggregate fair value.
- Gross realized and unrealized holding gains.
- Gross realized and unrealized holding losses.
- The change in net unrealized holding gains and losses.
- Amortized cost basis by major security type.

For debt securities, information should be reported about maturities by disclosing the fair value and cost for at least 4 maturity groupings: (a) within 1 year, (b) after 1 year through 5 years, (c) after 5 years through 10 years, and (d) after 10 years.

PART B: EQUITY METHOD

As pointed out earlier, an investment of 51% or more of the voting stock (common or preferred) of another corporation, generally results in consolidation of the financial statements of the “parent” and “subsidiary.” When an investor does not have “control,” but still is able to exercise significant influence over the operating and financial policies of the investee, the investment should be accounted for by the equity method. It should be presumed, in the absence of evidence to the contrary, that the investor exercises significant influence over the investee when an investor owns between 20% and 50% of the investee’s voting shares.

By the equity method, the investor recognizes investment income in an amount equal to the investor’s percentage share (based on share ownership) of the net income earned by the investee, instead of the amount of that net income it receives as cash dividends. The investor adjusts its investment account for the investor’s percentage share of net income reported by the investee. When the investor actually receives dividends, the investment account is reduced accordingly. The rationale is that as the investee earns additional net assets, the investor’s share of those net assets increases. As the investee’s net assets decline due to paying dividends, the investor’s share of those

---

1 A detailed discussion of consolidated financial statements often is a major focus of the “Advanced Accounting” course or is taught as a separate “Consolidations” course. In this chapter, we’ll briefly overview the subject only to provide perspective to aspects of the equity method that purposely mimic some effects of consolidation.

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net assets decreases. The investor’s share of net assets is reflected in the investment account. Let’s look at an example:

**ILLUSTRATION**

**EQUITY METHOD:**

On January 1, 2006, Deuce Hardware paid $200 million for 12 million of the 48 million outstanding shares of Farrah Faucets, Inc. common stock. In December 2006, Deuce received dividends of $1.00 per share. For the year ended December 31, 2006, Farrah Faucets reported net income of $160 million. The market value of Farrah Faucets’ common stock at December 31, 2006, was $19.25 per share.

- The book value of Farrah Faucets’ net assets was $600 million.
- The *fair market value* of Farrah Faucets’ depreciable assets exceeded their *book value* by $80 million. These assets had an average remaining useful life of 10 years.
- The remainder of the difference between the cost of the investment over the book value of net assets purchased was attributable to goodwill.

**To record the purchase of the shares.**

<table>
<thead>
<tr>
<th>Investment in Farrah Faucets shares</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>200</td>
</tr>
</tbody>
</table>

**To record Deuce’s share of Farrah Faucets’ net income.**

<table>
<thead>
<tr>
<th>Investment in Farrah Faucets shares (25%* x $160 million)</th>
<th>40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment revenue</td>
<td>40</td>
</tr>
</tbody>
</table>

\* 12 million / 48 million outstanding shares

**To record Deuce’s receipt of cash dividends.**

<table>
<thead>
<tr>
<th>Cash (12 million shares x $1)</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Farrah Faucets shares</td>
<td>12</td>
</tr>
</tbody>
</table>

When the *fair value* of assets acquired in an investment exceeds their *book value*, both the investment account and investment revenue may need to be adjusted for differences between net income reported by the investee and what that amount would have been if consolidation procedures had been followed.
Investments

To adjust for depreciation.

| Investment revenue ($20 million [calculation below] × 10 years) | 2 |
| Investment in Farrah Faucets shares | 2 |

<table>
<thead>
<tr>
<th>Calculations:</th>
<th>Investee Net Assets</th>
<th>Net Assets Purchased</th>
<th>Difference Attributed to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value:</td>
<td>$680* x 25% = $170</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Book value:</td>
<td>$600 x 25% = $150</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*[$600 + 80] = $680

Goodwill: $30

Undervaluation of assets: $20

The adjustments for depreciation approximate the effects of consolidation, without actually consolidating financial statements. Both the investment account and investment revenue are adjusted for differences between net income reported by the investee and what that amount would have been if consolidation procedures had been followed. In consolidated financial statements, the acquired company's assets are included in the financial statements at their fair values rather than their book values.

To record on December 31 the necessary adjusting entry when the market price of Farrah Faucets stock was $19.25 per share.

No entry; equity method investments are not adjusted to fair value.

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The investment is reported as follows:

**Investment in Farrah Faucets Shares**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>200</td>
</tr>
<tr>
<td>Share of net income</td>
<td>40</td>
</tr>
<tr>
<td>12 Dividends</td>
<td></td>
</tr>
<tr>
<td>2 Depreciation</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>226</td>
</tr>
</tbody>
</table>

When the Investment is Acquired in Mid-Year

When an investment is acquired sometime after the beginning of the year, the adjustments to cost are modified to include the appropriate fraction of each of those amounts. For instance, if in our illustration Deuce had purchased the Farrah Faucets shares on March 1, rather than January 1, we would simply record income, dividends, and amortization for 10 months, or $\frac{10}{12}$ of the amounts shown.

When the Nature of the Investment Changes

When a change *from* the equity method to another method is appropriate because the investor’s level of influence changes, for instance, if a sale of shares causes the investor’s ownership interest to fall from, say, 25% to 10%, we make *no adjustment* to the carrying amount of the investment. Instead, we would simply discontinue the equity method and apply the new method from then on.

When a change *to* the equity method is appropriate, we would retroactively adjust the investment account to the balance that would have existed if the equity method always had been used.

**Decision-Makers’ Perspective**

The way we account for an investment is dictated by the nature of the investment itself. It has little effect on a company’s cash flows. But, despite the lack of “real” impact on cash flows, the accounting method affects net income, including calculations of earnings per share and any rate of return ratios. So, it’s important for both company managers and external decision-makers to clearly understand those impacts and make decisions accordingly. Analysts should be particularly alert to changes in the method from one year to the next.

The equity method was designed in part to prevent the manipulation of income. That could occur if investing corporations who have significant influence over investees were permitted to recognize income only when received as dividends. The equity method limits that potential way of managing earnings. However, the discretion management has in classifying investments creates other potential abuses.
Appendix 12-A: Other Investments
(Special Purpose Funds, Investments in Life Insurance Policies)

A company can establish a special purchase fund for virtually any purpose. Common examples are petty cash and funds for future expansion. Some special purchase funds – like petty cash – are current assets. Special purchase funds that are noncurrent are reported within the category “Investments and funds.” Any investment revenue these funds produce is reported as investment revenue on the income statement.

Companies frequently take out life insurance policies on the life of key personnel. Some life insurance policies can be surrendered while the insured is still alive in exchange for its cash surrender value. A portion of each insurance premium the company pays represents an increase in the cash surrender value. This investment portion is recorded as an asset.

Appendix 12-B: Impairment of an Investment in a Receivable Due to a Troubled Debt Restructuring

If a receivable becomes impaired (worth less than before), it is remeasured. It is remeasured based on the discounted present value of currently expected cash flows at the loan’s original effective rate (regardless of the extent to which expected cash receipts have been reduced). One way impairment can occur is when the terms of a debt agreement are changed as a result of financial difficulties experienced by the debtor (borrower). This new arrangement is referred to as a troubled debt restructuring.

If, instead, the receivable is settled outright at the time of the restructuring the creditor simply records a loss for the difference between the carrying amount of the receivable and the fair value of the asset(s) or equity securities received. But, if the receivable is continued, but with modified terms, the difference between the receivable’s carrying amount and the discounted present value of the cash flows after the restructuring is reported as a loss.
SELF-STUDY QUESTIONS AND EXERCISES

Concept Review

1. For a security available-for-sale, the investor initially records the investment at the ________ and subsequently adjusts the investment account balance to fair market value.

2. Investment securities are classified as __________________, __________________, or __________________.

3. Securities are classified as “held-to-maturity” if an investor has the positive ________ and ability to hold the securities to maturity.

4. Securities available-for-sale are reported at fair value, and resulting holding gains and losses are reported ____________.

5. Unrealized holding gains or losses on ____________ securities are reported on the income statement as if they actually had been realized.

6. If a drop in the market price of an investment security is an other-than-temporary impairment, when the investment is written down to its fair value, the amount of the write-down should be treated as if it were a ____________ loss, meaning the loss is included in ____________ for the period.

7. A company is not required to report individual amounts for the three categories of investments – held-to-maturity, available-for-sale, or trading – on the face of the balance sheet, that information should be presented in the ____________.

8. The equity method is used when an investor can’t control, but can exercise ____________ over the operating and financial policies of the investee. We presume, in the absence of evidence to the contrary, that this is so when the investor owns between ___ % and ____ % of the investee's voting shares.

9. By the ____________ method, the investor reports its equity interest in the investee as a single investment account. That single investment account is periodically adjusted to reflect the effects of consolidation, without actually consolidating financial statements.

10. By the equity method, dividends from the investee should be accounted for by the investor as a reduction in the ____________ account.

11. The equity method attempts to approximate the effects of accounting for the purchase of the investee. Consolidated financial statements report ____________ for the excess of the acquisition price over the fair value of the acquired net assets.

12. By the equity method, both ____________ and the investment would be reduced by the negative income effect of “extra depreciation” due to the fair value of depreciable assets exceeding book value.

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Investments

13. The investment account was decreased. Cash increased by the same amount. There is no effect on the income statement. These sentences describe an adjustment to an equity method investment due to receiving ____________.

14. If it becomes necessary to change from the equity method to another method, ____________ is made to the carrying amount of the investment.

Answers:

REVIEW EXERCISES

Exercise 1
On January 3, 2006, Mercer Industries paid $48 million for 6 million shares of Sable House, Inc. common. The investment represents a 30% interest in the net assets of Sable House and gave Mercer the ability to exercise significant influence over Sable House's operating and financial policies. Mercer received dividends of $1.00 per share on December 15, 2006, and Sable House reported net income of $40 million for the year ended December 31, 2006. The market value of Sable House's common stock at December 31, 2006, was $9 per share.

Required:
Prepare the journal entries required by Mercer for 2006, assuming that:
a. The book value of Sable House's net assets was $90 million.
b. The fair market value of Sable House's depreciable assets, with an average remaining useful life of 6 years, exceeded their book value by $20 million.
c. The remainder of the excess of the cost of the investment over the book value of net assets purchased was attributable to goodwill.
Mercer purchases the Sable House shares.

Sable House reports net income.

Sable House pays cash dividends.

Adjustments.

Depreciation:

Increase in fair value of shares:
Solution:

Mercer purchases the Sable House shares.

Investment in Sable House shares ........................................ ($ in millions) 48
Cash ................................................................. 48

Sable House reports net income.
Investment in Sable House shares (30% x $40 million) ................ 12
Investment revenue .................................................. 12

Sable House pays cash dividends.
Cash (6 million shares x $1) ............................................... 6
Investment in Sable House shares ....................................... 6

Adjustment.

Depreciation:
Investment revenue ($6 million [calculation below\(\dagger\) + 6 years]) ........ 1
Investment in Sable House shares ....................................... 1

\(\dagger\)Calculations:

<table>
<thead>
<tr>
<th>Investee Net Assets</th>
<th>Net Assets Purchased</th>
<th>Difference Attributed to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$48</td>
<td></td>
</tr>
<tr>
<td>Fair value: $110* x 30% =</td>
<td>$33</td>
<td>Goodwill: $15</td>
</tr>
<tr>
<td>Book value: $90 x 30% =</td>
<td>$27</td>
<td>Undervaluation of assets: $6</td>
</tr>
</tbody>
</table>

*\([90 + 20] = 110\)

Increase in fair value of shares:
No entry; equity method investments are not adjusted to fair value.
Exercise 2

Prepare the appropriate journal entries for Mercer in Exercise 1 for 2006, assuming that the investment represents a 10% interest in the net assets of Sable House.

Mercer purchases the Sable House shares. ($ in millions)

Sable House reports net income. ($ in millions)

Sable House pays cash dividends. ($ in millions)

Adjustments

Depreciation: ($ in millions)

Increase in fair value of shares: ($ in millions)
Investments

Solution:

Mercer purchases the Sable House shares.

Investment in Sable House shares ................................................................. Cash ................................................................. ($ in millions) 48 48

Sable House reports net income.
No entry

Sable House pays cash dividends.
Cash (6 million shares x $1) ................................................................. Investment revenue ................................................................. 6 6

Adjustments.

Depreciation:
No entry

Increase in fair value of shares:
Fair value adjustment ([$9 x 6 million shares] - $48 million) ................................................................. Unrealized gain on investment in Sable House shares ................................................................. 6 6
MULTIPLE CHOICE

Enter the letter corresponding to the response that best completes each of the following statements or questions.

1. On January 1, 2006, Normal Plastics bought 15% of Model, Inc.'s common stock for $900,000. Model's net income for the years ended December 31, 2006, and December 31, 2007, were $600,000 and $1,500,000, respectively. During 2007, Model declared a dividend of $420,000. No dividends were declared in 2006. How much should Normal show on its 2007 income statement from this investment?
   a. $0.
   b. $63,000.
   c. $288,000.
   d. $378,000.

2. Fair value is used as the basis for valuation of a firm's investment securities when:
   a. Management's intention is to dispose of the securities within one year.
   b. The market value is less than cost for each equity security in the portfolio.
   c. The investment security is not classified as held-to-maturity.
   d. The investment security is classified as held-to-maturity.

3. Unrecognized holding gains and losses are included in an investor's earnings for:

<table>
<thead>
<tr>
<th>Trading Securities</th>
<th>Securities Available-For-Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

4. Investment securities are reported on a balance sheet at fair value for:

<table>
<thead>
<tr>
<th>Trading Securities</th>
<th>Securities Available-For-Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
Investments

5. Which of the following statements is untrue regarding investments in equity securities?
   a. If the investor owns less than 20 percent of outstanding voting common stock, the equity method usually is not used.
   b. If the investor owns more than 50 percent of the outstanding voting common stock, the financial statements are consolidated.
   c. If the investor owns 20-50 percent of the outstanding voting common stock, the equity method always is required.
   d. If the investor owns less than 20 percent of outstanding voting common stock, the securities generally are reported at their fair value.

6. Unrecognized holding gains and losses for securities to be held-to-maturity are:
   a. Reported as a separate component of the shareholders' equity section of the balance sheet.
   b. Included in the determination of income from operations in the period of the change.
   c. Reported as extraordinary items.
   d. Not reported in the income statement nor the balance sheet.

7. Unrecognized holding gains and losses for securities available-for-sale are:
   a. Reported as a separate component of the shareholders' equity section of the balance sheet.
   b. Included in the determination of income from operations in the period of the change.
   c. Reported as extraordinary items.
   d. Not reported in the income statement nor the balance sheet.

8. Unrecognized holding gains and losses for trading securities are:
   a. Reported as a separate component of the shareholders' equity section of the balance sheet.
   b. Included in the determination of income from operations in the period of the change.
   c. Reported as extraordinary items.
   d. Not reported in the income statement nor the balance sheet.

9. On January 12, Henderson Corporation purchased 4 million shares of Honeycutt Corporation common stock for $73 million and classified the securities as available-for-sale. At the close of the same year, the fair value of the securities is $81 million. Henderson Corporation should report:
   a. A gain of $8 million on the income statement.
   b. An increase in shareholders' equity of $8 million.
   c. An investment of $73 million.
   d. None of the above.

10. Evans Company owns 4.5 million shares of stock of Frazier Company classified as available-for-sale. During 2006, the fair value of those shares increased by $9 million. What effect did this increase have on Evans' 2006 financial statements?
    a. Net assets increased.
    b. Total assets decreased.
    c. Net income increased.
    d. Shareholders' equity decreased.
11. Level Company owns bonds of Leader Company classified as held-to-maturity. During 2006, the fair value of those bonds increased by $4 million. Interest was received of $3 million. What effect did the investment have on Level’s 2006 financial statements?
   a. Total assets increased by $7 million.
   b. Total assets increased by $3 million.
   c. Net income increased by $7 million.
   d. Shareholders’ equity increased by $4 million.

12. If the investment described in the previous question had been classified as available-for-sale, what effect would the investment have on Level’s 2006 financial statements?
   a. Total assets increased by $7 million.
   b. Total assets increased by $3 million.
   c. Net income increased by $7 million.
   d. Shareholders’ equity increased by $1 million.

13. On January 2, 2006, Garner, Inc. bought 10% of the outstanding common stock of Moody, Inc. for $60 million cash. At the date of acquisition of the stock, Moody’s net assets had a book value and fair value of $180 million. Moody’s net income for the year ended December 31, 2006, was $30 million. During 2006, Moody declared and paid cash dividends of $6 million. On December 31, 2006, Garner’s investment should be reported at:
   a. $60.0 million.
   b. $66.9 million.
   c. $69.0 million.
   d. $71.1 million.

14. On January 2, 2006, Garner, Inc. bought 30% of the outstanding common stock of Moody, Inc. for $60 million cash. At the date of acquisition of the stock, Moody’s net assets had a book value and fair value of $180 million. Moody’s net income for the year ended December 31, 2006, was $30 million. During 2006, Moody declared and paid cash dividends of $6 million. On December 31, 2006, Garner's investment account should be reported at:
   a. $60.0 million.
   b. $67.2 million.
   c. $69.0 million.
   d. $71.1 million.

15. The equity method is used when an investor can’t control, but can exercise significant influence over the operating and financial policies of the investee. We presume, in the absence of evidence to the contrary, that this is so if:
   a. The investor classifies the investment as available-for-sale.
   b. The investor classifies the investment as held-to-maturity.
   c. The investor owns between 51% or more of the investee's voting shares.
   d. The investor owns between 20% and 50% of the investee's voting shares.
16. On January 2, 2006, Germane, Inc. bought 30% of the outstanding common stock of Quality, Inc. for $56 million cash. At the date of acquisition of the stock, Quality’s net assets had a book value and fair value of $120 million. Quality’s net income for the year ended December 31, 2006, was $30 million. During 2006, Quality declared and paid cash dividends of $10 million. On December 31, 2006, Germane’s should report investment revenue of:
   a. $3 million.
   b. $6 million.
   c. $9 million.
   d. $30 million.

17. When applying the equity method, an investor should report dividends from the investee as:
   a. Dividend revenue.
   b. An extraordinary item.
   c. A reduction in the investment account.
   d. An increase in the investment account.

18. Western Manufacturing Company owns 40% of the outstanding common stock of Eastern Supply Company. During 2006, Western received a $50 million cash dividend from Eastern. What effect did this dividend have on Western’s 2006 financial statements?
   a. Total assets increased.
   b. Total assets decreased.
   c. Net income increased.
   d. The investment account decreased.

Answers:
1. b 6. d 11. b 16. c
2. c 7. a 12. a 17. c
3. a 8. b 13. a 18. d
4. b 9. b 14. b
5. c 10. a 15. d