

CHAPTER 16

Investments and International Operations

Chapter Overview

The chapter begins with a discussion of stock investments, stock prices, and how stock investments are classified. Students first learn how to account for trading investments, then how to account for long-term, available-for-sale investments, both using the market-value method. Entries are included for the purchase and sale of the investment, for receipt of dividends, and for adjusting to balance sheet values; balance sheet presentations are included. The equity method, used when the investor holds 20-50% of the investee's voting stock, is explained and various transactions are illustrated. Joint ventures are briefly discussed.

Accounting for consolidated subsidiaries, when the investor (parent) holds more than 50% of the investee (subsidiary) corporation's voting stock, is covered. Next, long-term investments in bonds and notes, called "held-to-maturity" investments, are accounted for using the amortized-cost method. Various entries, including amortization of bond discount, are presented. Decision Guidelines discuss the appropriate accounting method for various long-term investments. A mid-chapter summary problem reviews equity, market value, and consolidation methods of accounting for long-term investments.

The second part of the chapter focuses on accounting for international operations. The discussion includes relevant topics such as foreign-currency exchange rates, international transactions, and hedging. Journal entries help explain purchases and sales on account and foreign-currency transaction gains and losses. International accounting standards are discussed. Decision Guidelines summarize foreign-currency transactions. A final summary problem helps the student review international accounting by journalizing various transactions. An Excel Application problem reinforces concepts covered in the chapter.

Learning Objectives

After studying chapter 16, your students should be able to:

1. Account for trading investments
2. Account for available-for-sale investments
3. Use the equity method for investments
4. Understand consolidated financial statements
5. Account for long-term investments in bonds
6. Account for transactions stated in a foreign currency

Chapter Outline

Stock investments are shares of stock of a corporation (the **investee**) that have been purchased by an **investor**. Stock price (market price) information is quoted as illustrated in Exhibit 16-1.

- A. **Short-term** stock investments or **marketable securities** are current assets. These investments must be liquid and management must intend to sell these investments within one year.
- B. **Long-term** investments are all other investments that do not meet the criteria for short-term investments. Refer to Exhibit 16-2 for balance sheet presentation of both short-term and long-term investments.

Objective 1: Account for trading investments

- A. When the investor owns **less than 20%** of the investee company, the securities may be classified as either **trading investments** (classified as current assets because the intent is to sell in the very near future) *or* as **available-for-sale investments** (which may be current or long-term).
- B. **Trading investments** are stock investments that will be sold within a very short period of time with the intent to generate a profit on price changes.

- 1. Using the **market-value method**, begin by recording the investment purchase at **cost**.

Short-Term Investment	XX	
Cash		XX

- 2. Dividends received are reported as **dividend revenue**.
- 3. A year-end entry adjusts the carrying amount of the trading investment to its **current market value**. The gain or loss may be combined with other gains and losses and reported on the income statement. The adjusting entry will be one of the following:

<u>Gain</u>		<u>Loss</u>	
Short-Term Investment	XX	Loss on Trading	
Gain on Trading		Investment	XX
Investment	XX	Short-Term Investment	XX

- 4. When a trading investment is **sold**, the **gain or loss** is the difference between the sales proceeds and the last carrying amount on the balance sheet.

Objective 2: Account for available-for-sale investments

- A. **Available-for-sale investments** are also accounted for by the **market-value method**, because the company expects to resell the stock at its market value.
- 1. The original purchase is recorded at **cost**.

Long-Term Available-for-Sale Investment	XX	
Cash		XX

2. **Cash dividends** received are reported as dividend revenue when received; **stock dividends** are reported with a memo entry only.
3. An **unrealized gain or loss** is recorded to reflect the change in market value of the asset from period to period. *Unrealized* means the gain or loss results from a change in market value, *not* from a sale of the investment.

<u>Unrealized Gain</u>		<u>Unrealized Loss</u>	
Allowance to Adjust Investment to Market	XX	Unrealized Loss on Investment	XX
Unrealized Gain on Investment	XX	Allowance to Adjust Investment to Market	XX

4. The allowance account is a companion account to the investment account. It either adds to or is deducted from the investment account; therefore the investment is reported at its current market value, not its cost.
5. Unrealized Gain or Loss is shown as part of stockholders' equity, following Retained Earnings. An unrealized gain increases stockholders' equity while a loss reduces stockholders' equity.

- B. When an available-for-sale investment is sold, a **realized gain or loss** may be recorded; this is the difference between the amount received and the cost of the investment. Realized gains or losses are reported as part of "**Other gains or losses**" on the income statement.

Objective 3: Use the equity method for investments

- A. Long-term investments of **between 20% and 50%** of the investee's outstanding stock require the use of the **equity method**.
1. The investor may have **significant influence** on how the investee, often referred to as an affiliated company, operates its business.

2. The investment is initially recorded at **cost**.

Long-Term Equity-Method Investment	XX	
Cash		XX

3. Because of the close relationship of the two companies, the investor applies its percentage of ownership to record its share of the investee's net income and dividends. The investor *increases* the Investment account for its share of the investee's net income:

Long-Term Equity-Method Investment	XX	
Equity-Method Investment Revenue		XX

4. Cash dividends received *reduce* the Investment account because dividends decrease the investee's owners' equity. The investor *decreases* the Investment account when dividends are received from the investee with this entry:

Cash		XX
Long-Term Equity-Method Investment		XX

5. **Gain or loss on the sale** of the investment is the difference between the sales proceeds and the carrying amount of the investment.
6. This T-account summarizes the accounting for equity-method investments:

<u>Long-Term Equity-Method Investment</u>	
Cost	Share of losses
Share of income	Share of dividends received

- B. **Joint ventures** are accounted for using the **equity method** even if the investor owns less than 20% of the venture, because the joint venturer is presumed to have a significant influence on the investee company.

Objective 4: Understand consolidated financial statements

- A. **Long-term investments of greater than 50%** of the outstanding stock of the investee (subsidiary) require **consolidation accounting**.
 1. The investor or **parent** has **controlling** (majority) **interest** of the investee or **subsidiary**. (Refer to Exhibits 16-3 and 16-4.)
 2. **Consolidation accounting** combines financial statements of two or more companies that are controlled by the same owners into one set of consolidated statements. (Exhibit 16-5 illustrates accounting methods used depending on the investor's percentage of ownership in the investee company.)
- B. **Consolidated financial statements** help provide better insight into the total operations of the parent and its subsidiaries. Assets, liabilities, revenues, and expenses of the majority-owned subsidiaries are added to the parent's accounts for reporting purposes only.
- C. Both parent and subsidiaries continue to maintain their own separate set of books.
- D. **Goodwill** is an intangible asset that is recorded in the consolidation process and reported on the parent company's consolidated balance sheet. Goodwill is the excess of the cost to acquire the subsidiary over the market value of its net assets (assets minus liabilities).
- E. **Minority interest** represents the portion (less than 50%) of the subsidiary's stock that is owned by outsiders; it is usually reported as a **liability** on the consolidated balance sheet.
- F. The **consolidated income statement** will show the net income of the parent plus the parent's proportionate share of each subsidiary's net income.

Objective 5: Account for long-term investments in bonds

- A. The dollar amounts of bond transactions are the same for both issuer and investor; only the accounts differ. Short-term investments in bonds are rare.
- B. **Held-to-maturity investments** are investments in debt securities (bonds) that are intended to be held to maturity, and thus are usually **long-term (non-current) assets**. This type of bond investment is accounted for by the **amortized-cost method**.

1. Record the investment at **cost**.

Long-Term Investment in Bonds	XX	
Cash		XX

2. The carrying amount of the investment is reported on the balance sheet at **amortized cost**, that is, its cost less unamortized discount or cost plus unamortized premium.
3. The **discount or premium** amount is **amortized** directly to the Investment account; amortizing the discount increases the Investment account, while amortizing the premium reduces the Investment account.

Amortization of Discount

Amortization of Premium

Long-Term Investment in Bonds	XX			
Interest Revenue	XX	Interest Revenue	XX	
		Long-Term Investment in Bonds	XX	

4. **Interest revenue** is recorded when interest payments are received; it is also accrued at year-end.

- C. **Decision Guidelines** summarize the different accounting methods used for long-term investments.

Objective 6: Account for transactions stated in a foreign currency

- A. Many American companies do business in foreign countries. Exhibit 16-6 illustrates the extent of international business for several U.S. corporations.
- B. Each country uses its own currency. A **foreign-currency exchange rate** is used to state one country's currency in terms of another country's currency. (Several foreign-currency exchange rates are illustrated in Exhibit 16-7.)

1. **Translation** is the process of converting the cost of an item given in one currency to its cost in a second currency.
2. A **strong currency** results when the country's exchange rate is rising relative to other nations' currencies.

3. A **weak currency** results when the country's exchange rate is falling relative to other nations' currencies.

C. **International transactions** can be recorded in the foreign currency or in American currency.

1. When purchasing or selling goods on account, a **foreign-currency transaction gain or loss** may occur.
2. The foreign-currency exchange rate may be different on the day the purchase or sale is recorded than on the day when the payment or receipt actually occurs. Between the time the transaction is initiated and finalized, the company is exposed to *foreign-currency exchange risk*.
 - a. A **foreign-currency loss** (an **other expense** on the income statement) occurs when less cash is received due to a decline in the foreign country's exchange rate or when more cash must be paid due to an increase in the foreign country's exchange rate.
 - b. A **foreign-currency gain** (an **other revenue** on the income statement) occurs when more cash is received due to an increase in the foreign country's exchange rate or when less cash must be paid due to a decrease in the foreign country's exchange rate.
3. The following entries relate to receipts and payments in a foreign currency:

Cash receipts in a foreign currency

Cash payments in a foreign currency

Sale on account:

Accounts Receivable	XX
Sales Revenue	XX

Purchase on account:

Inventory	XX
Accounts Payable	XX

Collection on account:

Cash	XX
Accounts Receivable	XX
Foreign-Currency Gain	XX

Payment on account:

Accounts Payable	XX
Foreign-Currency Loss	XX
Cash	XX

Note: A transaction loss is recorded as a debit

Note: A transaction gain is recorded as a credit

- D. **Hedging** is a means of protecting oneself from losing in foreign currency transactions by engaging in another transaction that will offset any foreign-currency transaction gain or loss. Companies buy *futures contracts*, which are agreements for foreign currencies to be received in the future.
- E. **The International Accounting Standards Committee (IASC)** is working to eliminate differences in accounting standards in various countries, in order to increase comparability among financial statements. Exhibit 16-8 illustrates some international accounting differences.
- F. **Decision Guidelines** summarize foreign-currency transactions.