CHAPTER 8

INTERCORPORATE INVESTMENTS

1. (C) $60,000.

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 × 100,000) – (0.15 x 20,000) = 60,000.

(Module 8.2, LOS 8.a)

Related Material

SchweserNotes - Book 2

2. (A) I only.

Explanation

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

(Module 8.5, LOS 8.a)

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.

3. (C) $460,000.

Explanation

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

(Module 8.5, LOS 8.a)

Related Material

SchweserNotes - Book 2

4. (C) $72,000.

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) x 240,000 = 72,000.

(Module 8.5, LOS 8.a)

Related Material

SchweserNotes - Book 2

5. (C) $2,400,000.

Explanation

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

(Module 8.5, LOS 8.a)

Related Material

SchweserNotes - Book 2

6. (B) $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 x 20,000) + (0.4 x 30,000) – (0.3 x 8,000) – (0.4 x 12,000) = 10,800.

(Module 8.5, LOS 8.a)

Related Material

SchweserNotes - Book 2

Joseph Haggs, CFA, is an analyst working for Garvess Jones, a large publicly traded investment-banking 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 effects of the acquisition on Simpson's financial statements.

7. (B) **Equity 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.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

8. (A) **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 ford 1998.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

9. (A) **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.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

10. (C) **$-2,830,000.**

Explanation

Simpson paid a total of $-3,190,000 (290,000 shares x $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 x $1.20 = $360,000. This will make the total cash flow for the year $-2,830,000.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

11. (C) **Both methods report the same net income.**

Explanation

Both methods will report the same net income.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

12.	(C)	Unrealized amounts reported on income statement.	Assets reported at fair value.

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.

(Module 8.2, LOS 8.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.

13. (A) $3.5 million.

Explanation

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

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

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

14. (B) $2.6 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

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

15. (B) $150,000.

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

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

16. (B) +$50,000.

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 x ($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.

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

17. (A) carrying value (including goodwill) is greater than its fair value.

Explanation

To test goodwill for impairment under U.S. GAAP, the carrying value of the reporting unit (including goodwill) is compared to the fair value of the reporting unit. After an impairment has been detected, the loss is calculated as the difference between the book value of goodwill and the implied value of goodwill.

(Module 8.7, LOS 8.a)

Related Material

SchweserNotes - Book 2

18. (B) the equity method results in a single line item on the income statement, and a single line item on the balance sheet.

Explanation

On the income statement, the equity method results in a single line item (equity in income of the joint venture). On the balance sheet, the equity method also results in a single line item (investment in joint venture). Both IFRS and U.S. GAAP require the equity method of accounting for joint ventures; only under rare circumstances will proportionate consolidation be allowed for reporting of joint ventures under IFRS and U.S. GAAP. Total net assets of the investor is identical under the two methods.

(Module 8.8, LOS 8.a)

Related Material

SchweserNotes - Book 2

19. (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.

(Module 8.4, LOS 8.c)

Related Material

SchweserNotes - Book 2

20. (C) Acquisition 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.

(Module 8.4, LOS 8.b)

Related Material

SchweserNotes - Book 2

21. (C) more or less favorable depending on the leverage of the investee company.

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.

(Module 8.4, LOS 8.c)

Related Material

SchweserNotes - Book 2

22. (C) Acquisition.

Explanation

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

(Module 8.4, LOS 8.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 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.

23. (B) $600,000.

Explanation

Under the equity method, Flitenight would record $600,000 (= $3 million x 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.

(Module 8.3, LOS 8.b)

Related Material

SchweserNotes - Book 2

24. (B) 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 x 0.2) in dividends. That method would not be a permissible choice for Flitenight, however, since it controls more than 20% of Rocky Mountain.

(Module 8.3, LOS 8.b)

Related Material

SchweserNotes - Book 2

25. (C) equity under IFRS and 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.

(Module 8.3, LOS 8.b)

Related Material

SchweserNotes - Book 2

26. (C) Basten's statement is correct 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 x $3 million in 2003 earnings - 0.20 x $1.5 million in 2003 dividends) + (0.20 x -$800,000 in 2004 earnings - 0.20 x $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.

(Module 8.3, LOS 8.b)

Related Material

SchweserNotes - Book 2

27. (A) **Both have 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.

(Module 8.9, LOS 8.a)

Related Material

SchweserNotes - Book 2

28.

(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 x 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).

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

29. (A) **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.

(Module 8.9, LOS 8.a)

Related Material

SchweserNotes - Book 2

30. (A) **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.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

31. (C) **Acquisition method.**

Explanation

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

(Module 8.4, LOS 8.c)

Related Material

SchweserNotes - Book 2

32. (C) **Both are incorrect.**

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.

(Module 8.9, LOS 8.a)

Related Material

SchweserNotes - Book 2

33. (C) **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 activities without additional financial support.**

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.

(Module 8.9, LOS 8.b)

Related Material

SchweserNotes - Book 2

34. (A) **Maverick must 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.

(Module 8.9, LOS 8.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**

35. (A) **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.

(Module 8.4, LOS 8.c)

Related Material

SchweserNotes - Book 2

36. (B) **$93,000.**

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.

(Module 8.4, LOS 8.c)

Related Material

SchweserNotes - Book 2

37. (B) $10,700.

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

(Module 8.4, LOS 8.c)

Related Material

SchweserNotes - Book 2

38. (B) $125,000.

Explanation

Parent reported acquisition goodwill of $300,000 ($2,000,000 purchase price – $1,700,000 fair value of Sub's net assets). Since the carrying value of 1,980,000 exceeds the fair value of 1,950,000, an impairment exists.

New goodwill = fair value of subsidiary – fair value of subsidiary's assets

= 1,950,000 – 1,775,000 = 175,000

Impairment loss = 300,000 – 175,000 = $125,000

(Module 8.7, LOS 8.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.

39. (C) $0.00

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.

(Module 8.2, LOS 8.c)

Related Material

SchweserNotes - Book 2

40. (B) Income will rise by $200,000, but stockholders' equity 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.

(Module 8.2, LOS 8.c)

Related Material

SchweserNotes - Book 2

41. (B) **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.

(Module 8.1, LOS 8.b)

Related Material

SchweserNotes - Book 2

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

Explanation

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

(Module 8.3, LOS 8.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.

43. (A) 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.

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

44. (C) Both US GAAP and IFRS require that the equity method be used.

Explanation

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

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

45. (A) 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.

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

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

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.

(Module 8.9, LOS 8.a)

Related Material

SchweserNotes - Book 2

47. (A) **Equity method.**

Explanation

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

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

48. (A) **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.

(Module 8.9, LOS 8.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 (sold)	1,000	(200)	700	0
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 carried at amortized cost.

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.

49. (A) $19,900.

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 x (60 – 50)) on the shares purchased in Q1 and 10,500 (700 x (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).

(Module 8.1, LOS 8.a)

Related Material

SchweserNotes - Book 2

50.	(C)	$90,000	$90,000

Explanation

Under the FVPL and FVOCI classifications the balance sheet carrying values are the market values of the shares or 90,000 = (1,500 x 60).

(Module 8.1, LOS 8.a)

Related Material

SchweserNotes - Book 2

51. (A) $1,079,000.

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.

(Module 8.1, LOS 8.a)

Related Material

SchweserNotes - Book 2

52. (B) 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.

(Module 8.1, LOS 8.a)

Related Material

SchweserNotes - Book 2

53. (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 x $15 x 1,000.

(Module 8.6, LOS 8.c)

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.

54. (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.

(Module 8.2, LOS 8.a)

Related Material

SchweserNotes - Book 2

55. (B) Reclassification would not be allowed.

Explanation

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

(Module 8.2, LOS 8.a)

Related Material

SchweserNotes - Book 2

56. (A) amortized cost, fair value through OCI, or fair value through profit or loss.

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.

(Module 8.2, LOS 8.a)

Related Material

SchweserNotes - Book 2

57. (A) debt security only if the business model has changed.

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.

(Module 8.2, LOS 8.a)

Related Material

SchweserNotes - Book 2

58. (C) $400.

Explanation

The unrealized gain on the 120 shares available for sale is $600 (26 – 21 = 5 x 120 shares). There is also an unrealized gain of $400 (5 x 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 40 losses are reported on the income statement.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

59. (C) Equity method.

Explanation

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

(Module 8.3, LOS 8.b)

Related Material

SchweserNotes - Book 2

60. (B) $15,000.

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 x 100,000 = 15,000.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

61. (B) lower.

Explanation

The choice of full vs. partial goodwill will not impact consolidated debt. Compared to partial goodwill method, Alpha's equity will be higher under the full goodwill method (due to a higher minority interest value). Hence, full goodwill will report a lower debt-to-equity ratio (due to the higher denominator).

(Module 8.7, LOS 8.a)

Related Material

SchweserNotes - Book 2

62. (B) equity 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.

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

63. (B) 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.

(Module 8.2, LOS 8.c)

Related Material

SchweserNotes - Book 2

64. (C) and equity securities classified as fair value through OCI.

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).

(Module 8.1, LOS 8.a)

Related Material

SchweserNotes - Book 2

65. (A) $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.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

66. (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.

(Module 8.9, LOS 8.a)

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.

67. (B) $175,000.00.

Explanation

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

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

68. (C) $52,500.

Explanation

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

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

69. (B) $175,000.

Explanation

Birch would recognize 25% of the net income = $700,000 x 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 noncontrolling interest.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

70. (B) Reason 1.

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.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

71. (A) —$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 x $15 x 1,000 = $300 whereas the unrealized loss is $5,000 = ($15 – $20) x 1,000. The net income statement impact is $300 - $5,000 = -$4,700.

(Module 8.2, LOS 8.c)

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 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.

72. (A) $150,000.

Explanation

The investment income (for FVOCI securities) includes dividends and interest. 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 x $1.50 per share

= $150,000.

(Module 8.2, LOS 8.c)

Related Material

SchweserNotes - Book 2

73. (C) **$3.50 million.**

Explanation

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

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

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

74. (C) **None, reclassification is prohibited under IFRS 9.**

Explanation

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

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

75. (B) **$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.

(Module 8.3, LOS 8.c)

Related Material

SchweserNotes - Book 2

76. (B) **$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).

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

77. (B) **The use of the acquisition method by a company will generally report the less favourable results.**

Explanation

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

(Module 8.4, LOS 8.c)

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, Evergren 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.

78. (A) 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 the sponsor.

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.

(Module 8.1, LOS 8.a)

Related Material

SchweserNotes - Book 2

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

Explanation

To qualify as a VIE under US GAAP, any one of four conditions must be met, one of which is the presence of an insufficient at-risk equity investment.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

80. (B) Has exposure to the majority of the loss risks or receives the majority of the residual benefits of 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.

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

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.

(Module 8.6, LOS 8.a)

Related Material

SchweserNotes - Book 2

82. (B) **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 dependent 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.

(Module 8.3, LOS 8.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.

83. (C) **An investment in 5% of the equity of an entity that gives the owner significant influence over that entity.**

Explanation

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

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2

84. (A) **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. dividends).**

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.

(Module 8.3, LOS 8.a)

Related Material

SchweserNotes - Book 2