On January 9, 2006, Company X, reporting under U.S. GAAP, purchased $1,000,000 of government bonds at par and 100,000 shares of stock in Company S for $2,000,000. The company intends on holding the stock for the foreseeable future and holding the bonds to maturity. 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.

Question #1 of 117

The marketable securities balance amount shown on the balance sheet is:

A) $3,100,000.00

B) $3,000,000.00

C) $3,200,000.00

Explanation

The bonds are classified as debt securities held-to-maturity and are valued at amortized cost. Since the bonds were purchased at par, the amortized cost = cost (par). The stocks are classified as available for sale and are valued at market value.

(Study Session 5, Module 14.3, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #2 of 117

The impact of the marketable securities on net income is:

A) $70,000.

B) $270,000.

C) $140,000.

Explanation

The bonds are classified as debt securities held-to-maturity, and the income generated from them is $50,000. The stocks are classified as debt and equity securities available for sale, and although the increased value is reported as an asset, the gain is reported in the securities valuation account in the equity section and not on the income statement. The effect of the stocks on income is the $20,000 of dividends.

(Study Session 5, Module 14.3, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #3 of 117

In late 2006, Company X decided to reclassify the investments in stock as trading securities. What is the impact of this change in status on the value of the assets of Company X?

A) $200,000.

B) $70,000.

C) $0.

Explanation

The stocks were classified as available for sale, but now they will be classified as trading securities. However, although it will affect net income, the change in status will not impact the reported value of the assets. According to SFAS 115, securities transferred from available-for-sale to trading securities are transferred at fair market value and unrealized gains or losses would be included in income.

(Study Session 5, Module 14.3, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #4 of 117

Assuming that the company would report under IFRS 9, the appropriate classification for the investment in government bonds would be:

A) Amortized cost only.

B) Amortized cost or Available for Sale only.

C) Amortized cost or held for trading security.

Explanation

Under IFRS 9 (new standards), debt securities can be classified at amortized cost (if they meet business model and cash flow characteristic test). IFRS 9 does away with available for sale and held for trading classifications.

(Study Session 5, Module 14.3, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #5 of 117

Assuming that the company would report under IFRS 9 and that the investments were initially classified as fair value through profit or loss. The company can reclassify:

A) Equity security but only into fair value through OCI.

B) Both debt and equity securities into fair value through OCI.

C) Debt security only if the business model has changed.

Explanation

Reclassification of equity securities under the new 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.

(Study Session 5, Module 14.3, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #6 of 117

In 2010 the company recorded an impairment loss on their investment in government bonds. Two years later, the bonds recovered. Under U.S. GAAP a reversal of impairment loss:

A) Is not allowed.

B) Is only allowed if the reversal is other than temporary.

C) Not exceeding the original loss is allowed.

Explanation

U.S. GAAP does not allow for reversal of impairment losses on financial assets.

(Study Session 5, Module 14.3, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

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 SheetsDecember 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

Question #7 of 117

What will be the post-acquisition current ratio, using both the acquistion method and the equity method, respectively, for TME? *The choices below represent Acquisition and Equity, respectively.*

A) 1.04, 1.11.

B) 1.21, 1.02.

C) 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.

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #8 of 117

Using the acquistion method to account for the acquisition, what will be the post-acquisition current assets of TME?

A) $93,000.

B) $105,000.

C) $118,000.

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.

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #9 of 117

Using the acquistion method to account for the acquisition, which of the following is *closest* to the post-acquisition amount that will be recorded as the minority interest under US GAAP?

A) $10,700.

B) $21,000.

C) $6,300.

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

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #10 of 117

Barrett Inc. is advised by its banker to create a special purpose entity (SPE) to convert its existing $15 million loan off-balance sheet. Under the terms of the deal, SPE would obtain a loan for $15 million from the bank with Barrett providing loan guarantee. Barrett would then sell $15 million of accounts receivable to the SPE and use the proceeds to pay off the current loan. Barrett prepares its financial statements under U.S. GAAP. Which of the following statements is *most accurate* regarding the impact of such an arrangement on Barrett's ratios?

A) Barrett's leverage as well as receivables turnover would remain the same.

B) Barrett's leverage would remain the same while receivable turnover would increase.

C) Barrett's leverage would decrease and receivable turnover would increase.

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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #11 of 117

When comparing companies that hold equity investments in other corporations, which of the following statements is *most* accurate? All else being equal, leverage measures for a firm using consolidation will appear:

A) less favorable than those for a comparable firm using the equity method.

B) more favorable than those for a comparable firm using the equity method.

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.

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #12 of 117

Accounting standards for intercorporate investments establish different categories of securities with distinct ways of treating them on the financial statements of the company. One category requires the securities to be carried at fair value on the balance sheet with unrealized gains and losses excluded from the income statement. This category of security classification is called debt:

A) securities held-to-maturity.

B) and equity securities available-for-sale.

C) and equity trading securities.

Explanation

If securities are designated as debt and equity securities available-for-sale they can be sold to meet the liquidity and other needs of the company. As such, the securities are to be carried at fair value on the balance sheet with unrealized gains and losses excluded from the income statement.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #13 of 117

Harter Company recently acquired a 40% stake in Compton Corp. for $40 million in cash by borrowing at 10%. Harter will account for this acquisition using which of the following methods:

A) Acquisition Method.

B) Held to maturity debt securities method.

C) 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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #14 of 117

Maverick Incorporated formed a special purpose entity (SPE) to purchase and lease a 50,000 acre ranch. The SPE financed 95% of the purchase price with debt. The remaining 5% was financed with equity capital received from two separate independent investors. The lender would not make the loan without Maverick's guarantee. How should Maverick treat the SPE in its financial statements if Maverick is the lessee?

A) Maverick must consolidate the SPE.

B) No firm must consolidate the SPE.

C) Each equity investor must proportionately 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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #15 of 117

Milburne Company purchased 1,000 shares of Marino Co. for $20 per share on January 1. By December 31, shares of Marino were trading at $15 per share in the open market. Marino Co. has 100,000 shares outstanding with a dividend yield of 2% at year end. Milburne plans to hold the shares of Marino for near-term trading purposes. The impact of the Marino holding on the Milburne income statement is:

A) −$5,000.

B) −$4,700.

C) −$5,300.

Explanation

Since these securities are to be classified as trading securities, both the dividend received and the unrealized loss are posted to the income statement. The dividend is computed as 0.02 × $15 × 1,000 = $300 whereas the unrealized loss is $5,000 = ($15 - $20) × 1,000. The net income statement impact is $300 - $5,000 = -$4,700.

(Study Session 5, Module 14.2, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #16 of 117

Which of the following statements regarding securities classified as held to maturity is *most* accurate?

A) Equity securities can be classified as "held to maturity" if the security pays a large and consistent dividend and management has decided to hold the security for

B) Equity securities can be classified as "held to maturity" if the firm's management has decided to hold the security for more than five years.

C) Only debt securities can be classified as "held to maturity" securities.

Explanation

Only debt securities, which the firm has the positive intent and ability to hold until final maturity, may be classified as held to maturity.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #17 of 117

Which of the following statements about special purpose entities (SPE) are correct or incorrect?

Statement #1:	The sponsor usually maintains the decision-making power and voting control over the SPE.
Statement #2:	The equity owners of an SPE usually receive a rate of return that is tied to the performance of the SPE.

A) Both are incorrect.

B) Only one is correct.

C) Both are correct.

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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #18 of 117

Which of the following statements regarding special purpose entities (SPEs) is *least* accurate?

A) 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

B) According to U.S. GAAP, if a SPE is considered a VIE, it must be only consolidated by the primary beneficiary.

C) Under IFRS, a special purpose entity must be consolidated by the entity which exercises control over that entity.

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.

(Study Session 5, Module 14.10, LOS 14.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #19 of 117

Under which of the following is a minority interest account *most likely* to appear on the consolidated balance sheet?

I. The acquisition method.
II. Equity method.

A) I only.

B) Both I and II.

C) II only.

Explanation

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

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #20 of 117

Under U.S. GAAP rules, where an investor owns 41% of the voting shares of an investee and is able to control the investee, which of the following methods of accounting is *most* appropriate to use?

A) Acquistion method.

B) Proportionate consolidation method.

C) Equity 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.

(Study Session 5, Module 14.5, LOS 14.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #21 of 117

Accounting standards for passive intercorporate investments include a category of securities that is carried on the company balance sheet at amortized cost. This category of securities is called debt:

A) securities held-to-maturity.

B) and equity securities available-for-sale.

C) and equity trading securities.

Explanation

When debt securities are purchased with both the intent and ability to hold them until they mature, they are recorded on the balance sheet at amortized cost.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

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.

Question #22 of 117

After the acquisitions, the other assets reported by Company X will be:

A) $1,878,000.00

B) $1,962,000.00

C) $2,070,000.00

Explanation

Company X will treat the acquisition of Company A as an investment in financial assets, the acquisitions of Companies B and C using the equity method, and the acquisition of Company D using the acquisition method. The investments in Companies A, B, and C, will be reported, while Company D's financial statements will be consolidated with Company X. The other asset balance will be the starting balance plus the investments in Companies A, B, and C, plus the other asset amount for Company D, which equals 1,600,000 + 10,000 + 20,000 + 80,000 + 360,000 = 2,070,000.

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #23 of 117

After the acquisitions, the liabilities reported by company X will be:

A) $460,000.

B) $480,000.

C) $300,000.

Explanation

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

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #24 of 117

After the acquisitions, minority interest reported by Company X will be:

A) $168,000.

B) $0.

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) × 240,000 = 72,000.

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #25 of 117

Company X will report revenue for 2007 of:

A) $2,000,000.

B) $2,280,000.

C) $2,400,000.

Explanation

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

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #26 of 117

Company X will report income for 2007 of:

A) \$247,000.

B) \$246,400.

C) \$258,400.

Explanation

Income will equal the income of X, plus 10% of the dividends for A, plus 30% of the income of B, plus 40% of the income of C, plus the income of D less the minority interest, which is 200,000 + (0.1 × 4,000) + (0.3 × 20,000) + (0.4 × 30,000) + (40,000) − (0.3 × 40,000) = 246,400.

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #27 of 117

The change in the investment account (the account that reflects all non-consolidated investments in other companies) between January 3 and December 31 is:

A) \$27,600.

B) \$11,400.

C) \$10,800.

Explanation

The investment account will not change for company A, and there is no investment account for Company D. The investment 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 × 20,000) + (0.4 × 30,000) − (0.3 × 8,000) − (0.4 × 12,000) = 10,800.

(Study Session 5, Module 14.6, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #28 of 117

Mustang Corporation formed a special purpose entity (SPE) for purposes of providing research and development. An unrelated firm absorbs the expected losses of the SPE and the independent shareholders of the SPE receive the expected residual returns. Is the SPE considered a variable interest entity (VIE) according to FASB Interpretation No. 46(R) and is consolidation required by Mustang, respectively?

A) Yes ; No.

B) No ; No.

C) Yes ; Yes.

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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #29 of 117

Which of the following securities is *most likely* to be characterized as a held-to-maturity security?

A) Preferred stock that a company has a positive intent and ability to hold indefinitely.

B) Perpetual bonds.

C) Commercial paper.

Explanation

Only debt securities, that a company has a positive intent and ability to hold to maturity, can be characterized as a held-to-maturity security. Equity securities (including preferred stock) cannot be characterized as held-to-maturity because equities do not have maturity dates. Perpetual bonds pay interest for an indefinite period; because they have no maturity date the instruments do not qualify for held-to-maturity treatment.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

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 stock, Evergreen 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.

Question #30 of 117

Which of the following statements regarding special purpose entities (SPEs) is *least* accurate?

A) In general, the equity investors in an SPE can expect to receive a limited rate of return on their investment in exchange for limited risk exposure.

B) An SPE can be formed to isolate specific assets from the sponsor, thus lowering the cost of capital by protecting the assets of the SPE in the event the sponsor

C) 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

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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #31 of 117

In exchange for providing lower-cost financing to an SPE, lenders typically require additional financial support from a sponsor, which may be in the form of additional collateral or guarantees. In return, the sponsor will typically receive which of the following risk and return profiles?

A) Pro-rata share of the actual risks and returns on the project.

B) Pro-rata share of the actual returns on the project and a pre-determined fixed level of risk on the project.

C) Pro-rata share of the actual risk and a pre-determined fixed rate of return on the project.

Explanation

By transferring the variability in the risk of a project to a sponsor, a lender can provide a lower cost of financing to the company that creates the SPE. In return, the sponsor will receive pro-rata profits or other residual interests in the project.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #32 of 117

According to FIN 46(R), if an SPE is to be considered a variable interest entity (VIE), it must meet which of the following conditions?

A) The equity investors in the VIE must bear all of the SPE's risk up to a pre-determined level as outlined in the governing documents.

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

C) The SPE must be consolidated by the primary beneficiary, whose status as primary beneficiary is defined by the level of the firm's percentage of voting control.

Explanation

To qualify as a VIE under FIN 46(R), any one of four conditions must be met, one of which is the presence of an insufficient at-risk equity investment.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #33 of 117

In order to be considered a VIE under FIN 46(R), an entity must meet certain conditions. Which of the following statements about QuickTime is *most* accurate? Under FIN 46(R), QuickTime is:

A) considered a VIE because outside investors share the residual gains and losses at liquidation with Evergreen.

B) considered a VIE because the outside investor's capital contribution is not sufficient to finance QuickTime's operations.

C) not considered a VIE because the outside investor does not have any decision making rights.

Explanation

The outside investor contributed 25% of the necessary capital, but this was not sufficient because the dealer additionally required Evergreen's guarantee in order to close the deal. This condition satisfies the requirements established by FIN 46(R) in order to be classified as a VIE.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #34 of 117

As outlined in FIN 46(R), the primary beneficiary of a VIE is that entity which meets which of the following conditions?

A) Has exposure to the majority of the loss risks or receives the majority of the residual benefits of the VIE.

B) Holds the majority voting control of the VIE and has separate management from the VIE.

C) Holds the majority voting control of the VIE and shares management with 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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #35 of 117

Assuming that QuickTime is considered a VIE in accordance with FIN 46(R), which of the following statements regarding the consolidation of QuickTime on Evergreen's financial statements is *most* accurate?

A) The truck dealer is supplying the financing for the majority (75%) of QuickTime's debt, so Evergreen may not consolidate QuickTime on its financial statements.

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

C) Because the outside investor holds only nonvoting stock, Evergreen holds the majority controlling financial interest in QuickTime and must consolidate QuickTime

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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

James White works in the compliance and reporting department of Linnekt Inc., a large transportation company based on the west coast of the U.S.A. Linnekt has a small investment division which holds U.S. equities as a source of income. Linnekt's has no clear investment strategy, holding some stocks long term aiming for capital growth, and some short term with a view to turning a quick profit.

White is currently putting together a presentation for the investment department to show the impact of different accounting treatments on the group accounts.

White is considering the securities shown in Exhibit 1, all of which are currently held by GLI.

Exhibit 1 – Security Information

Security	Cost	2005 Value	2006 Value
ABC	$80	$75	$85
HIJ	$20	$30	$35
XYZ	$40	$20	$45

Linnekt holds 100,000 shares of each security. None of the holdings represents more than a 1% ownership in the respective company. As a result Linnekt has no significant influence over the any of the companies.

In addition to the securities shown in Exhibit 1, Linnekt purchased 40,000 shares in Trackite Inc. on the first day of this period. White has been tasked with deciding on the correct accounting treatment for this holding.

Trackite is a supplier of materials to several of Linnekt's divisions and the investment was initially made with a view to gaining significant influence over Trackite's operations through further share purchases. This plan was put hold, however, due to tough economic conditions during the year.

However, Linnekt intends to hold the shares permanently and may revisit increasing the holding to gain significant influence in the future.

White's supervisor, Dan Gatuso believes that the treatment of the shares is straightforward and sent White an email with the following recommendations:

Recommendation 1

As the shares are to be held permanently they should be valued at cost

Recommendation 2

Dividends should be taken to the income statement

Question #36 of 117

Which of the following statements regarding the income statement and balance sheet treatment of securities classified as held-to-maturity is *most* accurate? They are carried at:

A) cost on the balance sheet and realized and unrealized gains are taken to the income statement.

B) fair market value on the balance sheet with unrealized gains and losses excluded from income and reported as a separate component of shareholders' equity.

C) cost on the balance sheet and coupon receipts are considered income.

Explanation

Accounting standards require a company to classify its securities into categories based upon the company's intent relative to the eventual disposition of the securities.

One of these categories, held-to-maturity securities, is composed of debt securities which a company has the positive intent and ability to hold to maturity. These securities are carried at the cost on the balance sheet and coupon receipts are considered income.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #37 of 117

How many of Gatuso's recommendations are *most likely* accurate?

A) Recommendation one only

B) Both recommendations

C) Recommendation two only

Explanation

Shares cannot be classified as held to maturity. If they are not held for trading purposes, then they should be shown at fair value on the balance sheet. Dividend income should be taken to the income statement and unrealized gains and losses to other comprehensive income.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #38 of 117

Which of the following statements regarding the income statement and balance sheet treatment of securities classified as available-for-sale is *most* accurate? They are carried at:

A) cost on the balance sheet and coupon receipts are considered income.

B) fair market value on the balance sheet with unrealized gains and losses excluded from income and reported as a separate component of shareholders' equity.

C) fair market value on the balance sheet with unrealized gains and losses reported in income.

Explanation

Accounting standards require a company to classify its securities into categories based upon the company's intent relative to the eventual disposition of the securities.

One of these categories, available-for-sale securities, may be sold to address the liquidity and other needs of a company. Debt and equity securities classified as available-for-sale are carried at fair market value on the balance sheet with unrealized gains and losses excluded from income and reported as a separate component of shareholders' equity.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #39 of 117

Which of the following statements regarding the income statement and balance sheet treatment of securities classified as trading securities is *most* accurate? They are carried at:

A) fair market value on the balance sheet with unrealized gains and losses excluded from income and reported as separate component of shareholders' equity.

B) fair market value on the balance sheet with unrealized gains and losses reported in income.

C) cost on the balance sheet with unrealized gains and losses reported in income.

Explanation

Accounting standards require a company to classify its securities into categories based upon the company's intent relative to the eventual disposition of the securities.

One of these categories, trading securities, is for debt and equity securities acquired for the purpose of selling them in the near term. These securities are measured at fair market value and are listed as current assets on the balance sheet. Unrealized and realized gains and losses are reported in income.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #40 of 117

If the securities are classified as trading securities the balance sheet value for the portfolio at year-end 2005 is:

A) \$12,500,000 and record no gains or losses.

B) \$12,500,000 and record an unrealized loss of \$1,500,000.

C) \$14,000,000 and record no gains or losses.

Explanation

The original portfolio cost was: \$8,000,000 + \$2,000,000 + \$4,000,000 = \$14,000,000

In 2005: \$7,500,000 + \$3,000,000 + \$2,000,000 = \$12,500,000

Thus we write the portfolio down by \$1,500,000 and take an unrealized loss.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #41 of 117

If the securities are classified as trading securities the balance sheet value for the portfolio at year-end 2006 is:

A) \$14,000,000 and record an unrealized gain over the past year of \$2,500,000.

B) \$16,500,000 and record an unrealized gain over the past year of \$2,500,000.

C) \$16,500,000 and record an unrealized gain over the past year of \$4,000,000.

Explanation

The original portfolio cost was: \$8,000,000 + \$2,000,000 + \$4,000,000 = \$14,000,000

In 2005 the value of the portfolio was: \$7,500,000 + \$3,000,000 + \$2,000,000 = \$12,500,000

In 2006 the value of the portfolio was: \$8,500,000 + \$3,500,000 + \$4,500,000 = \$16,500,000

We write the balance sheet value up to current value and recognize an unrealized gain of \$4,000,000.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #42 of 117

Under IFRS rules, which of the following accounting treatments is *most* preferred for joint ventures where there is shared control?

A) Acquisition method.

B) Proportionate consolidation method.

C) Equity method.

Explanation

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

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

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.

Question #43 of 117

With regard to the $50 million of debt securities currently classified as held-to-maturity on Luna's financial statements:

A) they are carried at their amortized cost and cannot be sold prior to maturity except under unusual circumstances.

B) the cost method of accounting should be used on the income statement while the market method should be used on the balance sheet.

C) unrealized gains and losses are excluded from income but reported as a separate component of shareholders' equity.

Explanation

When debt securities are classified as held-to-maturity, the company has both the intent and ability to hold them until they reach their respective maturities. Only under unusual, isolated circumstances can a company liquidate prior to maturity. Note that only debt securities can be classified as held-to-maturity; equity securities cannot.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #44 of 117

Although the appropriate classification of investments is determined at the purchase date, management can reevaluate the classifications at the end of each financial period and adjust accordingly. When transferring debt securities from the available-for-sale portfolio to held-to-maturity, which of the following rules is *most likely* in accordance with SFAS 115? Available-for-sale securities transferred to held-to-maturity are transferred at:

A) their amortized cost, and any unrealized gains or losses remain in equity but are subsequently amortized over the remaining life of the security.

B) fair market value, and any unrealized gains or losses remain in equity but are subsequently amortized over the remaining life of the security.

C) fair market value, and any unrealized gains or losses are included in income in the period of transfer.

Explanation

When transferring debt securities between portfolios, available-for-sale securities transferred to held-to-maturity are transferred at fair market value, and any unrealized gains or losses remain in equity but are subsequently amortized over the remaining life of the security. Note that this only applies to debt securities because equity securities cannot be classified as held-to-maturity.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #45 of 117

Analysts should be wary of which of the following equity transactions a company may use to manipulate its reported earnings to reflect a higher net income? A company can move shares that have appreciated in value from:

A) available-for-sale to the trading portfolio. ✓

B) trading to the available-for-sale portfolio. ✗

C) held-to-maturity to the trading portfolio. ✗

Explanation

Because shares of the same company can be classified as separate investments, a company could move those securities with unrealized gains to the trading portfolio, and thus recognize the gains, while leaving those securities with unrealized losses in the available-for-sale portfolio. Equity shares cannot be classified as held-to-maturity.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #46 of 117

Which of the following investments would *most likely* be reported under the equity method?

A) An investment in 80% of the equity of an entity that gives the owner control over that entity.

B) An investment in 5% of the equity of an entity that gives the owner significant influence over that entity.

C) An investment in 40% of the equity of an entity that gives the owner control over that entity.

Explanation

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

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #47 of 117

Luna has recorded its investment in Instate utilizing the equity method of accounting for intercorporate investments. According to FASB, which of the following statements *most* accurately reflects the impact on an investor's financial statements by using the equity method?

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).

B) The investing firm will not make any adjustments to its financial statements to reflect its proportionate share of the investee's net assets, but will reference the

C) Market values can be compared with the carrying amount for analysis purposes, but only market values may be used in the financial statements.

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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #48 of 117

Suppose Luna had accounted for the Instate acquisition using the passive method for investments in financial assets rather than the equity method of accounting for intercorporate investments. Explain how the different methods would *most likely* impact Luna's financial statements? Under the equity method, Luna will report:

A) lower net income than under the passive method for investments in financial assets.

B) improved debt coverage than under the passive method for investments in financial assets.

C) higher return on investment than under the passive method for investments in financial assets.

Explanation

In this scenario where the investee reported positive earnings and paid out less than 100% of its earnings as dividends, the parent will report higher income (relative to accounting under available for sale classification), thus resulting in higher return on investment.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #49 of 117

Which of the following statements about the various classifications of securities held by a firm is *least* accurate?

A) Trading securities are, by definition, current assets because the firm intends to trade these securities in the near term.

B) Equity securities of other companies cannot be classified as "held to maturity" under SFAS 115.

C) A firm which invests in the debt securities of another firm cannot classify these securities as "held to maturity" if they have the positive intent and ability to hold the

Explanation

Under SFAS 115, only debt securities, which the firm has the *positive intent and ability to hold until final maturity*, may be classified as held to maturity.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

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.

Question #50 of 117

Assuming no significant influence exists, which of the following statements concerning percentage ownership and accounting method is *most* accurate?

A) When the ownership is less than 20%, both US GAAP and IFRS require the equity method.

B) When the ownership is less than 20%, US GAAP requires the investment in financial assets method, IFRS the equity method.

C) 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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #51 of 117

For instances in which Omricon holds exactly 50% of the outstanding equity of the investee firm's equity (i.e., the investee firm is a joint venture), which of the following statements is *most* accurate?

A) IFRS and US GAAP both permit a choice between the equity method and proportional consolidation.

B) IFRS requires that the equity method be used; US GAAP permits a choice between the equity method and proportional consolidation.

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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #52 of 117

The three classifications for passive investments in securities that trade in secondary markets are:

A) trading securities, marketable securities, held-to-maturity securities.

B) marketable securities, available-for-sale securities, held-to-maturity securities.

C) trading securities, available-for-sale securities, held-to-maturity securities.

Explanation

The three classifications for passive investments in securities that trade in secondary markets (i.e., marketable securities) are trading securities, available-for-sale securities, and held-to-maturity securities.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #53 of 117

When a passive investment in marketable equity securities is classified as available-for-sale:

A) US GAAP requires that unrealized gains and losses are reported on the income statement, while under IFRS the firm can elect to report on either the income

B) IFRS requires that unrealized gains and losses are reported in comprehensive income on the balance sheet, while under US GAAP the firm can elect to report on

C) US GAAP and IFRS require that unrealized gains and losses are reported as equity in other comprehensive income on the balance sheet.

Explanation

When a passive investment in marketable equity securities is classified as available-for-sale, US GAAP and IFRS require that unrealized gains and losses are reported as equity in other comprehensive income on the balance sheet.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #54 of 117

With respect to Lee's statement concerning securities that are currently worth less than when they were acquired, a security should be considered impaired when the:

A) decline in value is other than temporary, its value should be written down to the new fair value, and a loss reported in comprehensive income in equity on the

B) decline in value is other than temporary, its value should be written down to the new fair value, and a loss reported on the income statement.

C) decline in value is permanent, its value should be written down to the new fair value, and a loss reported on the income statement.

Explanation

A security should be considered impaired when the decline in value is "other than temporary". That is to say that it is obviously not due to a temporary decline in the market. No one knows for sure if any decline in value is permanent, but in most cases it is obvious that it is not simply a market phenomenon. When this is the case, the asset's value should be written down to the new fair value, and a loss reported on the income statement.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #55 of 117

Relative to consolidation, using the equity method of accounting for investments results in:

A) ROA being higher than under consolidation.

B) ROA being higher and leverage being higher than under consolidation.

C) ROA being lower and leverage 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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #56 of 117

Company A acquired a 50% stake in Company T on January 1, 2003 by paying T's shareholders $100,000 in cash. Pre-acquisition balance sheets for the two firms are presented below:

Balance Sheet		
	Company A	***Company T***
Current assets	$400,000	$60,000
Fixed assets	600,000	100,000
Total	$1,000,000	$160,000
Current liabilities	$50,000	$ 30,000
Common stock	350,000	60,000
Retained earnings	600,000	70,000
Total	$1,000,000	$160,000

The fair values of company T assets and liabilities was same as the book value. Company A reports under U.S. GAAP. What are the post-acquisition balance sheet values for total assets for Company A under the equity and acquisition methods of accounting respectively?

A) $1,060,000 and $1,095,000.

B) $1,000,000 and $1,095,000.

C) $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).

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #57 of 117

On December 31, 2008 Company P invests $5,000 in Company S in exchange for 25% of the company. During 2009, Company S earns $2,000 and pays a dividend of $500. If Company P uses the equity method of accounting, what values will be reported on the balance sheet and income statement? How much cash will be recognized from the investment?

	Balance Sheet	Income Statement	Cash
A)	$5,375	$500	$125
B)	$5,375	$125	$125
C)	$5,500	$0	$0

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 × 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).

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #58 of 117

Which of the following statements about variable interest entities (VIE) are correct or incorrect?

Statement #1:	One potential benefit of a VIE is a lower cost of capital since the assets and liabilities of the VIE are isolated in the event the sponsor experiences financial difficulties.
Statement #2:	The organizational form of a VIE must be either a partnership or a joint venture and it is necessary for the VIE to have separate management and employees.

A) Only one is correct.

B) Both are incorrect.

C) Both are 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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #59 of 117

The factors that determine the required accounting methods for intercorporate investments under both U.S. GAAP and IFRS rules are:

A) percentage of ownership and/or degree of influence.

B) purchase cost compared with book value of the interest purchased.

C) degree of influence and whether the acquiring firm has the intent and ability to hold the securities to maturity.

Explanation

The factors that determine the required accounting method for intercorporate investments are percentage of ownership and/or degree of influence over the investee firm. The principal accounting methods are cost, equity, and consolidation under both U.S. GAAP and IFRS rules.

(Study Session 5, Module 14.1, LOS 14.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

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 classed as held to maturity.

The chief investment officer believes a more appropriate classification would be available for sale, as he is not convinced the bonds will be held for the remaining 3 years.

Question #60 of 117

What is the income from the equity portfolio if the securities are classified as trading or available-for-sale?

	Trading	Available-for-sale
A)	-$6,600	$1,400
B)	$19,900	$19,900
C)	$19,900	$1,400

Explanation

Trading 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×(60-50)) on the shares purchased in Q1 and 10,500 (700×(60-45)) the shares purchased in Q3, or total unrealized gains of 18,500. Therefore, total income under the trading classification is 19,900 (2,400 - 1,000 + 18,500).

Under the available-for-sale classifications income is calculated as dividends plus realized gains and losses. Therefore, total income is 1,400 (2,400 + (-1,000)).

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #61 of 117

What is the balance sheet carrying value of the securities under each of the classifications at year-end?

	Trading	Available-for-sale
A)	$71,500	$71,500
B)	$90,000	$90,000
C)	$90,000	$71,500

Explanation

Under the trading and available-for-sale classifications the balance sheet carrying values are the market values of the shares or 90,000 = (1,500 × 60).

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #62 of 117

What is the rate of return (income/year-end carrying value) under each of the three methods?

Trading ; Available-for-sale

A)	22.11%	1.56%
B)	23.22%	23.22%
C)	2.67%	2.67%

Explanation

Trading = 22.11% (19,900/90,000)

Available-for-sale = 1.56% (1,400/90,000)

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #63 of 117

Given the information regarding the equity portfolio in the IPS extract, which of the following treatments for the securities in the portfolio detailed in Exhibit 1 is *most likely* correct?

A) Held to maturity

B) Trading

C) Available for sale

Explanation

The securities in the portfolio are equities and hence cannot be classed as held to maturity. As the IPS suggests that the shares are not purchased for resale at a profit, and will be held for several periods and only sold to meet liquidity needs, available for sale is the most likely classification.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #64 of 117

If the fixed income portfolio outlined in Exhibit 2 is remains classified as held to maturity, which of the following is *closest* to the interest income reported in the income statement for the year ending 31st December 2013?

A) $1,086,000

B) $1,079,000

C) $1,088,000

Explanation

If the bonds are classified as held to maturity they 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.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #65 of 117

If the bonds are reclassified as suggested by the chief investment officer, which of the following statements is *most likely* correct?

A) The difference between the amortized cost and fair value will be shown in other comprehensive income.

B) The difference between the amortized cost and fair value will be shown in net income.

C) The difference between the purchase price and fair value will be shown in other comprehensive income.

Explanation

Under US GAAP, bonds held for maturity will be shown at amortized cost. When reclassified to available for sale, the bond will be restated at fair value and the difference taken to other comprehensive income.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #66 of 117

Trading securities are defined as:

A) equity securities representing 20% to 50% ownership in a public firm.

B) debt and equity securities that are very liquid and easy to sell.

C) debt and equity securities acquired with the intent of selling them in the near future.

Explanation

Debt and equity securities acquired with the intent of selling them in the near future are likely to be considered trading securities.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

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 assured Neil Glenn, the Chairman of Flitenight's board, that he could turn Rocky Mountain around. He promised Glenn that, in 2005, Rocky Mountain would once again achieve $3 million in earnings and a 50% payout ratio. "With those results," Basten promised Glenn, "our asset accounts will value the Rocky Mountain investment at $10,240,000 on our December 31, 2005 balance sheet – so we'll show a gain on our original investment." Glenn was skeptical of anyone's ability to turn the airline around so quickly. Even so, Glenn assured Basten, "If it takes you longer to turn it around, at least we'll have the dividend income on our 2005 cash flow statements."

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.

Question #67 of 117

In 2003, Flitenight would reflect its investment in Rocky Mountain on its income statement by recording:

A) −$200,000.

B) $600,000.00

C) $300,000.00

Explanation

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

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #68 of 117

If Flitenight were to account for its Rocky Mountain investment as an investment in financial assets instead of the equity method, Flitenight's 2004 income statement would reflect its investment in Rocky Mountain by including which of the following?

A) Nothing, since the cost of the acquisition is not adjusted until the asset is sold.

B) Only income of $200,000.

C) Only a loss of $160,000.

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

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #69 of 117

Under the acquisition method, minority interest is considered:

A) equity under IFRS and a liability under US GAAP.

B) equity under IFRS and US GAAP.

C) a liability 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.

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #70 of 117

Regarding Basten's and Matthews' statements about the gain/loss that Flitenight had at the end of 2004 on its investment in Rocky Mountain, which is *most* accurate?

A) Basten's statement is incorrect and Matthews' statement is correct.

B) Basten's statement is correct and Matthews' statement is incorrect.

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 × $3 million in 2003 earnings − 0.20 × $1.5 million in 2003 dividends) + (0.20 × −$800,000 in 2004 earnings − 0.20 × $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.

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #71 of 117

Regarding Basten's and Glenn's statements about the impact of Rocky Mountain on Flitenight's 2005 balance sheet and cash flow statement, which is *most* accurate?

A) Basten's statement is incorrect and Glen's statement is correct.

B) Basten's statement is correct and Glen's statement is correct.

C) Basten's statement is incorrect and Glen's statement is incorrect.

Explanation

The equity method of accounting is used when the parent has significant influence over the investee but does not exercise control. The acquistion method is required when the parent controls, directly or indirectly, more than 50% of the voting stock.

Once Flitenight exercised its option to purchase the additional 40% of Rocky Mountain's stock (for total ownership of 60%) on December 31, 2004, it could no longer use the equity method and had to switch to the acquistion method. In the acquistion method, Flitenight's investment in Rocky Mountain is no longer listed as a separate asset on the balance sheet (all of Rocky Mountain's assets and liabilities are combined with Flitenight's, with the minority interest shown as equity), so Basten's statement is incorrect. In the acquistion method, parent company cash flows exclude those between parent and investee, so Glenn's statement is also incorrect.

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #72 of 117

GTH Corporation has just purchased 18% of the common stock of Pittor Corporation, one of their major suppliers, making GTH the largest single shareholder in Pittor. The primary motivation for the purchase is that managerial problems at Pittor have resulted in quality control difficulties, thereby affecting the reliability of several critical component parts for GTH products. At the time of the purchase, GTH management announced they plan to be an active investor and exercise significant influence on Pittor so the quality problems can be resolved. Given these circumstances, the accounting method used to record the intercorporate investment will *most likely* be the:

A) equity method. ✓

B) investment in financial assets method. ✗

C) acquisition 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 dependant 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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #73 of 117

Which of the following statements regarding asset securitizations and special purpose entities (SPEs) is *most* accurate?

A) The SPE usually issues debt to purchase receivables from the sponsor. ✓

B) If the sponsor has no recourse, then the transaction is nothing more than a collateralized borrowing. ✗

C) When receivables are securitized, the sponsor reports the cash inflow as an investing activity in the cash flow statement. ✗

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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #74 of 117

Milburne Company purchased 1,000 shares of Marino Co. for $20 per share on January 1. By December 31, shares of Marino were trading at $15 per share in the open market. Marino Co. has 100,000 shares outstanding with a dividend yield of 2% at year end. Milburne plans to hold the shares of Marino for longer-term investment and liquidity purposes. The impact of the Marino holding on the Milburne income statement is:

A) -$4,700. ✗

B) $300.

C) -$5,000.

Explanation

These securities are to be classified as available for sale and hence, all unrealized gains and losses are posted to a securities valuation reserve on the balance sheet. Hence, the only income statement impact is the $300 dividend = 0.02 × $15 × 1,000.

(Study Session 5, Module 14.7, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #75 of 117

Company X owns 15% of company S and exerts significant influence over the operations of the company. The book value of the investment on December 31, 2001, is $48,000. In 2002, company S earned $100,000 and paid dividends of $20,000. The value of the investment account on December 31, 2002, is:

A) $60,000.

B) $63,000.

C) $48,000.

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 x 100,000) − (0.15 x 20,000) = 60,000.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #76 of 117

Cosmo Inc. (Cosmo) invests in two portfolios – Portfolio 1 and Portfolio 2. Portfolio 1 contains securities with an overall intent to profit within a month or two. Portfolio 2 contains equity securities with a moderate amount of acquisition and disposition activity. Which of the following treatments of Cosmo's reporting of the investments in Portfolios 1 and 2, respectively, is *most* accurate?

	Portfolio 1	Portfolio 2
A)	Unrealized amounts reported on	Assets reported at
B)	Unrealized amounts reported on	Assets reported at
C)	Unrealized amounts reported on	Assets reported at

Explanation

Portfolio 1 contains *held-for-trading* securities because it is clear that the securities are acquired with the intent to profit over the near term. Therefore, the unrealized gains and losses would be reported immediately in the income statement.

Portfolio 2 contains *available-for-sale* securities. There are no debt securities and therefore, it cannot contain held-to-maturity securities. As well, there is no indication that the securities are acquired with the intent to profit over the near term. By default, the correct classification would be available-for-sale. Therefore, the securities (assets) would be reported at fair value.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #77 of 117

When comparing companies that hold equity investments in other corporations, which of the following statements is *most* accurate? All else being equal, return on asset measures for a firm using consolidation will appear:

A) more favorable than those for a comparable firm using the equity method.

B) less favorable than those for a comparable firm using the equity method.

C) same as 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.

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #78 of 117

Which of the following methods of accounting for investments will reflect the highest net income on a company's income statement?

A) Acquisition method.

B) Both methods report the same net income.

C) Equity method.

Explanation

Both methods will report the same net income.

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #79 of 117

Acme Corporation purchases a 3% interest in Bandy Company to become the single largest shareholder of Bandy. Acme will hold a seat on the Board of Directors of Bandy. Acme will account for its investment in Bandy using the:

A) acquisition method.

B) lower of cost or market method.

C) 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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #80 of 117

Firm A recently leased equipment used in its manufacturing plant. If the leased asset is worth less than $100,000 at the end of the lease, Firm A will pay the lessor the difference.

Firm B provided debt financing to an unrelated entity. The debt has a provision whereby Firm B cannot be repaid until all other senior debt is satisfied.

Do Firm A and Firm B have a variable interest?

A) Neither have a variable interest.

B) Both have a variable interest.

C) Only one has 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.

(Study Session 5, Module 14.10, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #81 of 117

The consolidation method results in:

A) same net income and shareholders' equity as the equity method.

B) same net income as the equity method but different shareholders' equity.

C) same equity as the cost method.

Explanation

Consolidation results in the **SAME** net income and higher equity as compared to the equity method.

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #82 of 117

Which of the following statements is INCORRECT regarding the classification of debt and equity security investments?

A) If equity and debt securities are available-for-sale securities, any realized and unrealized gains and losses are reported in the income statement.

B) If equity and debt securities are trading securities, any realized and unrealized gains and losses are reported in the income statement.

C) Debt held-to-maturity is reported in the balance sheet at amortized cost.

Explanation

In the case of available-for-sale securities, unrealized gains and losses are excluded from the income statement and are reported as a component of shareholders' equity.

(Study Session 5, Module 14.2, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #83 of 117

Which of the following methods of accounting for investments will reflect the highest assets and liabilities on a company's balance sheet?

A) Both methods result in reporting the same balances for assets and liabilities.

B) Acquisition method.

C) Equity method.

Explanation

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

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #84 of 117

Fiduciary Investors held two portfolios of marketable equity securities:

- $50 million in Portfolio A was accounted for as available-for-sale.
- $50 million in Portfolio B was accounted for as trading securities.

Assume that Fiduciary reclassified securities ($10 million carrying value, $8 million market value) from Portfolio B into Portfolio A under U.S. GAAP. If no previous write downs were made, Fiduciary must:

A) do nothing to its income statement or equity section of its balance sheet.

B) charge $2 million to its income statement.

C) charge $2 million to the equity section of its balance sheet.

Explanation

U.S. GAAP allows investment managers some latitude in reclassifying investment assets from "trading" to "available-for-sale." Unrealized gains and losses are recognized on the income statement. IFRS severely restricts reclassification out of the held-for-trading category.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

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 available-for-sale.

Dupree added that Zeisler also holds several million dollars of Market Square's debt securities, classified as a held-to-maturity investment. The holding in Market Square represents a small fraction of Zeisler's total fixed-income investments, all of which are also classified as held-to-maturity. The investment in Market Square's debt differs significantly from Zeisler's other investments in fixed-income securities in that Market Square's debt is trading slightly above Zeisler's cost while Zeisler's other fixed-income investments are all trading significantly below Zeisler's cost because of a general increase in market interest rates. Welch points out, however, that even if the firm were to sell all its marketable securities, the proceeds would not be sufficient to pay off the debt and avert bankruptcy.

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. This new information gave Dupree an idea.

Dupree suggested to Welch, "We could reclassify our equity investment in Market Square as trading before year-end. That will help raise our ROA for this year." Welch pointed out that a reclassification of the equity investment from available-for-sale to trading would reduce Zeisler's reported net income because the firm would be required to stop including the dividends it receives from Market Square in net income.

Welch suggested that, instead of reclassifying Market Square's equity, they sell Market Square's debt. That would reduce Zeisler's debt-to-assets ratio because the unrealized gain in the market value of the Market Square debt would be realized when the security was sold. Dupree added that the firm could also liquidate the General Nuclear investment to raise cash without affecting the firm's reported ROA for 2009. Welch and Dupree decided to liquidate the two assets to help improve the firm's financial position.

Question #85 of 117

What is the investment income that Zeisler Company will report for the year 2009 on its investment in Market Square Corporation shares if it continues to account for the shares as an available-for-sale investment?

A) $250,000.

B) $200,000.00

C) $150,000.

Explanation

The investment income for available-for-sale securities includes dividends, interest, and realized gains. 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 × $1.50 per share = $150,000.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #86 of 117

If Zeisler were to account for the Market Square Corporation shares as trading securities, assuming that the securities do not change in value between the December 15th meeting and the end of the year, the carrying amount of these shares on Zeisler's December 31, 2009 balance sheet would be:

A) $2.75 million.

B) $2.50 million.

C) $3.50 million.

Explanation

Trading securities are carried at fair market value:

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

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #87 of 117

If Zeisler reclassified the common stock of General Nuclear as a trading security, what effect would it have on Zeisler's 2009 income statement?

A) Net income would increase.

B) Net income would decline.

C) Reclassifying the security would have no effect on the income statement because gains and losses would be recognized in equity.

Explanation

Reclassifying a security from available-for-sale to trading requires unrealized gains and losses to be recognized in income. Since Zeisler's investment in General Nuclear has an unrealized loss, net income would be reduced.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #88 of 117

Regarding the statements made by Dupree and Welch about reclassifying Zeisler's equity investment in Market Square to trading:

A) Welch’s statement is incorrect; Dupree’s statement is incorrect.

B) Welch’s statement is correct; Dupree’s statement is incorrect.

C) Welch’s statement is incorrect; Dupree’s statement is correct.

Explanation

Welch's statement is incorrect because dividends and interest are recognized as income both when the securities are classified as trading and when they are classified as available-for-sale.

Dupree's statement is correct. Reclassifying the securities from available-for-sale to trading will significantly raise Zeisler's near-zero net income by allowing Zeisler to recognize the unrealized gain in income when the security is reclassified. It will have no material effect on asset value because the shares will be carried at fair market value as trading securities and were already carried at fair market value (with the net unrealized gain in equity) as available-for-sale securities. Even though it may appear that equity would decline by the amount of the unrealized gain if the securities were reclassified, the unrealized gain will flow through income in 2009 and thus return to equity. Consequently, reclassifying the equity securities of Market Square would help increase Zeisler's ROA by raising net income and having little effect on assets.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #89 of 117

If Zeisler were to account for the Market Square Corporation shares using the equity method, assuming that the securities do not change in value between the December 15th meeting and the end of the year, the carrying amount of these shares on Zeisler's December 31, 2009 balance sheet would be:

A) \$3.50 million.

B) \$2.60 million.

C) \$2.75 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.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #90 of 117

Regarding the statements made by Welch about reclassifying Zeisler's debt investment in Market Square to trading, and Dupree's statement on General Nuclear:

A) Welch's statement is correct; Dupree's statement is incorrect.

B) Welch's statement is correct; Dupree's statement is correct.

C) Welch's statement is incorrect; Dupree's statement is incorrect.

Explanation

Welch's statement is incorrect because accounting standards require a firm that sells a held-to-maturity security before maturity to carry its remaining held-to-maturity securities at market value instead of cost. Since the Market Square debt is the only fixed-income investment trading above Zeisler's cost, and it represents only a small part of Zeisler's total fixed-income portfolio, the net effect of selling the Market Square debt would be to reduce assets (not raise them) because it would require Zeisler to mark down all its other fixed-income investments. A decline in assets would effectively increase the debt to assets ratio.

Dupree's statement is also incorrect. The investment in General Nuclear would be carried on the books at fair market value, with the unrealized loss in equity. Selling the asset and converting it to cash would not materially affect total assets. However, selling the General Nuclear shares would reduce net income because the realized loss would have to be recognized in income. Thus, the sale would reduce reported ROA.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #91 of 117

Mashburn Company acquired 25% of the 100,000 outstanding shares of Humm Co. on January 1 for $250,000 in cash. Humm Co. earned $1 per share and had a dividend payout ratio of 40%. As of December 31, Humm Co. shares were trading in the open market at $12 per share. Calculate the income statement treatment of the Humm Co. investment as of December 31.

A) $25,000. ✓

B) $75,000. ✗

C) $10,000. ✗

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.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #92 of 117

Under U.S. GAAP rules, where an investor owns a significant number (39%) of the voting shares of an investee but has no involvement in policy making and no Board of Directors' representation, which of the following investment classifications is *most* appropriate to characterize the situation?

A) Investment in financial assets. ✓

B) Significant influence. ✗

C) Investment in associates. ✗

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.

(Study Session 5, Module 14.1, LOS 14.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

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

Fitzroy has to present to the board on the implications of the decision once he has spoken to the auditors. He intends to discuss the following impacts on the financial statements:

Impact One

If the auditors rule that the TRQ investment should be accounted for as a subsidiary rather than an associate, the group's liquidity ratios will be unaffected

Impact Two

If the auditors rule that the TRQ investment should be accounted for as a subsidiary rather than an associate, the group's net profit margin will be lower

Fitzroy also intends to ask the auditors about another potential acquisition that Birch may potentially make this year. The company under consideration is Tyrobin Inc., a small U.S. based company in the pharmaceutical industry.

Fitzroy has observed the note shown in exhibit two in the company's footnotes for last year. He is unsure how it would be accounted for in the event of a 100% acquisition of Tyrobin's share capital by Birch.

Exhibit Two – Tyrobin Footnote

Note 45 Contingent Liabilities

Tyrobin is involved in various legal proceedings considered typical to its business, including actual or threatened litigation and/or actual or potential government investigations relating to product liability, infringement of IP rights, the validity of certain patents and competition laws. All of the claims involve highly complex issues.

Often these issues are subject to substantial uncertainties and, therefore, the probability of a loss, if any, being sustained and an estimate of the amount of any loss is difficult to ascertain. Consequently, for a majority of these claims, it is not possible to make a reasonable estimate of the expected financial effect, if any, that will result from ultimate resolution of the proceedings.

Question #93 of 117

Assuming the equity method of accounting is used, what will be the reported investment income for Birch?

A) $60,000.00

B) $175,000.00

C) $115,000.00

Explanation

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

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #94 of 117

Assuming the equity method of accounting is used, what will be the cash flow received by Birch, due to their investment in TRQ?

A) $227,500.

B) $65,400.

C) $52,500.

Explanation

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

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #95 of 117

If the consolidation method is used, how much of TRQ's net income will Birch recognize in the group income statement?

A) $175,000

B) \$700,000

C) \$122,500

Explanation

Birch would recognize 25% of the net income = \$700,000 × 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 non controlling interest.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #96 of 117

Which of Fitzroy's reasons would most likely support the equity accounting method being appropriate for TRQ?

A) Reason 3

B) Reason 1

C) Reason 2

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.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #97 of 117

Which of the impacts Fitzroy intends to present to the board is most likely correct?

A) Neither impact is correct

B) Impact two only

C) Impact one only

Explanation

If TRQ is a subsidiary it will be consolidated on a line by line basis. This will affect liquidity ratios. Revenue will be increased but net income unaffected by the treatment as in both cases (associate and subsidiary) Birch's share of TRQ's net income will be included in the income statement.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #98 of 117

If Birch were to acquire 100% of the share capital of Tyrobin, how would the issues detailed in Exhibit 1 be treated when accounting for the business acquisition?

A) The contingent liabilities would not be recognized in the balance sheet or income statement on acquisition.

B) The contingent liabilities would be charged immediately as an expense to the group income statement.

C) The contingent liabilities would be measured at their fair value and shown as a liability in the group accounts.

Explanation

As the financial effect of the contingent liabilities cannot be reasonably estimated, under U.S. GAAP they should not be included.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #99 of 117

Sawbuck Corporation recently acquired a 60% stake in Rawboard Inc. for $70 million in newly issued common stock. Given this information, which of the following methods should be used to account for the acquisition of Rawboard?

A) The pooling of interest method.

B) Proportionate consolidation.

C) Acquisition.

Explanation

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

(Study Session 5, Module 14.5, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #100 of 117

Which of the following securities will *most likely* be characterized as an available-for-sale security?

A) Debt or equity securities that are carried on the balance sheet at fair market value and may be sold for liquidity purposes.

B) Debt securities that a company has a positive intent and ability to hold to maturity.

C) Equity securities representing 30% ownership in another firm.

Explanation

Debt or equity securities that are carried on the balance sheet at fair market value and may be sold for liquidity purposes are likely to be considered as available-for-sale.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #101 of 117

Equity method is:

A) required under IFRS and under U.S. GAAP for jointly controlled entities.

B) recommended under IFRS and U.S. GAAP for jointly controlled entities.

C) recommended under U.S GAAP for jointly controlled entities, but is not normally permitted under IFRS.

Explanation

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

(Study Session 5, Module 14.4, LOS 14.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #102 of 117

Accounting standards for passive intercorporate investments establish different categories of securities with distinct ways of treating them on the financial statements of the company. Which of the following categories requires realized and unrealized gains and losses to be reported as income? Debt:

A) and equity securities available-for-sale.

B) securities held-to-call.

C) and equity trading securities.

Explanation

Accounting standards for passive intercorporate investments include, debt and equity trading securities, is for securities that, when acquired, are intended to be resold within a near term time horizon. They are classified as current assets on the balance sheet, with any realized or unrealized gains and losses reported as income.

(Study Session 5, Module 14.1, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

On January 9, 2006, Company X paid $2,000,000 for 100,000 shares of stock in Company S. Originally the company intended on holding the securities for the foreseeable future. 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 decided to place the securities in their active marketable securities portfolio.

Question #103 of 117

What is the impact of this change in status on the value of the assets of Company X?

A) $70,000.00

B) $0.00

C) $200,000.00

Explanation

The stocks were classified as debt and equity securities available for sale, but now they will be classified as debt and equity trading securities. However, although it will affect net income, the change in status will not impact the reported value of the assets. According to SFAS 115, securities transferred from available-for-sale to trading securities are transferred at fair market value and unrealized gains or losses would be included in income.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #104 of 117

What is the impact of this change in status on the income and the stockholders' equity of Company X?

A) Income and stockholder's equity will rise by $200,000.

B) Stockholders' equity will rise by $200,000, but income will not change.

C) Income will rise by $200,000, but stockholders' equity will not change.

Explanation

The stocks were classified as debt and equity securities available for sale, but now they will be classified as debt and equity trading securities. The gain would have been reported in the securities valuation account in the equity section and not on the income statement, but now will be reported as income.

(Study Session 5, Module 14.3, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #105 of 117

A company reports an intercorporate investment using the acquisition method. Which of the following statements is *most* accurate?

A) The use of the equity method by a company will generally report the same results.

B) The use of the acquisition method by a company will generally report the less favorable results.

C) The use of the acquisition method by a company will generally report the more favorable results.

Explanation

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

(Study Session 5, Module 14.5, LOS 14.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

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

Question #106 of 117

Haggs wonders which accounting method Simpson uses to calculate the book value of the BC investment for the year ending December 31, 1999. Which is the correct method?

A) Investment in Financial Assets method.

B) Equity method.

C) Acquisition 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.

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #107 of 117

Haggs wonders which accounting method Simpson uses to calculate the book value of the BC investment for the year ending December 31, 1998. Which is the correct method?

A) Equity method.

B) Investment in Financial Assets method.

C) Acquisition 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 for 1998.

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #108 of 117

Haggs wonders which accounting method Simpson uses to calculate the book value of the BC investment for the year ending December 31, 2000. Which is the correct method?

A) Equity method.

B) Proportional consolidation method.

C) 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.

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #109 of 117

Haggs wants to make sure that he assumes the proper accounting method when he does his analysis. The acquisition of BC stock will lead to Simpson's total net cash flow equaling which of the following for the year ending December 31, 1999?

A) $−3,190,000.

B) $360,000.

C) $−2,830,000.

Explanation

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

(Study Session 5, Module 14.4, LOS 14.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #110 of 117

Carter Schmitz, Inc. (Schmitz) purchased 200 shares of Intelismart at $21 a share in June 2006 and intends to actively trade 80 shares in the near future and hold the remaining 120 shares as available for sale securities. Intelismart's closing price was $26 on December 31, 2006, and Schmitz did not sell any of its shares.

What amount should Schmitz report on this investment under the income statement?

A) $400.

B) $600.

C) $1,000.

Explanation

The unrealized gain on the 120 shares available for sale is $600 (26 - 21 = 5 × 120 shares). There is also an unrealized gain of $400 (5 × 80) related to the 80 shares that are trading securities which would be reported on the income statement. For trading securities, realized and unrealized gains and losses are reported on the income statement. For available for sale securities, only realized gains and losses are reported on the income statement.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #111 of 117

Company X owns 15% of company S and exerts significant influence over the operations of the company. The book value of the investment on December 31, 2008, is $48,000. In 2009, company S earned $100,000 and paid dividends of $20,000. The impact of the investment on the income statement of company X is:

A) $12,000.

B) $3,000.

C) $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 × 100,000 = 15,000.

(Study Session 5, Module 14.7, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

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.

Question #112 of 117

If the Anderson Company accounts for the Birschbach shares as trading securities, the carrying amount of these shares on Anderson's balance sheet at the end of 2012 is:

A) $3.5 million. ✓

B) $2.6 million. ✗

C) $2.5 million. ✗

Explanation

Trading securities are measured at fair market value.

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

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #113 of 117

If Anderson Company accounts for the Birschbach Company shares as securities available-for-sale, the carrying amount of these shares on Anderson's balance sheet at the end of 2012 is:

A) $2.6 million.

B) $3.5 million.

C) $2.5 million.

Explanation

Available-for-sale securities are measured at fair market value.

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

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #114 of 117

If Anderson Company accounts for the Birschbach Company shares using the equity method, the carrying amount of these shares on Anderson's balance sheet at the end of 2012 is *closest* to:

A) $2.8 million.

B) $2.6 million.

C) $3.5 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

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #115 of 117

For the year 2012, the investment income that Anderson Company reports on its investment in Birschbach Company shares, if Anderson accounts for the shares as an available-for-sale investment, is:

A) $250,000.

B) $100,000.

C) $150,000.

Explanation

Under the available-for-sale accounting method, 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

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #116 of 117

If the investment in Birschbach Company is treated as held-for-trading securities, transactions that impact the income statement include:

A) earnings of $250,000 and dividend income of $150,000.

B) an unrealized gain of $1,000,000 and dividend income of $150,000.

C) an unrealized gain of $1,000,000 and earnings of $250,000.

Explanation

Held for trading securities are reported at fair value, with unrealized gains and losses included in income. The income statement also includes dividends from equity securities that are classified as held for trading. Unrealized gains and losses and dividends received are both recognized in the income statement, however earnings are not.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #117 of 117

If Anderson Company accounts for the Birschbach Company shares using the equity method, the change in carrying value from 2012 to 2013 is *closest* to:

A) +$50,000.

B) +$2,650,000.

C) +$225,000.

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 × ($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.

(Study Session 5, Module 14.4, LOS 14.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3