

**Solution Manual for Advanced Accounting 13th Edition Beams Anthony
Bettinghaus Smith 0134472144 9780134472140**

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Solution Manual

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Chapter 2

STOCK INVESTMENTS - INVESTOR ACCOUNTING AND REPORTING

Learning Objectives

- 2.1 Recognize investors' varying levels of influence or control, based on the level of stock ownership.
- 2.2 Understand how accounting adjusts to reflect the economics underlying varying levels of investor influence.
- 2.3 Identify factors beyond stock ownership that affect an investor's ability to exert influence or control over an investee.
- 2.4 Apply the fair value/cost and equity methods of accounting for stock investments.
- 2.5 Apply the equity method to stock investments.
- 2.6 Learn how to test goodwill for impairment.

Chapter Outline

ACCOUNTING FOR STOCK INVESTMENTS – ALL STOCK INVESTMENTS MUST BE RECORDED AT THE INVESTOR'S COST (FAIR VALUE AT ACQUISITION).

(Learning Objectives 2.1 and 2.2)

- A** There are two basic methods of accounting for common stock investments: the **fair value (cost) method** and the **equity method**.

GAAP PRESCRIBED METHODS

- 1** Fair value (cost) method for up to 20% ownership
- 2** Equity method for 20% to 50% ownership
- 3** GAAP presumes 20% or more of ownership demonstrates the company has an ability to exercise significant influence over an investee.
- 4** In both methods, there are exceptions to the ownership percentage test, depending on whether or not the company has significant influence over the investee.

- B** In the absence of evidence to the contrary, an investment of 20% or more is presumed to give the investor an ability to exercise significant influence. The equity method requires that the investment be recorded at cost and the investment account adjusted for earnings, losses, and dividends each subsequent period.
- 1** The equity method should not be used if the ability to exercise significant influence is temporary or if the investee is a foreign company operating under severe exchange restrictions or controls.
 - 2** GAAP provides indicators of the inability to exercise significant influence: (*Learning Objective 2.3*)
 - a** Opposition by the investee that challenges the investor's influence
 - b** Surrender of significant stockholder rights by agreement between investor and investee
 - c** Concentration of majority ownership
 - d** Inadequate or untimely information to apply the equity method
 - e** Failure to obtain representation on the investee's board of directors

ACCOUNTING FOR NONCURRENT COMMON STOCK INVESTMENTS UNDER THE FAIR VALUE/COST METHOD:

- A** The fair value/cost method is used for common stock investments of less than 20% unless it can be demonstrated that the investor company has the ability to exercise significant influence over the investee company.
- B** GAAP classifies equity securities that have a readily determinable market value as either trading securities or available-for-sale securities.
- 1** Investment is initially recorded at cost.
 - 2** The investment is adjusted to fair value at the end of the fiscal period.
 - 3** Unrealized gains or losses are reported either in income or as an equity adjustment to the balance sheet (other comprehensive income), depending on the company's intention for holding the stock.
 - 4** Unrealized gains and losses associated with 'trading' securities are recorded as part of income. Trading securities are very short-term holdings; continued relationships are not expected.

- 5 Unrealized gains and losses associated with available-for-sale securities are considered “other comprehensive income” and are reported either on the income statement, a separate statement of comprehensive income, or a statement of changes in equity. Only dividend income and realized gains and losses impact income and EPS for available-for-sale securities.

C Procedures for the fair value/cost method
(*Learning Objective 2.4*)

- 1 Investment is initially recorded at cost.
- 2 Dividends received are recorded as dividend income.
 - a An exception: Liquidating dividends are deducted from the investment account. Liquidating dividends are those dividends received in excess of the investor’s share of earnings after the stock is acquired and are considered a return of capital.

ACCOUNTING FOR NONCURRENT COMMON STOCK INVESTMENTS UNDER THE EQUITY METHOD:

(*Learning Objective 2.5*)

A Application of the equity method

- 1 The investment is initially recorded at cost.
- 2 Subsequently, the investor records its share of the investee’s income as an increase to the investment account (losses will decrease the investment account).
- 3 Dividends received from the investee are recorded as a decrease to the investment account.
 - a The investment account moves in the same direction as the investee’s net assets (for example, income increases assets for both).
- 4 Additional adjustments are required.
 - a Intercompany profits and losses are eliminated until realized.
 - b Cost-book value differentials are accounted for as if the investee were a consolidated subsidiary.

- (1) The difference between the investment cost and the underlying equity is assigned to identifiable assets and liabilities based on their fair values with any remaining difference allocated to goodwill.
- (2) The difference between investment cost and book value acquired will disappear over the remaining lives of identifiable assets and liabilities, except for amounts assigned to land, goodwill, and intangible assets having an indeterminate life, which are not amortized.
- (3) If the book value acquired is greater than the investment cost, the difference should be allocated against non-current assets other than marketable securities with any remaining amount treated as an extraordinary gain (negative goodwill).

c The investment is reported on one line of the investor's balance sheet and income on one line of the investor's income statement, a one-line consolidation.

- (1) Except extraordinary and other below-the-line items

C Accounting for an interim investment

- 1** Absent evidence to the contrary, income of the investee is assumed to be earned proportionately throughout the year.
- 2** The investee's book value at an interim date is determined by adding income earned from the last statement date to beginning stockholders' equity and deducting dividends declared to the date of purchase.

D Investment in a step-by-step acquisition

- 1** An investor may acquire significant influence through a series of purchases.
- 2** Prior to obtaining significant influence, the fair value/cost method is used. When an investment qualifies for the equity method, the investment account is adjusted to the equity method, and the investor's retained earnings are adjusted retroactively.
 - a** This is a change in reporting entity, and it requires retroactive restatement if the effect is material.

E Sale of an equity interest

- 1** When an investor reduces its equity interest in an investee to below 20%, the retained investment is accounted for under the fair value/cost method.
 - a** Gain or loss from the equity interest sold is the difference between the selling price and the book value of the equity interest immediately before the sale.
 - b** Immediately after the sale, the balance of the investment account becomes the new cost basis.

- F** If the stock is purchased directly from the investee (rather than its shareholders), the investor's interest is determined by dividing shares acquired by shares outstanding immediately after the issuance of the additional shares.

- G** Investee corporation with preferred stock
 - 1** Special adjustments are necessary when investees have both common and preferred stock outstanding.
 - 2** The investee's stockholders' equity must be allocated into its common and preferred stock components to determine the book value of the common stock investment.
 - 3** The investee's net income must also be allocated into common and preferred stock components.
 - 4** Call or liquidating premiums and dividends in arrears must also be considered in determining the investor's share of earnings.

- H** The one-line consolidation does not apply when the investee's income includes discontinued operations. Investment income must be separated into ordinary and discontinued operations components.

DISCLOSURES FOR EQUITY INVESTEES

- A** Material investments accounted for by the equity method require disclosure of the following:
 - 1** The investee's name and percent of ownership in common stock, the investor's accounting policies with respect to investments in common stock, the cost/book value differentials and accounting treatment
 - 2** The aggregate value of each identified investment for which quoted market prices are available

- 3 Summarized information about the investee’s assets, liabilities, and results of operations
- B** Related-party transactions
- 1 Related-party transactions arise when one of the transacting parties has the ability to significantly influence the operations of the other.
 - 2 There is no presumption of arms-length bargaining between the related parties.
 - 3 Required disclosures include the nature of the relationship, a description of the transaction, the dollar amount of the transaction (and any change in the method used to establish the terms of the transaction), and amounts due to or due from related parties at the balance sheet date for each balance sheet presented.

TESTING GOODWILL FOR IMPAIRMENT

(Learning Objective 2.6)

- A** GAAP eliminates former requirements to amortize goodwill, but goodwill must be periodically tested for impairment.
- 1 Firms may find this valuable for two reasons.
 - a Firms may recognize significant impairment losses on initial adoption which are treated as a “cumulative effect of an accounting change” (appears after “income from operations”).
 - b Firms will no longer report annual goodwill expense charges.
- B** Recognizing and measuring impairment losses is a two-step process.
- 1 First, carrying values and fair values of net assets are compared at the business-reporting-unit level.
 - a If fair value is greater than carrying value, goodwill is deemed unimpaired, and no further action is necessary.
 - b If carrying value is greater than fair value, the firm proceeds to step 2.
 - 2 Step 2, when necessary, requires a comparison of the carrying value of goodwill with its implied fair value.

- 3** The implied fair value of goodwill is determined in the same manner used to originally record the goodwill at the business combination date.
 - a Allocate the fair value of the reporting unit to all identifiable assets and liabilities as if they had made the purchase on the measurement date. Any excess is the implied fair value of goodwill.
 - 4** The fair value of the reporting unit is the amount for which it could be purchased or sold in a current, arm's-length transaction.
 - a Current market prices (in an active market) are considered the most reliable indicator of fair value.
- C** Goodwill impairment testing must be conducted at least annually.
- 1** More frequent testing may be required if certain events occur such as adverse changes in the legal or business climate, new and unanticipated competition, loss of key personnel, and other similar events.
- D** Reporting and disclosures
- 1** Material aggregate amounts of goodwill must be reported as a separate line item on the balance sheet.
 - 2** Goodwill impairment losses are shown separately in the income statement.
- E** Equity method investments
- 1** Many of the rules regarding goodwill impairment apply only to goodwill arising from business combinations (parent acquiring a controlling interest in a sub). Impairment testing also applies to goodwill arising from use of the equity method.
 - 2** One notable exception is the rule regarding goodwill impairments; impairment tests are performed based on fair value versus book value of the investment taken as a whole.

Description of assignment material**Minutes**

Questions (14)

Exercises (16)

| | | | |
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| E2-1 | 5 MC general | 10 | |
| E2-2 | AICPA 8 MC general and problem-type | | 35 |
| E2-3 | [Son/Pop] Calculate percentage ownership and goodwill on investment acquired directly from investee | 12 | |
| E2-4 | [Pam/Sun] Calculate income for midyear investment | 15 | |
| E2-5 | [Pop/Son] Calculate income and investment balance allocation of excess to undervalued assets | 15 | |
| E2-6 | [Pam/Sun] Journal entry to record income from investee with loss from discontinued operations | 10 | |
| E2-7 | 4 MC problem-type | 20 | |
| E2-8 | [Pam/Sun] Calculate investment balance four years after acquisition | 15 | |
| E2-9 | [Son/Pop] Calculate income and investment balance when investee capital structure includes preferred stock | 20 | |
| E2-10 | [Pam/Sun] Calculate income and investment balance for midyear investment | 15 | |
| E2-11 | [Pop/Sun] Adjust investment account and determine income when additional investment qualifies for equity method of accounting | 25 | |
| E2-12 | [Sun/Pam] Journal entries (investment in previously unissued stock) | 15 | |
| E2-13 | [Pop/Sun] Prepare journal entries and income statement, and determine investment account balance | 20 | |
| E2-14 | [Pam/Sun] Calculate income and investment account balance (investee has preferred stock) | 20 | |
| E2-15 | [Pop/Sun] Goodwill impairment | 10 | |
| E2-16 | [Pam/Alpha/Beta] Goodwill impairment | 10 | |

Problems (12)

| | | | |
|------|--|----|--|
| P2-1 | [Pop/Sun] Computations for a midyear purchase (investee has a discontinued operations gain) | 25 | |
| P2-2 | [Pam/Sun] Journal entries for midyear investment (cost and equity methods) | 20 | |
| P2-3 | [Pop/Sun] Computations for investee when excess allocated to inventories, building, and goodwill | 20 | |
| P2-4 | [Pam/Sun] Journal entries for midyear investment (excess allocated to land, equipment, and goodwill) | 20 | |
| P2-5 | [Pop/Sun] Prepare an allocation schedule; compute income and the investment balance | 15 | |
| P2-6 | [Pam/Son] Computations for a midyear acquisition | 20 | |
| P2-7 | [Pop/Son] Partial income statement with a discontinued operations | 10 | |
| P2-8 | [Sun/Pam] Computations and journal entries with excess of book value over fair value | 25 | |

Description of assignment material**Minutes**

| | | |
|-------|---|----|
| P2-9 | [Pop/Sun] Prepare allocation schedules under different stock price assumptions (bargain purchase) | 20 |
| P2-10 | [Pam/Sun] Computations for a piecemeal acquisition | 25 |
| P2-11 | [Pam/Sun] Computations and a correcting entry (errors) | 25 |
| P2-12 | [Pop/Sun] Allocation schedule and computations (excess cost over fair value) | 25 |

PROFESSIONAL RESEARCH ASSIGNMENTS

Answer the following questions by reference to the FASB Codification of Accounting Standards. Include the appropriate reference in your response.

PR 2-1 The equity method of accounting is often referred to as a one-line consolidation. Since the net impact on the balance sheet and income statement is the same under both consolidation and the equity method, is it acceptable to report a noncontrolling investment using the simpler equity method?

PR 2-2 A firm sells a part of its investment interest, reducing its holding from 30% to 10%. The firm decides, correctly, that the equity method is no longer appropriate. What is the basis for the investment in applying the new accounting method?