

13 Intercorporate Investments

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Reporting Methods for investments

Method	Balance sheet	Income Statement
Cost	Cost	Dividends and interest Realized gains & losses
Market	Market value	Dividends Realized gains & losses Unrealized gains & losses
LOCOM Lower of cost or market	LOCOM	Dividends Realized gains & losses Unrealized losses

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Investments in securities under SFAS 115 (1993) – Classification criteria

Choice depends on management intent and ability.
- not a completely free choice.

Held-to-maturity (mainly for debt)
- Firm must have intent and ability to classify so.
- can not be sold before maturity

Transfers between portfolios subject to special rules.

Do companies misuse the classification options?

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Investments in securities

Investment in Common Shares, Notes, etc.

Individual investor: Total income earned on the investments
= Dividends and interest received
+ Capital gain (realized or unrealized)

For corporations: What should be reported in the
Income Statement
Should unrealized gains be reported in the income
statement ?
Balance sheet
Should assets be valued at market value ?

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Reporting Methods for investments in securities – SFAS 115 (1993)

Method	Balance sheet (carrying value)	Income Statement
Held to maturity	Amortized Cost	Dividends and interest Realized gains & losses
Available-for-sale	Market value	Dividends Realized gains & losses
Trading	Market value	Dividends Realized gains & losses Unrealized gains & losses
Equity	Cost + Δ Retained Earnings from purchase date	Share of earnings of the period Realized gains & losses

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Available-for-sale securities

Balance sheet at market values
Income statement ignores market values.

Leads to "Dirty Surplus"
Direct entries are made to balance sheet without going through
income statement.

Asset revised to market values
A new owner's equity account called
Other Comprehensive Income - Available-for-sale securities
used

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Market Value (MV) Added - Purchases

	End of year	During the	End of
	year	year (P)	last year
	MV (K 1)		MV (K 0)
	MV (P 1)	MV (P 0)	
Mark to market	MV (K 1)		- MV (K 0)
	MV (P 1)	- MV (P 0)	
B Income by cost method	0		
Market Value added	MV (K 1)		MV (K 0)
A	+ MV (P 1)		
	- Cost (K)		- Cost (K)
	- Cost (P)		

[Change in A] + B
 = Income by market value method; as Cost (P) = MV (P 0) 7

Market Value Added 2

Income by Market Value Method

=

Income by Cost Method

+

Change in Market Value Added

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Market Value (MV) Added - Sales

	End of year	During the	End of
	year	year (S)	last year
	MV (K 1)		MV (K 0)
		MV (S 1)	MV (S 0)
Mark to market	MV (K 1)		- MV (K 0)
income		MV (S 1)	- MV (S 0)
B: Income by cost method	MV (S 1)- Cost (S)		
Market Value added	MV (K 1)		MV (K 0)
A			+ MV (S 0)
	- Cost (K)		- Cost (K)
			- Cost (S)

[Change in A] + B = Income by market value method; All costs cancel 9

Guidelines – Equity Method

Degree of investor influence or control over the affiliate.
 % of ownership in the affiliate as guideline?

<20%	No significant influence	Cost or market
20-50%	Significant influence	Equity method
>50%	Control	Consolidation

Merely guidelines

Does the affiliate constitute an integral part of the parent company

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Equity Method

If investor can exercise significant influence over activities of the investee – the rationale.

» Investee has no majority shareholder

Equity method:

Income reported by the parent

= parent's share of the income of the affiliate

Parent's share of the dividend of the affiliate is a reduction in the carrying amount of the investment.

Income and asset accounts not affected by market prices.

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Equity Method - data

Equity method reports more different amount of income than SFAS 115 methods if dividend payout is usually < 100%

Is 20% an artificial limit? Companies play games -

If an affiliate is profitable own

19.9% or 20.1% (page 470)

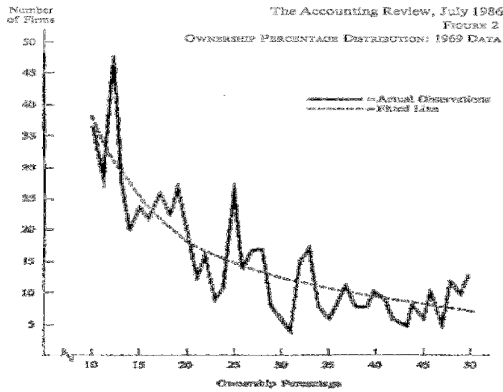
If an affiliate is not profitable own

19.9% or 20.1% (page 470)

Subsidiaries:	19% affiliates	20% affiliates
Loss	30% of the time	16% of the time

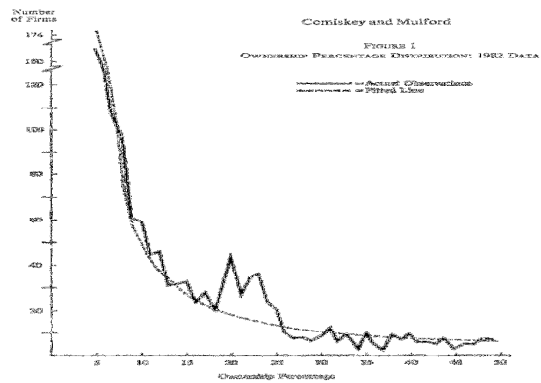
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Equity Method – Empirical Facts 1



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Equity Method – Empirical Facts 2



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Consolidation

All affiliates that a parent controls more than 50% of voting shares must be consolidated.

Only exceptions:

- Temporary controls
- governmental action, currency problems or civil disorder.

All share of income, assets and liabilities are consolidated

When consolidating intracompany transactions must be eliminated.

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Consolidation 2

Why do companies not want to consolidate?

Equity method vs. consolidation

Will net Income be different?

Equity ?

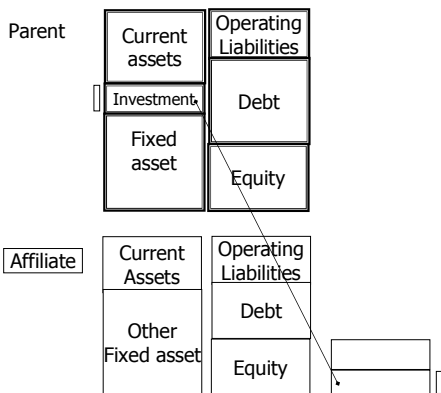
Debt ?

Ratios ?

Nonhomogeneous subsidiaries – not consolidated before 1993.

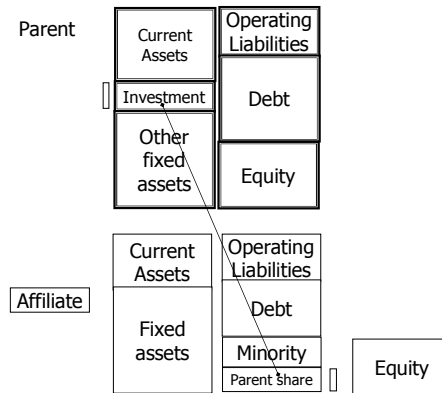
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Parent and affiliate



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Investment and parent share



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Consolidated Company

Current Assets	Operating Liabilities
Current Assets	Operating Liabilities
Fixed assets	Debt
	Debt
Other Fixed asset	Minority
	Equity

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Parent and affiliate – Excess (deficit) share

Parent	Current Assets	Operating Liabilities
	Investment	Debt
	Other fixed assets	Equity
Affiliate	Current Assets	Operating Liabilities
	Fixed assets	Debt
		Minority
		Parent share

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Excess (deficit) share consolidation

Investment	Parent share	Current Assets	Operating Liabilities
		Current Assets	Operating Liabilities
		Goodwill	Debt
		Other fixed assets	Debt
		Fixed assets	Minority
			Equity

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Income statement - Parent and Affiliate

Operating Income	EBIT	Interest	Parent
Equity Inv. Income		Taxes	
Operating Income	EBIT	Interest	Affiliate
Equity Inv. Income		Taxes	
		Minority	
		Equity Inv. Income	

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Income statement – Minority Interest

Operating Income	EBIT	Interest	Net Income
Equity Inv. Income		Taxes	
Operating Income	EBIT	Interest	Affiliate
Equity Inv. Income		Taxes	
		Equity Inv. Income	

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Income statement - Consolidated

Operating Income	EBIT	Interest	Net Income
Operating Income		Taxes	
		Interest	
		Taxes	
		Minority	

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