

Investments (Financial Assets)

Overview

When a company finds itself with excess cash, prudent management would invest these funds in investments which would generate higher rates of returns than those available in chequing or savings accounts.

Depending on the amount of cash available and the ongoing cash requirements of the company, management may decide to make either non-strategic or strategic investments. Although strategic investments are not generally covered in Introductory Accounting Courses, a brief discussion is helpful to gain a basic understanding of the accounting for these investments.

Strategic Investments

Control

The major reason for making a strategic investment is to either control or influence the policies and activities of another company ("the investee"). The company which makes an investment ("investor") usually has a motive other than simply earning a higher return on its investment - e.g. a strategic alliance. When the investor has the ability to elect a majority of the Board of Directors of the investee without the assistance of others, the investor is said to control the investee. An investee which is controlled by another company is known as a subsidiary. Under Canadian GAAP, the investor must prepare **consolidated financial statements** - i.e. financial statements which include all of the assets, liabilities, revenue and expenses of the investor and the investee.

Significant Influence

Where an investor holds more than 20% but does not control the investee, the investor is said to exercise significant influence over the investee. In such circumstances the investor records the initial investment at cost and then accounts for its proportional share of the net income of the investee. This is known as the "**Equity method**" of accounting.

You will deal with these situations in Intermediate and Advanced Accounting classes.

Non-strategic investments

Our focus in Introductory Accounting is on non-strategic investments - i.e. ones in which the investor will neither control nor exercise significant influence. The investor hopes to earn a reasonable return by the receipt of interest or dividend revenue and/or the appreciation in value of the investment.

The balance sheet classification of a non-strategic investment is dependent on the nature of the investment and management's intent in holding the investment. If management intends to liquidate the investment within the next twelve months, the investment should be disclosed as a current asset.

A company will generally classify its non-strategic investments into one of two categories:

- **Held-for-Trading Investments (HFTI)**– management will designate those investments which it intends to actively trade, or
- **Available-for-Sale Investments (AFSI)** – a category which includes investments which, as the name implies, are available for sale but investments which are not designated as HFTI by management.

In this course we will concern ourselves with HFTI.

Accounting for Non-strategic Investments

Regardless of classification, non-strategic investments are initially recorded under the cost principle at cost as follows:

Dr HFTI or AFSI
Cr Cash

Any brokerage costs incurred in acquiring these investments are expensed.

As dividends are earned, revenue is recorded as follows:

Dr Dividends Receivable
Cr Dividend revenue

Accounting for Non-strategic Investments continued

When financial statements are prepared, non-strategic investments on the Statement of Financial Position are to be measured **at their fair market value**. This deviation to the cost principle is based on the qualitative characteristics of **relevance and reliability**. Recall that the accounting profession (especially IFRS) is moving towards greater use of fair value accounting.

In order to account for this change to fair market value, a valuation allowance account is often used to track the changes from the original cost. The valuation allowance may be in either a debit or credit balance depending whether the market value has increased or decreased.

Example 1

Assume we buy 100 shares of Company A for \$1,000:

The entry to record the investment designated as Held for Trading is

Dr HFTI	1,000	
Cr Cash		1,000

Assumption A - At year end the market price of A is \$15/share

The share price has increased by \$5/share. The shares need to be measured at their fair market value.

Dr Valuation Allowance	500	
Cr Unrealized holding gain		500

First, notice that the valuation allowance account is now in a debit position. Second, the gain is identified as an unrealized holding gain because the investment has not yet been sold.

Assumption B - At year end the market price is \$7.50/share

Dr Unrealized holding loss	250	
Cr Valuation Allowance		250

Notice the valuation allowance account is in a credit balance. As in Assumption A, the loss is unrealized as no sale has occurred.

A realized gain or loss (i.e. the difference between the original cost and the selling price less commission costs) only arises when the investment is actually sold.

Accounting for Realized and Unrealized gains and losses

If an investment is classified as Held for Trading, both realized and unrealized gains or losses will be recorded in profit and loss.

If an investment is classified as Available for Sale, realized gains or losses will be recognized in the profit and loss statement. However unrealized gains and losses will be recognized in Other Comprehensive Income (OCI).

Example 2- Comprehensive

Facts

- 100 shares bought at \$10/share, commission expense of \$50
- Shares designated as HFTI
- Dividends of \$2/share received
- End of Year One shares are trading at \$15/ share
- In Year 2 half of the shares sold for \$12 , commission expense \$75
- End of Year Two shares are trading at \$13/share

Year One

Dr HFTI	1,000	
Dr Commissions expense	50	
Cr Cash		1,050

Dr Cash	200	
Cr Dividend Revenue		200

Dr Valuation Allowance	500	
Cr Unrealized Gain		500

Year Two

Dr Cash	525	
Dr Commission expense	75	
Cr HFTI		500 (Half of the original cost)
Cr Realized gain		100 (Realized as shares sold)

Remember to Adjust the Valuation Account

At the end of Year Two you have 50 shares with an original cost of \$10/share - the balance in HFTI is therefore \$500.

The market price of the remaining shares is \$13/share - an increase of \$3 from the original cost. The Valuation Allowance therefore should be 50 shares*3= \$150 debit.

Example 2- Comprehensive

The Valuation Allowance currently has a debit balance of \$500 (Balance from Year One).

An adjusting journal entry is required to adjust the Valuation account from \$500 debit to \$150 debit.

Dr	Loss on HFTI	350	
Cr	Valuation Allowance		350

Remember that both unrealized and realized gains and losses are recorded on the Income Statement. This means the overall loss in Year Two is \$100 gain - \$350 loss = \$250 loss

Let's prove our loss another way:

During Year Two, 50 shares were sold for \$12/share. The carrying value of the shares was \$15 at the end of Year One. The loss on these shares in Year Two is \$150 (50 shares * (12-15)). The remaining 50 shares with a carrying value of \$15/share at the end of Year One now have a market value of \$13/share at the end of Year Two. On these shares, an unrealized loss of \$100 (50 shares * (13-15)) needs to be recognized. **The loss of \$150 plus unrealized loss of \$100 total an overall loss of \$250- the same outcome as above.**