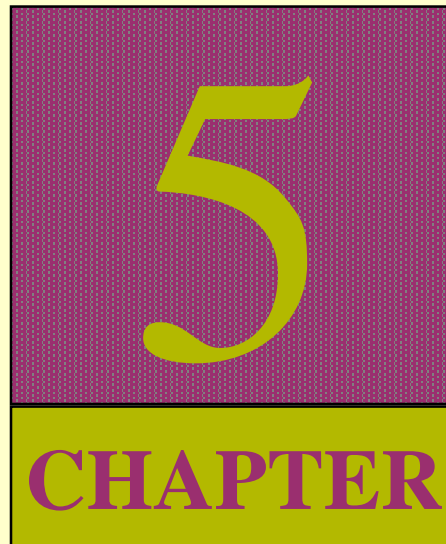


Analyzing Investing Activities: Intercorporate Investments



Investment Securities

Composition

Investment securities (also called *marketable securities*) are of two types:

Debt Securities

- Government or corporate debt obligations

Equity Securities

- Corporate stock that is readily marketable.

Investment Securities

Classification

Investment Securities

Debt Securities

Trading

Held-to-Maturity

Available-for-Sale

Equity Securities

No Influence (below 20% holding)

- Trading
- Available-for-Sale

Significant Influence (between 20% and 50% holding)

Controlling Interest (above 50% holding)

Investment Securities

Accounting for Debt Securities

Category		Description	Accounting		
			Balance Sheet	Income Statement	
				Unrealized Gains/Losses	Other
Held-to-Maturity	Securities acquired with both the intent and ability to hold to maturity	Amortized Cost	Not recognized in either net income or comprehensive income	Recognize realized gains/losses and interest income in net income	
Trading	Securities acquired mainly for short-term or trading gains (usually less than three months)	Fair Value	Recognize in net income	Recognize realized gains/losses and interest income in net income	
Available-for-Sale	Securities neither held for trading nor held-to-maturity	Fair Value	Not recognized in net income, but recognized in comprehensive income	Recognize realized gains/losses and interest income in net income	

Investment Securities

Accounting for Transfers between Security Classes

Transfer		Accounting	
From	To	Effect on Asset Value in Balance Sheet	Effect on Income Statement
Held-to-Maturity	Available-for-Sale	Asset reported at fair value instead of (amortized) cost	Unrealized gain or loss on date of transfer included in comprehensive income
Trading	Available-for-Sale	No effect	Unrealized gain or loss on date of transfer included in net income
Available-for-Sale	Trading	No effect	Unrealized gain or loss on date of transfer included in net income
Available-for-Sale	Held-to-Maturity	No effect at transfer; however, asset reported at (amortized) cost instead of fair value at future dates	Unrealized gain or loss on date of transfer included in comprehensive income

Investment Securities

Classification and Accounting for Equity Securities

Category	No Influence		Significant Influence	Controlling Interest
	Available-for-Sale	Trading		
Ownership	Less than 20%	Less than 20%	Between 20% and 50%	About 50%
Purpose	Long- or intermediate-term investment	Short-term investment or trading	Degree of business control	Full business control
Valuation Basis	Fair value	Fair value	Equity method	Consolidation
Balance Sheet Asset Value	Fair value	Fair value	Acquisition cost adjusted for proportionate share of investee's retained earnings and appropriate amortization	Consolidated balance sheet
Income Statement: Unrealized Gains	In comprehensive income	In income	Not recognized	Not recognized
Income Statement: Other Income Effects	Recognize dividends and realized gains and losses in income	Recognize dividends and realized gains and losses in income	Recognize proportionate share of investee's net income less appropriate amortization in income	Consolidated income statement

Investment Securities

Analyzing Investment Securities

At least three main objectives:

- (1) to separate operating from investing (and financing) performance
- (2) to evaluate investment performance and risk
- (3) to analyze accounting distortions due to accounting rules and /or earnings management involving investment securities



Investment Securities

Separating Operating from Investing Assets and Performance

Determine whether investment securities (and related income streams) are investing or operating in nature—based on an assessment of whether each investment is strategic or made purely for the purpose of investment

Remove all gains (losses) relating to investing activities—including dividends, interest income, and realized and unrealized gains and losses—when evaluating the operating performance of a company

Separate operating and non-operating assets when determining operating return on investment



Investment Securities

Analyzing Accounting Distortions from Investment Securities

Potential accounting distortions an analyst must be alert to:

- **Classification based on intent**
- **Opportunities for gains trading**
- **Liabilities recognized at cost**
- **Inconsistent definition of equity securities**



Auditors

Intercorporate Investments

Equity Method Accounting

Equity method accounting—reports the parent's investment in the subsidiary, and the parent's share of the subsidiary's results, as line items in the parent's financial statements (referred to as *one-line consolidation*)



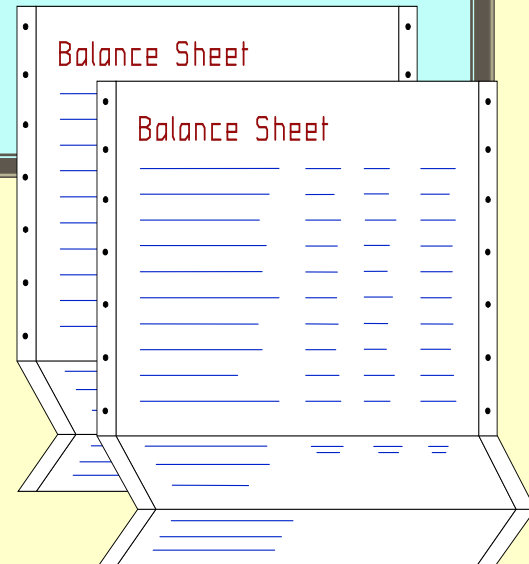
Note: Generally used for investments representing 20 to 50 percent of the voting stock of a company's equity securities--main difference between consolidation and equity method accounting rests in the level of detail reported in financial statements

Intercorporate Investments

Equity Method Accounting

Investment account:

- Initially recorded at acquisition cost
- Increased by % share of investee earnings
- Decreased by dividends received

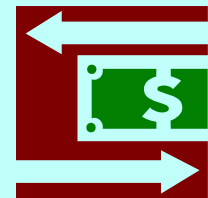


Intercorporate Investments

Equity Method Accounting

Income:

- Investor reports % share of investee company earnings as “equity earnings” in its income statement
- Dividends are reported as a reduction of the investment account, not as income



Equity Method Mechanics

- ❖ Assume that Global Corp. acquires for cash a 25% interest in Synergy, Inc. for \$500,000, representing one-fourth of Synergy's stockholders' equity as of the acquisition date.

- ❖ Acquisition entry:

Investment	500,000
Cash	500,000

Synergy, Inc.

Current assets	700,000
PP&E	<u>5,600,000</u>
Total assets	6,300,000

Current liabilities	300,000
Long-term debt	4,000,000
Stockholders' Equity	<u>2,000,000</u>
Total liabs and equity	6,300,000

Equity Method Mechanics

- ❖ Subsequent to the acquisition date, Synergy reports net income of \$100,000 and pays dividends of \$20,000. Global records its proportionate share of Synergy's earnings and the receipt of dividends as follows:

Investment 25,000
 Equity earnings 25,000
(to record proportionate share of investee company earnings)

Cash 5,000
 Investment 5,000
(to record receipt of dividends)

Investment balance = % Share of Investee Equity

Global Corp.
Investment Account

Beg. 500,000			
Inc. 25,000	5,000	Div.	
End 520,000			

Synergy, Inc.
Stockholders' equity

		2,000,000	Beg.
Div. 20,000	100,000		Inc.
		2,080,000	End.

Equity Investments

Important Points in Equity Method Accounting

- ❖ **The investment account represents the proportionate share of the stockholders' equity of the investee company. Substantial assets and liabilities may, therefore, not be recorded on balance sheet unless the investee is consolidated. This can have important implications for the analysis of the investor company.**
- ❖ **Investment earnings (the proportionate share of the earnings of the investee company) should be distinguished from core operating earnings in the analysis of the earnings of the investor company.**
- ❖ **Investments accounted for under the equity method are reported at adjusted cost, not at market value. Substantial unrealized gains may, therefore, not be reflected in assets or stockholders' equity.**

Equity Investments

Important Points in Equity Method Accounting

- ❖ **An investor should discontinue equity method accounting when the investment is reduced to zero (such as due to investee losses), and should not provide for additional losses unless the investor has guaranteed the obligations of the investee or is otherwise committed to providing further financial support to the investee. Equity method accounting only resumes once all cumulative deficits have been recovered via investee earnings.**
- ❖ **If the amount of the initial investment exceeds the proportionate share of the book value of the investee company, the excess is allocated to identifiable tangible and intangible assets that are depreciated/amortized over their respective useful lives. Investment income is reduced by this additional expense. The excess not allocated in this manner is treated as goodwill and is no longer amortized.**

Intercorporate Investments

Consolidation

Intercorporate investments — investments by one corporation in the equity securities of another corporation

Parent — corporation who controls, generally through ownership of equity securities, the activities of another separate legal entity known as a **subsidiary**

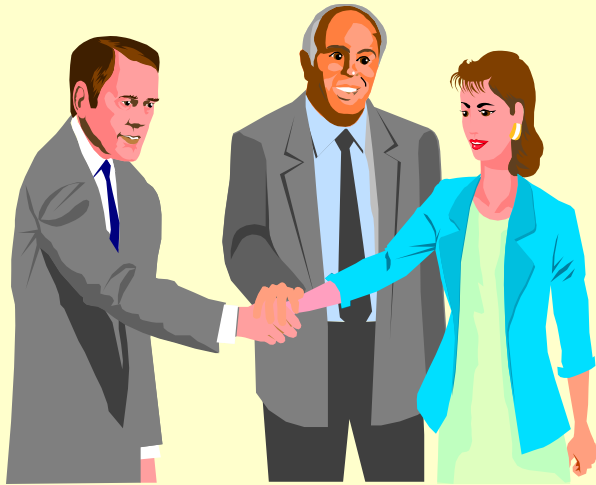
Parent-subsidiary relation — when one corporation owns all or a majority of the voting equity securities of another corporation



Business Combinations

Definitions

Business combinations—refer to the merger, acquisition, reorganization, or restructuring of two or more businesses to form another business entity

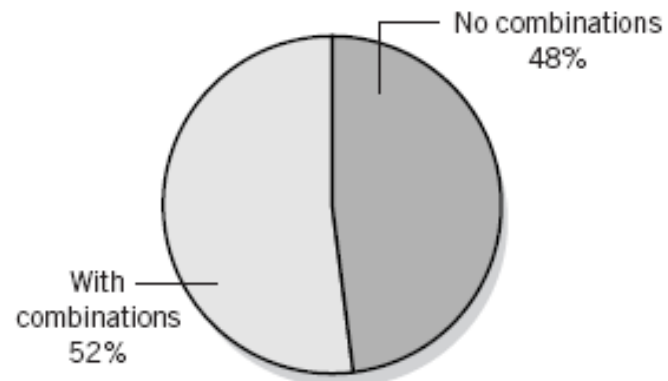


Motivations

- enhance company image and growth potential
- acquiring valuable materials and facilities
- acquiring technology and marketing channels
- securing financial resources
- strengthening management
- enhancing operating efficiency
- encouraging diversification
- rapidity in market entry
- achieving economies of scale
- acquiring tax advantages
- management prestige and perquisites
- management compensation

Business Combinations

Companies Reporting Business Combinations



Source: Accounting Trends & Techniques

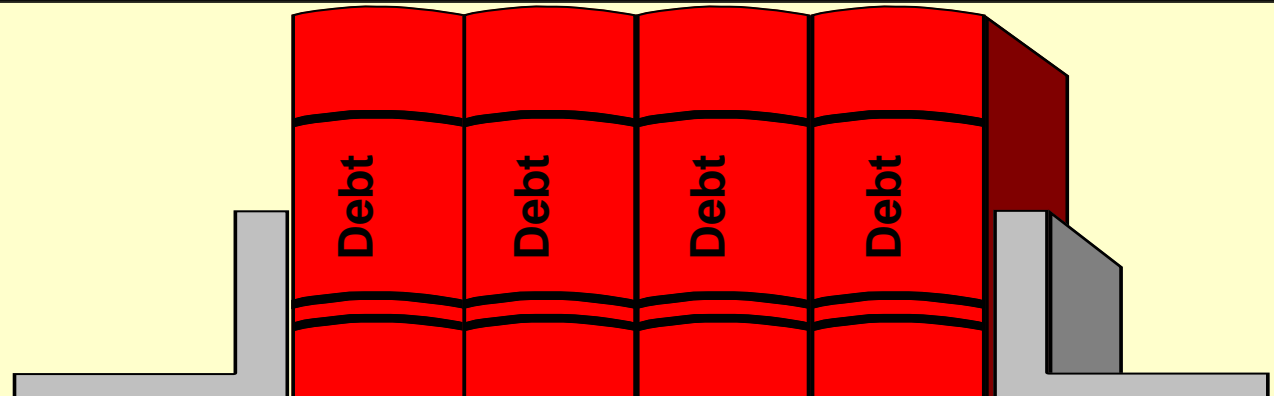
Business Combinations

Accounting

GAAP only allows one method of accounting for business combinations:

- **Purchase accounting**—reflects acquisition of one or more companies by another company; acquiror continues operating, while the acquired company disappears; acquiror records the acquired assets (including goodwill) and liabilities at fair values at date of acquisition

Previously, the Pooling-of-interest method was allowed. Although prior acquisitions accounted for as poolings are allowed to continue, acquisitions after 6/30/01 must use Purchase Method.



Intercorporate Investments

Consolidated Financial Statements

Consolidated financial statements report the results of operations and financial condition of a parent corporation and its subsidiaries in one set of statements

Basic Technique of Consolidation

Consolidation involves two steps: *aggregation* and *elimination*

Aggregation of assets, liabilities, revenues, and expenses of subsidiaries with the parent

Elimination of intercompany transactions (and accounts) between subsidiaries and the parent



Note: Minority interest represents the portion of a subsidiary's equity securities owned by other than the parent company

Intercorporate Investments

Consolidation Illustration

On December 31, Year 1, Synergy Corp. purchases 100% of Micron Company by exchanging 10,000 shares of its common stock (\$5 par value, \$77 market value) for all of the common stock of Micron.

On the date of the acquisition, the book value of Micron is \$620,000. Synergy is willing to pay the market price of \$770,000 because it feels that Micron's property, plant, and equipment (PP&E) is undervalued by \$20,000, it has an unrecorded trademark worth \$30,000 and intangible benefits of the business combination (corporate synergies, market position, and the like) are valued at \$100,000.

Intercorporate Investments

Consolidation Illustration

The purchase price is, therefore, allocated as follows:

Purchase price	770,000
Book value of Micron	<u>620,000</u>
Excess	150,000

Excess allocated to –		<u>useful life</u>	<u>annual deprec/amort.</u>
Undervalued PP&E	20,000	10	2,000
Trademark	30,000	5	6,000
Goodwill	<u>100,000</u>	indefinite	-0-
	150,000		

Intercorporate Investments

Synergy Corp. and subsidiary trial balances and consolidated financial statements for year-ended December 31, Year 2. Prepared under the purchase accounting method

	Synergy	Micron	Debits	Credits	Consolidated
Revenues	610,000	370,000			980,000
Oper. expenses	(270,000)	(140,000)			(410,000)
Deprec. Expense	(115,000)	(80,000) [4]	2,000		(197,000)
Amort. Expense	-	- [4]	6,000		(6,000)
Investment income	142,000	- [3]	142,000		-
Net Income	367,000	150,000			367,000
Retained Earn., 1/1	680,000	490,000 [1]	490,000		680,000
Net Income	367,000	150,000			367,000
Dividends Paid	(90,000)				(90,000)
Ret. Earn., 12/31	957,000	640,000			957,000
Cash	105,000	20,000			125,000
Receivables	380,000	220,000			600,000
Inventory	560,000	280,000			840,000
Invest. in Micron	912,000	-		[1] 620,000 [2] 150,000 [3] 142,000	-
PP&E (net)	1,880,000	720,000 [2]	20,000 [4]	2,000	2,618,000
Trademark	-	- [2]	30,000 [4]	6,000	24,000
Goodwill			100,000 [2]		100,000
Total assets	3,837,000	1,240,000			4,307,000
Liabilities	780,000	470,000			1,250,000
Common Stock	800,000	100,000 [1]	100,000		800,000
Add'l. Pd-In Cap.	1,300,000	30,000 [1]	30,000		1,300,000
Retained Earnings	957,000	640,000			957,000
Tot. Liab & Eq.	3,837,000	1,240,000	920,000	920,000	4,307,000

Intercorporate Investments

Synergy Corp and Micron Company Consolidated Income Statement Steps

- Income statement of Synergy Supplies is combined with that of Micron Corp.
- Depreciation / amortization of excess of purchase price over the book value of Micron's assets is recorded as an additional expense in the consolidated income statement
- Any intercompany profits on sales of inventories held by the consolidated entity at year-end, along with any intercompany profits on other asset transactions, are eliminated



Intercorporate Investments

Synergy Corp and Micron Company Consolidated Balance Sheet Steps

- The equity investment account on Synergy's balance sheet is replaced with the Micron assets / liabilities to which it relates.
- Consolidated assets / liabilities reflect the book value of Synergy plus the book value of Micron, plus the remaining undepreciated excess of purchase price over the book value of Micron assets.
- Goodwill, which was previously included in the investment account balance, is now broken out as a separately identifiable asset on the consolidated balance sheet



Intercorporate Investments

Synergy Corp and Micron Company Consolidated Balance Sheet Steps - Summary

Replace \$620,000 of the investment account with the book value of the assets acquired. If less than 100% of the subsidiary is owned, the credit to the investment account is equal to the percentage of the book value owned and the remaining credit is to a liability account, *minority interest*.

Replace \$150,000 of the investment account with the fair value adjustments required to fully record Micron's assets at fair market value, and

Eliminate the investment income recorded by Synergy and replace that account with the income statement of Micron. If less than 100% of the subsidiary is owned, the investment income reported by the Synergy is equal to its proportionate share and an additional expense is reported for the *minority interest* in Micron's earnings.

Intercorporate Investments

Concept of Control

Presumption of control if an entity:

- Has a majority voting interest in or a right to appoint a majority of an entity's governing body
- Has a large minority voting interest and no other party or organized group of parties has a significant voting interest
- No other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner

and



FASB

Intercorporate Investments

Concept of Control (cont.)

Presumption of control if an entity:

- Has a unilateral ability to (1) obtain a majority voting interest in or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost



FASB

Business Combinations

Purchase Accounting Concerns

Contingent Consideration—a company usually records the amount of any contingent consideration payable in accordance with a purchase agreement when the contingency is resolved and the consideration is issued or issuable

Allocating Total Cost—once a company determines the total cost of an acquired entity, it is necessary to allocate this cost to individual assets received; the excess of total cost over the amounts assigned to identifiable tangible and intangible assets acquired, less liabilities assumed, is recorded as goodwill

In-Process Research & Development (IPR&D)—some companies are writing off a large portion of an acquisition's costs as purchased research and development. Pending accounting standard will require capitalization of IRR&D and annual testing for impairment

Debt in Consolidated Financial Statements - Liabilities in consolidated financial statements do not operate as a lien upon a common pool of assets.

Business Combinations

Analysis Implications

Gain on subsidiary stock sales —The equity investment account is increased via subsidiary stock sales. Companies can record the gain either to income or to APIC

Consequences of Accounting for Goodwill—goodwill is not permanent and the present value of super earnings declines as they extend further into the future – future impairment losses are likely

Push-Down Accounting—a controversial issue is how the acquired company (from a purchase) reports assets and liabilities in its separate financial statements (if that company survives as a separate entity)



Preparers

Business Combinations

Analysis Implications

Validity of Taking Up Earnings—dollar-for-dollar equivalence of earnings cannot be taken for granted because:

- ❖ A regulatory authority can sometimes intervene in a subsidiary's dividend policy
- ❖ A subsidiary can operate in a country where restrictions exist on remittance of earnings or where the value of currency can deteriorate rapidly
- ❖ Dividend restrictions in loan agreements can limit earnings accessibility
- ❖ Presence of a stable or powerful minority interest can reduce a parent's discretion in setting dividend or other policies

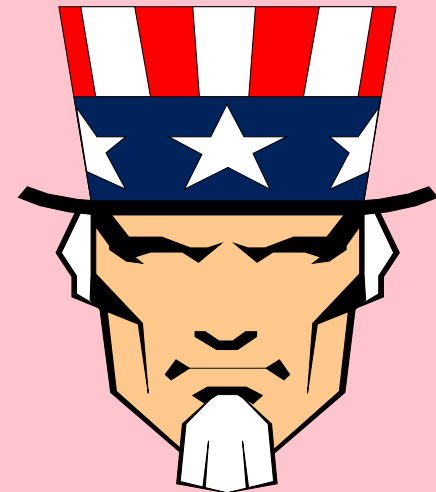


Business Combinations

Analysis Implications

Provision for Taxes on Undistributed Subsidiary Earnings

- ❖ Current practice assumes all undistributed earnings transfer to the parent and that a provision for taxes is made by the parent in the current period
- ❖ The decision on whether taxes are provided on undistributed earnings is that of management
- ❖ Management must report the amount of earnings for which no income taxes are provided by the parent



Business Combinations

Analysis Implications

Debt in Consolidated Financial Statements

- ❖ Liabilities in consolidated financial statements do not operate as a lien upon a common pool of assets
- ❖ Creditors, whether secured or unsecured, have recourse in the event of default only to assets owned by the specific corporation that incurred the liability
- ❖ If a parent company guarantees a liability of a subsidiary, then the creditor has the guarantee as additional security with potential recourse provisions
- ❖ To assess the security of liabilities, analysis must examine the individual financial statements of each subsidiary



Business Combinations

Analysis Implications

Additional Limitations of Consolidated Financial Statements

- ❖ Consolidated retained earnings actually available for payment of dividends are difficult to establish unless reported
- ❖ Composition of minority interest (e.g., between common and preferred) cannot be determined from a “combined” minority interest amount in the consolidated balance sheet
- ❖ Aggregation of dissimilar enterprises can distort ratios and other relations—for example, current assets of finance subsidiaries are not generally available to satisfy current liabilities of the parent; assets and liabilities of separate entities are not interchangeable

Business Combinations

Analysis Implications

Additional Limitations of Consolidated Financial Statements

- ❖ Financial statements of the individual companies comprising the larger entity are not always prepared on a comparable basis—these differences can inhibit homogeneity and impair the validity of ratios, trends, and other analyses
- ❖ Consolidated financial statements do not reveal restrictions on use of cash for individual companies--these factors obscure analysis of liquidity
- ❖ Companies in poor financial condition sometimes combine with financially strong companies, thus obscuring analysis
- ❖ Extent of intercompany transactions is unknown unless the procedures underlying the consolidation process are reported

Business Combinations

Analysis Implications of Pooling vs. Purchase

- Assets are acquired and carried at book value and not market value as reflected in consideration given—to the extent goodwill is purchased, the acquiring company does not report it on its balance sheet
- Understatement of assets yields understatement in combined company equity
- Understatement of assets (including inventory, property, plant, equipment, goodwill, and intangibles) yields understatement of expenses (such as cost of goods sold, depreciation, amortization) and overstatement of income
- Understatement of assets yields not only understatement of expenses but potential overstatement of gains on asset disposition; the combined company reports in its income any gains on sales of assets, yet these gains potentially arise at time of acquisition and are carried forward at unrealistically low amounts only to be recognized at disposition

Business Combinations

Analysis Implications of Pooling vs. Purchase

- Understatement of invested equity or overstatement of income yields overstatement in return on investment
- Retained earnings of the acquired entity are carried forward to the combined company
- Income statements and balance sheets of the combined entity are restated for all periods reported; under purchase accounting they are combined and reported *post acquisition*—although pro forma statements showing pre-acquisition combined results are typically furnished

Derivative Securities

Background

Market risks

commodity price risk

foreign currency risk

interest rate risk

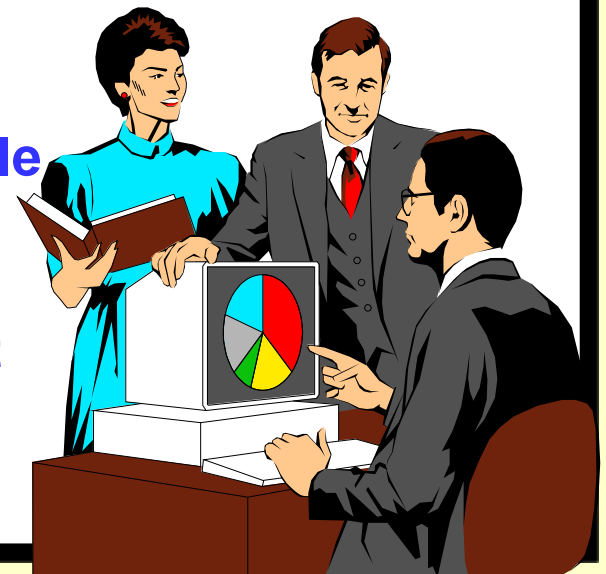
Derivative Securities

Background

Hedges are contracts that seek to insulate companies from market risks—securities such as futures, options, and swaps are commonly used as hedges

Derivative securities, or simply derivatives, are contracts whose value is derived from the value of another asset or economic item such as a stock, bond, commodity price, interest rate, or currency exchange rate

— they can expose companies to considerable risk because it can be difficult to find a derivative that entirely hedges the risks or because the parties to the derivative contract fail to understand the risk exposures



Derivative Securities

Definitions

Derivative is a contract possessing each of the following characteristics:

- One or more *underlying* indexes and one or more *notional* amounts (and/or payments)—the underlying indexes and the notional amounts determine the settlement amount, if any.
- No initial net investment or an initial net investment less than that required for a normal transaction yielding similar responses to market risk changes.
- Permits a net settlement.

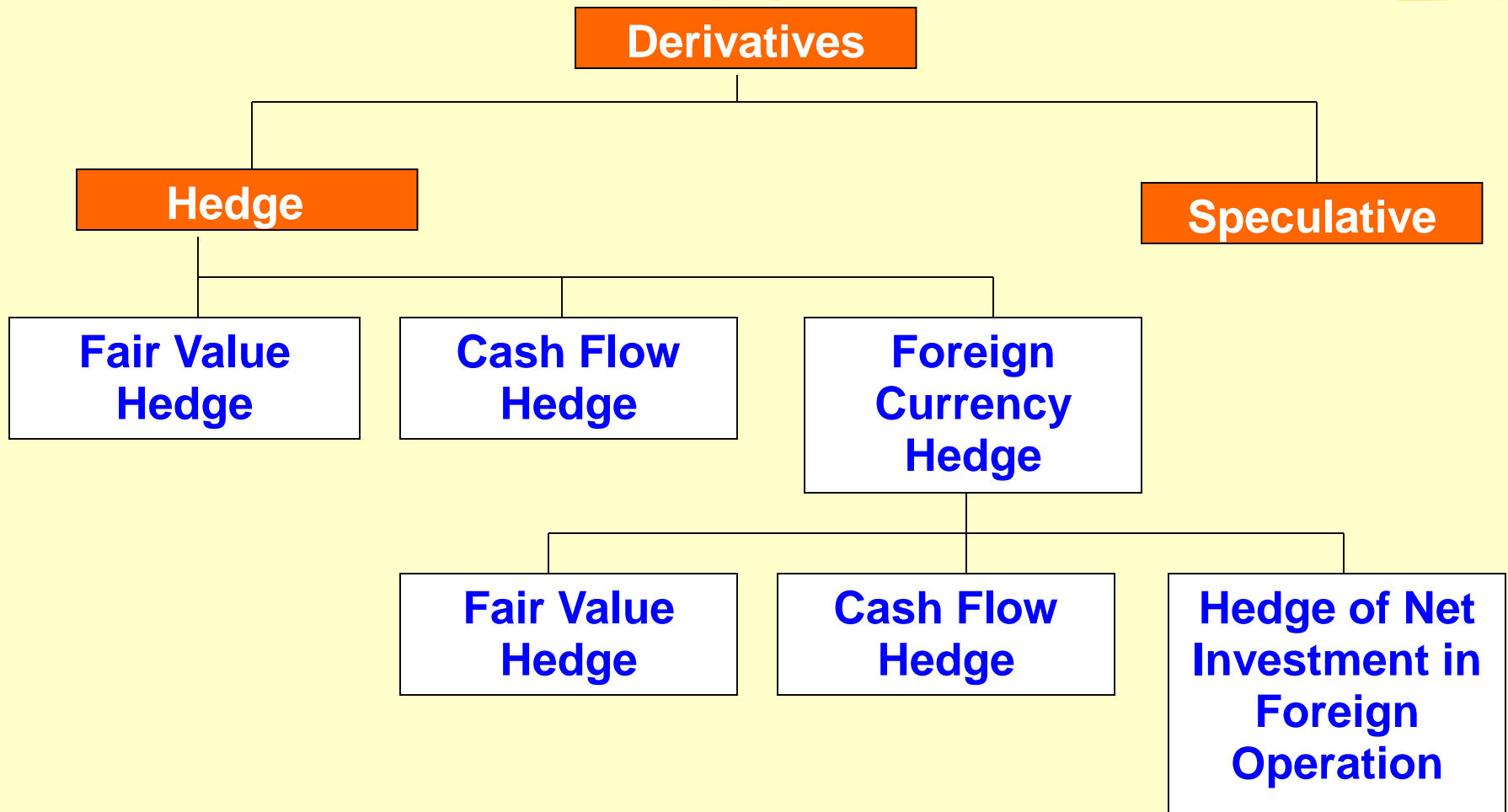
Underlying index, or simply *underlying* (also called a *primitive*), is the main driver of derivative value--it can be any economic variable such as a commodity price, security price, index, interest rate, or exchange rate

Notional amount is the number of units—expressed in figures, weight, volume, dollars, or other unit measure—as specified in the contract

Net settlement is a cash resolution for the contracting parties in lieu of settling up in full amounts (or quantities)

Derivative Securities

Classification of Derivatives



Derivative Securities

Accounting for Derivatives

Derivative	Balance Sheet	Income Statement
Speculative	Derivative recorded at fair value	Unrealized gains and losses included in income
Fair value hedge	Both derivative and hedged asset and/or liability recorded at fair value	Unrealized gains and losses on both derivative and hedged asset and/or liability included in income
Cash flow hedge	Derivative recorded at fair value (offset by accumulated comprehensive income)	Unrealized gains and losses on effective portion of derivative are recorded in other comprehensive income until settlement date, after which transferred to income; unrealized gains and losses on the ineffective portion of derivative are included in income
Foreign currency fair value hedge	Same as fair value hedge	Same as fair value hedge
Foreign currency cash flow hedge	Same as cash flow hedge	Same as cash flow hedge
Foreign currency hedge of net investment in foreign operation	Derivative (and cumulative unrealized gain or loss) recorded at fair value (part of cumulative translation adjustment in accumulated comprehensive income)	Unrealized gains and losses reported in other comprehensive income as part of translation adjustment

Derivative Securities

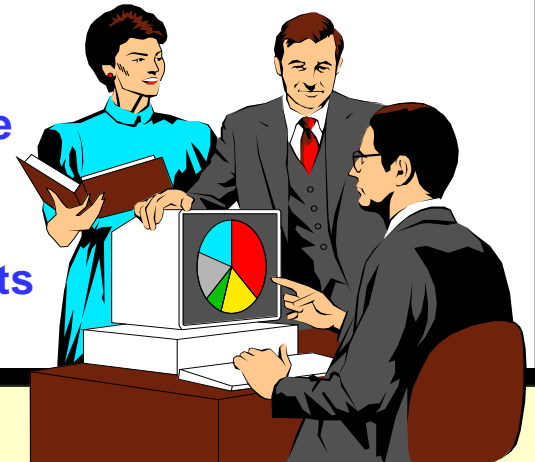
Analysis of Derivatives

Identify Objectives for Using Derivatives—risk associated with derivatives is much higher for speculation than for hedging; many companies implicitly speculate with derivatives

Risk Exposure and Effectiveness of Hedging Strategies—evaluate the underlying risks, the risk management strategy, the activities to hedge its risks, and the effectiveness of hedging operations; also consider counterparty risk

Transaction Specific versus Companywide Risk Exposure—evaluate companywide effects of derivatives; hedging specific risk exposures to transactions, commitments, assets, and/or liabilities does not necessarily ensure hedging of companywide risk

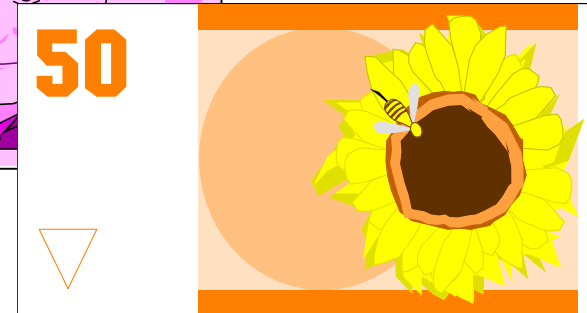
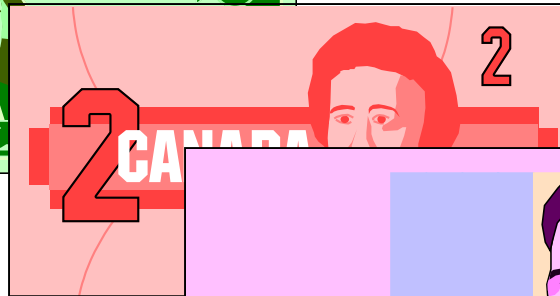
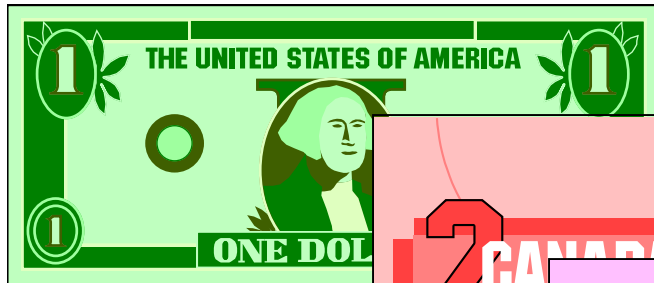
Inclusion in Operating or Nonoperating Income—to the extent derivatives are hedges, then unrealized and realized gains and losses should be excluded from operating income and their fair values should be excluded from operating assets



(Appendix 5A)

International Activities

Analysis obstacles with companies that operate in more than one country subdivide into two categories:

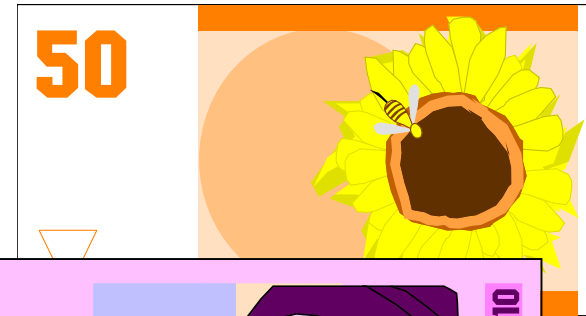
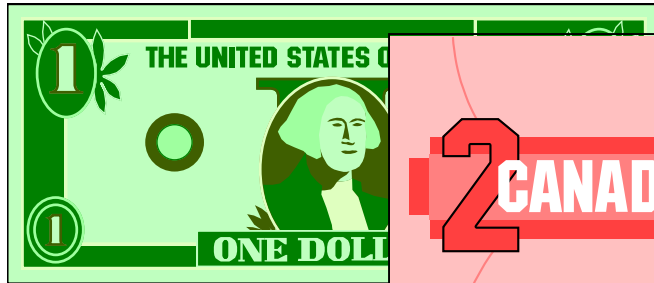


- Obstacles due to differences in accounting practices peculiar to a country where operations exist
- Obstacles arising from translation of assets, liabilities, and equities into the home-country measuring unit

International Activities

Translation of Foreign Currencies

Current rate method—translates all assets and liabilities at current rates



Temporal method—translates cash, receivables, payables, and other assets and liabilities measured at present or future prices at current rates, and assets and liabilities measured at past prices (historical costs) at historical rates



International Activities

Accounting using the Current Rate Method

Major provisions of accounting for foreign currency translation using a the Current Rate Method are:

- Translation requires identifying the functional currency of the entity—generally the currency of the country in which the subsidiary is located; all financial statement elements of the foreign entity are measured using the functional currency, but in conformity with the parent's accounting practices
- Translation from the functional currency into the reporting currency is required, if they are different—this translation occurs at the ***current*** exchange rate, except for revenues and expenses that are translated at the ***average*** current exchange rate during the period
- Translation adjustments are not included in income—they are reported and accumulated as a separate component of equity until such time the parent sells or completely or substantially liquidates the net investment in the foreign entity; translation adjustments are removed from equity and included as gains or losses in determining income for the period when such sale or liquidation occurs
- Exchange gains and losses attributable to intercompany foreign currency transactions, and balances that are of a trading nature, are included in income; but those attributable to long-term financing or capital transactions, where settlement is not expected for the foreseeable future, are reported as a separate component of equity

International Activities

Illustration of Foreign Currency Translation

Facts

- BritCo, a wholly owned U.K. subsidiary of DollarCo, incorporates when exchange rate is £1 = US\$1.10; Other exchange rates are:

January 1, Year 6	£1 = US\$1.20
December 31, Year 6	£1 = US\$1.40
Average for Year 6	£1 = US\$1.30
- Receivables, payables, and noncurrent liability amounts are denominated in local currency
- Dollar balance of Retained Earnings at December 31, Year 5, is \$60,000
- Cumulative Foreign Exchange Translation Adjustment at December 31, Year 5, is \$30,000 (Cr.)
- BritCo's December 31, Year 6, trial balance conforms to DollarCo's accounting principles; the pound (£) is the functional currency of BritCo:

	<u>Debit</u>	<u>Credit</u>	
Cash	£0,100,000		
Accounts receivable	300,000		
Inventories, at cost	500,000		
Prepaid expenses	25,000		
Property, plant, and equipment (net)	1,000,000		
Long-term note receivable	75,000		
Accounts payable		£0,500,000	
Current portion of long-term debt		100,000	
Long-term debt		900,000	
Capital stock		300,000	
Retained earnings, January 1, Year 6		50,000	
Sales		5,000,000	
Cost of sales	4,000,000		
Depreciation	300,000		
Other expenses	550,000		
	<u>£6,850,000</u>	<u>£6,850,000</u>	

- Sales, purchases, and all operating expenses occur evenly throughout the year—accordingly, cost of sales is convertible by use of the average rate
- Income tax consequences, if any, are ignored

International Activities

Illustration of Foreign Currency Translation

BritCo

Translated Balance Sheet and Income Statement

	£	Exchange Rate	Explanation*	Code or US \$
Balance Sheet				
Cash	100,000	1.4	C	140,000
Accounts receivable	300,000	1.4	C	420,000
Inventories, at cost	500,000	1.4	C	700,000
Prepaid expenses	25,000	1.4	C	35,000
Property, plant, and equipment (net)	1,000,000	1.4	C	1,400,000
Long-term note receivable	75,000	1.4	C	105,000
Total assets	<u>2,000,000</u>			<u>2,800,000</u>
Accounts payable	500,000	1.4	C	700,000
Current portion of long-term debt	100,000	1.4	C	140,000
Long-term debt	900,000	1.4	C	1,260,000
Total liabilities	<u>1,500,000</u>			<u>2,100,000</u>
Capital stock	<u>300,000</u>	1.1	H	<u>330,000</u>
Retained earnings:				
Balance, 1/1/Year 6	50,000		B	60,000
Current year net income	150,000		F	195,000
Balance, 12/31/Year 6	<u>200,000</u>			<u>255,000</u>
Cumulative foreign exchange translation adjustment:				
Balance, 1/1/Year 6			B	30,000
Current year translation adjustment			G	85,000
Balance, 12/31/ Year 6				115,000
Total stockholders' equity	<u>500,000</u>			<u>700,000</u>
Total liabilities and equity	<u>2,000,000</u>			<u>2,800,000</u>
Income Statement				
Sales	5,000,000	1.3	A	6,500,000
Cost of sales	(4,000,000)	1.3	A	(5,200,000)
Depreciation	(300,000)	1.3	A	(390,000)
Other expenses	<u>(550,000)</u>	1.3	A	<u>(715,000)</u>
Net income	<u>150,000</u>			<u>195,000</u>

*Translation code or explanation: **C** = Current rate. **H** = Historical rate. **A** = Average rate. **B** = Balance in U.S. dollars at the beginning of the period. **F** = Per income statement. **G** = Amount needed to balance the financial statements.

International Activities

Analysis Implications of Foreign Currency Translation

Current Rate Method—this is current practice; selectively introduces current value accounting and allows gains and losses to bypass the income statement

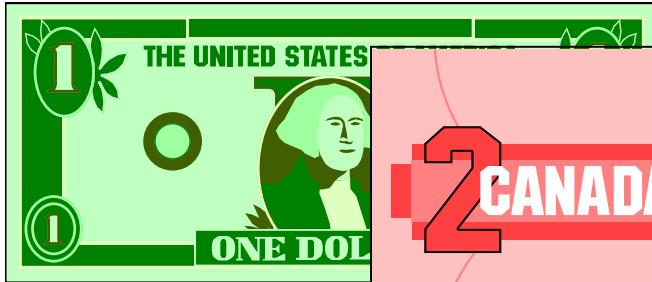
- Translation exposure is measured by ***size of the net investment***
- Translation adjustment is determined from net investment multiplied by change in exchange rates
- Currency translation affects equity (not income)
- Translated income varies directly with changes in exchange rates
- Income includes results of completed foreign exchange transactions
- Any gain or loss on translation of a current payable by subsidiary to parent flows through consolidated income
- Decline in the dollar relative to other currencies increases income of consolidated foreign subsidiaries
- It is management's decision whether the functional currency is the local currency
- Yields substantial changes in equity because of changes in the cumulative translation adjustment (CTA)

International Activities

Analysis Implications of Foreign Currency Translation

Temporal method—most faithful to and consistent with historical cost accounting; current practice does *not* follow the temporal method *except* in

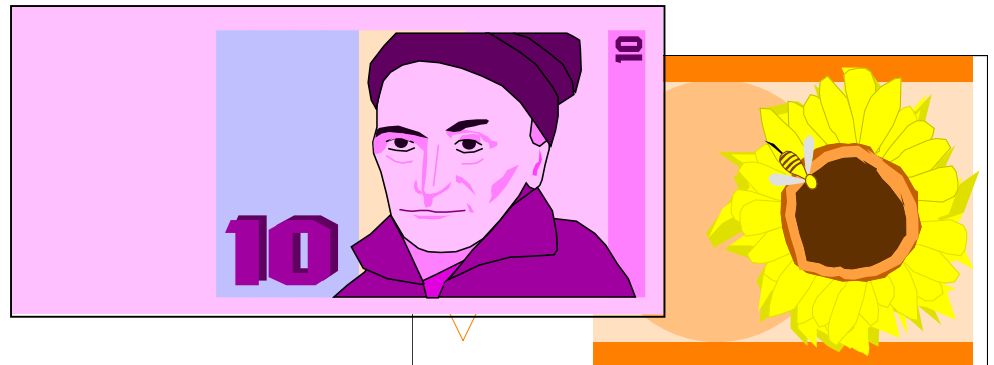
two cases:



- When a foreign entity is merely an extension of the parent and, thus, the functional currency is that of the parent



② When hyperinflation causes translation of nonmonetary assets to unrealistically low reported values because of using the current rate



International Activities

Summary of Translation Methods

Functional Currency	Local Currency	\$US
Translation method	Current Rate Method	Temporal method
<u>Account</u>	<u>Exchange Rate used for Translation</u>	
Cash & securities	current	current
Inventory	current	historical
PP&E & Intangibles	current	historical
Current Liabilities	current	current
Long-Term Liabilities	current	current
Capital stock	historical	historical
Retained earnings	derived	derived
Dividends	specific	specific
Revenues	average	average
Expenses	average	average
COGS	average	historical
Depreciation/ amortization	average	historical
Translation adjustment	Other Comprehensive Income	
Remeasurement gains (losses)		Income statement

(Appendix 5B)

Investment Securities

Evaluating Investment Performance and Risk

ROI

$$= \frac{\text{Investment income}}{(\text{Beginning fair value of investment} + \text{Ending fair value of investment})/2}$$

Investment income consists of three parts: Interest (and dividend) income + Realized gains and losses + Unrealized gains and losses

(Appendix 5B)

Investment Securities

Evaluating Investment Performance and Risk—Coca-Cola Case

	Held-to-Maturity	Available-for-Sale	Total
<u>Investment income (1998):</u>			
Interest and dividend	219	219	
Realized gains and losses			
Unrealized gains and losses		(70)	(70)
Total before tax	219	(70)	149
Tax adjustment (33%)	(72)	23	(49)
Total after tax	147	(47)	100
<u>Average investment base (1998):</u>			
1997 Fair value	1,591	526	2,117
1998 Fair value	1,431	422	1,853
Average	1,511	474	1,985
<u>Return on investment (ROI)</u>			
Before tax	14.5%	-14.8%	7.5%
After tax	9.7%	-9.9%	5.0%