

Portfolio Accounting

Accounting for stocks and bonds. Marketable securities.

Basically, FSB wanted the CPA's to break down all marketable securities into 4 portfolios, four groups.

(The first three below are publicly traded securities).

Trading Securities: A security bought with the intention to sell short term. A temporary place to park some cash. With trading securities we are hoping to benefit from short term market changes.

Available for Sale Securities: (Could be the) Exact same securities as Trading Securities but the company has announced it's intention to hold them a while.

Held to Maturity Securities: Bonds which have a maturity date and you have announced you will hold them to that maturity date. (This is your announced intention according to board minutes).

Fair Value Not Readily Determinable (FVNRD): A privately held security, not publicly traded. The value could be determined but not readably (easily). Would require an evaluation expert and a lot of research / work.

Note:

The company can change the status of any security in any portfolio at any time simply by announcing their changed intention. But when they do that they must call whatever the valuation is at the point of that decision (decision point to point of last valuation), whatever the gain or loss is, it must be called a Realized Gain/Loss.

Will only be taxed on Realized Gain/Loss. IRS does not care about Allowances or Unrealized Gains/Losses.

FMV: Fair Market Value
 FVNRD: Fair Value Not Readily Determinable
DIFF: solved for by difference
 G/L: difference between FMV at purchase and sale

These are the end of year valuation calculations

	12/31/x1		12/31/x2
Investment	\$ 35,000		\$ 35,000
Valuation Allowance	\$ 5,000		\$ (5,000)
(NV - TS (at FMV))	\$ 40,000	\$ (10,000)	\$ 30,000

		TRADING SECURITIES	
		DR	CR
Year 1	1) Purchase Security	Investments \$ 35,000	Cash \$ 35,000
End Year 1	FMV = \$40,000	Valuation Allowance \$ 5,000	Unrealized Gain/Loss \$ 5,000
		(income state acct)	
Year 2	End Year 2 FMV = \$30,000	Unrealized Gain/Loss \$ 10,000	Valuation Allowance \$ 10,000
			(income state acct)
Year 3	Sell for \$37,000	Cash \$ 37,000	Valuation \$ 5,000
		Realized Gain/Loss \$ 7,000	Investment \$ 35,000
		(sold asset, take it out of investment)	

		Available for Sale Securities (AFSS)	
		DR	CR
	Investments	\$ 35,000	
	Cash		\$ 35,000
	Valuation Allowance	\$ 5,000	
	Accum. G/L - AFSS		\$ 5,000
		(equity acct on balance sheet)	
	Accum. Gain/Loss	\$ 10,000	
	Valuation Allowance		\$ 10,000
		(equity acct on balance sheet)	
	Cash	\$ 37,000	
	Valuation Allowance	\$ 5,000	
	Accum Gain/Loss		\$ 5,000
	Investment		\$ 35,000
	Realized Gain/Loss		\$ 2,000
		(plug to balance)	

DIFF

DIFF

Valuation Account	
DR	CR
\$ 5,000	
	\$ 10,000
\$ 5,000	\$ 5,000

When investment is removed must remove the \$5,000 CR by entering a \$5,000 DR.

		Held to Maturity Securities	
		DR	CR
	Investments	\$ 35,000	
	Cash		\$ 35,000
	No Entry		(not held to maturity)
	No Entry		(not held to maturity)
	Cash	\$ 37,000	
	Realized Gain/Loss	DIFF \$ 2,000	
	Investment		\$ 35,000

		Fair Value Not Readily Determinable	
		DR	CR
	Investments	\$ 35,000	
	Cash		\$ 35,000
	No Entry		(not readily determinable)
	No Entry		(not readily determinable)
	Cash	\$ 37,000	
	Realized Gain/Loss	DIFF \$ 2,000	
	Investment		\$ 35,000

The following notes refer to the figure above.

Journal Entries for Portfolio Accounting

We will make the journal entries for all 4 types of a security. Here we are buying a security in year 1, holding it, and selling it year 3 for a gain.

Say one day 1 of year 1 securities are purchased. Basically it's this simple **you debit the investment and credit cash.**

The same entry is made for each type of security. The difference is how the security is classified.

Say that at the end of year 1 the fair market value of the security is \$40,000.

Here the value of the security has gone up. We have to consider what happens in the case of each type of security.

Trading Security

Here when we perform the valuation calculations on the security we will create either an adjunct or contra account depending on if the security has increased or decreased in value.

In this case we have a gain in the security so we will debit an account called **Valuation Allowance** (an asset account) for the amount of the gain (\$5,000) and credit the account **Unrealized Gain** (meaning we are recording a gain we have not actually cashed in yet) (a debit account).

This Valuation Allowance entry allows us to calculate the Net Value in Trading Securities at Fair Market Value (NV – TS @ FMV) shown below at the end of year 1:

	<u>12/31/x1</u>
Investment	\$ 35,000
Valuation Allowance	<u>\$ 5,000</u>
(INV - TS (at FMV))	\$ 40,000

They are using the Valuation Account to cause the investment value to go up or down. If the value had gone down the entry would be negative. Now what we are going to see on the balance sheet being reported is already at Fair Market Value on the date of the balance sheet. But they are never going to change the acquisition costs of the security. They only use the Valuation or Contra Account to value it up or down so that the market value of the security is reflected in the balance sheet.

Unrealized Gains/Losses are Valuations of Marketable Securities. This is an **Income Statement** account. Because this is a trading security we move it through the income statement because it is a short term gain of loss.

At the end of year 2 the fair market value changes to \$30,000. This represents a loss of \$5,000 from the purchase price of \$35,000 but also a loss of \$10,000 from the FMV of the previous year (which had been \$40,000 at the last valuation point). We will debit Unrealized Gain/Loss for \$10,000 and credit the Valuation Allowance for \$10,000. This entry reflects the change in value between the two valuation points as shown below:

	<u>12/31/x1</u>		<u>12/31/x2</u>
Investment	\$ 35,000		\$ 35,000
Valuation Allowance	\$ 5,000		\$ (5,000)
(INV - TS (at FMV))	<u>\$ 40,000</u>	\$ (10,000)	<u>\$ 30,000</u>

So we are using the Valuation Account to reflect the changes in the securities fair market value up or down.

Now year 3: say we sell the securities for \$37,000. This is a gain over the purchase price of \$35,000. We will debit Cash (to show an increase in a asset account) for the entire \$37,000 sale price. Now we have sold the security so we must **take it off the books**, that means we must credit the Investment Account for the purchase price of \$35,000. Now, if we do not have the investment then we do not need to Value the investment. We must figure out what is left in the Valuation Account. Look at the transactions in that account:

Valuation Account	
<u>DR</u>	<u>CR</u>
\$ 5,000	
	\$ 10,000
	\$ 5,000
\$ 5,000	

When investment is removed must remove the \$5,000 CR by entering a \$5,000 DR.

We have a net credit in the Valuation account of \$5,000. To remove this net credit we will debit the Valuation Allowance for the same amount, \$5,000. Again, we do this because we no longer have the asset, so we no longer need the Valuation Account. Must close it out.

Now look at our entries for the sale of this security:

	<u>DR</u>	<u>CR</u>
Cash	\$ 37,000	
Valuation	\$ 5,000	
Investment		\$ 35,000

Our entries are imbalanced, to balance them we will make an entry to the only other thing which has changed in this transaction, Realized Gain/Loss on investment. We find the amount of this entry by difference.

Cash	\$ 37,000	
Valuation	\$ 5,000	
Realized Gain/Loss		\$ 7,000 DIFF
Investment		\$ 35,000

$$\text{Realized Gain/Loss} = \text{Cash} + \text{Valuation} - \text{Investment} = 37 + 5 - 35 = 7$$

We do not go back and change the Unrealized Gain/Loss. The difference comes to \$7,000 from the last valuation point to the point of sale. In a sense this is a plug number.

Available for Sale Securities (AFSS)

These securities are long term, not intended to be held for temporary market fluctuation. Because these securities are not purchased for short term gain we do not move their temporary gains or losses through the income statement. But we do want to value the amount of the security to Fair Market Value.

So we will debit Valuation Allowance for the amount of the gain (\$5,000) and we will credit Accumulated Gain/Loss on available for sale securities for the amount of the gain. This appears in a subsection of the equity section of the balance sheet.

Net Income (or, as preferred by the FASB, Earnings)		\$ 63,250
① Other Comprehensive Income, Net of Tax		
② Foreign Currency Translation Adjustments (PLUG)		\$ 7,000
③ Unrealized Gains and Losses on Securities:		
Unrealized Holding Gains Arising during Period	\$13,000	
Less: Reclassification Adjustment for Gain Included in Net Income (Earnings)	(1,500)	11,500
④ Minimum Pension Liability Adjustment		(2,500)
Other Comprehensive Income (Loss)		\$ 16,000
Comprehensive Income (Loss)		\$ 79,250

Text, page 692

The above figure is an extract from the Comprehensive Income Statement on pg 692. There are two approaches, the one statement and two statement approaches. The above extract is from the one statement and shows the area below Net Income. It shows that there are 4 items which can affect the company's equity outside of net income.

One of the ways is called **Foreign Currency Translation Adjustment** which is a way for multinational companies to translate all the earnings of all their subsidiaries around the world back into US dollars. It describes the rules which must be followed to do so.

Ex.

Say we have a subsidiaries which is being accounted for in units of the local currency. At the end of it's fiscal year it will have a balanced balance sheet. This balanced balance sheet has to be translated into US dollars. The rule is that you translate monetary assets and liabilities at the current exchange rate on the date of the balance sheet.

By contrast, inventory and fixed assets are translated at historical acquisition rates. Whatever the rates were at the time you acquired those assets.

The result is that we had a balanced balance sheet but have translated different things at different exchange rates. This is going to result in an imbalanced balance sheet for the US parent company. The solution is that the difference is entered into the equity section of the balance sheet as the **Foreign Currency Translation Adjustment** plug. Just drop the total in.

The next entry in the table is Unrealized Gains & Losses on Securities. Unrealized holdings gains which are arising during the period. For long term securities this goes directly to the equity section, does not pass through net income. As a result of not passing through net income it does not affect net income. It goes directly into the equity section of the balance sheet so the

Valuation does show up there. The reason the FASB did this is because they wanted to reflect the fact that the fair market value had changed on the balance sheet without causing a temporary fluctuation impact on the income statement (because the intent of this type of investment is long term, why show the year by year fluctuations on the income statement, it's not relevant).

The point is that valuation activities are reflected as equity accounts on the balance sheet.

At the end of year 2 the fair market value changes to \$30,000. This represents a loss of \$5,000 from the purchase price of \$35,000 but also a loss of \$10,000 from the FMV of the previous year (which had been \$40,000 at the last valuation point). We will debit Accumulated Gain/Loss and credit Valuation Allowance each for \$10,000 (the amount of the loss in value from the last valuation point). Note this is the opposite of the entry we made in year 1 (with a different magnitude).

Now year 3: debit Cash for \$37,000, remove the investment by crediting Investment for the purchase price of \$35,000. Now must reverse both the Valuation Allowance and the Accumulated Gain/Loss.

Valuation Account		Accum. Gain/Loss	
<u>DR</u>	<u>CR</u>	<u>DR</u>	<u>CR</u>
\$ 5,000		\$ 10,000	\$ 5,000
	\$ 10,000	\$ 5,000	
	\$ 5,000		\$ 5,000
\$ 5,000			

We'll make these closing entries to year 3 of AFSS:

	<u>DR</u>	<u>CR</u>
Cash	\$ 37,000	
Valuation Allowance	\$ 5,000	
Accum Gain/Loss		\$ 5,000
Investment		\$ 35,000

Unbalanced, what is the only other thing to have changed in this transaction? Realized Gain/Loss, we'll find the value by difference:

	<u>DR</u>	<u>CR</u>
Cash	\$ 37,000	
Valuation Allowance	\$ 5,000	
Accum Gain/Loss		\$ 5,000
Investment		\$ 35,000
Realized Gain/Loss		\$ 2,000 DIFF
(plug to balance)		

$$\text{Realized G/L} = \text{Cash} + \text{Val. Allow} - \text{Accum G/L} - \text{Inv} = 37 + 5 - 5 - 35 = 2$$

Held to Maturity

Here it is clear that if we are holding this security to maturity we are not concerned about temporary fluctuations. So there is NO ENTRY for the valuation changes over the life of the security.

NO ENTRY for the year 2 fluctuation.

Year 3: here we debit Cash \$37,000 and credit Investment \$35,000 and a Realized Gain of \$2,000.

Fair Value Not Readily Determinable

Here we can see that the valuation changes are not readily determinable and there is NO ENTRY. Valuing these assets requires valuations experts whom are very expensive and usually only come into play when a company is being sold or acquired.

NO ENTRY for the year 2 fluctuation.

Year 3: here we debit Cash \$37,000 and credit Investment \$35,000 and a Realized Gain of \$2,000.

HOMEWORK

Handout, pg 444 pb 14.

c) is a FVNRD

Given acquisition date and cost, look at each individually.

Modification: show that the selling price for HTM was \$33,000 sold in year 3.

AFS selling price \$90,000 in year 3.

Value the securities at point of acquisition then the valuation at the end of year 1 and year 2 and then the sale entry when it is sold in year 3.

FINAL EXAM ITEMS

These are the topics for each question on the final exam.
7 questions total.

- 1) Depreciation, all methods. [CLASS]
- 2) Leases, journal entries. [CLASS]
Will have to know the 4 criteria for capitalizing a lease.
- 3) Bonds, FMV & journal entries. [CLASS]
- 4) Deferred Income Taxes, compute tax return and financial statement. [CLASS 8]
- 5) LIFO, FIFO, Weighted Average. [CLASS 6]
- 6) Manufacturing Inventory and Cost of Sales. [CLASS 6]
- 7) Portfolio Analysis for Marketable Securities. [CLASS 9]