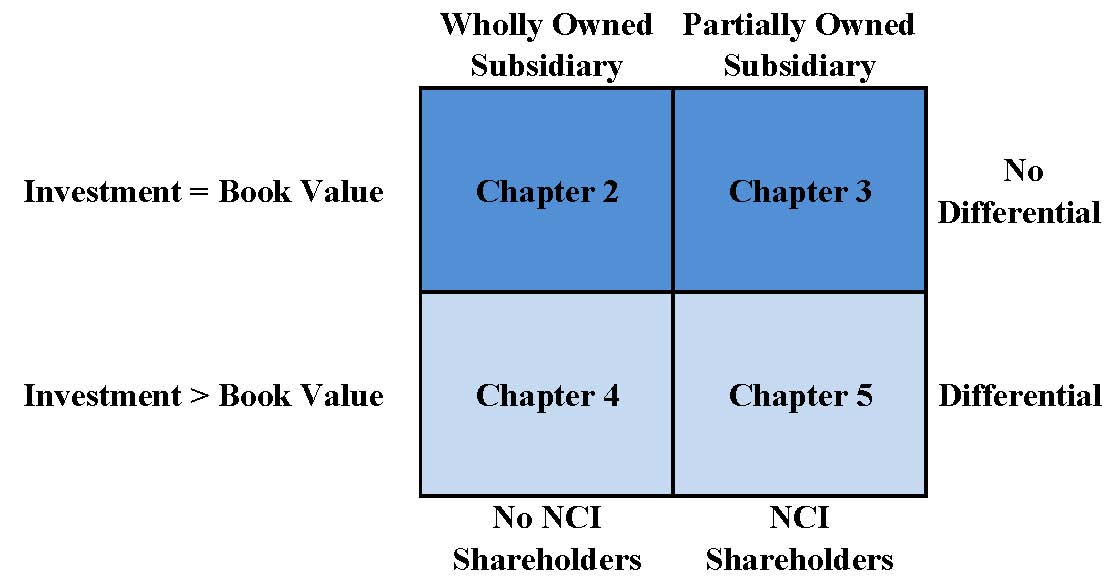
**CHAPTER 2**

**Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential**

**IMPORTANT NOTE TO INSTRUCTORS**

The 10th edition uses a building block approach to our coverage of consolidation in chapters 2 through 5. Chapter 2 introduces our coverage of consolidation in the most basic setting when the subsidiary is either created or purchased at an amount equal to the book value of the subsidiary’s underlying net assets.



Chapter 3 explains how the basic consolidation process changes when the parent company owns less than 100 percent of the subsidiary. Chapter 4 shows how the consolidation process differs when the parent company acquires the subsidiary for an amount greater (or less) than the book value of the subsidiary’s net assets. Finally, Chapter 5 presents the most complex consolidation scenario (where the parent owns less than 100 percent of the subsidiary’s outstanding voting stock and the acquisition price is not equal to the book value of the subsidiary’s net assets). In order to facilitate this new approach, we emphasize that this edition includes elimination entries used in consolidation to facilitate the elimination of the investment in a subsidiary in two steps: (1) first the book value portion of the investment and income from the subsidiary are eliminated and (2) then the differential portion of the investment and income from subsidiary are eliminated with separate entries. We believe that this approach is more intuitive for students.

**OVERVIEW OF CHAPTER 2**

Chapter 2 provides detailed coverage of the accounting and reporting requirements for investments in the common stock of another company. It presents the criteria used in determining when equity method reporting must be applied, and it fully illustrates and compares both the cost method and equity method. While coverage of this topic may seem to replicate materials presented in the typical intermediate accounting sequence, many students do not have an adequate understanding of the entries recorded on the parent company's books and experience problems with the elimination entries needed in the consolidation process as a result.

The discussion of the cost method includes purchases and sales of additional shares subsequent to the initial investment. The discussion of the equity method significantly extends beyond the cost method coverage to include changes in the number of shares held and retroactive application of the equity method when sufficient additional shares of the investee are acquired to attain significant influence.

Chapter 2 also illustrates the use of fair value option. This chapter briefly discusses interests other than investments in common stock (e.g., partnerships) and illustrates the three reporting alternatives (Cost method, Equity method, and Consolidation).

Additional Considerations portion of the chapter discusses how to determine significant influence and accounting for investments in subsidiaries.

We introduce the most basic setting for learning consolidation—when the subsidiary is created or 100% is purchased at book value. In this most simple scenario, there is no differential and there is no need to account for a noncontrolling interest. It allows students to become familiar with the consolidation process in the easiest possible scenario.

Appendix 2A covers many topics that may be more tangential, including accounting for dividends in excess of earnings since acquisition, unrealized intercompany profits, additional requirements under ASC 323-10, and Investors’ share of other comprehensive income.

Appendix 2B repeats the consolidation example from the chapter when the parent company uses the cost method instead of the equity method.

**LEARNING OBJECTIVES**

When students finish studying this chapter, they should be able to:

LO 2-1 Understand and explain how ownership and control can influence the accounting for investments in common stock.

LO 2-2 Prepare journal entries using the cost method for accounting for investments.

LO 2-3 Prepare journal entries using the equity method for accounting for investments.

LO 2-4 Understand and explain differences between the cost and equity methods.

LO 2-5 Prepare journal entries using the fair value option.

LO 2-6 Make calculations and prepare basic elimination entries for a simple consolidation.

LO 2-7 Prepare a consolidation worksheet.

**SYNOPSIS OF CHAPTER 2**

**Reporting Intercorporate Interests and**

**Consolidation of Wholly Owned Subsidiaries with no Differential**

Berkshire Hathaway’s Many Investments

LO 2-1 Understand and explain how ownership and control can influence the accounting for investments in common stock.

Accounting for Investments in Common Stock

LO 2-2 Prepare journal entries using the cost method for accounting for investments.

The Cost Method

Accounting Procedures under the Cost Method

Declaration of Dividends in Excess of Earnings since Acquisition

Acquisition at Interim Date

Changes in the Number of Shares Held

LO 2-3 Prepare journal entries using the equity method for accounting for investments.

The Equity Method

Use of the Equity Method

Investor's Equity in the Investee

Recognition of Income

Recognition of Dividends

Comparison of the Carrying Amount of the Investment and Investment Income under the Cost and Equity Methods

Acquisition at Interim Date

Changes in the Number of Shares Held

LO 2-4 Understand and explain differences between the cost and equity methods.

Comparison of the Cost and Equity Methods

LO 2-5 Prepare journal entries using the fair value option.

The Fair Value Option

LO 2-6 Make calculations and prepare basic elimination entries for a simple consolidation.

Overview of the Consolidation Process

Consolidation Procedures for Wholly-Owned Subsidiaries that are Created or Purchased at Book Value

LO 2-7 Prepare a consolidation worksheet.

Consolidation Worksheets

Worksheet Format

Nature of Elimination Entries

Consolidated Balance Sheet with Wholly-Owned Subsidiary

100 Percent Ownership Acquired at Book Value

Consolidation Subsequent to Acquisition

Consolidated Net Income

Consolidated Retained Earnings

Consolidated Financial Statements—100 Percent Ownership, Created or Acquired at Book Value

Initial Year of Ownership

Second and Subsequent Years of Ownership

Consolidated Net Income and Retained Earnings

Appendix 2A—Additional Considerations Relating to the Equity Method

Determination of Significant Influence

Alternative Versions of the Equity Method of Accounting for Investments in Subsidiaries

Unrealized Intercompany Profits

Additional Requirements of ASC 323-10

Investor’s Share of Other Comprehensive Income

Appendix 2B—Consolidation and the Cost Method

Consolidation—Year of Combination

Consolidation—Second Year of Ownership

**NOTES ON POWERPOINT SLIDES**

We have attempted to provide PowerPoint slides that will be useful to a broad set of users.  Since instructors often have different styles and preferences, we have attempted to include slides that will accommodate different approaches and that can be adapted to classes with different levels of preparation.  For example, some instructors prefer to introduce the material before students have read the chapter.  We have tried to facilitate these types of introductory discussions by including slides that replicate key points from the chapter. Other instructors expect students to have read the chapter and attempted homework problems before coming to class.  As a result, they may not find it useful to review all of the topics in the chapter or to include slides that simply review many of the details they expect students to study before class.  However, instructors following

this approach often like to use sample exercises and problems built into the slides that allow them to have extended discussions or to facilitate group interaction in class.

If instructors elect to spend two class periods on the same subject, they might find a combination of both styles to be useful by first introducing foundational material before students have read the chapter and studied the topic, followed by an extended discussion the next class period after students have read the chapter and attempted homework problems.

We have tried to develop slides that can facilitate a flexible approach to allow instructors to select the slides that best match their objectives and style for class discussions.  This is the reason we are including over 100 slides for some chapters in the text.  We do not expect all instructors to use all slides, but the slide files should help support different teaching approaches and allow instructors to select the subset of slides that best matches their specific discussion objectives.

The slides are organized by learning objective. We have included a slide at the beginning of each learning objective to show where the new material begins. Instructors may or may not want to use these learning objective slides in class. We provide them primarily as a way of organizing the material. We also include short multiple choice questions at the end of most learning objectives. Some instructors find it useful to pause periodically during class to assess students’ level of understanding. For this reason, we include several “practice quiz questions” that can be used throughout class discussions to engage students, help them focus on key points, or to facilitate group interaction. Finally, we provide longer exercises and problems that many instructors find useful in assessing understanding and encouraging group learning.

LO 2-1 Understand and explain how ownership and control can influence the accounting for investments in common stock.

* Slides 3-7 summarize basic concepts related to LO 2-1. While slide 4 repeats the diagram from the chapter, slide 5 provides a more interactive view of the same concept.
* Instructors should choose slides from this LO that they deem most important to emphasize to their students

LO 2-2 Prepare journal entries using the cost method for accounting for investments.

* Slides 11-21 summarize basic concepts related to LO 2-2 related to the cost method. The simple example in slide 19 allows students to practice cost method journal entries.
* Instructors should choose slides from this LO that they deem most important to emphasize to their students

LO 2-3 Prepare journal entries using the equity method for accounting for investments.

* Slides 25-35 summarize basic concepts related to LO 2-3 related to the equity method. The simple example in slides 31-32 allows students to practice equity method journal entries.
* Instructors should choose slides from this LO that they deem most important to emphasize to their students

LO 2-4 Understand and explain differences between the cost and equity methods.

* Slides 41-45 summarize basic concepts related to LO 2-4 comparing the cost and equity methods. The example in slides 42-45 allows students to practice making journal entries under both methods and to easily compare them.
* Instructors should choose slides from this LO that they deem most important to emphasize to their students

LO 2-5 Prepare journal entries using the fair value option.

* Slide 49 summarizes the fair value option and slide 50 provides an example to allow students to practice the fair value option.

LO 2-6 Make calculations and prepare basic elimination entries for a simple consolidation.

* Slides 52-53 provide a summary of the consolidation process.
* Slide 54 allows the instructor to explain how the worksheet is used to calculate the numbers used in consolidated financial statements.
* Slides 55-56 introduce the concept of elimination entries.
* Slide 57 introduces a comprehensive example to be used to illustrate the consolidation process under the equity method.
* Slide 58 explain the basic elimination entry and slides 59-61 show how to make basic book value calculations used in the basic elimination entry. This series of slides provides the foundation for helping students begin to learn how to prepare consolidated financial statements. Instructors should spend enough time here to ensure that students understand these basic concepts.

LO 2-7 Prepare a consolidation worksheet.

* Slides 63-65 show students how to set up the worksheet. In slide 63 instructors should explain that the first step in preparing a consolidation worksheet is to enter the numbers from trail balances of the parent and subsidiary into the first two columns of the worksheet. In slide 64, we emphasize that the same line items that are subtotaled in the actual financial statements of the companies need to subtotaled in the elimination entry columns. This is a critical point. In slide 65 we ask students to introduce the numbers from the basic elimination entry for the Pea Soup example from the previous section into the worksheet. We emphasize that debits and credits in each sub-section need to be sub-totaled. However, it is critical to help students understand that the articulation in the financial statements also applies to the adjustment columns. Since net income carries down to the statement of retained earnings, the sub totals in the elimination entry adjustment columns must be carried down with the net income number. Likewise, since the ending balance in retained earnings carries down from the statement of retained earnings to the balance sheet, the sub totals in the elimination entry columns must be carried down with the retained earnings ending balances. We spend a few minutes emphasizing the “mechanics” of the worksheet because students who try to work too quickly and skip these important details will inevitably make mistakes in their consolidation column. Emphasize that taking time to pay attention to these details will save students a significant amount of time (and headaches) in the long run.
* Slides 66-71 walk students through the consolidation worksheet one line item at a time. We only do this once in chapter 2. Once students have practiced adding across each row, we assume they can do it on future worksheets. While this may seem like a tedious exercise (and even though this is an advanced financial accounting text), we have found from our experience that students often forget the normal balance in different types of accounts and have trouble remembering whether a debit or credit entry increases or decreases different types of accounts. We find that walking through this exercise one time helps students to remember these basic concepts.
* Slide 72 emphasizes that when the parent uses the fully adjusted equity method, the parent’s net income and retained earnings ending balance will always be equal to the corresponding consolidated numbers.
* Slides 73-80 provide a detailed comprehensive consolidation example. We have students work this exercise in small groups in class. Advanced preparation includes either providing students a spreadsheet file or a hard copy similar to slide 73 so that they can work this exercise in class. In slide 74, we ask students to work together to perform the book value calculations. In slide 75, we review the book value calculations and explain which numbers are used in the basic elimination entry. We then ask students to attempt the basic elimination entry in their groups. In slide 76, we show them the answer.
* Slides 77-78 allow the instructor to explain the optional accumulated depreciation elimination entry. The idea is that if the company had purchased property, plant, and equipment assets “used” from another company, the acquiring company would have recorded the assets at their purchase price with zero accumulated depreciation. The acquiring company would not have been concerned with the former owner’s cost basis or accumulated depreciation. In purchasing another company, it is also useful to ensure that the fixed assets of the acquired company appear in the consolidated financial statements as if the acquiring company had acquired those assets on the date of acquisition. This elimination entry nets the accumulated depreciation on the date of acquisition against the cost basis, so that they appear as if they were newly acquired (at their net book values) on the acquisition date. This entry essentially allows these assets to start with a “clean slate” on the date of acquisition with no accumulated depreciation.
* Slide 79 allows the instructor to ask students to enter the basic elimination entry into the adjustment columns, calculate their sub-totals, and carry down the net income and retained earnings ending balance adjustments to ensure proper “mechanics” for their consolidation. After having students go through this process with their groups, we show them slide 79 BEFORE having them complete the worksheet. Slide 80 provides the solution.

Appendix 2B

* Slides 82-93 repeat the same consolidation example using the cost method. Some instructors like to show students how to perform a consolidation under the cost method.
* Slides 94-95 summarize differences between the cost and equity methods.

**TEACHING IDEAS**

1. Students could be asked to write a brief memo discussing why companies would be encouraged to invest in the stock of other companies. A question could be raised as to the trade-off of investing in stock of another company or increasing the capital expenditures of the company for additional fixed assets. What are the economic benefits of investing in another company?

2. Students could be assigned a recent article on investments on the Internet and asked to prepare an executive summary of the article, highlighting its major points for a business executive (e.g., a corporate controller or a partner in a CPA firm) who has not read the article.

3. Students could be asked to review the financial statements of a large public company and write a report on their investments. Students should list the different type of investments, percentage ownership, and method of accounting for the investments.

**DESCRIPTIONS OF CASES, EXERCISES, AND PROBLEMS**

|  |  |
| --- | --- |
| **C2-1A**  20 min.  LO 2-2, LO 2-3  E | **Choice of Accounting Method**  The criteria used in determining significant influence are reviewed. Students also must specify when investment income will be greater under the cost method and when it will be greater under the equity method. They should also explain why the use of the equity method becomes more appropriate as the percentage of ownership increases. |
| **C2-2**  30 min.  LO 2-2, LO 2-3  M | **Intercorporate Ownership**  Students are required to research current authoritative pronouncements and develop a memorandum to management supporting the use of either the cost or equity method in accounting for the company’s investment. They should support their findings with citations and quotations from the appropriate literature. |
| **C2-3A**  30 min.  LO 2-2, LO 2-3  M | **Application of the Equity Method**  Students must review authoritative pronouncements to determine whether the company should utilize the cost or equity method subsequent to the sale of part of its investment. Students must prepare a memorandum to the controller and outline and support their opinion. |
| **C2-4**  25 min.  LO 2-6, LO 2-7  M | **Need for Consolidation Process**  An effective answer to this case requires an understanding of which balances must be eliminated in order to avoid misstating the consolidated balance sheet totals. |
| **C2-5**  25 min.  LO 2-1  M | **Account Presentation**  Students must research authoritative literature to determine the proper way of combining account balances from different subsidiaries. A memorandum that reports findings and provides the necessary supporting references is required. |
| **C2-6**  25 min.  LO 2-6, LO 2-7  M | **Consolidating an Unprofitable Subsidiary**  An unprofitable venture is currently consolidated with a profitable entity without separately disclosing the loss. Students must research the issue to determine if disclosure is necessary, and describe what type of disclosures will be necessary in the financial statement notes or the management discussion. Reference to authoritative literature must be included in a memorandum to the treasurer. |
| **E2-1**  15 min.  LO 2-2, LO 2-3  E | **Multiple-Choice Questions on Use of Cost and Equity Methods**  **[AICPA Adapted]**  Seven multiple-choice questions deal with basic applications of the cost and equity methods and when each should be used. |

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| **E2-2**  5 min.  LO 2-4  M | **Multiple Choice Questions on Intercorporate Investments**  Two multiple-choice questions deal with conceptual issues related to the cost and equity methods. |
| **E2-3**  15 min.  LO 2-3  M | **Multiple-Choice Questions on Applying Equity Method**  [AICPA Adapted] Five multiple-choice questions focus primarily on the computation of equity method income. |
| **E2-4**  20 min.  LO 2-4  E | **Cost versus Equity Reporting**  Students must compute the income to be reported for three years under the (a) cost method and (b) the equity method. Liquidating dividends exist for the cost method. |
| **E2-5**  10 min.  LO 2-2, LO 2-3  E | **Acquisition Price**  Given the net income and dividend payments of an investee for a three-year period and the ending balance in the investment account on the investor's books, the acquisition price paid by the investor is computed under cost and equity method reporting. |
| **E2-6**  20 min.  LO 2-2, LO 2-3  M | **Investment Income**  The investor's income is computed for a four-year period using both the cost and equity methods. Journal entries for the final year are recorded under both methods. Dividends in excess of earnings are paid in the third year. |

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| **E2-7**  15 min.  LO 2-3  E | **Investment Value**  Calculation of the investment account balance is required for three consecutive years. |
| **E2-8A**  5 min.  LO 2-2, LO 2-3  E | **Income Reporting**  Separate recognition of an extraordinary gain reported by the investee is required on an investor's books. |
| **E2-9**  15 min.  LO 2-4, LO 2-5  M | **Fair Value Method**  Net income has to be calculated under three methods – cost, equity, and fair value methods. |
| **E2-10**  15 min.  LO 2-3, LO 2-5  M | **Fair Value Recognition**  Journal entries are required for all transactions occurring during the year of purchase assuming that the investor utilizes (1) the equity method and (2) the fair value method. |

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| **E2-11A**  15 min.  LO 2-3, LO 2-5  M | **Investee with Preferred Stock Outstanding**  Journal entries must be given for the investor under the equity method. Preferred stock information is provided. |
| **E2-12A**  15 min.  LO 2-2, LO 2-3  M | **Other Comprehensive Income Reported by Investee**  Journal entries must be given for the investor. Operating income and other comprehensive income reported by the investee is provided. |
| **E2-13A**  10 min.  LO 2-2, LO 2-3  E | **Other Comprehensive Income Reported by Investee**  The investee records an operating loss in the first year and a gain in the second year. Dividends are paid in both years. It also reports other comprehensive income in the second year. The balance in the investor’s equity-method investment account is given at the end of the second year. The purchase price must be calculated. |
| **E2-14**  20 min.  LO 2-7  M | **Basic Elimination Entry**  Elimination entry is required assuming acquisition of 100% of an investee's stock. |

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| **E2-15**  25 min.  LO 2-6, LO 2-7  E | **Balance Sheet Worksheet**  A simple balance sheet worksheet following the business consolidation is required. An entry for elimination of the investment account and the stockholders' equity balances of the subsidiary is needed. |
| **E2-16**  40 min.  LO 2-3, LO 2-7  M | **Consolidation Entries for Wholly Owned Subsidiary**  Students must prepare journal entries for an acquisition using the equity method.  Elimination entries to prepare consolidated financial statements are required. |
| **E2-17**  15 min.  LO 2-3, LO 2-7  E | **Basic Consolidation Entries for Fully Owned Subsidiary**  Journal entries recorded by the parent company and the elimination entries needed to prepare consolidated statements at the end of the first year of ownership are required for a fully-owned subsidiary. |
| **P2-18**  20 min.  LO 2-2, LO 2-3  H | **Retroactive Recognition**  Students must show the journal entries to be recorded on an investor’s books assuming that an increase in the percentage ownership over the past three years requires retroactive application of the equity method. |
| **P2-19**  20 min.  LO 2-4, LO 2-5  M | **Fair Value Method**  Investment income and the balances in the investment account are to be calculated for three years, assuming the cost method, the equity method, and the fair value method. |

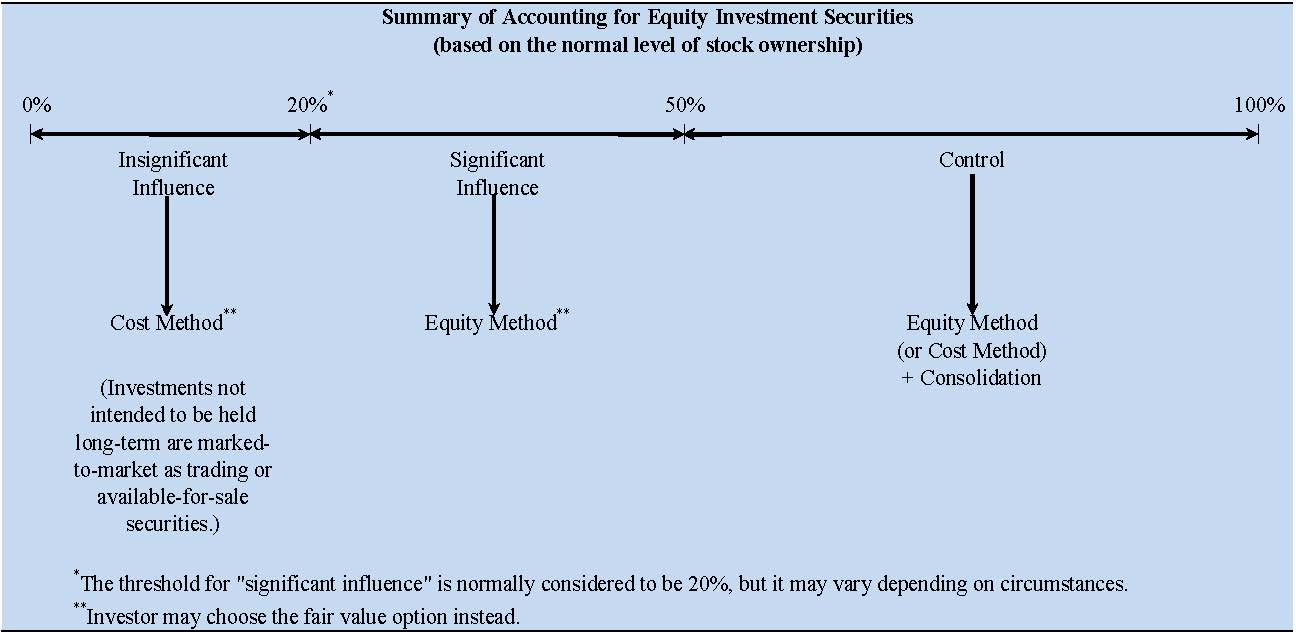
|  |  |
| --- | --- |
| **P2-20**  15 min.  LO 2-5  M | **Fair Value Journal entries**  All journal entries made by the investor are required for two years, assuming the usage of the fair value method. |
| **P2-21A**  25 min.  LO 2-5  H | **Other Comprehensive Income Reported by Investee**  An investee reports other comprehensive income during the period. Students must compute the equity-method income reported for the year, the increase in the balance in the investment account for the year, the amount of other comprehensive income reported by the investee, and the market value of the securities reported as available-for-sale by the investee at the end of the year. |

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| **P2-22A**  45 min.  LO 2-3, LO 2-7  H | **Equity-Method Income Statement**  An income statement and a retained earnings statement for both the investee and investor must be prepared. The investee has discontinued operations, an extraordinary item, and a cumulative adjustment from a change of accounting principle. This problem presents a good review of income statement disclosures for the investee and the resulting disclosures needed in the financial statements of the investor. |
| **P2-23**  30 min.  LO 2-3, LO 2-6, LO 2-7  M | **Consolidated Worksheet at End of the First Year of Ownership (Equity Method)** Students are asked to prepare journal entries on a parent company’s books at the time of an acquisition and then to prepare a consolidation worksheet at the end of the first year. |
| **P2-24**  30 min.  LO 2-3, LO 2-6, LO 2-7  M | **Consolidated Worksheet at End of the Second Year of Ownership (Equity Method)** As a continuation of P2-23, students are asked to prepare equity method journal entries on a parent company’s books related to the subsidiary and then to prepare a consolidation worksheet at the end of the second year. |
| **P2-25**  35 min.  LO 2-3, LO 2-6, LO 2-7  M | **Consolidated Worksheet at End of the First Year of Ownership (Equity Method)** Students are asked to prepare journal entries on a parent company’s books at the time of an acquisition and then to prepare a consolidation worksheet at the end of the first year. |
| **P2-26**  35 min.  LO 2-3, LO 2-6, LO 2-7  M | **Consolidated Worksheet at End of the Second Year of Ownership (Equity Method)** As a continuation of P2-25, students are asked to prepare equity method journal entries on a parent company’s books related to the subsidiary and then to prepare a consolidation worksheet at the end of the second year. |
| **P2-27B**  30 min.  LO 2-3, LO 2-6, LO 2-7  M | **Consolidated Worksheet at End of the First Year of Ownership (Cost Method)** This problem uses the same data as provided in P2-23 except that it assumes the parent uses the cost method for subsidiary investments. Students are asked to prepare journal entries on a parent company’s books at the time of an acquisition and then to prepare a consolidation worksheet at the end of the first year. |

|  |  |
| --- | --- |
| **P2-28B**  30 min.  LO 2-3, LO 2-6, LO 2-7  M | **Consolidated Worksheet at End of the Second Year of Ownership (Cost Method)** This problem uses the same data as provided in P2-24 except that it assumes the parent uses the cost method for subsidiary investments. As a continuation of P2-27, students are asked to prepare any cost method journal entries on a parent company’s books related to the subsidiary and then to prepare a consolidation worksheet at the end of the second year. |

**OTHER RESOURCES**

**Level of Ownership and Accounting and Reporting**



**Chapter 2**

**Investment Example**

On July 1, 20X8, A Company purchases a 20 percent ownership interest in B Company for $500. At this date, the book value of B’s assets is $2,000 and the fair value of B’s depreciable assets is $300 greater than book value. Depreciable assets have a remaining economic life of 10 years. Goodwill is not amortized.

B Company reports net income of $400 for the year, earned evenly throughout the year. Dividends of $300 are declared and paid on December 31.

A. Assume that A Company is able to exert significant influence over B Company.

B. Assume that A Company is unable to exert significant influence over B Company.



**A. EQUITY METHOD**

Changes in Investment Account and Calculation of End of Period Balance:



Income from Equity Investment:



**B. COST METHOD**

|  |  |  |
| --- | --- | --- |
| Dividend on December 31: |  |  |
|  | **Total** | **20%** |
| Income from 7/1 to 12/31 | $200 | $40 |
| Dividend on December 31 | (300) | (60) |
| Preacquisition earnings distributed | $(100) | $(20) |
| (Return of Investment Capital) |  |  |

Changes in Investment Account and Calculation of End of Period Balance:



Income from Equity Investment:

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**COMPARISON OF COST AND EQUITY METHODS**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Transaction |  | COST METHOD | | |  | EQUITY METHOD | | |
|  |  |  |  |  |  |  |  |  |
| 1.) Acquired stock |  | Investment | 500 |  |  | Investment | 500 |  |
|  |  | Cash |  | 500 |  | Cash |  | 500 |
|  |  |  |  |  |  |  |  |  |
| 2.) Investee reports income |  | --- no entry --- |  |  |  | Investment | 40 |  |
|  |  |  |  |  |  | Income-Invest. | | 40 |
|  |  |  |  |  |  |  |  |  |
| 3.) Investee declares cash dividends |  | Cash | 60 |  |  | Cash | 60 |  |
|  |  | Div. Income |  | 40 |  | Investment |  | 60 |
|  |  | Investment |  | 20 |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| 4.) Amortization of differential |  | --- no entry --- |  |  |  | Income-Invest. | 3 |  |
|  |  |  |  |  |  | Investment |  | 3 |