15.514 SUMMER 2003

SESSION 12
MARKETABLE SECURITIES AND VALUATION ADJUSTMENTS

Objectives:

1. Understand when accounting departs from the “transactions-based” model and towards market-driven valuations
2. Illustrate the role of judgment in applying the LCM rule for inventory
3. Understand how marketable securities are valued on companies’ Balance Sheets
4. Understand the Income Statement effects of valuation adjustments

Reading Assignment

Pratt: Chapter 8, through p. 332.
Intel: pp. 24, 27-28

Class Preparation Questions

1. When should market values be used in the valuation of assets and liabilities in the Balance Sheet?
2. Are there cash flow effects of the "mark-to-market" rule?
3. The former GAAP requires lower-of-cost-or-market in the accounting for marketable securities, applied on a portfolio basis. If managers have the incentive to increase earnings, what behavior is induced by this rule? How does "mark-to-market" mitigate this behavior?
4. The new GAAP gives discretion to managers on how marketable securities are classified, based on managers' intent. Although most securities are marked-to-market, this new GAAP still allows securities (in particular, debt securities) to be carried at historical cost. Given this discretion in classification, does the new rule improve the ability of accounting to measure firm performance?
5. What was the market value of the Available for Sale securities held by Intel at the end of 2001? What was the original cost to Intel? What was the tax effect of the appreciation/depreciation?

Optional Problems

P7-4, c); E8-2, E8-6, P8-5, P8-6, ID8-8