2025 CFA®
Exam Prep

SchweserNotes™
Financial Statement Analysis and Corporate Issuers

Level II Book 2

KAPLAN SCHWESER

Book 2: Financial Statement Analysis and Corporate Issuers

SchweserNotes™ 2025

Level II CFA®

SCHWESERNOTES™ 2025 Level II CFA® BOOK 2: FINANCIAL STATEMENT ANALYSIS AND CORPORATE ISSUERS

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Learning Outcome Statements (LOS)

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The candidate should be able to:

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b. compare and contrast IFRS and US GAAP in their classification, measurement, and disclosure of investments in financial assets, investments in associates, joint ventures, business combinations, and special purpose and variable interest entities.
c. analyze how different methods used to account for intercorporate investments affect financial statements and ratios.

8. Employee Compensation: Post-Employment and Share-Based

The candidate should be able to:

a. contrast types of employee compensation.
b. explain how share-based compensation affects the financial statements.
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d. explain how post-employment benefits affect the financial statements.
e. explain financial modeling and valuation considerations for post-employment benefits.

9. Multinational Operations

The candidate should be able to:

a. compare and contrast presentation in (reporting) currency, functional currency, and local currency.
b. describe foreign currency transaction exposure, including accounting for and disclosures about foreign currency transaction gains and losses.
c. analyze how changes in exchange rates affect the translated sales of the subsidiary and parent company.
d. compare the current rate method and the temporal method, evaluate how each affects the parent company's balance sheet and income statement, and determine which method is appropriate in various scenarios.
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j. analyze how currency fluctuations potentially affect financial results, given a company's countries of operation.

10. Analysis of Financial Institutions

The candidate should be able to:

a. describe how financial institutions differ from other companies.
b. describe key aspects of financial regulations of financial institutions.
c. explain the CAMELS (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity) approach to analyzing a bank, including key ratios and its limitations.
d. analyze a bank based on financial statements and other factors.
e. describe other factors to consider in analyzing a bank.
f. describe key ratios and other factors to consider in analyzing an insurance company.

11. Evaluating Quality of Financial Reports

The candidate should be able to:

a. demonstrate the use of a conceptual framework for assessing the quality of a company's financial reports.
b. explain potential problems that affect the quality of financial reports.
c. describe how to evaluate the quality of a company's financial reports.
d. evaluate the quality of a company's financial reports.
e. describe indicators of earnings quality.
f. describe the concept of sustainable (persistent) earnings.
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j. describe indicators of balance sheet quality.
k. evaluate the balance sheet quality of a company.
l. describe indicators of cash flow quality.
m. describe sources of information about risk.

12. Integration of Financial Statement Analysis Techniques

The candidate should be able to:

a. demonstrate the use of a framework for the analysis of financial statements, given a particular problem, question, or purpose (e.g., valuing equity based on comparables, critiquing a credit rating, obtaining a comprehensive picture of financial leverage, evaluating the perspectives given in management's discussion of financial results).
b. identify financial reporting choices and biases that affect the quality and comparability of companies' financial statements and explain how such biases may affect financial decisions.
c. evaluate the quality of a company's financial data and recommend appropriate adjustments to improve quality and comparability with similar companies, including adjustments for differences in accounting standards, methods, and assumptions.
d. evaluate how a given change in accounting standards, methods, or assumptions affects financial statements and ratios.
e. analyze and interpret how balance sheet modifications, earnings normalization, and cash flow statement related modifications affect a company's financial statements, financial ratios, and overall financial condition.

13. Analysis of Dividends and Share Repurchases

The candidate should be able to:

a. describe the expected effect of regular cash dividends, extra dividends, liquidating dividends, stock dividends, stock splits, and reverse stock splits on shareholders' wealth and a company's financial ratios.
b. compare theories of dividend policy and explain implications of each for share value given a description of a corporate dividend action.
c. describe types of information (signals) that dividend initiations, increases, decreases, and omissions may convey.
d. explain how agency costs may affect a company's payout policy.
e. explain factors that affect dividend policy in practice.
f. calculate and interpret the effective tax rate on a given currency unit of corporate earnings under double taxation, dividend imputation, and split-rate tax systems.
g. compare stable dividend with constant dividend payout ratio, and calculate the dividend under each policy.
h. describe broad trends in corporate payout policies.
i. compare share repurchase methods.
j. calculate and compare the effect of a share repurchase on earnings per share when 1) the repurchase is financed with the company's surplus cash and 2) the company uses debt to finance the repurchase.
k. calculate the effect of a share repurchase on book value per share.
l. explain the choice between paying cash dividends and repurchasing shares.

m. calculate and interpret dividend coverage ratios based on 1) net income and 2) free cash flow.
n. identify characteristics of companies that may not be able to sustain their cash dividend.

14. Environmental, Social, and Governance (ESG) Considerations in Investment Analysis

The candidate should be able to:

a. describe global variations in ownership structures and the possible effects of these variations on corporate governance policies and practices.
b. evaluate the effectiveness of a company's corporate governance policies and practices.
c. describe how ESG-related risk exposures and investment opportunities may be identified and evaluated.
d. evaluate ESG risk exposures and investment opportunities related to a company.

15. Cost of Capital: Advanced Topics

The candidate should be able to:

a. explain top-down and bottom-up factors that impact the cost of capital.
b. compare methods used to estimate the cost of debt.
c. explain historical and forward-looking approaches to estimating an equity risk premium.
d. compare methods used to estimate the required return on equity.
e. estimate the cost of debt or required return on equity for a public company and a private company.
f. evaluate a company's capital structure and cost of capital relative to peers.

16. Corporate Restructuring

The candidate should be able to:

a. explain types of corporate restructurings and issuers' motivations for pursuing them.
b. explain the initial evaluation of a corporate restructuring.
c. demonstrate valuation methods for, and interpret valuations of, companies involved in corporate restructurings.
d. demonstrate how corporate restructurings affect an issuer's EPS, net debt to EBITDA ratio, and weighted average cost of capital.
e. evaluate corporate investment actions, including equity investments, joint ventures, and acquisitions.
f. evaluate corporate divestment actions, including sales and spin offs.
g. evaluate cost and balance sheet restructurings.

READING 7

INTERCORPORATE INVESTMENTS

EXAM FOCUS

There are no shortcuts here. Spend the time necessary to learn how and when to use each method of accounting for intercorporate investments because the probability of this material being tested is high. Be able to determine the effects of each method on the financial statements and ratios. Pay particular attention to the examples illustrating the difference between the equity method and the acquisition method.

MODULE 7.1: CLASSIFICATIONS

Video covering this content is available online.

Categories of Intercorporate Investments

LOS 7.a: Describe the classification, measurement, and disclosure under International Financial Reporting Standards (IFRS) for 1) investments in financial assets, 2) investments in associates, 3) joint ventures, 4) business combinations, and 5) special purpose and variable interest entities.

LOS 7.b: Compare and contrast IFRS and US GAAP in their classification, measurement, and disclosure of investments in financial assets, investments in associates, joint ventures, business combinations, and special purpose and variable interest entities.

Intercorporate investments in marketable securities are categorized as either (1) investments in financial assets (when the investing firm has no significant control over the operations of the investee firm), (2) investments in associates (when the investing firm has significant influence over the operations of the investee firm, but not control), or (3) business combinations (when the investing firm has control over the operations of the investee firm).

Percentage of ownership (or voting control) is typically used to determine the appropriate category for financial reporting purposes. However, the ownership percentage is only a guideline. Ultimately, the category is based on the investor's ability to influence or control the investee.

Investments in financial assets. An ownership interest of less than 20% is usually considered a passive investment. In this case, the investor cannot significantly influence or control the investee.

Investments in associates. An ownership interest between 20% and 50% is typically a noncontrolling investment; however, the investor can usually significantly influence the

investee's business operations. Significant influence can be evidenced by the following:

- Board of directors representation.
- Involvement in policy making.
- Material intercompany transactions.
- Interchange of managerial personnel.
- Dependence on technology.

It may be possible to have significant influence with less than 20% ownership. In this case, the investment is considered an investment in associates. Conversely, without significant influence, an ownership interest between 20% and 50% is considered an investment in financial assets.

The equity method is used to account for investments in associates.

Business combinations. An ownership interest of more than 50% is usually a controlling investment. When the investor can control the investee, the acquisition method is used.

It is possible to own more than 50% of an investee and not have control. For example, control can be temporary or barriers may exist such as bankruptcy or governmental intervention. In these cases, the investment is not considered controlling.

Conversely, it is possible to control with less than a 50% ownership interest. In this case, the investment is still considered a business combination.

Joint ventures. A joint venture is an entity whereby control is shared by two or more investors. Both IFRS and U.S. GAAP require the equity method for joint ventures. In rare cases, IFRS and U.S. GAAP allow proportionate consolidation as opposed to the equity method.

Figure 7.1 summarizes the accounting treatment for investments.

Figure 7.1: Accounting for Investments

Ownership	Degree of Influence	Accounting Treatment
Less than 20% (investments in financial assets)	No significant influence	Amortized cost, fair value through OCI, fair value through profit or loss
20%–50% (investment in associates)	Significant influence	Equity method
More than 50% (business combinations)	Control	Acquisition method

MODULE QUIZ 7.1

1. Tall Company owns 30% of the common equity of Short Incorporated. Tall has been unsuccessful in its attempts to obtain representation on Short's board of directors. For financial reporting purposes, Tall's ownership interest is *most likely* considered a(n):

   A. investment in financial assets.

   B. investment in associates.

C. business combination.

MODULE 7.2: INVESTMENTS IN FINANCIAL ASSETS (IFRS 9)

Video covering this content is available online.

IFRS 9

IASB and FASB have each issued similar new standards for accounting for investment in financial assets (minor differences remain). Consistent with the curriculum, the terminology mentioned here is the **International Financial Reporting Standards (IFRS)** terminology.

IFRS categorizes financial assets depending on whether they are carried at amortized cost or at fair value. The result is three classifications: amortized cost, fair value through profit or loss, and fair value through OCI. Corresponding classifications under U.S. GAAP are held-to-maturity, held for trading, and available for sale.

Amortized Cost (for Debt Securities Only)

Debt securities that meet two criteria are accounted for using the amortized cost method.

Criteria for amortized cost accounting:

1. **Business model test:** Debt securities are being held to collect contractual cash flows.
2. **Cash flow characteristic test:** The contractual cash flows are either principal, or interest on principal, only.

These debt securities are reported on the balance sheet at amortized cost. Amortized cost is the original cost of the debt security plus any discount, or minus any premium, that has been amortized to date.

Interest income (coupon cash flow adjusted for amortization of premium or discount) is recognized in the income statement, but subsequent changes in fair value are ignored.

Fair Value Through Profit or Loss (for Debt and Equity Securities)

Debt securities may be classified as **fair value through profit or loss (FVPL)** if held for trading, or if accounting for those securities at amortized cost results in an accounting mismatch. Equity securities that are held for trading must be classified as FVPL. Other equity securities may be classified as either fair value through profit or loss, or **fair value through other comprehensive income (FVOCI)**. Once classified, the choice is irrevocable. Derivatives that are not used for hedging are always carried at FVPL. If an asset has an embedded derivative (e.g., convertible bonds), the asset as a whole is valued at FVPL.

FVPL securities are reported on the balance sheet at fair value. The changes in fair value, both realized and unrealized, are recognized in the income statement along with any dividend or interest income.

Fair Value Through OCI (for Debt and Equity Securities)

Securities classified as fair value through OCI are carried on the balance sheet at fair value and any unrealized gain or loss is reported in OCI. Dividends and interest income are

reported in the income statement.

Figure 7.2 summarizes the effects of the different classifications for financial assets on the balance sheet and income statement.

Figure 7.2: Summary of Classifications of Financial Assets

	Amortized Cost	Fair Value Through Profit or Loss	Fair Value Through OCI
Balance sheet	Amortized cost	Fair value	Fair value, with G/L recognized in equity
Income statement	Interest (including amortization) Realized G/L*	Interest Dividends G/L	Interest Dividends

* G/L = gains and losses

Let's look at an example of the different classifications for financial assets.

EXAMPLE: Investment in financial assets

At the beginning of the year, Midland Corporation purchased a 9% bond with a face value of $100,000 for $96,209 to yield 10%. The coupon payments are made annually at year-end. Suppose that the fair value of the bond at the end of the year is $98,500.

Determine the impact on Midland's balance sheet and income statement if the bond investment is classified as (1) amortized cost, (2) fair value through profit or loss, and (3) fair value through OCI.

Answer:

Amortized cost: Balance sheet value is based on amortized cost. At year-end, Midland recognizes interest revenue of $9,621 ($96,209 beginning bond investment × 10% yield). The interest revenue includes the coupon payment of $9,000 ($100,000 face value × 9% coupon rate) and the amortized discount of $621 ($9,621 interest revenue – $9,000 coupon payment).

At year-end, the bond is reported on the balance sheet at $96,830 ($96,209 beginning bond investment + $621 amortized discount).

Fair value through profit or loss: The balance sheet value is based on fair value of $98,500. Interest revenue of $9,621 ($96,209 beginning bond investment × 10% yield) and an unrealized gain of $1,670 ($98,500 – $96,209 – $621) are recognized in the income statement.

Fair value through OCI: The balance sheet value is based on fair value of $98,500. Interest revenue of $9,621 ($96,209 beginning bond investment × 10% yield) is recognized in the income statement. The unrealized gain of $1,670 ($98,500 – $96,209 – $621) is reported in stockholders' equity as a component of other comprehensive income.

Reclassification Under IFRS 9

Reclassification of equity securities under the new standards is not permitted as the initial designation (FVPL or FVOCI) is irrevocable. Reclassification of debt securities is permitted only if the business model has changed. For example, unrecognized gains/losses on debt securities carried at amortized cost and reclassified as FVPL are recognized in the income statement. Debt securities that are reclassified out of FVPL as measured at amortized cost are transferred at fair value on the transfer date, and that fair value will become the carrying amount.

Loan Impairment Under IFRS 9

A key feature of IFRS 9 was that the incurred loss model for loan impairment was replaced by the **expected credit loss model**. This requires companies to not only evaluate current and historical information about loan (including loan commitments and lease receivables) performance, but to also use forward-looking information. The new criteria results in an earlier recognition of impairment (12-month expected losses for performing loans and lifetime expected losses for nonperforming loans).

MODULE QUIZ 7.2

Use the following information to answer Questions 1 through 5.

Kirk Company acquired shares of both Company A and Company B. We have the following information from the public market about Company A and Company B's investment value at the time of purchase and at two subsequent dates:

Security	Cost	t = 1	t = 2
A	$950	$850	$900
B	250	180	350

1. Kirk Company will report the initial value of its investment in financial assets as:
   A. $700.
   B. $950.
   C. $1,200.

2. At t = 1, Kirk will:
   A. carry the financial assets at cost.
   B. write down the financial assets to $1,030 and recognize an unrealized loss of $170.
   C. write down the financial assets to $1,030 and recognize a realized loss of $170.

3. At t = 2, Kirk will report the carrying value of its financial assets as:
   A. $1,030.
   B. $1,200.
   C. $1,250.

4. Based on the information provided, which of the following statements is *most accurate*?
   A. Classifying the shares as fair value through profit or loss would result in greater reported earnings volatility for Kirk.
   B. Classifying the shares as fair value through OCI would result in a $220 realized gain for Kirk between t = 1 and t = 2.
   C. It is optimal for Kirk to classify its shares in Company A and Company B as fair value through profit or loss since it results in a net $50 gain recognized on the income

statement at t = 2.

5. Suppose for this question only that Security A and Security B are both debt securities carried at amortized cost and purchased initially at par. At t = 2, Kirk will report the carrying value of these securities as:

   A. $1,030.
   B. $1,200.
   C. $1,250.

Video covering this content is available online.

MODULE 7.3: INVESTMENT IN ASSOCIATES, PART 1—EQUITY METHOD

Investments in Associates

Investment ownership of between 20% and 50% is usually considered influential. Influential investments are accounted for using the equity method. Under the equity method, the initial investment is recorded at cost and reported on the balance sheet as a noncurrent asset.

In subsequent periods, the proportionate share of the investee's earnings increases the investment account on the investor's balance sheet and is recognized in the investor's income statement. Dividends received from the investee are treated as a return of capital and thus, reduce the investment account. Unlike investments in financial assets, dividends received from the investee are not recognized in the investor's income statement.

If the investee reports a loss, the investor's proportionate share of the loss reduces the investment account and also lowers earnings in the investor's income statement. If the investee's losses reduce the investment account to zero, the investor usually discontinues use of the equity method. The equity method is resumed once the proportionate share of the investee's earnings exceed the share of losses that were not recognized during the suspension period.

Fair Value Option

U.S. GAAP allows equity method investments to be recorded at fair value. Under IFRS, the fair value option is only available to venture capital firms, mutual funds, and similar entities. The decision to use the fair value option is irrevocable and any changes in value (along with dividends) are recorded in the income statement.

EXAMPLE: Implementing the equity method

Suppose that we are given the following:

- December 31, 20X5, Company P (the investor) invests $1,000 in return for 30% of the common shares of Company S (the investee).
- During 20X6, Company S earns $400 and pays dividends of $100.
- During 20X7, Company S earns $600 and pays dividends of $150.

Calculate the effects of the investment on Company P's balance sheet and reported income for 20X6 and 20X7.

Answer:

Using the equity method for 20X6, Company P will:

- Recognize $120 ($400 × 30%) in the income statement from its proportionate share of the net income of Company S.

- Increase its investment account on the balance sheet by $120 to $1,120, reflecting its proportionate share of the net assets of Company S.
- Receive $30 ($100 × 30%) in cash dividends from Company S and reduce its investment in Company S by that amount to reflect the decline in the net assets of Company S due to the dividend payment.

At the end of 20X6, the carrying value of Company S on Company P's balance sheet will be $1,090 ($1,000 original investment + $120 proportionate share of Company S net income − $30 dividend received).

For 20X7, Company P will recognize income of $180 ($600 × 30%) and increase the investment account by $180. Also, Company P will receive dividends of $45 ($150 × 30%) and lower the investment account by $45. Hence, at the end of 20X7, the carrying value of Company S on Company P's balance sheet will be $1,225 ($1,090 beginning balance + $180 proportionate share of Company S net income − $45 dividend received).

Excess of Purchase Price Over Book Value Acquired

Rarely does the price paid for an investment equal the proportionate book value of the investee's net assets, since the book value of many assets and liabilities is based on historical cost.

At the acquisition date, the excess of the purchase price over the proportionate share of the investee's book value is allocated to the investee's identifiable assets and liabilities based on their fair values. Any remainder is considered goodwill.

In subsequent periods, the investor recognizes expense based on the excess amounts assigned to the investee's assets and liabilities. The expense is recognized consistent with the investee's recognition of expense. For example, the investor might recognize additional depreciation expense as a result of the fair value allocation of the purchase price to the investee's fixed assets.

It is important to note that the purchase price allocation to the investee's assets and liabilities is included in the investor's balance sheet, not the investee's. In addition, the additional expense that results from the assigned amounts is not recognized in the investee's income statement. Under the equity method of accounting, the investor must adjust its balance sheet investment account and the proportionate share of the income reported from the investee for this additional expense.

PROFESSOR'S NOTE

Under the equity method, the investor does not actually report the separate assets and liabilities of the investee. Rather, the investor reports the investment in one line on its balance sheet. This one-line investment account includes the proportionate share of the investee's net assets at fair value and the goodwill.

EXAMPLE: Allocation of purchase price over book value acquired

At the beginning of the year, Red Company purchased 30% of Blue Company for $80,000. On the acquisition date, the book value of Blue's identifiable net assets was

$200,000. Also, the fair value and book value of Blue's assets and liabilities were the same except for Blue's equipment, which had a book value of $25,000 and a fair value of $75,000 on the acquisition date. Blue's equipment is depreciated over 10 years using the straight-line method. At the end of the year, Blue reported net income of $100,000 and paid dividends of $60,000.

Part A: Calculate the goodwill created as a result of the purchase.

Part B: Calculate Red's income at the end of the year from its investment in Blue.

Part C: Calculate the investment in Blue that appears on Red's year-end balance sheet.

Answer:

Part A

The excess of purchase price over the proportionate share of Blue's book value is allocated to the equipment. The remainder is goodwill.

Purchase price:	$80,000
Less: Pro rata book value of net assets:	60,000 ($200,000 book value × 30%)
Excess of purchase price:	$20,000
Less: Excess allocated to equipment:	15,000 [($75,000 FV – $25,000 BV) × 30%]
Goodwill:	$5,000

Part B

Red recognizes its proportionate share of Blue's net income for the year. Also, Red must recognize the additional depreciation expense that resulted from the purchase price allocation.

Red's proportionate share of Blue's net income:	$30,000 ($100,000 NI × 30%)
Less: Additional depreciation from excess of purchase price allocated to Blue's equipment:	1,500 ($15,000 excess / 10 years)
Equity income:	$28,500

Part C

The beginning balance of Red's investment account is increased by the equity income from Blue and is decreased by the dividends received from Blue.

Investment balance at beginning of year:	$80,000 (Purchase price)
Equity income:	28,500 (From Part B)
Less: Dividends:	18,000 ($60,000 × 30%)
Investment balance at end of year:	$90,500

PROFESSOR'S NOTE

An alternative method of calculating the year-end investment is as follows:

$$\%\text{ acquired} \times (\text{book value of net assets at beginning of year} + \text{net income} - \text{dividends}) + \text{unamortized excess purchase price}$$
$$= [0.3 \times (200{,}000 + 100{,}000 - 60{,}000)] + (20{,}000 - 1{,}500) = \$90{,}500$$

MODULE QUIZ 7.3

1. If a company uses the equity method to account for an investment in another company:

   A. income is combined to the extent of ownership.
   B. all income of the affiliate is included except intercompany transfers.
   C. earnings of the affiliate are included but reduced by any dividends paid to the company.

Use the following information to answer Questions 2 through 4.

Suppose Company P acquired 40% of the shares of Company A for $1.5 million on January 1, 2023. During the year, Company A earned $500,000 and paid dividends of $125,000.

2. At the end of 2023, Company P reported investment in Company A as:

   A. $1.5 million.
   B. $1.65 million.
   C. $1.7 million.

3. For 2023, Company P reported investment income of:

   A. $50,000.
   B. $150,000.
   C. $200,000.

4. For 2023, Company P received cash flow from the investee of:

   A. $50,000.
   B. $150,000.
   C. $200,000.

Video covering this content is available online.

MODULE 7.4: INVESTMENT IN ASSOCIATES, PART 2

Impairments of Investments in Associates

Equity method investments must be tested for impairment. Under U.S. GAAP, if the fair value of the investment falls below the carrying value (investment account on the balance sheet) and the decline is considered other-than-temporary, the investment is written-down to fair value and a loss is recognized on the income statement. Under IFRS, impairment needs to be evidenced by one or more loss events. While U.S. GAAP prohibits reversal of impairment losses, IFRS allows reversal to the extent the net recoverable amount subsequently increases.

Transactions With the Investee

So far, our discussion has ignored transactions between the investor and investee. Because of its ownership interest, the investor may be able to influence transactions with the investee. Thus, profit from these transactions must be deferred until the profit is confirmed through use or sale to a third party.

Transactions can be described as upstream (investee to the investor) or downstream (investor to the investee). In an upstream sale, the investee has recognized all of the profit in its income statement. However, for profit that is unconfirmed (goods have not been used or sold by the investor), the investor must eliminate its proportionate share of the profit from the equity income of the investee.

For example, suppose that Investor owns 30% of Investee. During the year, Investee sold goods to Investor and recognized $15,000 of profit from the sale. At year-end, half of the goods purchased from Investee remained in Investor's inventory.

All of the profit is included in Investee's net income. Investor must reduce its equity income of Investee by Investor's proportionate share of the unconfirmed profit. Since half of the goods remain, half of the profit is unconfirmed. Thus, Investor must reduce its equity income by $2,250 [($15,000 total profit × 50% unconfirmed) × 30% ownership interest]. Once the inventory is sold by Investor, $2,250 of equity income will be recognized.

In a downstream sale, the investor has recognized all of the profit in its income statement. Like the upstream sale, the investor must eliminate the proportionate share of the profit that is unconfirmed.

For example, imagine again that Investor owns 30% of Investee. During the year, Investor sold $40,000 of goods to Investee for $50,000. Investee sold 90% of the goods by year-end.

In this case, Investor's profit is $10,000 ($50,000 sales – $40,000 COGS). Investee has sold 90% of the goods; thus, 10% of the profit remains in Investee's inventory. Investor must reduce its equity income by the *proportionate share* of the unconfirmed profit: $10,000 profit × 10% unconfirmed amount × 30% ownership interest = $300. Once Investee sells the remaining inventory, Investor can recognize $300 of profit.