

## CHAPTER 2

# Intercorporate Equity Investments: An Introduction

This chapter reviews the accounting for intercorporate investments. The discussion covers investments such as passive investments; controlled entities such as subsidiaries and structured entities; associates and joint ventures; as well as the appropriate method of accounting for each. Private company reporting (i.e. accounting standards for private enterprises), as it applies to accounting for investments, is also discussed. The chapter concentrates on investments that are controlled or subject to significant influence.

The concepts of control and significant influence (both direct and indirect) are discussed from both a qualitative and a quantitative perspective. Simple examples of wholly owned parent founded subsidiaries are used to illustrate consolidation and equity reporting, and to draw the distinction between the reporting and recording of intercorporate investments. Two approaches are used to illustrate the consolidation process: the direct and the worksheet approach. The usefulness and shortcomings of consolidation and equity reporting are discussed, as are the conditions under which nonconsolidated statements may be useful.

### SUMMARY OF ASSIGNMENT MATERIAL

#### **Case 2-1: Multi-Corporation**

Two short examples of investments are described. The student must determine the appropriate method of accounting for these investments.

#### **Case 2-2: Salieri Ltd.**

An investor corporation has varying ownership interests in several other companies. Students are asked which basis of reporting is appropriate based on the nature of the relationships between the investor and the investees, and also which subsidiaries should be consolidated. This case is useful for reviewing the substance of significant influence and for reviewing the criteria for consolidation as described in IFRS 10 Consolidated Financial Statements.

#### **Case 2-3: Heavenly Hakka, Nature's Harvest, and Crystal**

Three independent investment scenarios are provided. Students are required to first discuss the various reporting alternatives available to account for each investment scenario and then decide on the appropriate method of accounting for that scenario. Students will need to refer to relevant international standards for finding appropriate solutions.

**Case 2-4: Inter Provincial Banking Corporation and Safe Investments**

This is a single issue case focussing on whether reputational risk by itself requires consolidation. During the 2007-2009 financial crisis many financial institutions decided to provide support to and consolidated structured entities whose demise posed significant reputational risk to the institutions. The institutions however had no legal or contractual obligation towards the structured entities. Consequently, the IASB considered whether reputational risk by itself warranted consolidation. Eventually, the IASB decided not to mention reputational risk in ED 10 or in the ensuing IFRS 10 as a feature indicating presence of control warranting consolidation. However, under IFRS 10 reputational risk is one of many other factors which should be considered for deciding whether one entity is exposed to risks and rewards arising from another entity and whether the former controlled and had power over the latter and thus should be required to consolidate the latter.

**Case 2-5: Eany, Meeny, Miny and Moe; and Tick, Tack, and Toe**

The two situations in this case both focus on whether the arrangement between investors constitutes a joint arrangement under IFRS 11, wherein some or all of the parties concerned possess joint control over the investee. Students are required to decide on the reporting choice investors have to follow to report their investments in the investee.

**Case 2-6: XYZ Ltd.**

A business combination has occurred but has the new investor acquired control? This is the central issue in this case where the new investor has purchased all the Class A voting shares but the Class B voting shares are held by another party. The shareholder's agreement is also relevant.

**Case 2-7: Jackson Capital Ltd.**

This is a multi-competency case with coverage of both accounting and assurance issues. The majority of the issues in the case relate to the appropriate accounting method for a series of investments. If desired, the instructor could request that the students focus on the accounting issues only.

**P2-1** (15 minutes, easy)

An investment scenario is provided and students are asked to identify when each of proportionate consolidation, the cost method, the fair value method, the equity method and consolidation would be appropriate, with explanations.

**P2-2** (20 minutes, easy)

A simple problem that requires students to determine the income/gains and losses an investor has to report for two consecutive years in relation to an investment under the (1) cost and (2) equity methods respectively and alternatively if the investment were classified as a (3) FVTPL and (4) FVTOCI investment respectively. The problem also

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requires students to calculate the balance of the investment under each of these alternate reporting methods.

### **P2-3** (12 minutes, easy)

A simple problem on the application of the equity method to a parent-founded subsidiary. Students are required to provide adjustments necessary for going from the cost method of recording to the equity method of reporting.

### **P2-4** (25 minutes, medium)

For the given investment scenario students are first asked to assume that it is a FVTPL and alternatively as a FVTOCI investment and are required to i) provide the journal entries required in relation to the investment, and ii) balance in the investment account. Next the students are asked to assume that at year-end the investor decided to change the method of record to the equity method and wants to report under the method as well and are required to provide the necessary adjusting entries, total income of the investor and the balance in the investment account.

### **P2-5** (20 minutes, easy)

For an investment which is treated as a fair value through other comprehensive income investment students are asked to provide i) the dividend income and unrealized gains/losses recognized by the investor and ii) the balance in the carrying value of the investment, over a four-year period.

### **P2-6** (30 minutes, medium)

Five independent scenarios are present, each extending the simple consolidation problem in p. xxx to xxx of the text. Students are asked to assume that either the cost or the equity method was used to record the investment in the subsidiary and are asked to either report using the equity method or via consolidation and to provide the necessary adjusting entries.

### **P2-7** (10-15 minutes, medium)

A scenario wherein the investor records its investment in the investee under the cost method is provided. Students are required to provide the adjusting entries required to report the investment under the equity method, initially in the first year, and next in the second year. This problem is well suited for making the students appreciate how the adjusting entries for year 1 are different when they are made in year 2, since now, year 1 is no longer the current year but the previous year and thus the nature of the related adjusting entry is different. Specifically, instead of recognizing the earnings of the investee as equity in its earnings in the SCI, as done in year 1, the change in retained earnings of the investee in year 1 is added to the beginning retained earnings of the investor in year 2.

### **P2-8** (20 minutes, easy)

This is a straightforward consolidation of a parent-founded subsidiary several years after its establishment. Only an SFP and related adjusting entries are required.

**P2-9** (25 minutes, easy)

A consolidated SCI for a parent-founded subsidiary is required. Three eliminations must be made. The investment is carried at cost on the parent's books.

**P2-10** (35 minutes, medium)

The first requirement is consolidation of a parent-founded subsidiary when the investment account is carried at cost. Second, adjusting entries to convert from the cost method to the equity method and the financial statements of parent under equity method are required. Finally, consolidation from equity method financial statements is required. Both a SCI and a SFP are required. A number of eliminations must be made.

**P2-11** (20 minutes, medium)

Consolidation of a parent-founded subsidiary when the investment account is carried on the equity basis. Two eliminations are required. There are goods in inventory that were sold from one company to the other but, since the sales were at cost, there is no unrealized profit. This problem could be used to introduce the treatment of inventories arising from intercompany transactions. Both SFP and SCI are required.

**P2A-1** (12-15 minutes, easy)

Students are required to provide the journal entry necessary to recognize the additional purchase of shares in a FVTOCI investment.

**P2A-2** (15-20 minutes, easy)

Students are required to provide the journal entry necessary to recognize the acquisition of significant influence consequent to the additional purchase of shares in a FVTOCI investment.

**P2A-3** (15-20 minutes, easy)

Students are required to provide journal entries required in relation to (1) a significantly influenced investment (2) the subsequent partial sale of shares in the investment, and (3) the remaining significantly influenced investment.

**P2A-4** (15-20 minutes, easy)

Students are required to provide journal entries required in relation to (1) a significantly influenced investment (2) the subsequent loss of significant influence without any partial sale of the investment on the part of the investor, and (2) the remaining FVTOCI investment.

**P2A-5** (15-20 minutes, easy)

Students are required to provide journal entries required in relation to (1) a significantly influenced investment (2) the subsequent partial sale of shares in the investment with associated loss of significant influence, and (3) the remaining FVTOCI investment.

## ANSWERS TO REVIEW QUESTIONS

**Q2-1:** The two types of passive or non-strategic investments are Fair Value Through Profit and Loss (FVTPL) investments and Fair Value Through Other Comprehensive Income (FVTOCI) investments. FVTPL are reported at fair value on the SFP. Dividends received are recognized as part of net income on the SCI as are any unrealized holding gains and losses. FVTOCI investments are also reported at fair value on the SFP. Dividends received are recognized in the net income portion of the SCI. However, all gains and losses are recognized directly in equity without any reclassification into profit and loss even when the investment is subsequently sold.

**Q2-2:** Both Fair Value Through Profit and Loss (FVTPL) investments and Fair Value Through Other Comprehensive Income (FVTOCI) investments are passive investments where the investor does not have control or significant influence. Equity investments are classified as FVTPL investments unless the entity irrevocably classifies them as FVTOCI. FVTPL are held for trading, i.e. intended to be held for the short-term and traded hopefully for a profit, whereas normally FVTOCI are intended to be held for relatively a longer term.

**Q2-3:** Based on quantitative factors, the investment in XYZ would be classified as a passive investment. If the investment in XYZ constitutes either a Fair Value Through Profit and Loss (FVTPL) investment or a Fair Value Through Other Comprehensive Income (FVTOCI) investment it has to be reported at fair value. International standards do not allow the use of cost for valuing equity investments classified either as FVTPL or FVTOCI investments. However, cost can be deemed to be the best estimate of fair value when the fair value of the investment cannot be determined because of lack of timely or relevant information.

Alternatively, the equity method would be appropriate if ABC Corporation has significant influence over XYZ Corporation. Typically, a shareholding of 20% or more is indicative of significant influence. However, this quantitative cut-off is not definitive. Other factors should also be considered to determine whether or not significant influence exists. Therefore, depending on other factors (about which the question is silent), ABC may very well have significant influence over XYZ, in which case the equity method would be appropriate.

Notwithstanding the above discussion and irrespective of the nature of its investment in XYZ, if ABC is a private Canadian company, it can use the cost method to account for its investment in XYZ following the provisions of private company reporting.

**Q2-4:** Some of the factors that must be considered in order to determine whether significant influence exists are: i) representation on the board of directors or other

equivalent governing body of the investee, ii) participation in the policy-making process of the investee, iii) material transactions between the investor and the investee, iv) interchange of managerial personnel between the investor and investee, or v) provision of essential technical information by the investor to the investee.

**Q2-5:** A joint venture is a cooperative venture between several investors, called coventurers, who jointly control a specific business undertaking and contribute resources towards its accomplishment. Joint ventures are usually incorporated (as private corporations) but can also be unincorporated. The joint venture's strategic policies are determined jointly by the co-venturers; no one investor has control, and no investor can act unilaterally. Strategic policies require the consent of the co-venturers, as set out in the joint venture agreement (which is a type of shareholders' agreement). Therefore, there is joint control.

**Q2-6:** A joint venture exists when there is joint control. This is not to be confused with profit sharing. The distribution of profits can be unequal depending on what each venturer is contributing to the joint venture. The distribution of the profits is set out in the joint venture agreement.

**Q2-7:** Under the equity method, dividends received are credited to the investment account thereby reducing the carrying value of the investment.

**Q2-8:** Whether or not one company controls another company depends on whether or not the former has the power to direct the activities of the latter to generate returns to itself. Usually, such power is obtained by owning the majority of the voting shares of a company. However, power over another company can be obtained by other means even in the absence of such majority share ownership. For example, a dominant shareholder of a company can exercise power over it when the other shares are widely held, and the other shareholders cannot co-operate to stop the dominant shareholder from having power over the company. Likewise, a company holding less than 50 percent of the voting shares of another company can dominate the voting process of and thus exercise control over another company by obtaining proxies from other shareholders of that company. Other ways of exercising control over a company are by having the ability to appoint, hire, transfer or fire key members of that entity's management or by sharing resources such as having the same members on the governing body or key management members or staff. Conversely, a majority ownership of the voting shares of a company may not confer control if the investor is prevented from exercising control over the investee consequent to contractual agreements, incorporation documents, or legal requirements.

**Q2-9:** A corporation may control another without owing a majority of the voting shares if (1) it is the dominant shareholder of the other company and the other shares are widely held such that the other shareholders cannot co-operate to stop the dominant shareholder

from having power over the company, (2) it can dominate the voting process of and thus exercise control over the other company by obtaining proxies from other shareholders of that company, (3) it has the ability to appoint, hire, transfer or fire key members of that entity's management or.

**Q2-10:** Yes, T is a subsidiary of P, because P's control of S gives P the ability to control S's voting of T's shares. This is called indirect control.

**Q2-11:** W Ltd. is a subsidiary of P Corporation because P can control 60% of the votes for W's board of directors through P's control of Q Corp. and R Corp. W is not a subsidiary of either Q or R, however, because neither can control W by itself.

**Q2-12:** The advantage of owning 100% of a subsidiary's shares is that it gives the parent unfettered control over the subsidiary, without having to be concerned about fair treatment of any outside non-controlling shareholders. Less than 100% ownership enables the parent to obtain the benefits of control at less cost. It also permits the ownership participation in the subsidiary of other parties (such as someone with local expertise) who may be beneficial to the operations of the subsidiary or to the consolidated entity as a whole.

**Q2-13:** Corporations establish subsidiaries in order to facilitate conduct of some aspect of the parent's business activities, usually for legal, regulatory, or tax reasons. Subsidiaries are usually established in each foreign country where the parent operates, and also are established to carry out separate lines of business. A multiple-subsidiary structure helps to comply with local taxation and other business requirements, and also helps to isolate the risk inherent in each line of business or geographic region of operation.

**Q2-14:** A subsidiary would be purchased in order to provide for entry into a new line of business (as a going concern), to complement the parent's existing operations, to lessen competition, to gain access to established technology, customer bases, etc., or to diversify the entity's economic sphere of operations and thereby reduce its business risk. Further, establishing a similar subsidiary from scratch takes time and expertise, which the parent may not possess. Further, the parent may be able to buy the shares of the existing company at a discount. A purchased subsidiary will already have its own management, sources of financing, legal constraints, tax environment, and so forth. Maintenance of both the existing business and the economic relationships of the new subsidiary is generally facilitated by continuing to keep the acquired company as a separate legal entity.

**Q2-15:** Two legitimate uses for a SE are identified in the text. One use is for registered pension plans. Through the use of a pension fund SE, the funds in the pension plan are removed from the reach of the company's management, the trustee can fulfill its

obligations and the plan is administered in accordance with the pension agreement and provincial law. A second use is to securitize a company's receivables.

**Q2-16:** An investee corporation would be reported on the equity basis when the investor corporation has significant influence or joint control over the investee but does not have sole control. Equity reporting may also be used, instead of consolidation, (at the parent's choice) when the investor corporation issues non-consolidated, special purpose financial statements, or under the provisions of private company reporting. It is important to understand however that equity reporting of the investment in a subsidiary to the general public is not permitted under international accounting standards.

**Q2-17:** The objective of consolidated statements is to show the reader the total economic activity of the parent and its subsidiaries, as well as all of the resources that are under the control of the parent company and all of the obligations of the entire economic entity.

**Q2-18:** The recording of intercorporate investments in the books of the investor is usually done using the recording method which simplifies bookkeeping. Reporting of an investments refers to the manner in which the investments are accounted for on the investor's financial statements, which is in accordance with the substance of the relationship between the investor and the investee. Both equity-basis reporting and consolidation require substantial year-end adjustments. These adjustments are made in working papers, not on the books of the investor or investee. Therefore, the investor may record its investments on its books on the cost basis, regardless of the method that is required for reporting the investments on its financial statements.

**Q2-19:** The direct approach and the worksheet approach are two alternate approaches available for preparing consolidated financial statements. Both approaches provide the same result.

**Q2-20:** The sales price to the selling company is equal to the purchase price to the buying company. Therefore, the appropriate eliminating entry for intercompany sales is to reduce sales by the amount of the sale and to reduce purchases (cost of goods sold) by the amount of the purchase, both amounts being the same.

**Q2-21:** Consolidation eliminating and adjusting entries are not entered on either company's books as they are strictly worksheet entries, prepared for reporting purposes only.

**Q2-22:** The equity method is frequently referred to as one-line consolidation because both the equity and the consolidation methods result in the same net income and shareholders' equity for the parent.



**Q2-23:** Creditors of a parent company generally do not have recourse to the assets of the subsidiaries. Therefore, creditors may want to see the unconsolidated statements of the parent in order to know exactly what the resources and obligations of the legal entity are. Shareholders (and other users) of a private company may elect to receive nonconsolidated statements in order to evaluate the creditworthiness, management performance, or the dividend-paying ability of the parent entity. Finally, for tax purposes, unconsolidated legal entity statements must be provided to the Canada Revenue Agency. Additionally, in some countries, for example Germany, regulators require companies to file their separate entity financial statements in addition to consolidated financial statements.

**Q2-24:** When the equity method has been used to record a parent's investment in a subsidiary, it is necessary to eliminate the parent's recorded equity in the earnings of the subsidiary as well as the cost of the acquisition of, or investment in, the subsidiary.

**Q2-25:** Consolidated statements could be misleading because the combination of the parent's and subsidiaries' assets and liabilities could conceal the precarious financial position of one or more of the legal entities being consolidated, including the parent. Consolidation could make the parent look healthier than it really is as a separate legal entity.

**Q2-26:** Yes. Because the parent and the subsidiaries are separate legal entities, each can fail independently of the others.

**Q2-27:** Generally, creditors have a claim only on the assets of the corporation to which they have extended credit or granted loans. A creditor of a subsidiary can look to the parent to make good on any specific debt guarantee that the parent may have given to that creditor, but even when a guarantee exists, the creditor has no direct claim on the assets of the parent.

**Q2-28:** Users of private companies often prefer non-consolidated financial statements as the cost of preparing consolidated financial statements exceeds the benefits. In addition, non-consolidated financial statements permit the users to evaluate the creditworthiness, management performance and/or the dividend-paying ability of the separate entity.

**Q2-29:** Accounting standards for private enterprises permit a private company to account for:

- investments subject to control using either the cost or equity method, in addition to consolidation;
- investments subject to significant influence using the cost method, in addition to the equity method;

- interests in joint ventures using the cost, proportionate consolidation or the equity method; and
- an SPE using either the cost or the equity method, in addition to consolidation.

**Q2-30:** Two circumstances when the cost method is appropriate for strategic investments are when: the parent company is allowed under international accounting standards not to consolidate its subsidiary, or the parent is a private company and thus can follow the options available under the accounting standards for private enterprises for investments subject to significant influence and/or investments subject to control.

## CASE NOTES

### CASE 2-1: Multi-Corporation

#### *Objectives of the Case*

The purpose of this case is to provide two situations where the student must determine the appropriate method of accounting for intercorporate investments. In both situations, there are qualitative factors that must be considered.

#### *Objectives of Financial Reporting*

Multi-Corporation (MC) appears to be a private corporation as it is financed by the bank and private investors. However, there is mention that it is going to issue shares to the public next year. Therefore, even if MC was not constrained to follow international standards in the past, it will be required to do so now for going public. The bankers and other investors are likely interested in cash flow prediction to evaluate if the company can pay off its loans.

#### *Accounting for the Investments*

Suds Limited (SL) — MC has 100,000 out of 180,000 votes or 56%. This would indicate that MC has control and should consolidate SL. However, there are factors that indicate that MC does not have the power to direct the activities of SL. MC's ability to direct the activities of and thus control SL appears impaired because Megan can restrict day-to-day decision making and long term plans through her ability to refuse the appointment of management and to approve significant transactions. On the other hand MC may be able to exert significant influence over Suds. The terms of the sale agreement, including the length of time these terms are in effect, and other relevant factors should be reviewed. If such review indicates that control is absent but nevertheless MC can exert significant influence over SL, then MC should report its investment in SL using the equity basis.

Berry Corporation (BC) — MC owns 37% of the voting shares that, based on the guidelines provided under international standards, would indicate significant influence

and thus require the use of the equity method. However, there are factors that indicate that MC has no influence over BC. The family has elected all members of the Board, MC has not been able to obtain a seat on the Board and all shares are closely held by family members. Thus, the investment in BC appears to be passive. Therefore, it has to be accounted at fair value, with dividends received (if any) being recorded as revenue in the net income section of the SCI.

[CICA, adapted]

### **Case 2-2: Salieri Ltd.**

#### *Objectives of the Case*

To require the application of professional judgment in deciding on the appropriate reporting policies for intercorporate investments, including whether control and/or significant influence exists. This is a good opportunity to identify that the quantitative guidelines included in the standards are guidelines only, and are to be used as a starting point. Qualitative factors must also be considered to determine the appropriate basis of accounting.

#### *Objectives of Financial Reporting*

Salieri is a public company and is, therefore, constrained to follow international standards when accounting for its investments. In addition, the shareholders will be interested in management evaluation.

Salieri's reporting of its share investments:

1. Bach Burgers, Inc.— Bach is 80%-owned by Salieri, which would indicate Salieri has control. However, Bach is operated without intervention by Salieri, and Salieri apparently has only one nominee on the Bach board at present. Nevertheless, Salieri has the ability to control Bach without the cooperation of others and can easily replace the entire board of directors if it decides to. Students should understand that it is the ability to control, not the exercise of control, which determines whether a company is a subsidiary that should be consolidated. Another argument against consolidation that may come up in discussion is whether Bach should not be consolidated because it is in a totally different line of business than Salieri. Salieri is simply a diversified company that (through its subsidiaries) is operating in several lines of business. The key to consolidation is compatibility of accounting, not the compatibility of businesses.
2. Pits Mining Corporation — Salieri owns 45% of Pits. This size of ownership would normally suggest that significant influence is present since it is over the 20% guideline. In this case, however, Salieri has been blocked from exercising influence by the other shareholders. Even if Salieri is successful in gaining access to Pits' board of directors, Salieri's influence may be sharply limited by a hostile majority on the

board. Salieri should report its investment in Pits as a Fair Value Through Other Comprehensive Income investment (FVTOCI). It is not clear from the case whether a quoted market price exists for the shares of Pits or whether the fair value of such shares can be determined. If such values exist then Salieri should use the fair value method to report its investment in Pits. Otherwise, cost can be used as the best estimate of fair value.

3. Mozart Piano Corporation — Salieri has a 20% interest in Mozart, and conducts joint marketing efforts with Mozart. This interaction does not necessarily represent significant influence. The other 80% of Mozart's shares are held by the Amadeus family, which thereby has firm control. Salieri could nevertheless have significant influence over Mozart, irrespective of whether or not the Amadeus family is or is not actively involved with the company. More information is needed as to the influence of Salieri over Mozart's business. If it is determined that Salieri exerts significant influence over Mozart the equity basis of reporting would be appropriate. Otherwise, Salieri's investment in Mozart would constitute a FVTOCI investment. Therefore, fair value basis reporting would be appropriate.
4. Leopold Klaviers, Inc.— Leopold Klaviers is a subsidiary of Mozart, since Mozart controls 80% of the votes, and thus will be consolidated with Mozart. If Mozart is reported by Salieri on the equity basis, then Salieri's 20% share of Mozart's earnings will include 20% of Mozart's 80% share of Leopold's earnings. If Salieri reports Mozart using the fair value basis, then Leopold's earnings will have no impact on Salieri's reporting except to the extent that Mozart's share price or dividends are affected.
5. Frix Flutes, Ltd.— Frix is 15% owned by Salieri. This proportion of ownership normally falls within the range that qualifies for reporting the investment as passive (below 20%). However, there is evidence to suggest that Salieri may have significant influence. Salieri was instrumental in helping Frix out of financial difficulties, and influence may have been acquired in the process. It is known that Salieri holds the patents that were helpful in restoring Frix's financial health, and even if these patents pertain to only a minority of Frix's business, they may mean the difference between a going concern and bankruptcy. Salieri also has the option of cancelling the licensing agreement with short notice, thereby suggesting more influence is possible. In addition to the equity financing, Salieri may also have provided debt financing to Frix. If so, the debt may carry covenants that could be very important to Frix and that could give Salieri considerable additional influence. Obviously, additional information is needed as to the relationship between the two companies before any firm decision on equity versus fair value basis reporting can be reached. Nevertheless, there are indications that equity basis reporting may be appropriate.
6. Salieri Acceptance Corporation — This is a wholly-owned subsidiary. Its function is to provide financing for Salieri's customers. As such, the company is closely related to its parent and Salieri would be required to consolidate Salieri Acceptance Corporation.

### **Case 2-3: Heavenly Hakka, Nature's Harvest, and Crystal**

#### *Objectives of the Mini-Cases*

To require the application of professional judgment in deciding on the appropriate reporting policies for three independent intercorporate investments, including whether control and/or significant influence exists in each case. Both quantitative and more importantly qualitative factors should be considered while determining the appropriate basis of accounting.

#### **1. Heavenly Hakka**

##### *Objectives of Financial Reporting*

Heavenly Hakka (HH) is a private company given that Vincent is its sole owner. Therefore, with Vincent's consent, HH can choose to use accounting standards for private enterprises to report its investment in Szechwan Samosas Inc. (SS).

##### *Analysis of the Case Scenario and Appropriate Accounting Alternative(s)*

HH, Ibrahim, and Venkat each own 1/3<sup>rd</sup> of the shares of SS. However, HH is entitled to 40 percent of the profits of SS, given Vincent's involvement. Lately, however, because of differences between Vincent and the other two owners relating to expansion of the operations of SS beyond Ontario, Vincent has not been visiting the premises of SS. The case is not clear on how this is going to affect the profit sharing agreement. Further, the case is also not clear on why HH is being compensated for Vincent's time spent on the operations of SS via a larger share of the profits of SS instead of via a management fee. Any management fees paid by SS to HH for Vincent's time would, for tax purposes, constitute an expense to SS. Further, paying for Vincent's time via a management fee is a more accurate reflection of the underlying economic reality.

It is not clear from the facts of the case whether the three owners have joint control over SS. The incorporation documents and any other agreements that may exist between the three owners of SS have to be reviewed to obtain further details on this point. Nevertheless, the facts in the case clearly indicate that HH does not possess sole control of SS. While HH is the sole supplier of the fillings that go into the samosas of SS, that fact by itself is not indicative of control of SS by HH. At most, it indicates that HH has significant influence over SS. Further, HH does not have the power to direct the activities of SS without the cooperation of the other two shareholders. Thus, the facts in the case suggest that HH either has joint control over or can significantly influence SS.

Recently, however, differences have cropped up between Vincent and the other two shareholders of SS. If incorporation documents or other agreements between the shareholders of SS exist evidencing joint control, such control will not be affected by the recent differences between the shareholders. On the other hand if such documents or

agreements do not exist, the other two shareholders could, based on their combined 2/3<sup>rd</sup> ownership of SS, theoretically join together to prevent HH from having any influence over SS. However, that seems unlikely given that HH is the sole supplier of the fillings that go into the samosas of SS. Thus, the recent differences between the shareholders most probably will not affect any significant influence that HH has over SS.

Thus, HH should account for its investment in SS either as a joint venture or as an investment over which it has significant influence. If HH decides not to use standards for private enterprises, then it should use the equity basis to report its investment in SS. Alternatively, if HH opts to use accounting standards for private enterprises, it can use the cost basis to report its investment in SS. In case of a joint venture, proportionate consolidation is also available as another reporting alternative under ASPE. Irrespective of the method chosen, SS and HH should account for Vincent's time devoted to SS as a management fee.

An investor is also required by IFRS 12 to provide the following disclosures relating to its material associates and joint ventures:

- Significant judgements and assumptions made while determining that the investor has significant influence over the associate or joint control over the joint venture
- Name of, nature of relationship with, and principal place of business of, joint arrangement or associate
- Proportion of ownership interest held, and if different the proportion of voting shares held
- Whether investment in the joint venture or associate measured using fair value or equity method
- Summarized financial information including amounts in aggregate for assets, liabilities, revenues and profits and losses.
- If the joint venture associate has a different year-end than that of the investor, the fact of that difference and the reason for it.
- The nature and extent of significant restrictions on the ability of the associate or joint venture to pay dividends or loans and advances.
- Any unrecognized portion of the losses of the joint venture or associate under the equity method of accounting.
- Contingent liabilities relating to associate or joint venture in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

## 2. Nature's Harvest

### *Objectives of Financial Reporting*

Mid-West is a publicly incorporated company in Canada. Therefore, Mid-West has to follow all the reporting requirements which publicly accountable enterprises are required to follow in Canada.

### *Analysis of the Case Scenario and Appropriate Accounting Alternative(s)*

Mid-West owns 60 percent of the voting shares of Nature's Harvest (NH). Assuming that Venezuela's laws relating to corporations are similar to those of Canada's, such ownership would normally provide Mid-West control over NH. Thus, in normal circumstances, it would be appropriate for Mid-West to consolidate the financial statements of NH with its own financial statements while reporting its consolidated financial statements.

However, lately, the nationalistic government of Venezuela appears to have changed its statutes relating to corporations to encourage Venezuelan management of Venezuelan companies and to prohibit repatriation of profits by Venezuelan companies to their foreign parents. Thus, the ability of Mid-West to direct the operations of NH appears to have been lost. Therefore, Mid-West no longer controls NH. Consequently, Mid-West has to revalue its investment in NH at fair market value on the date on which it lost control, recognizing a gain or loss for the difference between such fair market value and the carrying value of its investment in NH in its consolidated financial statements.

Under international accounting standards, any retained interest in the investee has to be recorded initially at fair market value. However, how Mid-West reports its retained interest in NH will depend on the present nature of the investment. Mid-West still has two of its appointees as members of the board of directors of NH. Further, Mid-West continues to provide technical expertise to NH. Therefore, it appears that Mid-West has significant influence over the operations of NH. Mid-West should thus report its investment in NH using the equity basis.

Further, when an investor determines that it does not control an entity despite being the dominant shareholder of that entity, the basis for such determination, and any related significant assumptions and judgments have to be disclosed. The investor is also required to disclose sufficient information needed for investors to assess the accounting consequences of such determination.

- The disclosures required by an investor relating to its associates as discussed in part 1 above relating to Heavenly Hakka's investment in Szechwan Samosas also apply to the case of Mid-West's investment in Nature's Harvest.

### 3. Premier Inc.

#### *Objectives of Financial Reporting*

Premier is a Canadian public limited company. Therefore, it has to report its investment in Crystal using international accounting standards.

#### *Analysis of the Case Scenario and Appropriate Accounting Alternative(s)*

Premier has a 19 percent shareholding in Crystal. Based on quantitative factors alone the investment of Premier in Crystal would be classified as a passive investment. However, the nature of an investment cannot be classified solely based on quantitative factors; qualitative factors should also be considered. Premier is represented on Crystal's board of directors. There is no information to suggest that the other shareholders are inimical of Premier's influence on Crystal. Thus, it appears that Premier has significant influence over Crystal. More importantly, Premier also has veto and blocking rights as set forth in the partnership agreement between itself and Crystal. The case has not provided details about the nature of the veto and blocking rights possessed by Premier. Nevertheless, these additional rights are strongly indicative of significant influence. In conclusion, since it appears that Premier has significant influence over Crystal it should report its investment in the latter using the equity basis.

The disclosures required by an investor relating to its associates as discussed in part 1 above relating to Heavenly Hakka's investment in Szechwan Samosas also apply to the case of Premier's investment in Crystal. Further, Premier has to disclose the significant assumptions and judgements made by it in determining that it has significant influence over Crystal despite owning less than 20 percent of the voting rights of Crystal.

#### **Case 2-4**

#### *Objective of the Miny Case*

This case requires students to consider whether reputational risk by itself is an appropriate reason requiring consolidation. Students will need to refer to the Basis for Conclusions on IFRs 10, Paragraph 37 while providing their answer.

During the 2007-2009 financial crisis many financial institutions like HSBC and Citi Bank decided to consolidate sponsored structured entities which were imminently in financial collapse and thus posed reputational risk to the sponsors. For example HSBC announced in November 2007 that it planned to take control of Cullinan Finance and Asscher by providing them additional funding of \$35 billion and therefore would be consolidating them. In these cases the financial institutions had no contractual obligation relating to the structured entities and choose to provide additional support and take control of the structured entities purely because of the reputational risk posed by their imminent collapse. Neither Exposure Draft 10, nor the ensuing IFRS 10, references reputational risk as a factor indicating control, since such risk in isolation is not an



adequate basis for consolidation. The board believes that reputational risk does expose an institution to risk and rewards but nonetheless is a non-contractual source of risk. Therefore, reputational risk is a factor to be considered along with other facts and circumstances for assessing presence and absence of control. While reputational risk is not by itself an indicator of power, it may increase an investor's incentive to obtain rights that give it power over the sponsored entity.

*Discussion*

Inter-Provincial owns only 3% of the equity of Safe Investments. No side agreements seem to exist which obligate Inter-Provincial for the debt of Safe Investments. Thus, Inter-Provincial appears to have no legal or contractual obligation in relation to Safe Investments. Further, the management of Safe Financial is by an independent board of trustees. Consequently, Inter-Provincial has no rights or other bases of power giving it control over Safe Investments. Nevertheless, most of the investors in the equity and debt of Safe Investments are deposit holders of Inter-Provincial. These investors invested in Safe Investments based on the marketing blitz carried out by Inter-Provincial to promote Safe Investments and on the advice provided to them by the branch-level financial advisors of Inter-Provincial. Consequently, the reputational cost for Inter-Provincial could potentially be severe if Safe Investments were to face financial difficulties. However, reputational cost is not explicitly referred to by IFRS 10 as an indicator of control. Therefore, reputational cost in isolation is not a basis for consolidation. Rather, such cost should be considered along with other facts and circumstances for assessing whether or not control exists over Safe Financial. There do not appear to exist any other source of risk or rewards in relation to Safe Financial or the presence of any other rights that provide power over Safe Financial. It is surprising that Inter-Provincial did not retain rights that would give it power over Safe Financial given the significant reputational cost it could potentially face if the latter were to fall into financial difficulty. In conclusion, there is no basis to indicate that Safe Financial ought to be consolidated by Inter-Provincial when issuing its consolidated financial statements.

**Case 2-5 Eany, Meeny, Miny and Moe; and Tick, Tack, and Toe**

*Objective of the Miny Cases*

The two mini-cases require students to consider the nature of the arrangement which exists between the investors and the reporting method each investor should use to report its investment in the joint arrangement.

Eany, Meeny, Miny and Moe

*Discussion*

The contractual agreement between the four parties specifies that at least 65 percent of the voting rights are required to make decisions affecting IT Company. None of the four

parties can control IT Company by themselves, however, Eany (with its 40% shareholding) along with Miny (with its 25% shareholding) jointly control IT Company. Since all parties have rights only to the net assets of IT Company Eany and Miny should report their investment in IT Company as an investment in a Joint Venture, and thus should use the equity method of reporting. While Meeny has a shareholding of 15%, Moe has a shareholding of 20% in IT Company. A shareholding of 20% is a preliminary but not sufficient indicator of significant influence. By the same token, the absence of a 20% shareholding does not by itself negate the presence of significant influence. The case is silent on the rights possessed by each party vis-a-vis IT Company. If either Meeny or Moe is able to exercise significant influence over IT Company it has to report its investment in IT Company under the equity method. Otherwise, they have to report their investment as a passive investment (FVTPL or FVTOCI) at its fair value on the SFP date.

Tick, Tack, and Toe

### *Discussion*

The arrangement between Tick, Tack, and Toe specifies that at least 70% votes are required to make decisions about Draw Ltd. Therefore, no one party by itself controls Draw Ltd. Instead, Tick can jointly control Draw Ltd. with either Tack or Toe. Since joint control can be achieved by more than one combination of investors, for the arrangement between Tick, Tack, and Toe to constitute a joint arrangement as defined under IFRS 11, the agreement between them has to specify which particular combination of investors controls the joint arrangement. Since the case does not mention that such an agreement exists it appears that the arrangement between Tick, Tack, and Toe is not a joint arrangement under IFRS 11. However, some or all three investors may be able to exercise significant influence over Draw Ltd. Additional evidence indicating the presence of significant influence is not provided in the case. Investors possessing significant influence over Draw are required to report their investment using the equity method. If significant influence is absent, the investment is passive (FVTPL or FVTOCI investment) and therefore has to be reported at fair value on the SFP date.

### **Case 2-6: XYZ Ltd.**

#### *Objective of the Case*

This case requires students to consider the issue of when consolidation is appropriate. An investor has purchased 100% of the Class B shares but the previous owner has retained the Class A shares and the shareholder agreement provides the previous owner with some additional rights.

#### *Discussion*

XYZ Ltd. (XYZ) is a corporation that must issue financial statements according to international standards, presumably to receive an unqualified audit opinion. XYZ may or may not need to issue consolidated financial statements. We do not know if XYZ would

qualify for using private enterprise reporting standards and thus need more information to determine whether this is an option. Even if it did qualify for using private enterprise reporting standards, the users may request consolidated financial statements.

Both XYZ and Sub Limited (Sub) existed before XYZ's purchase of shares, thus the issue becomes whether XYZ Ltd. has acquired control. XYZ has acquired all of the Class B voting shares, representing 100,000 votes. Mr. Bill, the previous owner, retained all 20,000 outstanding Class A shares, with 4 votes each, representing 80,000 votes. Presumably these are all of the voting shares outstanding. It appears that XYZ is the acquirer, since the company owns 56% (100,000/180,000) of the voting rights. This would indicate that XYZ should consolidate the operations of Sub. However, in this case, a shareholder agreement exists which affords Mr. Bill the right to refuse the appointment of management for Sub and to approve any significant transactions of Sub.

These two provisions indicate that Mr. Bill has not given up control of the strategic operating, investing and financing policies of Sub. As a result, XYZ is in a position to significantly influence Sub, but not in a position to control it without the co-operation of Mr. Bill. Therefore, consolidation would not be an appropriate method of accounting. The equity method of reporting its investment in Sub would therefore be recommended since there is significant influence but not control.

Further, when an investor determines that it does not control an entity despite being the dominant shareholder of that entity, the basis for such determination, and any related significant assumptions and judgments have to be disclosed. The investor is also required to disclose sufficient information needed for investors to assess the accounting consequences of such determination.

An investor is also required by IFRS 12 to provide the following disclosures relating to its material associates and joint ventures:

- Significant judgements and assumptions made while determining that the investor has significant influence over the associate or joint control over the joint venture
- Name of, nature of relationship with, and principal place of business of, joint arrangement or associate
- Proportion of ownership interest held and if different the proportion of voting shares held
- Whether investment in the joint venture or associate measured using fair value or equity method
- Summarized financial information including amounts in aggregate for assets, liabilities, revenues and profits and losses.
- If the joint venture associate has a different year-end than that of the investor, the fact of that difference and the reason for it.

- The nature and extent of significant restrictions on the ability of the associate or joint venture to pay dividends or loans and advances.
- Any unrecognized portion of the losses of the joint venture or associate under the equity method of accounting.
- Contingent liabilities relating to associate or joint venture in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

### **Case 2-7: Jackson Capital Inc.**

#### *Objectives of the Case*

This is a multi-competency case with coverage of both accounting and assurance issues. The accounting issues covered include the appropriate accounting for a variety of investments, bonds payable and share capital. The assurance issues covered include audit risk and specific audit procedures for the accounting issues identified. A secondary issue in the case is the identification of cash flow issues. If preferred, the instructor could request that the students address only the accounting issues. This case should be written in memo format.

#### Memo

To: Mr. Potter

From: CA

Re: Significant Accounting Issues, Audit Risk, and Related Audit Procedures for JCI and Cash Flow Issues

#### **Accounting Issues**

This memo presents a review of the accounting issues associated with each specific investment held by Jackson Capital Inc. (JCI), as well as with the long-term debt issued by JCI and its share capital.

While JCI is a private company, it is unlikely that private enterprise accounting standards are appropriate due to the apparently large number of shareholders. Therefore, private enterprise accounting options will not be considered in the following analysis.

#### *Investment in Fairex Resource Inc.*

JCI holds 15% of Fairex Resource Inc., a company listed on the TSX Venture Exchange. This investment is likely a passive investment, since JCI holds less than 20% of the shares of Fairex and may not exercise significant influence. Since JCI management are monitoring the investee's performance for the next six months prior to making a hold/sell decision, it appears that this investment was purchased for trading and should, therefore, be classified as a fair value through profit or loss security (FVTPL).

However, under international standards, an entity can irrevocably classify an equity investment as a fair value through other comprehensive income investment (FVTOCI). Both types of investments are reported at fair value on the SFP and dividends are recognized as investment income. However, while all gains and losses are recognized in net income for FVTPL investments, such gains and losses have to be recognized directly in equity for FVTOCI investments.

On the face of it, Fairex appears to be a passive investment for JCI. JCI may, however, have significant influence despite the fact that its shareholding is under the “benchmark” 20% level. Fairex Resource Inc. is a public company and its shares may be widely held. A 15% holding may be sufficient to result in significant influence. We should check the shareholdings of Fairex to determine whether FCI exercises significant influence over Fairex. Are there other significant blocks of shares held: are there any shareholders groups? Does JCI have representation on the board of Fairex, and so on? If JCI does exercise significant influence, equity accounting would apply. The investment would be initially recorded at cost: JCI’s share of Fairex’s net income would be recorded as investment income and would increase the value of the investment on the SFP. Any dividends paid by Fairex would decrease the value of the investment on the SFP.

An investor is also required by IFRS 12 to provide the following disclosures relating to its material associates and joint ventures:

- Significant judgements and assumptions made while determining that the investor has significant influence over the associate or joint control over the joint venture
- Name of, nature of relationship with, and principal place of business of, joint arrangement or associate
- Proportion of ownership interest held and if different the proportion of voting shares held
- Whether investment in the joint venture or associate measured using fair value or equity method
- Summarized financial information including amounts in aggregate for assets, liabilities, revenues and profits and losses.
- If the joint venture associate has a different year-end than that of the investor, the fact of that difference and the reason for it.
- The nature and extent of significant restrictions on the ability of the associate or joint venture to pay dividends or loans and advances.
- Any unrecognized portion of the losses of the joint venture or associate under the equity method of accounting.
- Contingent liabilities relating to associate or joint venture in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Further, Jackson has to disclose the significant assumptions and judgements made by it in determining that it has significant influence over Fairex despite owning less than 20 percent of the voting rights of Fairex.

The following are the main types of disclosures required for passive investments (financial assets) required under IFRS 7:

- Disclosures relating to the significance of each category of financial assets, including the carrying value and fair value of each category and gains and losses relating to each category.
- Disclosure on the type of fair value measurement and technique used and assumption used to arrive at the fair value. Specifically, disclosure of whether fair value is based on market prices or using valuing techniques is required. If fair value is determined using valuation techniques and an equally acceptable valuation technique provides a drastically different fair value, mention of that fact and the fair value effect is required.
- Disclosure relating to the nature and risk exposure for each type of financial asset including information about credit risk, liquidity risk, and market risk.

### *Investment in Hellon Ltd.*

JCI holds a 25% interest in the common shares of Hellon Ltd., a private Canadian real estate company. JCI likely exercises significant influence over Hellon Ltd. due to the size of its investment (greater than 20%). The conversion feature on the debentures held also contributes to JCI's exercising significant influence and possibly control.

If JCI exercises significant influence over Hellon Ltd., it should account for the investment under the equity method described above. If JCI has control over Hellon, taking into account the convertible nature of the bond, Hellon's results should be consolidated with JCI's results.

Under international standards financial instruments have to be reported either at amortized cost or at fair value. The decision relating to which method applies is based on two classification criteria: i) the business model test and the ii) contractual cash flow characteristic test. The amortized cost method can be used only when both of the previous classification criteria are met. Specifically, the contractual cash flow characteristic test requires that the asset's contractual cash flows represent solely payment of principal and interest. Convertible instruments do not satisfy this criterion. Therefore, they are required to be classified as FVTPL and valued at fair value, with associated dividends and gains and losses being recognized in the net income section of the SCI.

Therefore, the debentures should be recorded at \$1.96 million (98% of \$2 million). JCI should accrue any interest receivable on the debentures at June 30, 20X6, recording the same as income in the net income section of the SCI.

All the disclosures required in relation to associates, as discussed previously, apply to the Hellon investment as well. The disclosure requirements noted above relating to financial assets apply to the debentures of the private company.

### *Loan to Ipanema Ltd.*

JCI holds a five-year loan to Ipanema Ltd., a Brazilian company—75% of the loan is secured by a power generating station under construction. The loan is denominated in Brazilian reais. International standards require loans and receivables to be recorded at amortized cost, unless impaired. We need to assess whether the loan is impaired, due to two factors: the possible instability of the Brazilian currency and the risk that Brazil will impose currency restrictions, as well as the non-portability of the security for the loan. If the loan is permanently impaired, the carrying amount of the loan should be reduced. The reduction in the carrying amount would be recognized as a charge in the current financial statements.

The loan should be translated at the exchange rate at the SFP date. This restatement will result in an exchange gain or loss through the SCI. An exchange gain or loss will be taken to the SCI at each SFP date. These gains or losses could create a great deal of volatility in the SCI if the Brazilian real fluctuates against the Canadian dollar.

All the disclosure requirements noted previously relating to financial assets apply to the loan to Ipanema. JCI is required to make two main types of disclosures relating to its loan to Ipanema: i) Information about the significance of the loan to JCI's financial position and performance, and ii) Information about the nature and extent of risks arising from the loan. It should disclose the terms of the loan, the security, and the foreign exchange gain or loss, the currency of the loan and, if the loan is carried in excess of its fair value, disclosure of the fair value and the reason for not reducing the carrying amount.

### *Interest in Western Gas*

JCI has a 50% interest in Western Gas, a gas exploration business in Western Canada. The 50% interest level and the fact that it is “jointly-owned” suggest that this investment is a joint venture. If joint control exists, JCI may use either the proportionate consolidation method or the equity method to account for its investment in Western Gas. Joint control may not exist, however, since JCI has only one member of a three-member board. Despite this fact, if board decisions require unanimous consent, JCI may still have joint control, through its effective power of veto. We should scrutinize the venture agreement to properly assess the control exercised by JCI and decide on the appropriate accounting treatment for this investment.

- All the disclosures required in relation to associates, as discussed previously, apply to an investment in a joint venture.

### *Warrants in Toronto Hydrocarbons Ltd.*

The stock warrants would be considered a FVTPL investment as it appears there is intent to generate a short term profit. These warrants would be reported at fair value and all gains and losses would be recognized in the net income section of the SCI. Alternatively, they can irrevocably be classified as FVTOCI investments in which case they have to be reported at fair value, while all associated gains and losses have to be taken directly to equity.

### *Stock-indexed Bond Payable*

On March 1, 20X6, JCI issued long-term 5% stock-indexed bonds payable for \$6 million. This bond, the principal repayment of which is indexed to the TSX Composite, bears the risk that the principal repayment will increase or decrease due to factors beyond the control of management. Therefore, the bond is an example of a hybrid instrument. There are two broad approaches for valuing financial liabilities under IFRS 9: Financial liabilities at fair value through profit and loss, and other financial liabilities which are measured at amortized cost using the effective interest method. The long-term 5% stock-indexed bond obviously is not a financial liability at fair value through profit and loss, since (1) it is not being held for trading purposes (it is long-term), (2) there is no indication that a measurement or recognition inconsistency will result by measuring it at amortized cost, and (3) it is not part of a group of liabilities which are evaluated on a fair value basis, in accordance with a documented risk management strategy. Therefore, we will discuss the second alternative further below.

In case of a hybrid instrument that is not a financial liability at fair value through profit and loss, the issuer is required to separate the embedded derivative (the indexed principal payment) from the value of the underlying liability, since the indexed principal payment is not closely related to the host debt instrument (i.e. the bonds payable) as their inherent risks are dissimilar. Because the principal payment can increase or decrease, the embedded derivative is a non-option derivative whose value is indexed to the TSX Composite. While the derivative component is valued at fair value with any associated gain or loss being taken to net income, the bonds payable is measured at amortized cost using the effective interest method.

[The exact mechanism of how the derivative component is valued is a finance issue and thus is not part of the requirements in this case.]

JCI can elect to value the hybrid instrument using the fair value option if it does not wish to separate the embedded derivative from the host liability. In this case JCI will have to present in the OCI changes in the fair value related to changes in its own credit risk.

JCI should disclose the carrying value and fair value of the debt and information necessary to evaluate the nature and extent of risks arising from the debt which JCI is exposed.



### *Share Capital*

JCI's share capital consists of 1 million 8% Class A shares redeemable at the holders' option on or after August 10, 20X8. Thus the Class A shares are puttable financial instruments having characteristics of a liability instrument (the holder has the right to require the issuer to redeem the shares), even if the legal form is equity. Since choices under private enterprise standards cannot be used, the redeemable shares should be presented as a liability at their redemption amount. Dividends would then be considered interest costs. The characteristics of the Class A shares should be disclosed.

## **Audit Risks and Procedures**

### *Overview*

The risk associated with this engagement is high for many reasons:

1. JCI is a new company that operates in a high-risk industry.
2. There is no audit history to assess the ability of management to make good investment decisions and effectively monitor the loans and investments.
3. The investment managers' remuneration is tied to the performance of the companies in which JCI has made investments. They may be too aggressive in making their investment decisions in order to "cash in big" if they choose a high performer. Their incentive package may also lead them to fail to highlight problem investments in the hope that they will recover.
4. The fair value of the investments may be difficult to establish and/or verify.
5. The fair value of the investments may be highly volatile.
6. Reliance on the financial statements is likely to be high, as very little other information is available on the performance of JCI.

Given the high-risk nature of this engagement, we will need to perform extensive tests. We will need to focus our procedures on valuation, as it is the critical issue in this audit. A substantive audit approach may be the most efficient approach due to the low number of high-dollar transactions. A substantial amount of our effort should be spent on assessing and verifying the fair value of the investments.

### *Fairex Resource Inc.*

Fairex is a publicly listed company, and we can therefore verify the fair market value by checking the quoted stock market price at the SFP date. We could also review the annual financial statements of Fairex to find out whether there are any significant issues to consider. Is there any information on reserves or production costs, for example? Such information may help us to ascertain management's intention regarding this investment. We should also check management's intention by reviewing the minutes of the board meetings.

*Hellon Ltd.*

Hellon Ltd. is a private company, and the fair value information will be more difficult to audit than in Fairex's case. We should examine the financial statements of Hellon to gain an understanding of the company and its financial situation. We should find out whether the financial statements are audited. If so, perhaps we could rely on the audited statements. We could also perform some ratio analysis using the annual financial statements and any information gathered by the investment managers. We should compare our analysis with management's analysis and review management's assumptions for the determination of fair value (discounted cash flows, for example). We could also have the fair value determined by appraisal and could review independent information, such as press releases.

*Ipanema Ltd.*

We should make sure that the loan to Ipanema is not impaired in any way. We should find out whether the Brazilian government has imposed any currency restrictions. We should also check the value of the Brazilian real at the SFP date and consider the foreign currency risk. The currency may suffer devaluation. We should assess the security given and determine whether the security is realistic. The Brazilian government may appropriate the power generator in the future and the generator is not movable. We should consider whether the value of the loan is affected by potentially inadequate security at this time. We should get a valuation of the underlying security. We should review the payment history to see if there have been any late payments or if the loan is currently delinquent.

*Western Gas*

Western Gas is a private corporation whose value will be difficult to determine. We should review the financial statements of Western Gas. Western Gas may also be audited. If so, we could rely on the audited statements, which may contain some fair value information. We could also have a valuation of Western Gas performed by a valuation expert. We should review the initial investment report for any pertinent information, as well as management assumptions for valuation purposes. We may also have access to the records of Western Gas. JCI is a participant in a joint venture in this company, thereby giving us access to more detailed information on its operations.

*Toronto Hydrocarbons Ltd.*

The value of the Toronto Hydrocarbons warrants should be assessed against the value of the underlying shares, which are traded publicly. We should check the value of the underlying shares at the SFP date and examine the terms of the warrants.

## Cash Flow Issues

JCI seems to have very few guaranteed sources of income and a very low level of short-term revenue. As well, the Brazilian debt may be subject to currency fluctuations and restrictions, making the cash flow from this loan extremely uncertain. To compound this problem, JCI seems to have a fairly high debt load (with the associated interest payments) and high operating expenses.

We need to carefully consider JCI's cash flow situation and what actions JCI would take if the company found itself short of operating cash. We should obtain representations from management as to which investments it would liquidate if cash flow needs arose. This assessment may affect the accounting treatment of certain investments (such as their classification as current or non-current). We should assess whether the value of the liquidated investments would cover JCI's cash flow needs. If we conclude that JCI is likely to run into serious cash flow difficulties, there may be a need to include a going concern note in the financial statements or to modify our audit report.

[CICA, adapted]

## SOLUTIONS TO PROBLEMS

### P2-1

- a. The equity method of accounting should be used if Alex exercises significant influence over Calvin but does not exercise control. Alex can also use the equity method if it jointly controls Calvin with others (joint venture). If Alex is a private company it has the choice of using proportionate consolidation or the equity method to report its joint venture interest in Calvin. A holding of 40% would generally be indicative of significant influence. However, if Alex is unable to obtain membership on Calvin's board of directors or to participate in strategic policy making, it should treat its investment in Calvin as a passive investment, classifying it either as a fair value through net income investment or a fair value through other comprehensive income investment. If Alex classifies its investment as a FVTOCI investment, such a classification is irrevocable. In both cases Alex has to use the fair value method of accounting. When there is joint control, neither Alex nor the other investor(s) can make strategic decisions unilaterally. Major decisions require the consent of all the co-venturers. If Alex is a private corporation it can use the cost method to account for its investment in Calvin. The option of using the cost method is available for investments which are passive, investments with significant influence, joint ventures or controlled subsidiaries.
- b. If Alex is able to exercise control over Calvin (that is, have the power to direct the activities of Calvin), it should prepare consolidated financial statements to report the investment in Calvin. This would generally be evidenced by an ability to elect the majority of the board of directors of Calvin. Such ability may relate to rights, options, convertible shares, and so on, which would give it enough voting power to control the

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board of Calvin, if exercised. Alternatively, even though 60% of the shares are held by others, if they are widely held as portfolio investments by such other investors, they may be unable to unite together to thwart Alex from exercising control over Calvin. If Alex itself is a subsidiary of another corporation it is exempt from consolidating its subsidiaries (in this case Calvin) if its parent or ultimate parent issues consolidated financial statements, and all of its shareholders agree to that arrangement. In such a case, Alex can use the cost or fair value method to report its investment in Calvin.

**P2-2**

The following information from the problem will be used to calculate the answer for each of the four scenarios in the problem:

Year	Net Income	Dividends	Fair value at year-end
20X3	\$40,000	\$30,000	\$180,000
20X4	30,000	40,000	160,000

a. Cost Method:

The dividend income reported as part of net income for 20X3 and 20X4 respectively and the balance in the investment account at the end of each of those two years are provided below:

	20X3	20X4
Net income	\$ 7,500	\$ 10,000
OCI	-	-
Balance	150,000	150,000

Rose will report dividend income of \$7,500 ( $\$30,000 \times 25\%$ ) in 20X3 and \$10,000 ( $\$40,000 \times 25\%$ ) in 20X4. The reported balance in the investment account at the end of each of the two years will be \$150,000.

b. FVTPL Investment:

The dividend income and unrealized gains/losses reported as part of net income for 20X3 and 20X4 respectively and the balance in the investment account at the end of each of those two years are provided below:

	20X3	20X4
Net income		
Dividends	\$7,500	\$ 10,000
Unrealized gains/losses	\$30,000	(\$20,000)
OCI	-	-
Balance reported	\$180,000	160,000

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Rose will report dividend income of \$7,500 ( $\$30,000 \times 25\%$ ) in 20X3 and \$10,000 ( $\$40,000 \times 25\%$ ) in 20X4. Further, Rose will report as part of net income an unrealized gain of \$30,000 ( $\$180,000 - \$150,000$ ) in 20X3 and an unrealized loss of \$20,000 ( $\$160,000 - \$180,000$ ) in 20X4. The reported balance in the investment account in 20X3 will be the fair value at year-end of \$180,000, and likewise in 20X4, the corresponding fair value at year-end of \$160,000.

### c. FVTOCI Investment:

The dividend income reported as part of net income and unrealized gains/losses reported as part of OCI for 20X3 and 20X4 respectively and the balance in the investment account at the end of each of those two years are provided below:

<b>FVTOCI</b>	<b>20X3</b>	<b>20X4</b>
Net income		
Dividends	\$7,500	\$ 10,000
Unrealized gains/losses	-	-
OCI		
Unrealized gains/losses	\$30,000	(\$20,000)
Balance reported	\$180,000	\$160,000

Rose will report dividend income of \$7,500 ( $\$30,000 \times 25\%$ ) in 20X3 and \$10,000 ( $\$40,000 \times 25\%$ ) in 20X4 in the net income section of its SCI. Further, Rose will report as part of OCI an unrealized gain of \$30,000 ( $\$180,000 - \$150,000$ ) in 20X3 and an unrealized loss of \$20,000 ( $\$160,000 - \$180,000$ ) in 20X4. The reported balance in the investment account in 20X3 will be the fair value at year-end of \$180,000, and likewise in 20X4, the corresponding fair value at year-end of \$160,000.

### d. Equity Method:

Under the equity method, Rose will report its share of Jasmine's income (after making suitable consolidation-related adjustments) in its net income section. Under the equity method, the fair value of the investment is ignored, unless such fair value indicates presence of impairment in the value of the investment. Rose will also adjust the balance in its Investment in Jasmine account for its share of Jasmine's income and for the dividends received from it. The equity in the earnings of Jasmine and the balance in the Investment in Jasmine account at year-end for 20X3 and 20X4 are provided in the table below:

<b>EQUITY METHOD</b>	<b>20X3</b>	<b>20X4</b>
Net income		
Dividends	-	-
Equity in the earnings of Jasmine	\$10,000	7500
OCI		
Unrealized gains/losses	-	-

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Balance reported	\$152,500	\$150,000
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Since there are no consolidation-related adjustments, the equity in the earnings of Jasmine for 20X3 is  $25\% \times \$40,000 = \$10,000$  and for 20X4 is  $25\% \times \$30,000 = \$7,500$ . The balance in the Investment in Jasmine account at the end of 20X3 is \$152,500 [ $\$150,000 + \$10,000 - (25\% \times \text{dividends paid by Jasmine of } \$30,000)$ ]. Likewise, the balance in the Investment in Jasmine account at the end of 20X4 is \$150,000 [ $\$152,500 + \$7,500 - (25\% \times \text{dividends paid by Jasmine of } \$40,000)$ ].

**P2-3**

a. Huge's equity in Tiny's 20X7 earnings is \$110,000.

b. Investment account, December 31, 20X7:

Original investment	\$550,000
Tiny's earnings, 20X4-20X7	166,000
Less dividends received	<u>(114,000)</u>
Balance, December 31, 20X7	<u>\$602,000</u>

c. The adjusting entry required in 20X7 to convert from the cost to the equity method is:

Investment in Tiny	\$52,000	
Retained earnings beg.	4,000	
Dividend revenue	54,000	
Equity in the earnings of Tiny		\$110,000

**P2-4**

a. Investment in Sally classified as a fair value through profit and loss investment:

Fair value through profit and loss investments have to be reported at fair value. All gains/losses, including unrealized gains and losses arising at year-end to the extent of the difference between the fair value of the investment and the carrying value of the investment are taken to Net Income.

The journal entries required to be made by Harry in its books relating to its investment in Sally are provided below:

January 1, 20X2:

Entry to record the initial investment in Sally:

Investment in Sally Account Dr.	\$160,000	
Cash Account Cr.		\$160,000

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During 20X2 (already made under the cost method):

Entry to record dividends received by Harry from Sally:

Cash Account Dr.	\$6,000	
Dividend Revenue Account Cr.		\$6,000

December 31, 20X2:

Entry to record unrealized loss:

Unrealized loss on FVTPL investment Dr.	\$60,000	
Investment in Sally Account Cr.		\$60,000

- b. Investment in Sally classified as a fair value through other comprehensive income investment:

Fair value through other comprehensive income investments have to be reported at fair value. All gains/losses, including unrealized gains and losses arising at year-end to the extent of the difference between the fair value of the investment and the carrying value of the investment are taken to Other Comprehensive Income. Such gains and losses can never be recycled in net income, but can be transferred directly to retained earnings.

The journal entries required to be made by Harry in its books relating to its investment in Sally are provided below:

January 1, 20X2:

Entry to record the initial investment in Sally:

Investment in Sally Account Dr.	\$160,000	
Cash Account Cr.		\$160,000

During 20X2 (already made under the cost method):

Entry to record dividends received by Harry from Sally:

Cash Account Dr.	\$6,000	
Dividend Revenue Account Cr.		\$6,000

December 31, 20X2:

Entry to record unrealized loss:

Other Comprehensive Income Dr.	\$60,000	
Investment in Sally Account Cr.		\$60,000

- c. Investment in Sally recorded and reported under the equity method:

The problem states that Harry used the cost basis for 20X12 and its income for that year is \$100,000. Therefore, the following two journal entries would have been

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recorded by Harry in its books relating to its investment in Sally under the cost method:

January 1, 20X2:

Entry to record the initial investment in Sally:

Investment in Sally Account Dr.	\$160,000	
Cash Account Cr.		\$160,000

During 20X2:

Entry to record dividends received by Harry from Sally:

Cash Account Dr.	\$6,000	
Dividend Revenue Account Cr.		\$6,000

The problem states that Harry changed its mind at year-end and decided to record and report its investment in Sally using the equity method. Therefore, Harry has to record the following journal entries to (1) treat the dividends received from Sally as a reduction of its investment in Sally rather than being dividend income, and (2) recognize its share of Sally's earnings as income:

December 31, 20X2:

Entry to reclassify dividends as reduction from its investment in Sally:

Dividend Revenue Account Dr.	\$6,000	
Investment in Sally Account Cr.		\$6,000

Investment in Sally Account Dr.	\$8,000	
Equity in the Earnings of Sally Account Cr.		\$8,000

To record and report its investment in Sally using the equity basis, Harry has to first eliminate the dividend income recognized on the SCI. Harry will instead recognize its equity in the earnings of Sally's in its SCI, while increasing its Investment in Sally account by that amount. All dividends received from Sally are reduced from its Investment in Sally account.

Harry's equity in the earnings of Sally is calculated below:

Sally's Income for the year	\$20,000
Harry's share @ 40%	8,000

We can now calculate Harry's total income for the year when its uses the equity basis to report its investment in Sally:

Harry's separate entity income under cost basis	\$100,000
Less Harry's share of dividends	(6,000)



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Add Harry's share of Sally's adjusted income	8,000
Total income of Harry for the year under the equity basis	<u>\$102,000</u>

The balance in the Investment in Sally account at year-end under the equity basis will be:

Balance of Investment in Sally account	\$160,000
Harry's equity in earnings of Sally	8,000
Less dividends received	<u>(8,000)</u>
Balance of Investment in Sally account under equity basis at year-end	<u>\$162,000</u>

If the difference between the carrying value of the investment in Sally of \$162,000 as calculated above and the market value of Harry's investment in Sally of \$100,000 (\$100 per share x 1,000 shares) at year-end represents a permanent impairment in the value of Harry's investment in Sally, Harry will have to recognize a related loss of \$62,000 in its SCI, reducing the balance in its Investment in Sally account by that amount.

**P2-5**

Take Inc. and Give Inc.	20X1	20X2	20X3	20X4
Dividends declared by Give	\$140,000	\$110,000	\$100,000	\$80,000
Take's dividend income from Give for the year	28,000	22,000	20,000	16,000
Carrying value of Take's Investment in Give at year-end	60,000	48,000	45,000	50,000
Market price per share of Give	\$4.80	\$4.50	\$5.00	\$4.70
Number of Give's share held by Take	10,000	10,000	10,000	10,000
Market value of Take's Investment in Give at year-end	48,000	45,000	50,000	47,000
Unrealized gains/losses	(12,000)	(3,000)	5,000	(3,000)
Carrying value of Take's Investment in Give at year-end after recognizing unrealized gains/losses	48,000	45,000	50,000	47,000

**P2-6**

**Case 1:**

**The separate entity financial statements of Parent Co. and Subsidiary Co. at the end of 20X10 are provided below:**

**Separate Statements of Comprehensive Income  
Year Ended December 31, 20X10**

	Parent Co.	Subsidiary Co
Earnings		100

Dividend revenue	
NET	
INCOME	<u>100</u>

**Separate Statements of Financial Position  
December 31, 20X10**

	<b>Parent</b>	<b>Subsidiary</b>
Assets		
Cash	9,000	1,100
Investment in subsidiary	<u>1,000</u>	
TOTAL ASSETS	<u>10,000</u>	<u>1,100</u>
Liabilities and shareholders' equity		
Share capital	5,000	1,000
Retained earnings	<u>5,000</u>	<u>100</u>
TOTAL LIABILITIES & SHAREHOLDERS EQUITY	<u>10,000</u>	<u>1,100</u>

The consolidated statements issued by Parent Co. in 20X10 are provided below:

**Consolidated Statement of Comprehensive Income  
Year Ended December 31, 20X10**

	Parent Co.
Earnings (\$0 + 100)	100
Dividend revenue	
NET INCOME	<u>100</u>

**Parent Consolidated Statement of Financial Position  
December 31, 20X10**

	<b>Parent</b>
Assets	
Cash (\$9,000 + \$1,100)	10,100
Investment in subsidiary (\$1,000 – \$1,000)	<u>0</u>
TOTAL ASSETS	<u>10,100</u>
Liabilities and shareholders' equity	
Share capital (\$5,000 + \$1,000 – \$1,000)	5,000
Retained earnings (\$5,000 + \$100)	<u>5,100</u>
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	<u>10,100</u>

Notice that the retained earnings of Subsidiary Co. are not eliminated during consolidation but added to those of Parent Co. This is because such retained earnings represent earnings of the Subsidiary after its creation and equity not already included the owners' equity of Parent Co.

*Adjusting entries required:*

Share capital (Subsidiary) Dr.	1,000	
Investment in Subsidiary Co. (in Parent Co.'s books)		1,000

**Case 2:**

**The separate entity financial statements of Parent Co. and Subsidiary Co. at the end of 20X10 are provided below:**

**Separate Statements of Comprehensive Income and Changes in Equity-Retained Earnings Section**

Year Ended December 31, 20X10

	Parent Co.	Subsidiary Co
Earnings		100
Dividend revenue	40	
<b>NET INCOME</b>	<u>40</u>	<u>100</u>
Retained earnings Jan. 1, 20X10	5000	0
Net Income	40	100
Dividends declared		<u>40</u>
Retained earnings Dec. 31, 20X10	<u>5040</u>	<u>60</u>

**Separate Statements of Financial Position  
December 31, 20X10**

	Parent	Subsidiary
<b>Assets</b>		
Cash	9,040	1,060
Investment in subsidiary	<u>1,000</u>	
<b>TOTAL ASSETS</b>	<u>10,040</u>	<u>1,060</u>
<b>Liabilities and shareholders' equity</b>		
Share capital	5,000	1,000
Retained earnings	<u>5,040</u>	<u>60</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS EQUITY</b>	<u>10,040</u>	<u>1,060</u>

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The consolidated statements issued by Parent Co. in 20X10 are provided below:

**Consolidated Statement of Comprehensive Income and Changes in Equity-Retained  
Earnings Section  
Year Ended December 31, 20X10**

	<b>Parent Co.</b>
Earnings (\$0 + \$100)	100
Dividend revenue (\$40 – \$40)	0
<b>NET INCOME</b>	<b>100</b>
Retained earnings Jan. 1, 20X10	5000
Net Income	100
Dividends declared (\$40 – \$40)	
Retained earnings Dec. 31, 20X10	5100

**Parent Consolidated Statement of Financial Position  
December 31, 20X10**

	<b>Parent</b>
<b>Assets</b>	
Cash (\$9,040 + \$1,060)	10,100
Investment in subsidiary (\$1,000 – \$1,000)	<u>0</u>
<b>TOTAL ASSETS</b>	<u><b>10,100</b></u>
<b>Liabilities and shareholders' equity</b>	
Share capital (\$5,000 + \$1,000 – \$1,000)	5,000
Retained earnings (\$5,040 + \$60 – \$40 + \$40)	<u>5,100</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>	<u><b>10,100</b></u>

Notice that the consolidated FS in this case is identical to the consolidated FS in Case 1 above. This makes sense since the economic situation of the consolidated entity in the present case is identical to that in Case 1. The intercompany dividend of \$40 in the present case merely shuffled cash from Subsidiary Co. to Parent Co. and thus will have no impact on the equity of the overall entity.

*Adjusting entries required:*

Dividend revenue Dr.	40	
Dividend declared Cr.		40
 Share capital (Subsidiary) Dr.	 1,000	
Investment in Subsidiary Co. (in Parent Co.'s books)		1,000

**Case 3:**

The separate entity financial statements of Parent Co. and Subsidiary Co. at the end of 20X10 are provided below:

**Separate Statements of Comprehensive Income and Changes in Equity-Retained Earnings  
Section  
Year Ended December 31, 20X10**

	<b>Parent Co.</b>	<b>Subsidiary Co</b>
Earnings in the earnings of Subsidiary Co.	100	100
Dividend revenue	0	
<b>NET INCOME</b>	<u>100</u>	<u>100</u>
Retained earnings Jan. 1, 20X10	5000	0
Net Income	<u>100</u>	<u>100</u>
Dividends declared		
Retained earnings Dec. 31, 20X10	<u>5100</u>	<u>100</u>

**Separate Statements of Financial Position  
December 31, 20X10**

	<b>Parent</b>	<b>Subsidiary</b>
<b>Assets</b>		
Cash	9,000	1,100
Investment in subsidiary	<u>1,100</u>	
<b>TOTAL ASSETS</b>	<u>10,100</u>	<u>1,100</u>
<b>Liabilities and shareholders' equity</b>		
Share capital	5,000	1,000
Retained earnings	<u>5,100</u>	<u>100</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS EQUITY</b>	<u>10,100</u>	<u>1,100</u>

The consolidated statements issued by Parent Co. in 20X10 are provided below:

**Consolidated Statement of Comprehensive Income and Changes in Equity-Retained  
Earnings Section  
Year Ended December 31, 20X10**

	<b>Parent Co.</b>
Earnings (\$100 + \$100 – \$100)	100
Dividend revenue	0

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NET INCOME	100
Retained earnings Jan. 1, 20X10	5000
Net Income	100
Dividends declared	
Retained earnings Dec. 31, 20X10	5100

**Parent Consolidated Statement of Financial Position  
December 31, 20X10**

	<b>Parent</b>
<b>Assets</b>	
Cash (\$9,000 + \$1,100)	10,100
Investment in subsidiary (\$1,100 – \$1,100)	<u>0</u>
<b>TOTAL ASSETS</b>	<u><b>10,100</b></u>
<b>Liabilities and shareholders' equity</b>	
Share capital (\$5,000 + \$1,000 – \$1,000)	5,000
Retained earnings (\$5,100 + \$100 – \$100)	<u>5,100</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>	<u><b>10,100</b></u>

*Adjusting entries required:*

Share capital (Subsidiary) Dr.	1,000	
Equity in the earnings of Subsidiary (Parent) Dr.		100
Investment in Subsidiary Co. (in Parent Co.'s books)		1,100

**Case 4:**

**The separate entity financial statements of Parent Co. and Subsidiary Co. at the end of 20X10 are provided below:**

**Separate Statements of Comprehensive Income and Changes in Equity-Retained Earnings  
Section  
Year Ended December 31, 20X10**

	<b>Parent Co.</b>	<b>Subsidiary Co</b>
Earnings in the earnings of Subsidiary Co.	100	100
Dividend revenue	0	
<b>NET INCOME</b>	<u>100</u>	<u>100</u>
Retained earnings Jan. 1, 20X10	5000	0
Net Income	<u>100</u>	<u>100</u>

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Dividends declared		40
Retained earnings Dec. 31, 20X10	<u>5100</u>	<u>60</u>

**Separate Statements of Financial Position  
December 31, 20X10**

	<b>Parent</b>	<b>Subsidiary</b>
Assets		
Cash	9,040	1,060
Investment in subsidiary	<u>1,100</u>	
<b>TOTAL ASSETS</b>	<u><b>10,140</b></u>	<u><b>1,060</b></u>
Liabilities and shareholders' equity		
Share capital	5,000	1,000
Retained earnings	<u>5,100</u>	<u>60</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS EQUITY</b>	<u><b>10,100</b></u>	<u><b>1,060</b></u>

The consolidated statements issued by Parent Co. in 20X10 are provided below:

**Consolidated Statement of Comprehensive Income and Changes in Equity-Retained Earnings Section  
Year Ended December 31, 20X10**

	<b>Parent Co.</b>
Earnings (\$100 + \$100 – \$100)	100
Dividend revenue	0
<b>NET INCOME</b>	100
Retained earnings Jan. 1, 20X10	5000
Net Income	100
Dividends declared (\$40 – \$40)	
Retained earnings Dec. 31, 20X10	<u>5100</u>

**Parent Consolidated Statement of Financial Position  
December 31, 20X10**

	<b>Parent</b>
Assets	
Cash (\$9,040 + \$1,060)	10,100
Investment in subsidiary (\$1,060 – \$1,000 – \$100 + \$ 40)	<u>0</u>
<b>TOTAL ASSETS</b>	<u><b>10,100</b></u>
Liabilities and shareholders' equity	
Share capital (\$5,000 + \$1,000 – \$1,000)	5,000

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Retained earnings (\$5,100 + \$60 – \$100 + \$40)			<u>5,100</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>			<u><b>10,100</b></u>
Investment in Subsidiary Co.(Parent) Dr.	40		
Dividend declared Cr.		40	
Equity in the earnings of Subsidiary Co. (Parent) Dr.	100		
Investment in Subsidiary Co. (Parent) Cr.		100	
Share Capital (Subsidiary) Dr.	1,000		
Investment in Subsidiary Co. (Parent) Cr.		1,000	

**Case 5:**

**The separate entity financial statements of Parent Co. and Subsidiary Co. at the end of 20X10 are provided below:**

**Separate Statements of Financial Position  
December 31, 20X10**

	<b>Parent</b>	<b>Subsidiary</b>
<b>Assets</b>		
Cash	8,900	1,100
Investment in subsidiary	<u>1,100</u>	
<b>TOTAL ASSETS</b>	<u><b>10,000</b></u>	<u><b>1,100</b></u>
<b>Liabilities and shareholders' equity</b>		
Share capital	5,000	1,000
Retained earnings	<u>5,000</u>	<u>100</u>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS EQUITY</b>	<u><b>10,000</b></u>	<u><b>1,100</b></u>

The consolidated statements issued by Parent Co. in 20X10 are provided below:

**Parent Consolidated Statement of Financial Position  
December 31, 20X10**

	<b>Parent</b>
<b>Assets</b>	
Cash (\$8,900 + \$1,100)	10,000
Investment in subsidiary (\$1,100 – \$1,100)	<u>0</u>
<b>TOTAL ASSETS</b>	<u><b>10,000</b></u>
<b>Liabilities and shareholders' equity</b>	
Share capital (\$5,000 + \$1,000 – \$1,000)	5,000
Retained earnings (\$5,000 + \$100 – \$100)	<u>5,000</u>



TOTAL LIABILITIES & SHAREHOLDERS' EQUITY 10,000

Adjusting entries

Retained Earnings (Subsidiary Co.) Dr.	100	
Share capital (Subsidiary Co.) Dr.	100	
Investment in Subsidiary Co. (Parent Co.)		1,100

A parent can consolidate the operations of the subsidiary only from the date of the latter's acquisition. Since in the present case Parent Co. purchased Subsidiary Co. on December 31, 20X10, Parent Co. cannot include Subsidiary Co.'s income of \$100 earned in 20X10. These earnings instead belong to the erstwhile shareholders of Subsidiary Co., because of which Parent Co. paid \$1,100 for purchasing Subsidiary Co., \$1,000 for the original share capital of Subsidiary Co. and \$100 for the earnings of Subsidiary Co. in 20X10.

**P2-7**

Adjustments in 20X3

Dividend revenue	1,600	
Investment in Deep Value		1,600
Investment in Deep Value	3,200	
Equity in the earnings of Deep Value		3,200

The first entry is required to reclassify the dividends received from Deep Value from being reported as dividend revenue to a reduction in the Investment in Deep Value balance since under the equity method the receipt of dividends is a return of capital and not revenue.

The second entry is required to recognize Capital Investment's 40% share of the earnings of Deep Value as income and a corresponding increase in the Investment in Deep Value balance.

Adjustments in 20X4

Investment in Deep Value	1,600	
Retained earnings beginning		1,600
Dividend revenue	2,000	
Investment in Deep Value		2,000
Investment in Deep Value	4,000	
Equity in the earnings of Deep Value		4,000

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The last two entries are similar to the entries required in 20X3. Remember that consolidation-related entries are not recorded in the books of the investor. Therefore, the first entry is required in 20X4 to recognize the impact on Capital Investment of its share of Deep Value's operations in 20X3. Under the cost method, Capital Investment would have already recorded and reported its share of the dividends paid by Deep Value in 20X3. Therefore, Capital Investment should now recognize its portion of the remaining earnings of Deep Value in 20X3, i.e. change in Deep Value's retained earnings in 20X3 of \$1,600 [40% × \$8,000 – \$4,000] as an addition to its beginning retained earnings and Investment in Deep Value balance.

**P2-8**

Max Corporation  
Consolidated SFP  
December 31, 20X6

ASSETS

Current assets:

Cash	\$ 120,000	
Accounts Receivable	370,000	\$ 490,000
	<u>          </u>	

Capital assets:

Property, plant and equipment	3,900,000	
Accumulated depreciation	(1,030,000)	2,870,000
	<u>          </u>	<u>          </u>

Total assets		<u><u>\$ 3,360,000</u></u>
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LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:

Accounts payable		540,000
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Long-term liabilities:

Bonds payable		1,000,000
Deferred tax liability		150,000
		<u>          </u>

Total liabilities		1,690,000
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Shareholders' equity:

Common shares	400,000	
Retained earnings	1,270,000	1,670,000
	<u>          </u>	<u>          </u>

Total liabilities and shareholders' equity		<u><u>\$ 3,360,000</u></u>
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Eliminations required:

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1. Intercompany receivable/payable of \$100,000.
2. Investment account offset against Min’s Common shares, \$600,000.

The worksheet with the required adjustments is provided below:

Max	Min	Adjustments	Consolidated SFP
\$90,000	\$30,000		\$120,000
220,000	150,000		370,000
100,000	0	(100,000)	0
2,400,000	1,500,000		3,900,000
-670,000	-360,000		(1,030,000)
600,000	0	(600,000)	0
<u>\$2,740,000</u>	<u>\$1,320,000</u>		<u>\$3,360,000</u>
<u>\$340,000</u>	<u>\$200,000</u>		<u>\$540,000</u>
0	100,000	(100,000)	0
1,000,000	0		1,000,000
100,000	50,000		150,000
400,000	600,000	(600,000)	400,000
900,000	370,000		1,270,000
<u>\$2,740,000</u>	<u>\$1,320,000</u>		<u>\$3,360,000</u>

Since only a SFP is required, the intercompany sales and dividends require no adjustments or eliminations.

**P2-9**

Chappell Inc.  
Consolidated Statement of Comprehensive Income  
Year Ended December 31, 20X6

Revenues:		
Sales	\$7,600,000	
Interest	170,000	\$7,770,000
Expenses:		
Cost of goods sold	3,600,000	
Depreciation	760,000	
Administrative expense	1,110,000	
Income tax expense	950,000	
Other expenses	330,000	6,750,000

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Net income	<u>1,020,000</u>
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Retained Earnings Section of the Consolidated Statement of Changes in Equity  
Year ended December 31, 20X6

Retained earnings, January 1, 20X6	2,440,000
Net income	1,020,000
Dividends declared	<u>(330,000)</u>
Retained earnings, December 31, 20X6	<u><u>\$3,130,000</u></u>

Eliminations required:

1. \$1,000,000 intercompany sales (Chappell’s sales; Hook’s cost of goods sold).
2. \$90,000 accrued interest (Chappell’s interest revenue; Hook’s administrative expenses).
3. \$110,000 intercompany dividends (Chappell’s dividend revenue; Hook’s dividends declared).

The worksheet with the required adjustments is provided below:

	Chappell Inc.	Hook Corp.	Adjustments	Consolidated
<b>Revenues:</b>				
Sales	\$6,500,000	\$2,100,000	(\$1,000,000)	\$7,600,000
Interest	200,000	60,000	(90,000)	170,000
Dividends	<u>110,000</u>	=	<u>(110,000)</u>	<u>0</u>
Total revenue	<u>6,810,000</u>	<u>2,160,000</u>	<u>-1,200,000</u>	<u>7,770,000</u>
<b>Expenses:</b>				
Cost of goods sold	3,300,000	1,300,000	(1,000,000)	3,600,000
Depreciation expense	600,000	160,000		760,000
Administrative expense	900,000	300,000	(90,000)	1,110,000
Income tax expense	780,000	170,000		950,000
Other operating expenses	<u>290,000</u>	<u>40,000</u>		<u>330,000</u>
Total expense	<u>5,870,000</u>	<u>1,970,000</u>	<u>-1,090,000</u>	<u>6,750,000</u>
Net earnings	<u>\$940,000</u>	<u>\$190,000</u>	<u>(\$110,000)</u>	<u>1,020,000</u>

**Statements of Changes in Equity—Retained Earnings Section  
Year Ended December 31, 20X6**

Retained earnings, January 1, 20X6	\$1,920,000	\$520,000		2,440,000
Net earnings	940,000	190,000	(\$110,000)	1,020,000
Dividends declared	<u>(330,000)</u>	<u>(110,000)</u>	<u>110,000</u>	<u>(330,000)</u>
Retained earnings, December 1, 20X6	<u>\$2,530,000</u>	<u>\$600,000</u>		<u>\$3,130,000</u>

**P2-10**

1.

Fellows Corporation  
Consolidated Statement of Comprehensive Income and RE/SCE  
Year ended December 31, 20X6

Sales (5,600 + 4,700 – 3,500)	\$6,800,000
Interest, dividend and lease income (850 + 15 – 360 – 70 – 200)	<u>235,000</u>
Total revenue	<u>7,035,000</u>
Cost of goods sold (4,400 + 2,500 – 3,500)	3,400,000
Interest expense (70 – 70)	0
Other expenses (1,300 + 1,795 – 360)	
<u>2,735,000</u>	
Total expenses	<u>6,135,000</u>
Net income	900,000
Retained earnings, January 1	1,430,000
Dividends declared (–700 – 200 + 200)	<u>(700,000)</u>
Retained earnings, December 31	<u>\$1,630,000</u>

Note: Fellows’ separate entity statements report the investment in Thorne on the cost basis, as can be discerned from the fact that the investment account balance is equal to just the common share amount rather than the full shareholder’s equity in Thorne, as would be the case if the equity basis were being used. Therefore, Fellows’ interest, dividend and lease account contains dividends received from Thorne.

Chapter 2 – Intercorporate Equity Investments: An Introduction

Fellows Corporation  
Consolidated SFP  
December 31, 20X6

ASSETS

Current assets:

Cash	\$ 205,000
Accounts receivable (700 + 135 – 20)	815,000
Temporary investments and accrued investment income (360 + 90 – 50)	400,000
Inventories	<u>330,000</u>
	<u>1,750,000</u>

Property, plant and equipment:

Land	900,000
Buildings and equipment	1,500,000
Accumulated depreciation	<u>(500,000)</u>
	<u>1,900,000</u>

Long-term note receivable (700 – 700)	0
Investment in Thorne (500 – 500)	<u>0</u>
Total assets	<u>\$3,650,000</u>

EQUITIES

Current liabilities:

Accounts payable and accrued liabilities (240 + 80 – 20)	\$ 300,000
Dividends payable (120 + 50 – 50)	<u>120,000</u>
	<u>420,000</u>

Shareholders' equity:

Common shares (1600 + 500 – 500)	1,600,000
Retained earnings	<u>1,630,000</u>
	<u>3,230,000</u>

Total equities	<u>\$3,650,000</u>
----------------	--------------------

Eliminations (not required):

Common shares	\$ 500,000	
Investment in Thorne		\$ 500,000
Sales	3,500,000	
Cost of goods sold		3,500,000
Interest, dividend and lease income	360,000	
Other expenses		360,000
Interest, dividend and lease income	70,000	
Interest expense		70,000
Interest, dividend and lease income	200,000	
Dividends declared		200,000

Chapter 2 – Intercorporate Equity Investments: An Introduction

Accounts payable	20,000	
Accounts receivable		20,000
Dividends payable	50,000	
Temporary investments and accrued investment income		50,000
Long-term note payable	700,000	
Long-term note receivable		700,000

2.

The adjusting entries required for Fellows to convert from the cost to the equity method to account for its investment in Thorne are:

Investment in Thorne	100,000	
Retained Earnings Beginning		100,000
Investment in Thorne	350,000	
Equity in the earnings of Thorne		350,000
Dividend Income	200,000	
Investment in Thorne		200,000

Fellows Separate-Entity Financial Statements:

Fellows Corporation  
Statements of Comprehensive Income and RE/SCE  
Year ended December 31, 20X6

Revenues:	
Sales	\$5,600,000
Interest, dividend and lease	650,000
Equity in earnings of Thorne	<u>350,000</u>
Total revenue and other income	<u>6,600,000</u>
Expenses:	
Cost of goods sold	4,400,000
Interest expense	—
Other expenses	<u>1,300,000</u>
Total expenses	<u>5,700,000</u>
Net income	900,000
Retained earnings, January 1, 20X6	1,430,000
Dividends declared	<u>(700,000)</u>
Retained earnings, December 31, 20X6	<u>\$1,630,000</u>

Chapter 2 – Intercorporate Equity Investments: An Introduction

Fellows Corporation  
Statement of Financial Position  
December 31, 20X6

Assets		
Current assets:		
Cash	\$ 180,000	
Accounts receivable	700,000	
Temporary investments and accrued investment income	360,000	
Inventories	<u>          —</u>	1,240,000
Property, plant, and equipment		
Land	900,000	
Buildings and equipment	<u>          —</u>	
Accumulated depreciation	<u>          —</u>	900,000
Long-term note receivable		700,000
Investment in Thorne		<u>750,000</u>
Total assets		<u>\$3,590,000</u>
Equities		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 240,000	
Dividends payable	<u>120,000</u>	<u>360,000</u>
Total liabilities		360,000
Shareholders' equity		
Common shares	1,600,000	
Retained earnings	<u>1,630,000</u>	<u>3,230,000</u>
Total liabilities and shareholders' equity		<u>\$3,590,000</u>

3.

Fellows Corporation  
Consolidated Statement of Comprehensive Income and RE/SCE  
Year ended December 31, 20X6

Sales (5,600 + 4,700 – 3,500)	\$6,800,000	
Interest, dividend and lease income (650 + 15 – 360 – 70)		<u>235,000</u>
Total revenue		<u>7,035,000</u>
Cost of goods sold (4,400 + 2,500 – 3,500)		3,400,000
Other expenses (1,300 + 1,795 – 360)		<u>2,735,000</u>
Total expenses		<u>6,135,000</u>
Net income		900,000
Retained earnings, January 1		1,430,000
Dividends declared		<u>(700,000)</u>



Chapter 2 – Intercorporate Equity Investments: An Introduction

Retained earnings, December 31 \$1,630,000

Note: Fellow's separate entity statements report the investment in Thorne on the equity basis, as can be discerned from the fact that the investment account balance is equal to the full shareholder's equity in Thorne, rather than just the common share amount, as would be the case if the cost basis were being used. Therefore, Fellow's miscellaneous revenue account contains no dividends received from Thorne.

Fellows Corporation  
Consolidated SFP  
December 31, 20X6

ASSETS

Current assets:

Cash	\$ 205,000
Accounts receivable (700 + 135 – 20)	815,000
Temporary investments & acc. Invest. Inc. (360 + 90 – 50)	400,000
Inventories	<u>330,000</u>
	<u>1,750,000</u>

Property, plant and equipment:

Land	900,000
Buildings and equipment	1,500,000
Accumulated depreciation	<u>(500,000)</u>
	<u>1,900,000</u>

Total assets \$3,650,000

EQUITIES

Current liabilities:

Accounts payable (240 + 80 – 20)	\$ 300,000
Dividends payable (120 + 50 – 50)	<u>120,000</u>
	<u>420,000</u>

Shareholders' equity:

Common shares	1,600,000
Retained earnings	<u>1,630,000</u>
	<u>3,230,000</u>

Total equities \$3,650,000

Chapter 2 – Intercorporate Equity Investments: An Introduction

**P2-11**

Empire Optical Co. Ltd.  
Consolidated SCI  
Year ended December 31, 20X6

Sales (16,000 + 7,100 – 2,000)	\$21,100,000	
Dividend and interest income	<u>100,000</u>	\$21,200,000
Cost of goods sold (11,000 + 5,000 – 2,000)	14,000,000	
Other operating expenses	<u>5,500,000</u>	<u>19,500,000</u>
Net income		<u>\$ 1,700,000</u>

Empire Optical Co., Ltd.  
Consolidated SFP  
December 31, 20X6

Current assets:		
Cash	\$ 450,000	
Accounts receivable (300 + 150 – 250)	200,000	
Inventory	<u>1,800,000</u>	\$2,450,000
Fixtures and equipment (net)		6,400,000
Investments		<u>500,000</u>
Total Assets		<u>\$9,350,000</u>
Accounts payable (700 + 500 – 250)		\$ 950,000
Common shares	\$1,600,000	
Retained earnings*	<u>6,800,000</u>	<u>8,400,000</u>
Total Equities		<u>\$9,350,000</u>

\*  $\$5,700,000 + \$1,700,000 - \$600,000 = \$6,800,000$

Eliminations (not required):

Common shares	\$1,000,000	
Retained earnings	1,300,000	
Dividends paid		\$ 200,000
Investment in Class Glass		2,100,000
Accounts payable	250,000	
Accounts receivable		250,000
Sales	2,000,000	
Cost of goods sold		2,000,000

Note to instructor:

*Since the intercompany sales were at cost, there is no intercompany profit. Therefore, it does not matter whether or not there are still intercompany sales in Class's inventory as there is no unrealized profit to eliminate.*

Q2A-1: Step purchases/sales (changes in ownership) can broadly be divided into two categories—(1) those which do not lead to a change in the nature of the investment, and (2) those which lead to a change in the nature of the investment. While the former category of changes in ownership does not require a change in the reporting method, the latter category requires a change in the reporting method.

Q2A-2: In addition to potentially impacting the reporting method required to be used, both types of changes in ownership have accounting implications potentially requiring changes to or recognition of: (1) the cost of the new purchase, (2) the carrying value of the existing investment, (3) the value of the new investment, (4) value of the portion sold, and (5) any associated gains or losses.

Q2A-3: The accounting implication of changes in ownership that do not change the nature of the investment depends on how the investment was originally classified—fair value investment (FVTPL or FVTOCI), investment in an associate or a joint venture, or an investment in a controlled entity. Briefly, therefore, the accounting implication of such changes in ownership by each investment category is:

- Passive investment—adjust carrying amount of investment by (1) adding cost of purchase, or (2) subtracting carrying value of portion sold and recognizing associated gains/losses
- Joint venture or associate— Adjust carrying amount of investment by (1) adding cost of purchase, or (2) subtracting carrying value of portion sold, recognizing associated gains/losses; apply equity method based on new ownership level
- Controlled entity— Report the sale/purchase as a equity transaction, i.e., transaction between shareholders in their capacity of owners

Q2A-4: Changes in ownership leading to a change in the nature of the investment can be divided broadly into (1) those which lead to a deemed sale of the existing investment and the deemed purchase of the new investment, and (2) those which do not lead to such a deemed sale/purchase. The vast majority of changes in ownership leading to a change in the nature of the investment fall under the former category. Under the deemed sale/deemed purchase rule the existing investment is deemed to be sold entirely at fair value with the recognition of associated gains and losses, and the retained portion of the investment, if any, is deemed to be purchased at fair value. The deemed sale/deemed purchase rule is required when the nature of the investment changes from:

- a passive investment to a controlled investment or vice-versa,
- a joint venture investment/investment in associate to controlled entity or vice-versa,, and
- a joint venture investment/investment in associate to a passive investment.

## Chapter 2 – Intercorporate Equity Investments: An Introduction

The deemed sale/purchase rule does not apply when the nature of the investment changes from passive to an investment in a joint venture/associate. In this case, the cost of the additional investment if any is added to the carrying value of the existing investment.

### **P2A-1**

The carrying value of the 10,000 shares of Give Inc. in the books of Take Inc. on December 31, 20X4 is equal to its fair value of \$47,000 (10,000 shares × \$4.70) on that date. Since the purchase of the additional 1,000 shares does not change the nature of the investment, Take should add the cost of the additional shares to the carrying value of the existing 10,000 shares. Therefore, the journal entry required to record the purchase of the additional 1,000 shares is as follows:

January 3, 20X5		
Investment in Give Inc. (FVTOCI Investment)	4,800	
Cash		4,800
(to record the additional purchase of shares)		

### **P2A-2**

The carrying value of the 10,000 shares of Give Inc. in the books of Take Inc. on December 31, 20X4 is equal to its fair value of \$47,000 (10,000 shares × \$4.70) on that date. IFRS requires an investment in an associate to be initially valued at cost. Therefore, the cost of the additional purchase of 10,000 shares in Give Inc. has to be added to the carrying value of the existing investment in Give Inc. The journal entry required in relation to the change in the investment type, from FVTOCI to investment in an associate is provided below:

January 3, 20X5		
Investment in Give Inc. (Investment in Associate)	\$95,000	
Cash		\$48,000
Investment in Give Inc. (FVTOCI Investment)		47,000
During 20X5		
Investment in Give Inc. (Investment in Associate)	\$48,000	
Equity in the Earnings of Give Inc. (Investment in Associate)		\$48,000
Cash	32,000	
Investment in Give Inc. (Investment in Associate)		32,000

**P2A-3**

The equity in the earnings of Jasmine in 20X3 and 20X4 and the balance in the Investment in Jasmine account at the end of each of the two years is provided below:

<b>EQUITY METHOD</b>	<b>20X3</b>	<b>20X4</b>
Net income		
Dividends	-	-
Equity in the earnings of Jasmine	\$10,000	\$7500
OCI		
Unrealized gains/losses	-	-
Balance in Investment in Jasmine account	\$152,500	\$150,000

Since there are no consolidation-related adjustments, the equity in the earnings of Jasmine for 20X3 is  $25\% \times \$40,000 = \$10,000$  and for 20X4 is  $25\% \times \$30,000 = \$7,500$ . The balance in the Investment in Jasmine account at the end of 20X3 is \$152,500 [ $\$150,000 + \$10,000 - (25\% \times \text{dividends paid by Jasmine of } \$30,000)$ ]. Likewise, the balance in the Investment in Jasmine account at the end of 20X4 is \$150,000 [ $\$152,500 + \$7,500 - (25\% \times \text{dividends paid by Jasmine of } \$40,000)$ ].

January 2, 20X5

Cash	\$32,000	
Investment in Jasmine (Significant Influence)		\$30,000
Gain on partial sale of investment in Jasmine		2,000

During 20X5

Investment in Jasmine (Investment in Associate)	\$12,000	
Equity in the Earnings of Jasmine (Investment in Associate)		\$12,000
Cash	8,000	
Investment in Jasmine (Investment in Associate)		8,000

**P2A-4**

The equity in the earnings of Jasmine in 20X3 and 20X4 and the balance in the Investment in Jasmine account at the end of each of the two years is provided below:

<b>EQUITY METHOD</b>	<b>20X3</b>	<b>20X4</b>
Net income		
Dividends	-	-
Equity in the earnings of Jasmine	\$10,000	\$7500
OCI		

## Chapter 2 – Intercorporate Equity Investments: An Introduction

Unrealized gains/losses	-	-
Balance in Investment in Jasmine account	\$152,500	\$150,000

Since there are no consolidation-related adjustments, the equity in the earnings of Jasmine for 20X3 is  $25\% \times \$40,000 = \$10,000$  and for 20X4 is  $25\% \times \$30,000 = \$7,500$ . The balance in the Investment in Jasmine account at the end of 20X3 is \$152,500 [ $\$150,000 + \$10,000 - (25\% \times \text{dividends paid by Jasmine of } \$30,000)$ ]. Likewise, the balance in the Investment in Jasmine account at the end of 20X4 is \$150,000 [ $\$152,500 + \$7,500 - (25\% \times \text{dividends paid by Jasmine of } \$40,000)$ ].

January 2, 20X5

Investment in Jasmine (FVTOCI Investment)	\$160,000	
Investment in Jasmine (Significant Influence)		\$150,000
Gain on Deemed Sale/purchase of Investment in Jasmine		10,000

During 20X5

Cash	\$15,000	
Dividend Revenue		\$15,000
Investment in Jasmine (FVTOCI Investment)	10,000	
OCI (to value FVTOCI investment at fair value)		10,000

### P2A-5

The equity in the earnings of Jasmine in 20X3 and 20X4 and the balance in the Investment in Jasmine account at the end of each of the two years is provided below:

#### EQUITY METHOD

	20X3	20X4
Net income		
Dividends	-	-
Equity in the earnings of Jasmine	\$10,000	\$7,500
OCI		
Unrealized gains/losses	-	-
Balance in Investment in Jasmine account	\$152,500	\$150,000

Since there are no consolidation-related adjustments, the equity in the earnings of Jasmine for 20X3 is  $25\% \times \$40,000 = \$10,000$  and for 20X4 is  $25\% \times \$30,000 = \$7,500$ . The balance in the Investment in Jasmine account at the end of 20X3 is \$152,500 [ $\$150,000 + \$10,000 - (25\% \times \text{dividends paid by Jasmine of } \$30,000)$ ]. Likewise, the balance in the Investment in Jasmine account at the end of 20X4 is \$150,000 [ $\$152,500 + \$7,500 - (25\% \times \text{dividends paid by Jasmine of } \$40,000)$ ].

## Chapter 2 – Intercorporate Equity Investments: An Introduction

January 2, 20X5		
Cash	\$96,000	
Investment in Jasmine (FVTPL Investment)	64,000	
Investment in Jasmine (Significant Influence)		\$150,000
Gain on Deemed Sale/purchase of Investment in Jasmine		10,000
During 20X5		
Cash	\$6,000	
Dividend Revenue		\$6,000
Investment in Jasmine (FVTPL Investment)	4,000	
Unrealized gain on FVTPL Investment (to value FVTPL investment at fair value)		4,000

## SSP 2-1

### Statement of Comprehensive Income Year Ended December 31, 20X6

Sales (13,000,000 + 5,000,000 – 4,000,000)	\$14,000,000
Cost of sales (7,000,000 + 3,200,000 – 2,600,000)	7,600,000
Other expenses (3,500,000 + 700,000)	<u>4,200,000</u>
	11,800,000
Net income	<u>\$ 2,200,000</u>

### Statement of Retained Earnings Year Ended December 31, 20X6

Retained Earnings, December 31, 20X5	\$ 3,700,000
Net Income	4,100,000
Dividends	<u>(2,500,000)</u>
Retained Earnings, December 31, 20X6	<u>\$5,300,000</u>

### Statement of Financial Position December 31, 20X6

Assets	
Cash and current receivables (200,000 + 400,000 – 200,000 – 80,000)	\$ 320,000
Inventories (900,000 + 500,000)	1,400,000
Furniture, fixtures, and equipment (2,000,000 + 1,700,000)	3,700,000
Buildings under capital lease (6,000,000 + 3,000,000)	<u>9,000,000</u>
	<u>\$14,420,000</u>
Liabilities and Shareholders' Equity	
Current liabilities (1,500,000 + 400,000 – 200,000 – 80,000)	\$ 1,620,000
Long-term liabilities (4,000,000 + 2,000,000)	6,000,000
Common shares	1,500,000
Retained earnings	<u>5,300,000</u>
	<u>\$14,420,000</u>



**SSP 2-2**

**Statement of Comprehensive Income  
Year Ended December 31, 20X7**

Sales revenue (7,100 + 3,400 – 1,400)	\$9,100
Other income (235 + 840 – 30)	<u>1,045</u>
Total revenue	<u>10,145</u>
Operating expenses	
Cost of goods sold (4,175 + 1900 – 1,100)	4,975
Selling expenses (435 + 560)	995
General and administrative exp (995 + 770)	1,765
Interest and other expenses (1,015 + 30 – 30)	<u>1,015</u>
Total operating expenses	8,750
Earnings before income taxes	1,395
Income tax expense (215 + 290)	<u>505</u>
Net earnings	<u>\$ 890</u>

**Statement of Retained Earnings  
Year Ended December 31, 20X7**

Retained Earnings, December 31, 20X5	\$ 45,910
Net Income	890
Dividends	<u>(160)</u>
Retained Earnings, December 31, 20X6	<u>\$46,840</u>

## Chapter 2 – Intercorporate Equity Investments: An Introduction

**Statement of Financial Position**  
**December 31, 20X6**

<b>Assets</b>	
Cash and temporary investments (1,500 + 450)	\$ 1,950
Current receivables (3,400 + 1,890 – 200 – 100)	4,990
Inventories (10,640 + 5,210)	<u>15,850</u>
Current assets	22,790
Land	18,000
Buildings and equipment (net) (37,700 + 22,450)	<u>60,150</u>
Total assets	<u><u>\$100,940</u></u>
Liabilities and shareholders' equity	
Current payables (2,820 + 1,540 – 200 – 100)	\$ 4,060
Income tax payable (180 + 85)	<u>265</u>
Current liabilities	4,325
Long-term debt payable	33,750
Deferred tax liability (2,650 + 375)	<u>3,025</u>
Total liabilities	41,100
Common shares	13,000
Retained earnings	<u>46,840</u>
Total shareholders' equity	59,840
Total liabilities and shareholders' equity	<u><u>\$100,940</u></u>