CHAPTER ONE

As Chapter 1 is an introduction to the textbook and very general in nature, there are no supplementary materials related to Chapter 1 in this Study Guide.

CHAPTER TWO

How To Work Through Chapter Two

Introduction

❒ Read the text page 19-21 (paragraph 2-1 through 2-12).

The Conceptual Basis For Classification

❒ Read the text page 21 (paragraph 2-13 through 2-18).

Held-For-Trading Investments

❒ Read the text page 22-24 (paragraph 2-19 through 2-34).

❒ Complete Exercise Two-1 on page 24 of the text. The solution is on page S-3.

❒ Complete Self Study Problem Two-1 on page 56 of the text. The solution is on page S-7 and S-8.

Available-For-Sale Investments - Fair Value Method

❒ Read the text page 24-26 (paragraph 2-35 through 2-44).

❒ Complete Exercise Two-2 on page 26 of the text. The solution is on page S-3 and S-4.

❒ Complete Self Study Problem Two-2 on page 56 and 57 of the text. The solution is on page S-8.

Available-For-Sale Investments - Cost Method And Return Of Capital

❒ Read the text page 27 (paragraph 2-45 through 2-49).

❒ Complete Exercise Two-3 on page 27 of the text. The solution is on page S-4.

❒ Complete Self Study Problem Two-3 on page 56 and 57 of the text. The solution is on page S-9.

❒ Read the text page 27-28 (paragraph 2-50 through 2-54).

❒ Complete Exercise Two-4 on page 28 and 29 of the text. The solution is on page S-4.

Subsidiaries

❒ Read the text page 29-32 (paragraph 2-55 through 2-76).

❒ Complete Exercise Two-5 on page 32 of the text. The solution is on page S-5.

❒ Read the text page 32-33 (paragraph 2-77 through 2-85).

Variable Interest Entities

❒ Read the text page 33-34 (paragraph 2-86 through 2-96).

Significantly Influenced Companies - Equity Method

❒ Read the text page 34-38 (paragraph 2-97 through 2-110).

❒ Complete Exercise Two-6 on page 38 of the text. The solution is on page S-5.

❒ Complete Self Study Problem Two-4 on page 57 of the text. The solution is on page S-10.

Significantly Influenced Companies - Intra Statement Disclosure

❒ Read the text page 38-39 (paragraph 2-111 through 2-115).

❒ Complete Exercise Two-7 on page 40 of the text. The solution is on page S-5.

❒ Complete Self Study Problem Two-5 on page 57 and 58 of the text. The solution is on page S-11.

Significantly Influenced Companies - EIC Abstract No. 8 And Disclosure

❒ Read the text page 40-41 (paragraph 2-116 through 2-121).

❒ Complete Exercise Two-8 on page 41 of the text. The solution is on page S-6.

❒ Read the text page 41-44 (paragraph 2-122 through 2-134).

Joint Ventures

❒ Read the text page 44-45 (paragraph 2-135 through 2-143).

Accounting Methods Summarized

❒ Read the text page 45 (paragraph 2-144 through 2-146).

❒ Complete Self Study Problem Two-6 on page 58 of the text. The solution is on page S-12.

Impairment

❒ Read the text page 45-46 (paragraph 2-147 through 2-154).

Gains And Losses On The Sale Of Equity Investments

❒ Read the text page 47 (paragraph 2-155 through 2-157).

Differential Reporting

❒ Read the text page 47-49 (paragraph 2-158 through 2-165).

❒ Complete Exercises Two-9 and Two-10 on page 49 of the text. The solutions are on page S-6 and S-7.

❒ Read the text page 50 (paragraph 2-166 through 2-168).

International Convergence

❒ Read the text page 50-52 (paragraph 2-169 through 2-178).

Investments In Canadian Practice

❒ Read the text page 53-55 (paragraph 2-179 through 2-184).

To Complete This Chapter

❒ Review the Learning Objectives of the Chapter found on page S-13 of this Study Guide.

Solution to Chapter Two Exercises

Exercise Two - 1 Solution

The required journal entries would be as follows:

January 1, 2007		
Investment In Santin [(5,000)($23)]	$115,000	
Miscellaneous Expense	1,150	
Cash		$116,150
During 2007		
Cash [(5,000)($0.90)]	$4,500	
Investment Income (Net Income)		$4,500
December 31, 2007		
Investment Loss (Net Income)	$20,000	
Investment In Santin [(5,000)($19 - $23)]		$20,000
March 1, 2008		
Cash [(5,000)($25) - $1,250]	$123,750	
Miscellaneous Expense	1,250	
Investment In Santin [(5,000)($19)]		$95,000
Investment Income (Net Income) [(5,000)($25 - $19)]		30,000

January 1, 2007 Expense	($ 1,150)
2007 Dividends	4,500
December 31, 2007 Fair Value Loss	(20,000)
March 1, 2008 Expense	(1,250)
Gain On Sale	30,000
Total Effect On Net Income	$12,100

Exercise Two - 2 Solution

The required journal entries would be as follows:

January 1, 2007		
Investment In Santin [(5,000)($23) + $1,150]	$116,150	
Cash		$116,150
During 2007		
Cash [(5,000)($0.90)]	$4,500	
Investment Income (Net Income)		$4,500
December 31, 2007		
Other Comprehensive Income - Loss*	$21,150	
Investment In Santin [$116,150 - (5,000)($19)]		$21,150

*After inclusion in the Statement Of Comprehensive Income, this item will be closed to the Balance Sheet account Accumulated Other Comprehensive Income.

March 1, 2008		
Cash [(5,000)($25) - $1,250]	$123,750	
Miscellaneous Expense	1,250	
Accumulated Other Comprehensive Income		$21,150
Investment In Santin ($116,150 - $21,150)]		95,000
Investment Income (Net Income) [(5,000)($25 - $23)		8,850

(This entry removes the beginning of the year balance in Accumulated Other Comprehensive Income and leaves the balance in this account at nil. It also recognizes the fact that, during the period that it was held, there was a gain on the investment of $8,850. This amount must be included in Net Income in the period of disposition.)

January 1, 2007 Expense	Nil
2007 Dividends	$ 4,500
March 1, 2008 Expense	(1,250)
Gain On Sale	8,850
Total Effect On Net Income	$12,100

Exercise Two-3 Solution

The required journal entries are as follows:

January 1, 2007		
Investment In Santin [(5,000)($23) + $1,150]	$116,150	
Cash		$116,150
During 2007		
Cash [(5,000)($0.90)]	$4,500	
Investment Income (Net Income)		$4,500

December 31, 2007

No entry is possible as no fair value information is available.

March 1, 2008		
Cash [(5,000)($25) - $1,250]	$123,750	
Miscellaneous Expense	1,250	
Investment In Santin		$116,150
Investment Income (Net Income)		8,850

January 1, 2007 Expense	Nil
2007 Dividends	$ 4,500
March 1, 2008 Expense	(1,250)
Gain On Sale	8,850
Total Effect On Net Income	$12,100

Exercise Two-4 Solution

The required journal entries are as follows:

January 1, 2007		
Investment In Montag	$785,000	
Cash		$785,000
During 2007		
Cash [(5%)($500,000)]	$25,000	
Investment Income		$25,000

At this point, Montag's Retained Earnings since acquisition is $200,000 ($700,000 - $500,000).

During 2008		
Cash [(5%)($500,000)]	$25,000	
Investment Income [(5%)($700,000 - $500,000)]		$10,000
Investment In Montag [(5%)($500,000 - $200,000)		15,000

At the beginning of 2008, Montag had Retained Earnings since acquisition of $200,000. This means that $300,000 ($500,000 - $200,000) of the 2008 dividend was paid out of Retained Earnings that were present when Jondy acquired its investment in Montag. Given this, $15,000 of the dividend must be recorded as a return of capital.

Exercise Two-5 Solution

Morton has direct control over Salt and would classify this investment as a subsidiary. Morton would account for this investment using the full consolidation method.

Morton has direct ownership of 40 percent of the Backy shares and, in addition, has indirect control of a further 15 percent through its control of Salt. Given this, Morton has control of Backy and would classify the investment as a subsidiary. Based on this classification, Morton would account for its Investment In Backy using the full consolidation method.

Exercise Two-6 Solution (See also Exercise Two-10 Solution)

Under the equity method, the required journal entries are as follows:

January 1, 2007		
Investment In Plastee	$300,000	
Cash		$300,000
Year Ending December 31, 2007		
Cash [(20%)($100,000)]	$20,000	
Investment In Plastee [(20%)($150,000 - $100,000)]	10,000	
Investment Income [(20%)($150,000)]		$30,000
Year Ending December 31, 2008		
Cash [(20%)($50,000)]	$10,000	
Investment Loss [(20%)($40,000)]	8,000	
Investment In Plastee [(20%)($40,000 + $50,000)]		$18,000
Year Ending December 31, 2009		
Cash [(20%)($80,000)]	$16,000	
Investment In Plastee [(20%)($90,000 - $80,000)]	2,000	
Investment Income [(20%)($90,000)]		$18,000

The balance in the Investment in Plastee account can be calculated as follows:

Initial Investment		$300,000
2007 Increase	$10,000	
2008 Decrease	(18,000)	
2009 Increase	2,000	(6,000)
Balance - December 31, 2009		$294,000

The $6,000 decrease in the Investment in Plastee account is equal to 20 percent of the $30,000 ($150,000 - $100,000 - $40,000 - $50,000 + $90,000 - $80,000) decrease in Plastee's Retained Earnings since acquisition.

Exercise Two-7 Solution

The required 2008 journal entry would be as follows:

Cash [(25%)($103,000)]	$25,750	
Loss From Discontinued Operations [(25%)($300,000)]	75,000	
Investment Income [(25%)($346,000)]		$86,500
Investment In Muddle [(25%)($103,000 - $46,000)]		14,250

Note that the 2007 information does not affect the journal entry.

Exercise Two-8 Solution

Ausser's share of the Aussee Net Loss would be $600,000 [(40%)($1,500,000)], an amount that exceeds the carrying value of the Investment In Aussee. This means that, if the usual Investment Income entry was used, the Investment In Aussee would become a credit balance that would have to be disclosed as a liability. In the absence of a commitment on the part of Ausser to provide financial support, recording a liability would be inappropriate and, as a consequence, the following entry would be made for the year ending December 31, 2007 to reduce the carrying value to nil:

Investment Loss	$400,000	
Investment In Aussee		$400,000

Before Investment Income can be recorded in the year ending December 31, 2008, the $200,000 deficit in the Investment In Aussee account must be recovered. This would require the first $500,000 ($200,000 ÷ 40%) of Ausser's 2008 Net Income, leaving only $300,000 ($800,000 - $500,000) as a basis for recording Investment Income. Given this, the required entry would be as follows:

Investment In Aussee [(40%)($800,000 - $500,000)]	$120,000	
Investment Income		$120,000

The balance in the Investment in Aussee account can be calculated as follows:

Initial Investment		$400,000
2007 Decrease To Nil Carrying Value	($400,000)	
2008 Increase	120,000	(280,000)
Balance - December 31, 2008		$120,000

The $280,000 decrease in the Investment in Aussee account is equal to 40 percent of the $700,000 (-$1,500,000 + $800,000) decrease in Aussee's Retained Earnings since acquisition.

Exercise Two-9 Solution

The total cost and total number of shares for Salson's holding of Tofal shares would be calculated as follows:

	Number Of Shares	Cost
1st Purchase	2,400	$ 27,600
2nd Purchase	3,450	42,600
3rd Purchase	1,740	22,450
4th Purchase	4,360	72,400
Totals	11,950	$165,050

Given the preceding totals, the average cost of the shares would be $13.81, and the gain on the sale of 5,250 shares would be calculated as follows:

Proceeds Of Disposition [(5,250)($28)]	$147,000
Adjusted Cost Base [(5,250)($13.81)]	(72,503)
Gain On Sale Of Shares	$ 74,497

Exercise Two-10 Solution (See also Exercise Two-6 Solution)

Under the cost method, the required journal entries are as follows:

January 1, 2007		
Investment In Plastee	$300,000	
Cash		$300,000
Year Ending December 31, 2007		
Cash [(20%)($100,000)]	$20,000	
Investment Income		$20,000
Year Ending December 31, 2008		
Cash [(20%)($50,000)]	$10,000	
Investment In Plastee [(20%)($40,000)]		$8,000
Investment Income [(20%)($50,000 - $40,000)]		2,000

[After deducting the 2008 loss, the cumulative Retained Earnings since acquisition balance is equal to $10,000 ($150,000 - $100,000 - $40,000). The remainder of this dividend was paid out of pre-acquisition Retained Earnings. After this payment, the cumulative Retained Earnings since acquisition balance is a negative $40,000 ($10,000 - $50,000)].

Year Ending December 31, 2009		
Cash [(20%)($80,000)]	$16,000	
Investment Income		$16,000

[At this point, there is still a negative balance in the cumulative Retained Earnings since acquisition of $30,000 (-$40,000 + $90,000 - $80,000). However, the investment was written down for this last year and, as a consequence, all of the dividends can be credited to Investment Income.]

The balance in the Investment in Plastee account can be calculated as follows:

Initial Investment	$300,000
2008 Decrease	(8,000)
Balance - December 31, 2009	$292,000

Solution to Self Study Problem Two - 1

With the Investment In Barnes classified as held for trading, the required journal entries would be as follows:

June 30, 2007		
Investment In Barnes [(2,500)($55.00)]	$137,500	
Miscellaneous Expense	500	
Cash		$138,000
December 31, 2007		
Investment In Barnes	$16,250	
Investment Income (Net Income) [(2,500)($61.50 - $55.00)]		$16,250
December 31, 2008		
Investment Loss (Net Income)	$45,750	
Investment In Barnes [(2,500)($43.20 - $61.50)]		$45,750

September 5, 2009

Cash [(2,500)($56.25) - $500]	$140,125	
Miscellaneous Expense	500	
Investment In Barnes		
($137,500 + $16,250 - $45,750)		$108,000
Investment Income (Net Income)		
[(2,500)($56.25 - $43.20)]		32,625

The net result for the three years will be a gain of $2,125 (-$500 + $16,250 - $45,750 - $500 + $32,625). This amount will be included in Laxator's December 31, 2009 Retained Earnings.

Solution to Self Study Problem Two - 2

With the Investment In Barnes classified as available for sale, the required journal entries would be as follows:

June 30, 2007

Investment In Barnes [(2,500)($55.00)]	$137,500	
Miscellaneous Expense	500	
Cash		$138,000

December 31, 2007

Investment In Barnes	$16,250	
Other Comprehensive Income - Gain		
[(2,500)($61.50 - $55.00)]		$16,250

When Other Comprehensive Income is closed out at year end, this will leave a $16,250 credit balance in Accumulated Other Comprehensive Income.

December 31, 2008

Other Comprehensive Income - Loss	$45,750	
Investment In Barnes [(2,500)($43.20 - $61.50)]		$45,750

After closing entries, this will leave a $29,500 ($45,750 - $16,250) debit balance in Accumulated Other Comprehensive Income.

September 5, 2009

Cash [(2,500)($56.25) - $500]	$140,125	
Miscellaneous Expense	500	
Investment In Barnes ($137,500 + $16,250 - $45,750)		$108,000
Accumulated Other Comprehensive Income		29,500
Investment Income [(2,500)($56.25 - $55.00)]		3,125

(This entry removes the 2007 gain and the 2008 loss from the Accumulated Other Comprehensive Income account, leaving a balance of nil. The $3,125 Net Gain on the investment is then included in the 2009 Net Income calculation.)

The net result for the three years will be a gain of $2,125 (-$500 + $3,125 - $500). This amount will be included in Laxator's December 31, 2009 Retained Earnings.

Solution to Self Study Problem Two - 3

The required journal entries under the cost method would be as follows:

Year 1 Journal Entries

Investment In Rapone	$5,000,000	
Cash		$5,000,000
Cash	$ 200,000	
Investment Income		$ 200,000

(To record the investment transaction and Lestor's 20 percent share of Rapone's dividends paid.)

Year 2 Journal Entry

Cash	$ 200,000	
Investment In Rapone		$ 200,000

(At the end of Year 1, there was a $500,000 ($1,500,000 - $1,000,000) accumulation of Retained Earnings since Lester acquired its Investment In Rapone. The Year 2 Net Loss eliminates this balance and, in fact, creates a negative Retained Earnings since acquisition of $500,000 ($500,000 - $1,000,000). Given this, Lestor's 20 percent share of Rapone's Year 2 dividends must be recorded as a return of capital, rather than as Investment Income.)

Year 3 Journal Entry

Cash	$ 200,000	
Investment Income		$ 200,000

(The Year 3 earnings of $4,000,000 serve to eliminate the deficit in Retained Earnings since acquisition that accrued in Year 2. This means that Lester's 20 percent share of Rapone's Year 3 dividends can be recorded as Investment Income.)

The preceding entries will leave a balance in the Investment In Rapone account of $4,800,000 ($5,000,000 - $200,000). An argument can be made that, because there is no longer a deficit in Retained Earnings since acquisition, the Investment In Rapone account should be restored to the original cost value of $5,000,000. However, it is our understanding that this would never be done in practice.

Solution to Self Study Problem Two - 4

Given the Lestor Company has significant influence over the Rapone Company, the use of the equity method would be required. The entries under this method would be as follows:

Year 1 Journal Entries

Investment In Rapone	$5,000,000	
Cash		$5,000,000
Cash	$ 200,000	
Investment in Rapone	100,000	
Investment Income		$ 300,000

(To record the investment transaction and Lestor's 20 percent share of Rapone's dividends paid and net income)

Year 2 Journal Entry

Cash	$ 200,000	
Investment Loss	200,000	
Investment In Rapone		$ 400,000

(To record Lestor's 20 percent share of Rapone's dividends paid and net loss)

Year 3 Journal Entry

Cash	$ 200,000	
Investment In Rapone	600,000	
Investment Income		$ 800,000

(To record Lestor's 20 percent share of Rapone's dividends paid and net income)

With the use of the equity method, the ending balance in the Investment In Rapone account would be $5,300,000. This would be calculated as follows:

Balance at acquisition		$5,000,000
First year addition	$100,000	
Second year reduction	(400,000)	
Third year addition	600,000	300,000
Third year ending balance		$5,300,000

Note the $300,000 increase in the Investment in Rapone account is equal to 20 percent of the $1,500,000 ($1,500,000 - $1,000,000 - $1,000,000 - $1,000,000 + $4,000,000 - $1,000,000) increase in Retained Earnings since acquisition.

Solution to Self Study Problem Two - 5

Buy Company's Income Statement for the year ending December 31, 2010 would be as follows:

Buy Company
Income Statement
For the Year Ending December 31, 2010

Total Revenues	$5,000,000
Cost Of Goods Sold	$3,000,000
Other Expenses	800,000
Investment Loss - Ordinary [(25%)($200,000)]	50,000
Total Expenses and Losses	$3,850,000
Income Before Extraordinary Items	$1,150,000
Extraordinary Investment Income [(25%)($600,000)]	150,000
Net Income	$1,300,000

Buy Company's Statement Of Retained Earnings for the year ending December 31, 2010, would be as follows:

Buy Company
Statement Of Retained Earnings
For the Year Ending December 31, 2010

Opening Balance - As Previously Stated	$15,000,000
Prior Period Error [(25%)($50,000)]	(12,500)
Opening Balance - As Restated	$14,987,500
Net Income	1,300,000
Balance Available	$16,287,500
Dividends	(500,000)
Closing Balance	$15,787,500

The December 31, 2010 balance in the Investment In Sell account would be $1,800,000. This amount can be calculated as follows:

Investment Cost	$1,500,000
Equity Pickup to December 31, 2009	
[(25%)($3,000,000 - $2,000,000)]	250,000
Ordinary Investment Loss	(50,000)
Dividends Received	(37,500)
Extraordinary Investment Income	150,000
Prior Period Error	(12,500)
Balance In Investment In Sell Account	$1,800,000

An alternate calculation, using end of period figures, is as follows:

Investment Cost	$1,500,000
Equity Pickup to December 31, 2010	
[(25%)($3,400,000 - $2,150,000)]	312,500
Prior Period Error	(12,500)
Balance In Investment In Sell Account	$1,800,000

Solution to Self Study Problem Two - 6

The appropriate accounting treatment for these investments would be as follows:

Best Parts Inc. While Carson does not own the majority of the voting shares of Best Parts Inc., it would appear to have control. Carson owns 48 percent of the voting shares, owns a majority of the preferred shares, and is the purchaser for 90 percent of Best's sales. Unless the other 52 percent of the voting shares of Best are held by a single investor or a related group of investors, these factors should give Carson control over Best. Given this, Best would be classified as a subsidiary of Carson and consolidation procedures would be applied.

With respect to Carson's investment in the Best preferred shares, if the Best accounts were consolidated with those of Carson, this intercompany holding would be eliminated (this point is not covered in the Chapter 2 material).

Research Tech Ltd. As there appears to be a management agreement under which Carson has joint control over the affairs of this investee, it would appear that Research Tech is a joint venture. Given this, Section 3055 would require the use of proportionate consolidation.

Entell Ltd. With Carson's share ownership at the 46 percent level, this investment would be classified as a significantly influenced company and the equity method would be used.

With respect to Entell's investment in Chelsea, 18 percent ownership would appear to indicate a lack of significant influence. This means that the investment would fall within the scope of Section 3855 and be classified as either held for trading or available for sale. If it is classified as held for trading, it would be accounted for at fair value with changes in fair value being allocated to Net Income. If it is classified as available for sale, it would be accounted for at fair value with changes in fair value being allocated to Comprehensive Income.

Under either classification, Chelsea's going concern problem would be reflected in reduced fair values. If it is classified as held for trading, these changes would automatically be allocated to Net Income and no further action would be required. However, if it is classified as available for sale, any loss that has been allocated to Other Comprehensive Income should be removed from that category and recognized in Net Income for the current period.

Chelsea Distributors Inc. As Carson does not control Entell Ltd. (see preceding paragraph), it does not control Entell's 18 percent shareholding in Chelsea Distributors Inc. Carson's 37 percent shareholding means that Chelsea is not a subsidiary but, rather, a significantly influenced company for which the equity method would be appropriate. Carson may consider writing down its Investment In Chelsea if it believes that it has experienced a non-temporary decline in value (See Paragraph 3051.18 in the *CICA Handbook*.)

With respect to Chelsea's investment in Carson, this is a reciprocal shareholding that would be classified by Chelsea as held for trading or available for sale. This would require fair value accounting by Chelsea. This reciprocal shareholding would be disclosed on the books of Carson as a reduction in total shareholders' equity (this point is not covered in the Chapter 2 material).

Chapter Two Learning Objectives

After completing Chapter 2, you should be able to:

1. Demonstrate an understanding of the basic concepts involved in classifying various types of investments in equity securities, including held-for-trading and available-for-sale investments, significantly influenced companies, joint ventures and subsidiaries (paragraphs 2-1 to 2-18).

2. Define held-for-trading investments and apply the procedures required (fair value method) to account for them (paragraphs 2-19 to 2-34).

3. Define available-for-sale investments and apply the procedures required (fair value method or cost method) to account for them (paragraphs 2-35 to 2-54).

4. Define subsidiaries and apply the procedures required (full consolidation) to account for them (paragraphs 2-55 to 2-85).

5. Demonstrate a basic understanding of variable interest entities and why they are an issue (paragraphs 2-86 to 2-96).

6. Define significantly influenced companies and apply the procedures required (equity method) to account for them (paragraphs 2-97 to 2-106).

7. Apply the equity method to non-complex situations that do not involve fair value changes, goodwill, or unrealized intercompany profits (paragraphs 2-107 to 2-134).

8. Define joint ventures and apply the procedures required (proportionate consolidation) to account for them (paragraphs 2-135 to 2-143).

9. Summarize the accounting methods used for the various classifications of investments in equity securities (paragraphs 2-144 to 2-146).

10. Describe the circumstances that will require the write-down of an equity investment (paragraphs 2-147 to 2-154).

11. Determine gains or losses on the sale of equity investments (paragraphs 2-155 to 2-157).

12. Describe the differential reporting options for accounting for equity investments and the additional disclosure required if the option is used (paragraphs 2-158 to 2-168).

13. Describe the basic differences between the *CICA Handbook* requirements for accounting for equity investments and the relevant international financial reporting standards (paragraphs 2-169 to 2-178).